INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
April 26, 2011
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

# FORM 10 - Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTER ENDED MARCH 31, 2011**

**1-2360**

**(Commission file number)**

# INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **New York**<br>(State of incorporation) | **13-0871985**<br>(IRS employer identification number) |
| **Armonk, New York**<br>(Address of principal executive offices) | **10504**<br>(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 x No o

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 x No o

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

| | |
|---|---|
| Large accelerated filer x | Accelerated filer o |
| Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

The registrant has 1,211,200,200 shares of common stock outstanding at March 31, 2011.

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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)**

| (Dollars in millions except per share amounts) | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| **Revenue:** | | |
| Services | $ 14,696 | $ 13,805 |
| Sales | 9,387 | 8,508 |
| Financing | 524 | 545 |
| **Total revenue** | 24,607 | 22,857 |
| | | |
| **Cost:** | | |
| Services | 10,116 | 9,384 |
| Sales | 3,390 | 3,224 |
| Financing | 243 | 273 |
| **Total cost** | 13,749 | 12,880 |
| | | |
| **Gross profit** | 10,858 | 9,976 |
| | | |
| **Expense and other income:** | | |
| Selling, general and administrative | 5,826 | 5,677 |
| Research, development and engineering | 1,587 | 1,509 |
| Intellectual property and custom development income | (262) | (261) |
| Other (income) and expense | (202) | (545) |
| Interest expense | 93 | 82 |
| **Total expense and other income** | 7,041 | 6,462 |
| | | |
| **Income before income taxes** | 3,817 | 3,515 |
| Provision for income taxes | 954 | 914 |
| **Net income** | $ 2,863 | $ 2,601 |
| | | |
| **Earnings per share of common stock:** | | |
| Assuming dilution | $ 2.31 | $ 1.97 |
| Basic | $ 2.34 | $ 2.00 |
| | | |
| **Weighted-average number of common shares outstanding: (millions)** | | |
| Assuming dilution | 1,240.0 | 1,321.6 |
| Basic | 1,222.2 | 1,301.2 |
| | | |
| **Cash dividend per common share** | $ 0.65 | $ 0.55 |

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION**
**AND SUBSIDIARY COMPANIES**

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

**ASSETS**

| (Dollars in millions) | At March 31, 2011 | At December 31, 2010 |
|---|---|---|
| **Assets:** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 12,763 | $ 10,661 |
| Marketable securities | 482 | 990 |
| Notes and accounts receivable trade (net of allowances of $328 in 2011 and $324 in 2010) | 10,148 | 10,834 |
| Short-term financing receivables (net of allowances of $318 in 2011 and $342 in 2010) | 14,365 | 16,257 |
| Other accounts receivable (net of allowances of $12 in 2011 and $10 in 2010) | 1,145 | 1,134 |
| Inventories, at lower of average cost or market: | | |
| Finished goods | 548 | 432 |
| Work in process and raw materials | 2,001 | 2,018 |
| Total inventories | 2,549 | 2,450 |
| Deferred taxes | 1,695 | 1,564 |
| Prepaid expenses and other current assets | 4,376 | 4,226 |
| Total current assets | 47,524 | 48,116 |
| | | |
| Plant, rental machines and other property | 40,765 | 40,289 |
| Less: Accumulated depreciation | 26,557 | 26,193 |
| Plant, rental machines and other property net | 14,208 | 14,096 |
| Long-term financing receivables (net of allowances of $39 in 2011 and $58 in 2010) | 10,254 | 10,548 |
| Prepaid pension assets | 3,788 | 3,068 |
| Deferred taxes | 3,076 | 3,220 |
| Goodwill | 25,408 | 25,136 |
| Intangible assets net | 3,324 | 3,488 |
| Investments and sundry assets | 5,380 | 5,778 |
| **Total assets** | $ 112,960 | $ 113,452 |

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION**
**AND SUBSIDIARY COMPANIES**

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

**LIABILITIES AND EQUITY**

| (Dollars in millions) | At March 31, 2011 | At December 31, 2010 |
|---|---|---|
| **Liabilities and equity:** | | |
| Current liabilities: | | |
| Taxes | $ 2,531 | $ 4,216 |
| Short-term debt | 8,508 | 6,778 |
| Accounts payable | 6,747 | 7,804 |
| Compensation and benefits | 4,446 | 5,028 |
| Deferred income | 12,820 | 11,580 |
| Other accrued expenses and liabilities | 5,336 | 5,156 |
| Total current liabilities | 40,387 | 40,562 |
| Long-term debt | 21,749 | 21,846 |
| Retirement and nonpension postretirement benefit obligations | 15,995 | 15,978 |
| Deferred income | 3,724 | 3,666 |
| Other liabilities | 8,330 | 8,226 |
| **Total liabilities** | 90,185 | 90,279 |
| | | |
| **Equity:** | | |
| IBM stockholders equity: | | |
| Common stock, par value $0.20 per share, and additional paid-in capital | 46,278 | 45,418 |
| Shares authorized: 4,687,500,000 | | |
| Shares issued: 2011 - 2,169,188,522 | | |
| 2010 - 2,161,800,054 | | |
| Retained earnings | 94,590 | 92,532 |
| Treasury stock - at cost | (100,078) | (96,161) |
| Shares: 2011 - 957,988,323 | | |
| 2010 - 933,806,510 | | |
| Accumulated other comprehensive income/(loss) | (18,119) | (18,743) |
| Total IBM stockholders equity | 22,671 | 23,046 |
| Noncontrolling interests | 104 | 126 |
| **Total equity** | 22,776 | 23,172 |
| **Total liabilities and equity** | $ 112,960 | $ 113,452 |

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION**
**AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS**
**FOR THE THREE MONTHS ENDED MARCH 31, (UNAUDITED)**

| **(Dollars in millions)** | **2011** | **2010** |
|---|---|---|
| **Cash flow from operating activities:** | | |
| Net income | $ 2,863 | $ 2,601 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation | 918 | 924 |
| Amortization of intangibles | 310 | 286 |
| Stock-based compensation | 170 | 169 |
| Net (gain)/loss on asset sales and other | (320) | (578) |
| Changes in operating assets and liabilities, net of acquisitions/divestitures | (147) | 1,033 |
| **Net cash provided by operating activities** | 3,792 | 4,437 |
| | | |
| **Cash flow from investing activities:** | | |
| Payments for plant, rental machines and other property, net of proceeds from dispositions | (915) | (758) |
| Investment in software | (143) | (146) |
| Acquisition of businesses, net of cash acquired | (51) | (824) |
| Non-operating finance receivables net | 541 | 457 |
| Purchases of marketable securities and other investments | (415) | (1,747) |
| Proceeds from disposition of marketable securities and other investments | 1,481 | 2,319 |
| **Net cash provided by/(used in) investing activities** | 498 | (699) |
| | | |
| **Cash flow from financing activities:** | | |
| Proceeds from new debt | 1,054 | 1,190 |
| Payments to settle debt | (1,539) | (2,382) |
| Short-term borrowings/(repayments) less than 90 days net | 2,135 | 1,673 |
| Common stock repurchases | (4,045) | (4,017) |
| Common stock transactions other | 877 | 885 |
| Cash dividends paid | (795) | (718) |
| **Net cash used in financing activities** | (2,314) | (3,368) |
| | | |
| Effect of exchange rate changes on cash and cash equivalents | 126 | (81) |
| Net change in cash and cash equivalents | 2,102 | 289 |
| | | |
| Cash and cash equivalents at January 1 | 10,661 | 12,183 |
| **Cash and cash equivalents at March 31** | $ 12,763 | $ 12,472 |

(Amounts may not add due to rounding.)

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

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**Notes to Consolidated Financial Statements:**

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

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the assets, liabilities, revenue, costs, expenses and accumulated other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. Actual results may be different. See the company s 2010 Annual Report on pages 50 to 53 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 2010 Annual Report.

Noncontrolling interest amounts in income of $2.6 million and $1.8 million, net of tax, for the three months ended March 31, 2011 and March 31, 2010, respectively, are not presented separately in the Consolidated Statement of Earnings due to immateriality, but are reflected within the other (income) and expense line item. Additionally, changes to noncontrolling interests which are presented in Note 9, Equity Activity , on page 25 were $(22) million and $(2) million at March 31, 2011 and 2010, respectively.

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 December 2010, the Financial Accounting Standards Board (FASB) issued amended guidance to clarify the acquisition date that should be used for reporting pro-forma financial information for business combinations. If comparative financial statements are presented, the pro-forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been completed as of the beginning of the comparable prior annual reporting period. The amendments in this guidance became effective prospectively for business combinations for which the acquisition date is on or after January 1, 2011. There was no impact in the consolidated financial results as the amendments relate only to additional disclosures.

In December 2010, the FASB issued amendments to the guidance on goodwill impairment testing. The amendments modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In making that determination, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The amendments were effective January 1, 2011 and did not have a material impact in the Consolidated Financial Statements.

In January 2011, the FASB temporarily deferred the disclosures regarding troubled debt restructurings which were included in the disclosure requirements about the credit quality of financing receivables and the allowance for credit losses which was issued in July 2010. In April 2011, the FASB issued additional guidance and clarifications to help creditors in determining whether a creditor has granted a concession, and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The new guidance and the previously deferred disclosures are effective July 1, 2011 applied retrospectively to January 1, 2011. Prospective application is required for any new impairments identified as a result of this guidance. These changes are not expected to have a material impact in the Consolidated Financial Statements. For further information on the disclosures regarding the credit quality of financing receivables, see Note 5 on pages 13 to 17.

In January 2010, the FASB issued additional disclosure requirements for fair value measurements which the company included in its interim and annual financial statements in 2010. Certain disclosure requirements relating to fair value measurements using significant unobservable inputs (Level 3) were deferred until January 1, 2011. These new requirements did not have an impact in the consolidated financial results as they relate only to additional disclosures.

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

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

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

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

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

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

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

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. See Note A, Significant Accounting Policies, on pages 68 to 79 in the 2010 Annual Report for further information. There were no material impairments of non-financial assets for the three months ended March 31, 2011 and 2010, respectively.

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

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

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, 2011 and December 31, 2010.

| **(Dollars in millions)**<br>**At March 31, 2011** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| **Assets:** | | | | |
| Cash and cash equivalents(1) | | | | |
| Time deposits and certificates of deposit | $ | $ 4,874 | $ | $ 4,874 |
| Commercial paper | | 2,269 | | 2,269 |
| Money market funds | 2,708 | | | 2,708 |
| Other securities | | 10 | | 10 |
| Total | 2,708 | 7,153 | | 9,861 |
| Debt securities current(2) | | | | |
| Commercial paper | | 282 | | 282 |
| U.S. government securities | | 200 | | 200 |
| Total | | 482 | | 482 |
| Debt securities noncurrent(3) | 1 | 6 | | 7 |
| Non-equity method alliance investments(3) | 121 | 21 | | 142 |
| Derivative assets(4) | | | | |
| Interest rate contracts | | 548 | | 548 |
| Foreign exchange contracts | | 279 | | 279 |
| Equity contracts | | 21 | | 21 |
| Total | | 848 | | 848(6) |
| **Total assets** | $ 2,830 | $ 8,511 | $ | $ 11,340(6) |
| | | | | |
| **Liabilities:** | | | | |
| Derivative liabilities(5) | | | | |
| Foreign exchange contracts | $ | $ 967 | $ | $ 967 |
| Equity contracts | | 4 | | 4 |
| **Total liabilities** | $ | $ 971 | $ | $ 971(6) |

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

(2) 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, 2011 are $292 million and $556 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, 2011 are $894 million and $77 million, respectively.

(6) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by $396 million each.

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

| (Dollars in millions)<br>At December 31, 2010 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| **Assets:** | | | | |
| Cash and cash equivalents(1) | | | | |
| Time deposits and certificates of deposit | $ | $ 2,473 | $ | $ 2,473 |
| Commercial paper | | 2,673 | | 2,673 |
| Money market funds | 1,532 | | | 1,532 |
| Foreign government securities | | 1,054 | | 1,054 |
| U.S. government securities | | 44 | | 44 |
| U.S. government agency securities | | 22 | | 22 |
| Other securities | | 3 | | 3 |
| Total | 1,532 | 6,269 | | 7,801 |
| Debt securities current(2) | | | | |
| Commercial paper | | 490 | | 490 |
| U.S. government securities | | 500 | | 500 |
| Other securities | | 1 | | 1 |
| Total | | 990 | | 990 |
| Debt securities noncurrent(3) | 1 | 6 | | 7 |
| Non-equity method alliance investments(3) | 445 | 13 | | 458 |
| Derivative assets(4) | | | | |
| Interest rate contracts | | 548 | | 548 |
| Foreign exchange contracts | | 539 | | 539 |
| Equity contracts | | 12 | | 12 |
| Total | | 1,099 | | 1,099(6) |
| **Total assets** | $ 1,978 | $ 8,377 | $ | $ 10,355(6) |
| | | | | |
| **Liabilities:** | | | | |
| Derivative liabilities(5) | | | | |
| Foreign exchange contracts | $ | $ 1,003 | $ | $ 1,003 |
| Equity contracts | | 3 | | 3 |
| **Total liabilities** | $ | $ 1,006 | $ | $ 1,006(6) |

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

(2) 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, 2010 are $511 million and $588 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, 2010 are $871 million and $135 million, respectively.

(6) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions would have been reduced by $475 million each.

There were no significant transfers between Levels 1 and 2 for the quarter ended March 31, 2011 and for the year ended December 31, 2010.

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

**4. Financial Instruments (excluding derivatives):** Cash and cash equivalents, debt and marketable equity securities are recognized and measured at fair value in the company s Consolidated Financial Statements. Notes and other accounts receivable and other investments are financial assets with carrying values that approximate fair value. Accounts payable, other accrued expenses and short-term debt are financial liabilities with carrying values that approximate fair value. In the absence of quoted prices in active markets, considerable judgment is required in developing estimates of fair value. Estimates are not necessarily indicative of the amounts the company could realize in a current market transaction. The following methods and assumptions are used to estimate fair values:

**Loans and Long-term Receivables**

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities.

**Long-term Debt**

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt is $21,749 million and $21,846 million and the estimated fair value is $23,668 million and $24,006 million at March 31, 2011 and December 31, 2010, respectively.

**Debt and Marketable Equity Securities**

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

| (Dollars in millions) At March 31, 2011 | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Cash and cash equivalents(1) | | | | |
| Time deposits and certificates of deposit | $ 4,874 | $ | $ (0) | $ 4,874 |
| Commercial paper | 2,269 | | (0) | 2,269 |
| Money market funds | 2,708 | | | 2,708 |
| Other securities | 10 | | | 10 |
| Total | $ 9,861 | $ | $ (0) | $ 9,861 |
| Debt securities current(2) | | | | |

| | | | | |
|---|---|---|---|---|
| Commercial paper | $ 282 | $ 0 | $ | $ 282 |
| U.S. government securities | 200 | 0 | | 200 |
| Other securities | 2 | | (2) | 0 |
| Total | $ 484 | $ 0 | $ (2) | $ 482 |
| Debt securities noncurrent(3) | | | | |
| Other securities | $ 7 | $ 0 | $ | $ 7 |
| Total | $ 7 | $ 0 | $ | $ 7 |
| Non-equity method alliance investments(3) | $ 80 | $ 63 | $ (0) | $ 142 |

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

(2) Reported as marketable securities within the Consolidated Statement of Financial Position.

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

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

| (Dollars in millions) At December 31, 2010 | Adjusted Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Cash and cash equivalents(1) | | | | |
| Time deposits and certificates of deposit | $ 2,473 | $ | $ (0) | $ 2,473 |
| Commercial paper | 2,673 | | (0) | 2,673 |
| Money market funds | 1,532 | | | 1,532 |
| Foreign government securities | 1,054 | | | 1,054 |
| U.S. government securities | 44 | 0 | (0) | 44 |
| U.S. government agency securities | 22 | 0 | (0) | 22 |
| Other securities | 3 | | | 3 |
| Total | $ 7,801 | $ 0 | $ (0) | $ 7,801 |
| Debt securities current(2) | | | | |
| Commercial paper | $ 490 | $ | $ (0) | $ 490 |
| U.S. government securities | 500 | | (0) | 500 |
| Other securities | 1 | | (0) | 1 |
| Total | $ 990 | $ | $ (0) | $ 990 |
| Debt securities noncurrent(3) | | | | |
| Other securities | $ 6 | $ 1 | $ (0) | $ 7 |
| Total | $ 6 | $ 1 | $ (0) | $ 7 |
| Non-equity method alliance investments(3) | $ 194 | $ 264 | $ (0) | $ 458 |

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

(2) Reported as marketable securities within the Consolidated Statement of Financial Position.

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

Based on an evaluation of available evidence as of March 31, 2011, the company believes that unrealized losses on debt and marketable equity securities are temporary and do not represent a need for an other-than-temporary impairment.

Proceeds from sales of debt securities and marketable equity securities were approximately $315 million and $9 million for the three months ended March 31, 2011 and 2010, respectively. The gross realized gains (before taxes) on these sales totaled $203 million for the three months ended March 31, 2011. The gross realized losses (before taxes) on these sales totaled less than $1 million for the three months ended March 31, 2011. The gross realized gains (before taxes) on these sales totaled $4 million for the three months ended March 31, 2010. The company determines the cost of the securities sold based on the specific identification method.

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

**(Dollars in millions)**

| **For the three months ended March 31:** | | **2011** | | **2010** |
|---|---|---|---|---|
| Net unrealized gains/(losses) arising during the period | $ | 1 | $ | 41 |
| Less: Net (losses)/gains included in net income for the period* | | 124 | | (1) |
| **Net unrealized gains/(losses) on marketable securities** | $ | (123) | $ | 42 |

* Includes writedowns of $3.1 million for the three months ended March 31, 2010.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at March 31, 2011.

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

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

| (Dollars in millions) | At March 31, 2011 | At December 31, 2010 |
|---|---|---|
| Current: | | |
| Net investment in sales-type and direct financing leases | $ 4,063 | $ 3,945 |
| Commercial financing receivables | 4,873 | 6,777 |
| Client loan receivables | 4,651 | 4,718 |
| Installment payment receivables | 777 | 816 |
| Total | $ 14,365 | $ 16,257 |
| Noncurrent: | | |
| Net investment in sales-type and direct financing leases | $ 5,290 | $ 5,384 |
| Commercial financing receivables | 42 | 43 |
| Client loan receivables | 4,612 | 4,734 |
| Installment payment receivables | 310 | 388 |
| Total | $ 10,254 | $ 10,548 |

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 $814 million and $871 million at March 31, 2011 and December 31, 2010, respectively, and is reflected net of unearned income of $808 million and $816 million and net of the allowance for credit losses of $116 million and $126 million at those dates, respectively.

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

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

The company utilizes certain of its financing receivables as collateral for non-recourse borrowings. Financing receivables pledged as collateral for borrowings were $263 million and $302 million at March 31, 2011 and December 31, 2010, respectively.

The company did not have any financing receivables held for sale as of March 31, 2011 and December 31, 2010.

**Financing Receivables by Portfolio Segment**

The following tables present financing receivables on a gross basis excluding the allowance for credit losses and residual value, by portfolio segment and by class, excluding current commercial financing receivables and other miscellaneous current financing receivables at March 31, 2011 and December 31, 2010. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio via two classes: major markets and growth markets. For additional information on the company s accounting policies for the allowance for credit losses, see the company s 2010 Annual Report beginning on page 77.

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

| **(Dollars in millions)**<br>**At March 31, 2011** | | **Major Markets** | | **Growth Markets** | | **Total** |
|---|---|---|---|---|---|---|
| Financing receivables: | | | | | | |
| Lease receivables | $ | 6,542 | $ | 2,055 | $ | 8,597 |
| Loan receivables | | 8,597 | | 2,013 | | 10,610 |
| Ending balance | $ | 15,139 | $ | 4,068 | $ | 19,207 |
| Collectively evaluated for impairment | $ | 14,774 | $ | 3,878 | $ | 18,651 |
| Individually evaluated for impairment | $ | 365 | $ | 190 | $ | 556 |
| | | | | | | |
| Allowance for credit losses: | | | | | | |
| Lease receivables* | $ | 84 | $ | 42 | $ | 126 |
| Loan receivables* | | 150 | | 76 | | 226 |
| Beginning balance at January 1, 2011 | $ | 234 | $ | 119 | $ | 353 |
| Charge-offs | | (29) | | (1) | | (30) |
| Provision | | (11) | | 2 | | (9) |
| Other | | 6 | | 1 | | 7 |
| Lease receivables | | 71 | | 45 | | 116 |
| Loan receivables | | 129 | | 75 | | 204 |
| Ending balance at March 31, 2011 | $ | 201 | $ | 120 | | 321 |
| Collectively evaluated for impairment | $ | 45 | $ | 9 | $ | 54 |
| Individually evaluated for impairment | $ | 156 | $ | 111 | $ | 267 |

| **(Dollars in millions)**<br>**At December 31, 2010** | | **Major Markets** | | **Growth Markets** | | **Total** |
|---|---|---|---|---|---|---|
| Financing receivables: | | | | | | |
| Lease receivables | $ | 6,562 | $ | 1,983 | $ | 8,545 |
| Loan receivables | | 9,087 | | 1,993 | | 11,080 |
| Ending balance | $ | 15,650 | $ | 3,975 | $ | 19,625 |
| Collectively evaluated for impairment | $ | 15,199 | $ | 3,794 | $ | 18,993 |
| Individually evaluated for impairment | $ | 451 | $ | 181 | $ | 632 |
| | | | | | | |
| Allowance for credit losses: | | | | | | |
| Lease receivables* | $ | 84 | $ | 42 | $ | 126 |
| Loan receivables* | | 150 | | 76 | | 226 |
| Ending balance at December 31, 2010 | $ | 234 | $ | 119 | $ | 353 |
| Collectively evaluated for impairment | $ | 60 | $ | 11 | $ | 71 |
| Individually evaluated for impairment | $ | 174 | $ | 108 | $ | 282 |

* Reclassified to conform with 2011 presentation.

When calculating 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 calculated by applying a reserve rate to its different portfolios, excluding accounts that have been specifically reserved. This reserve rate is based upon credit rating, probability of default, term, characteristics (lease/loan) and loss history.

**Financing Receivables on Non-Accrual Status**

Certain receivables for which the company has recorded a specific reserve may also be placed on non-accrual status. Non-accrual assets are those receivables with specific reserves and other accounts for which it is likely that the company will be unable to collect all amounts due according to original terms of the lease or loan agreement. Income recognition is discontinued on these receivables.

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

The following table presents the recorded investment in financing receivables which were on non-accrual status at March 31, 2011 and December 31, 2010.

| (Dollars in millions) | At March 31, 2011 | At December 31, 2010 |
|---|---|---|
| Major markets | $ 69 | $ 69 |
| Growth markets | 39 | 33 |
| Total lease receivables | $ 108 | $ 101 |
| | | |
| Major markets | $ 109 | $ 141 |
| Growth markets | 98 | 123 |
| Total loan receivables | $ 207 | $ 264 |
| | | |
| Total receivables | $ 315 | $ 366 |

**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 (see section Financing Receivables on Non-Accrual Status ).

The following tables present impaired client loan receivables at March 31, 2011 and December 31, 2010.

| (Dollars in millions) At March 31, 2011: | Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized* | Interest Income Recognized on Cash Basis |
|---|---|---|---|---|---|
| Major markets | $ 155 | $ 98 | $ 176 | $ 0 | $ 0 |
| Growth markets | 136 | 70 | 134 | 0 | 0 |
| Total | $ 292 | $ 168 | $ 310 | $ 1 | $ 0 |

* Impaired loans are placed on non-accrual status, depending on the level of impairment.

| (Dollars in millions) At December 31, 2010: | Recorded Investment | Related Allowance |
|---|---|---|
| Major markets | $ 196 | $ 119 |
| Growth markets | 132 | 68 |
| Total | $ 328 | $ 187 |

**Credit Quality Indicators**

The company s credit quality indicators are based on rating agency data, publicly available information and information provided by the companies, and 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. Moody s has not provided to the company a credit rating on its clients.

The tables on page 16 present the gross recorded investment for each class of receivables, by credit quality indicator, at March 31, 2011 and December 31, 2010. Receivables with a credit quality indicator ranging from Aaa to Baa3 are considered investment grade. All others are considered non-investment grade.

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

| (Dollars in millions) At March 31, 2011: | Lease Receivables Major Markets | Lease Receivables Growth Markets | Loan Receivables Major Markets | Loan Receivables Growth Markets |
|---|---|---|---|---|
| Credit Rating: | | | | |
| Aaa Aa3 | $ 916 | $ 162 | $ 1,204 | $ 159 |
| A1 A3 | 1,367 | 210 | 1,797 | 205 |
| Baal Baa3 | 2,414 | 849 | 3,172 | 831 |
| Bal Ba2 | 929 | 454 | 1,221 | 445 |
| Ba3 B1 | 530 | 236 | 696 | 231 |
| B2 B3 | 249 | 90 | 327 | 89 |
| Caa D | 137 | 53 | 181 | 52 |
| Total | $ 6,542 | $ 2,055 | $ 8,597 | $ 2,013 |

At March 31, 2011, the industries which made up Global Financing s receivables portfolio consist of: Financial (37 percent), Government (16 percent), Manufacturing (14 percent), Retail (9 percent), Services (8 percent), Communications (5 percent) and Other (12 percent).

| (Dollars in millions) At December 31, 2010: | Lease Receivables* Major Markets | Lease Receivables* Growth Markets | Loan Receivables* Major Markets | Loan Receivables* Growth Markets |
|---|---|---|---|---|
| Credit Rating: | | | | |
| Aaa Aa3 | $ 794 | $ 173 | $ 1,100 | $ 173 |
| A1 A3 | 1,463 | 182 | 2,026 | 183 |
| Baal Baa3 | 2,494 | 837 | 3,453 | 841 |
| Bal Ba2 | 899 | 403 | 1,245 | 405 |
| Ba3 B1 | 518 | 242 | 718 | 243 |
| B2 B3 | 230 | 93 | 318 | 94 |
| Caa D | 164 | 54 | 227 | 54 |
| Total | $ 6,562 | $ 1,983 | $ 9,087 | $ 1,993 |

* Reclassified to conform with 2011 presentation.

At December 31, 2010, the industries which make up Global Financing s receivables portfolio consist of: Financial (36 percent), Government (16 percent), Manufacturing (14 percent), Retail (9 percent), Services (8 percent), Communications (5 percent) and Other (12 percent).

**Past Due Financing Receivables**

The company views receivables as past due when payment has not been received after 90 days, measured from billing date.

| (Dollars in millions)<br>At March 31, 2011: | Total Past Due > 90 days* | Current | Total Financing Receivables | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|
| Major markets | $ 16 | $ 6,526 | $ 6,542 | $ 7 |
| Growth markets | 19 | 2,036 | 2,055 | 7 |
| Total lease receivables | $ 34 | $ 8,563 | $ 8,597 | $ 14 |
| | | | | |
| Major markets | $ 17 | $ 8,580 | $ 8,597 | $ 7 |
| Growth markets | 33 | 1,980 | 2,013 | 13 |
| Total loan receivables | $ 50 | $ 10,560 | $ 10,610 | $ 20 |
| | | | | |
| Total | $ 84 | $ 19,123 | $ 19,207 | $ 34 |

* Does not include accounts that are fully reserved.

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

| (Dollars in millions) At December 31, 2010: | Total Past Due > 90 days* | Current | Total Financing Receivables | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|
| Major markets | $ 10 | $ 6,552 | $ 6,562 | $ 5 |
| Growth markets | 13 | 1,970 | 1,983 | 5 |
| Total lease receivables | $ 22 | $ 8,523 | $ 8,545 | $ 10 |
| | | | | |
| Major markets | $ 11 | $ 9,076 | $ 9,087 | $ 4 |
| Growth markets | 32 | 1,961 | 1,993 | 17 |
| Total loan receivables | $ 43 | $ 11,037 | $ 11,080 | $ 21 |
| | | | | |
| Total | $ 65 | $ 19,560 | $ 19,625 | $ 31 |

* Does not include accounts that are fully reserved.

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

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

The company is also a party to collateral security arrangements with most of its major counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds. Posting thresholds can be fixed or can vary based on credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at March 31, 2011 and December 31, 2010 was $420 million and $363 million, respectively, for which the company posted collateral of $1 million and $9 million, respectively. Full collateralization of these agreements would be required in the event that the company s credit rating falls below investment grade or if its credit default swap spread exceeds 250 basis points, as applicable, pursuant to the terms of the collateral security arrangements. The aggregate fair value of derivative instruments in net asset positions as of March 31, 2011 and December 31, 2010 was $848 million and $1,099 million, respectively. This amount represents the maximum exposure to loss at the reporting date as a result of the counterparties failing to perform as contracted. This exposure was reduced by $396 million and $475 million at March 31, 2011 and December 31, 2010, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at March 31, 2011 and December 31, 2010, this exposure was reduced by $34 million and $88 million of collateral, respectively, received by the company.

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

The company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. At March 31, 2011 and December 31, 2010, respectively, $1 million and $9 million was recognized in other receivables for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral totaled $34 million and $88 million at March 31, 2011 and December 31, 2010, respectively. The company restricts the use of cash collateral received to rehypothecation, and therefore reports it in prepaid expenses and other current assets in the Consolidated Statement of Financial Position. At March 31, 2011 and December 31, 2010, respectively, $1 million and $9 million was rehypothecated.

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

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

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

**Interest Rate Risk**

**Fixed and Variable Rate Borrowings**

The company issues debt in the global capital markets, principally to fund its financing lease and loan portfolio. Access to cost-effective financing can result in interest rate mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company uses interest-rate swaps to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt issuances into fixed-rate debt (i.e., cash flow hedges). At March 31, 2011 and December 31, 2010, the total notional amount of the company s interest rate swaps was $7.1 billion and $7.1 billion, respectively. The weighted-average remaining maturity of these instruments at March 31, 2011 and December 31, 2010 was approximately 5.2 years and 5.7 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, 2011 and December 31, 2010.

At March 31, 2011 and December 31, 2010, net losses of approximately $11 million and $13 million (before taxes), respectively, were recorded in accumulated other comprehensive income/(loss) in connection with cash flow hedges of the company s borrowings. For both periods, $8 million of losses are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying transactions.

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

**Foreign Exchange Risk**

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

A large portion of the company s foreign currency denominated debt portfolio is designated as a hedge of net investment 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, 2011 and December 31, 2010, the total notional amount of derivative instruments designated as net investment hedges was $2.1 billion and $1.9 billion, respectively. The weighted-average remaining maturity of these instruments at March 31, 2011 and December 31, 2010 was approximately 0.3 years and 0.4 years, respectively.

In addition, at March 31, 2011 and December 31, 2010, the company had liabilities of $106 million and $221 million, respectively, representing the fair value of derivative instruments that were previously designated in qualifying net investment hedging relationships, but were de-designated prior to March 31, 2011 and December 31, 2010, respectively; of these amounts $106 million and $221 million are expected to mature over the next 12 months, respectively. The notional amount of these instruments at March 31, 2011 and December 31, 2010 was $0.8 billion and $1.6 billion, respectively, including original and offsetting transactions.

**Anticipated Royalties and Cost Transactions**

The company s operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company s non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is 3.9 years. At March 31, 2011 and December 31, 2010, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was $11.2 billion and $11.3 billion, respectively, with a weighted-average remaining maturity of 0.7 years and 0.8 years, respectively.

At March 31, 2011 and December 31, 2010, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of $287 million and of $147 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts $396 million and $249 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

**Foreign Currency Denominated Borrowings**

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is 2.8 years. At March 31, 2011 and December 31, 2010, the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was $0.1 billion and $0.2 billion, respectively.

At March 31, 2011 and December 31, 2010, net losses of approximately $0 million and $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 $2 million and approximately $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 transactions.

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

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

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company s nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than two years. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At March 31, 2011 and December 31, 2010, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was $9.2 billion and $13.0 billion, respectively.

**Equity Risk Management**

The company is exposed to market price changes in certain broad market indices and in the company s own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company s common stock. They are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At March 31, 2011 and December 31, 2010, the total notional amount of derivative instruments in economic hedges of these compensation obligations was $1.0 billion and $1.0 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, 2011 and December 31, 2010.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company utilizes credit default swaps to economically hedge its credit exposures. These derivatives have terms of one year or less. The swaps are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any derivative instruments relating to this program outstanding at March 31, 2011 and December 31, 2010.

The following tables provide a quantitative summary of the derivative and non-derivative instrument related risk management activity as of March 31, 2011 and December 31, 2010 as well as for the three months ended March 31, 2011 and 2010, respectively:

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

**Fair Values of Derivative Instruments in the Consolidated Statement of Financial Position**

**As of March 31, 2011 and December 31, 2010**

| | Fair Value of Derivative Assets | | | Fair Value of Derivative Liabilities | | |
|---|---|---|---|---|---|---|
| (Dollars in millions) | Balance Sheet Classification | 3/31/2011 | 12/31/2010 | Balance Sheet Classification | 3/31/2011 | 12/31/2010 |
| **Designated as hedging instruments:** | | | | | | |
| **Interest rate contracts:** | Prepaid expenses and other current assets | $ 34 | $ 33 | Other accrued expenses and liabilities | $ | $ |
| | Investments and sundry assets | 514 | 514 | Other liabilities | | |
| **Foreign exchange contracts:** | Prepaid expenses and other current assets | 132 | 224 | Other accrued expenses and liabilities | 673 | 498 |
| | Investments and sundry assets | 17 | 22 | Other liabilities | 77 | 135 |
| **Fair value of derivative assets** | | $ 697 | $ 794 | **Fair value of derivative liabilities** | $ 750 | $ 633 |
| **Not designated as hedging instruments:** | | | | | | |
| **Foreign exchange contracts:** | Prepaid expenses and other current assets | $ 105 | $ 242 | Other accrued expenses and liabilities | $ 217 | $ 370 |
| | Investments and sundry assets | 25 | 51 | Other liabilities | | |
| **Equity contracts:** | Prepaid expenses and other current assets | 21 | 12 | Other accrued expenses and liabilities | 4 | 3 |
| **Fair value of derivative assets** | | $ 151 | $ 305 | **Fair value of derivative liabilities** | $ 221 | $ 373 |
| **Total debt designated as hedging instruments:** | | | | | | |
| Short-term debt | | N/A | N/A | | $ 864 | $ 823 |
| Long-term debt | | N/A | N/A | | 1,908 | 1,746 |
| **Total** | | $ 848 | $ 1,099 | | $ 3,743 | $ 3,576 |

N/A not applicable

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

**The Effect of Derivative Instruments in the Consolidated Statement of Earnings**

**For the three months ended March 31, 2011 and 2010**

| (Dollars in millions)<br>For the three months ended March 31: | Consolidated Statement of Earnings Line Item | Gain (Loss) Recognized in Earnings<br>Recognized on Derivatives(1)<br>2011 | <br><br>2010 | <br>Attributable to Risk Being Hedged(2)<br>2011 | <br><br>2010 |
|---|---|---|---|---|---|
| **Derivative instruments in fair value hedges:** | | | | | |
| Interest rate contracts | Cost of financing | $ (9) | $ 72 | $ 52 | $ (24) |
| | Interest expense | (6) | 40 | 34 | (14) |
| **Derivative instruments not designated as hedging instruments:(1)** | | | | | |
| Foreign exchange contracts | Other (income) and expense | 87 | (128) | N/A | N/A |
| Equity contracts | SG&A expense | 59 | 21 | N/A | N/A |
| Total | | $ 131 | $ 5 | $ 86 | $ (38) |

| For the three months ended March 31: | Gain (Loss) Recognized in Earnings and Other Comprehensive Income<br>Effective Portion Recognized in AOCI<br>2011 | <br><br>2010 | <br>Consolidated Statement of Earnings Line Item | <br>Effective Portion Reclassified from AOCI to Earnings<br>2011 | <br><br>2010 | <br>(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3)<br>2011 | <br><br>2010 |
|---|---|---|---|---|---|---|---|
| **Derivative instruments in cash flow hedges:** | | | | | | | |
| Interest rate contracts | $ | $ (0) | Interest expense | $ (2) | $ (2) | $ | $ |
| Foreign exchange contracts | (237) | 631 | Other (income) and expense | (47) | (53) | 0 | (6) |
| | | | Cost of sales | (34) | (88) | | |
| | | | SG&A expense | (17) | (51) | | |
| **Instruments in net investment hedges(4):** | | | | | | | |
| Foreign exchange contracts | (151) | 247 | Interest expense | 0 | | (1) | |
| Total | $ (388) | $ 878 | | $ (101) | $ (194) | $ (1) | $ (6) |

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

(1) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these derivative contracts.
(2) The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging relationships during the period.
(3) The amount of gain (loss) recognized in income represents ineffectiveness on hedge relationships.
(4) Instruments in net investment hedges include derivative and non-derivative instruments.

For the three months ending March 31, 2011 and 2010, 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.

Refer to the 2010 IBM Annual Report, Note A, Significant Accounting Policies, on pages 75 and 76 for additional information on the company s use of derivative financial instruments.

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

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

| **(Dollars in millions)**<br>**For the three months ended March 31:** | **2011** | **2010** |
|---|---|---|
| Cost | $ 24 | $ 25 |
| Selling, general and administrative | 130 | 133 |
| Research, development and engineering | 16 | 12 |
| Pre-tax stock-based compensation cost | 170 | 169 |
| Income tax benefits | (61) | (62) |
| Total stock-based compensation cost | $ 108 | $ 107 |

The change in pre-tax stock-based compensation cost for the three-month period ended March 31, 2011, as compared to the corresponding period in the prior year, reflects an increase related to the company s assumption of stock-based awards previously issued by acquired entities ($11 million), partially offset by reductions related to stock options, restricted and performance-based stock units ($11 million).

As of March 31, 2011, the total unrecognized compensation cost of $943 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately 2.5 years.

There was no significant capitalized stock-based compensation cost at March 31, 2011 and 2010.

**8. Segments:** The table on page 24 reflects the results of operations of the company s segments consistent with the management and measurement system utilized within the company. These results are not necessarily a depiction that is in conformity with GAAP. Performance measurement is based on pre-tax income. These results are used, in part, by senior management, both in evaluating the performance of, and in allocating resources to, each of the segments.

Effective January 1, 2011, the company transitioned its management and measurement system to reflect operating earnings in an effort to provide better transparency into the operational results of the business. As a result, certain acquisition-related charges and non-operating retirement-related costs are not reflected in the segment results. See the Snapshot section on pages 34 and 35 for additional information regarding this change. Prior year segment pre-tax income and pre-tax margin have been reclassified to conform to the new management and measurement system.

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

**SEGMENT INFORMATION**

**(UNAUDITED)**

| (Dollars in millions) | Global Services: Global Technology Services | Global Services: Global Business Services | Software | Systems and Technology | Global Financing | Total Segments |
|---|---|---|---|---|---|---|
| **For the three months ended March 31, 2011:** | | | | | | |
| External revenue | $ 9,863 | $ 4,710 | $ 5,308 | $ 4,019 | $ 516 | $ 24,416 |
| Internal revenue | 307 | 200 | 830 | 244 | 497 | 2,078 |
| Total revenue | $ 10,170 | $ 4,910 | $ 6,138 | $ 4,263 | $ 1,013 | $ 26,494 |
| Pre-tax income | $ 1,238 | $ 640 | $ 1,735 | $ 132 | $ 519 | $ 4,264 |
| Revenue year-to-year change | 5.7% | 6.4% | 6.3% | 19.8% | 7.7% | 8.1% |
| Pre-tax income year-to-year change | 29.3% | 43.6% | (18.4)% | nm% | 21.5% | 13.4% |
| Pre-tax income margin | 12.2% | 13.0% | 28.3% | 3.1% | 51.3% | 16.1% |
| **For the three months ended March 31, 2010*:** | | | | | | |
| External revenue | $ 9,306 | $ 4,410 | $ 5,018 | $ 3,385 | $ 537 | $ 22,657 |
| Internal revenue | 320 | 203 | 758 | 173 | 403 | 1,858 |
| Total revenue | $ 9,626 | $ 4,613 | $ 5,776 | $ 3,559 | $ 941 | $ 24,515 |
| Pre-tax income* | $ 957 | $ 445 | $ 2,127 | $ (197) | $ 427 | $ 3,760 |
| Pre-tax income margin* | 9.9% | 9.7% | 36.8% | (5.5)% | 45.4% | 15.3% |

* Reclassified to conform with 2011 presentation.

nm - not meaningful

**Reconciliations to IBM as Reported:**

| (Dollars in millions)<br>For the three months ended March 31: | 2011 | 2010* |
|---|---|---|
| Revenue: | | |
| Total reportable segments | $ 26,494 | $ 24,515 |
| Eliminations/other | (1,887) | (1,658) |
| Total IBM Consolidated | $ 24,607 | $ 22,857 |
| Pre-tax income: | | |

| | | |
|---|---|---|
| Total reportable segments | $ 4,264 | $ 3,760 |
| Amortization of acquired intangible assets | (159) | (115) |
| Acquisition related charges | (7) | (2) |
| Non-operating retirement-related costs | (4) | 76 |
| Eliminations/other | (278) | (205) |
| Total IBM Consolidated | $ 3,817 | $ 3,515 |

* Reclassified to conform with 2011 presentation.

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

**9. Equity Activity:**

| (Dollars in millions) | Common Stock and Additional Paid in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income/(Loss) | Total IBM Stockholders Equity | Noncontrolling Interests | Total Equity |
|---|---|---|---|---|---|---|---|
| **Equity - January 1, 2011** | $ 45,418 | $ 92,532 | $ (96,161) | $ (18,743) | $ 23,046 | $ 126 | $ 23,172 |
| Net income | | 2,863 | | | 2,863 | | 2,863 |
| Other comprehensive income/(loss), net of tax (total) | | | | 624 | 624 | | 624 |
| Cash dividends declared common stock | | (795) | | | (795) | | (795) |
| Stock transactions related to employee plans net | 860 | (9) | 102 | | 953 | | 953 |
| Other treasury shares purchased not retired | | | (4,019) | | (4,019) | | (4,019) |
| Changes in noncontrolling interests | | | | | | (22) | (22) |
| **Equity March 31, 2011** | $ 46,278 | $ 94,590 | $ (100,078) | $ (18,119) | $ 22,671 | $ 104 | $ 22,776 |

| (Dollars in millions) | Common Stock and Additional Paid in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income/(Loss) | Total IBM Stockholders Equity | Noncontrolling Interests | Total Equity |
|---|---|---|---|---|---|---|---|
| **Equity - January 1, 2010** | $ 41,810 | $ 80,900 | $ (81,243) | $ (18,830) | $ 22,637 | $ 118 | $ 22,755 |
| Net income | | 2,601 | | | 2,601 | | 2,601 |
| Other comprehensive income/(loss), net of tax (total) | | | | 652 | 652 | | 652 |
| Cash dividends declared common stock | | (718) | | | (718) | | (718) |
| Stock transactions related to employee plans net | 854 | | 100 | | 955 | | 955 |
| Other treasury shares purchased not retired | | | (4,095) | | (4,095) | | (4,095) |
| Changes in noncontrolling interests | | | | | | (2) | (2) |
| **Equity March 31, 2010** | $ 42,665 | $ 82,783 | $ (85,238) | $ (18,178) | $ 22,033 | $ 116 | $ 22,149 |

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

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

| **(Dollars in millions)**<br>**For the three months ended March 31:** | **2011** | **2010** |
|---|---|---|
| Net income | $ 2,863 | $ 2,601 |
| Other comprehensive income/(loss) net of tax: | | |
| Foreign currency translation adjustments | 535 | (152) |
| Net change in retirement-related benefit plans | 307 | 224 |
| Net unrealized gains/(losses) on marketable securities | (123) | 42 |
| Net unrealized gains/(losses) on cash flow hedge derivatives | (95) | 539 |
| Total other comprehensive income/(loss) | 624 | 652 |
| Net income plus other comprehensive income/(loss) | $ 3,487 | $ 3,253 |

**10. 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 table provides the total retirement-related benefit plans impact on income before income taxes.

| **(Dollars in millions)**<br>**For the three months ended March 31:** | **2011** | **2010** | **Yr. to Yr. Percent Change** |
|---|---|---|---|
| Retirement-related plans cost: | | | |
| Defined benefit and contribution pension plans cost | $ 432 | $ 321 | 34.5% |
| Nonpension postretirement plans cost | 86 | 87 | (1.5) |
| Total | $ 517 | $ 408 | 26.8% |

The following table provides the components of the cost/(income) for the company s pension plans:

Cost/(Income) of Pension Plans

| **(Dollars in millions)** | **U.S. Plans** | | **Non-U.S. Plans** | |
|---|---|---|---|---|
| **For the three months ended March 31:** | **2011** | **2010** | **2011** | **2010** |
| Service cost | $ | $ | $ 131 | $ 127 |
| Interest cost | 620 | 653 | 454 | 469 |
| Expected return on plan assets | (1,015) | (1,007) | (620) | (626) |
| Amortization of prior service costs/(credits) | 2 | 2 | (40) | (42) |
| Recognized actuarial losses | 211 | 119 | 245 | 178 |
| Curtailments and settlements | | | 0 | 27 |
| Multi-employer plan/other costs | | | 34 | 31 |
| | (182) | (234) | 204 | 165 |

| | | | | |
|---|---|---|---|---|
| Total net periodic pension (income)/cost of defined benefit plans | | | | |
| Cost of defined contribution plans | 265 | 265 | 146 | 124 |
| Total pension plan cost recognized in the Consolidated Statement of Earnings | $ 82 | $ 31 | $ 349 | $ 290 |

In 2011, the company expects to contribute to its non-U.S. defined benefit plans approximately $900 million, which is the legally mandated minimum contribution for the company s non-U.S. plans. In the first quarter of 2011, the company contributed $212 million to its non-U.S. plans.

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

The following table provides the components of the cost for the company s nonpension postretirement plans.

Cost of Nonpension Postretirement Plans

| **(Dollars in millions)** | **U.S. Plan** | | **Non-U.S. Plans** | |
|---|---|---|---|---|
| **For the three months ended March 31:** | **2011** | **2010** | **2011** | **2010** |
| Service cost | $ 8 | $ 9 | $ 3 | $ 2 |
| Interest cost | 59 | 65 | 17 | 15 |
| Expected return on plan assets | | | (3) | (2) |
| Amortization of prior service costs/(credits) | | (4) | (1) | (1) |
| Recognized actuarial losses | | | 3 | 3 |
| Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings | $ 67 | $ 71 | $ 19 | $ 16 |

The company received a $9.3 million subsidy in the first quarter of 2011 in connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003. A portion of this amount is used by the company to reduce its obligation and expense related to the plan, and the remainder is contributed to the plan to reduce contributions required by the participants. For further information related to the Medicare Prescription Drug Act, see page 125 in the company s 2010 Annual Report.

**11. Acquisitions/Divestitures:**

Acquisitions: During the three months ended March 31, 2011, the company did not complete any acquisitions. On March 22, 2011, the company announced a definitive agreement to acquire privately-held TRIRIGA, Inc. (TRIRIGA), a Las Vegas, Nevada-based provider of facility and real estate management software solutions. TRIRIGA will be integrated into Software and Global Business Services segments. This transaction closed on April 13, 2011. At the date of issuance of these financial statements, the initial purchase accounting was not complete.

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

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

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

| (Dollars in millions)<br>Intangible asset class: | At March 31, 2011<br>Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|
| Capitalized software | $ 1,541 | $ (717) | $ 824 |
| Client relationships | 1,652 | (654) | 998 |
| Completed technology | 2,108 | (770) | 1,338 |
| In-process R&D | 22 | (0) | 21 |
| Patents/trademarks | 212 | (80) | 132 |
| Other(a) | 41 | (30) | 11 |
| Total | $ 5,575 | $ (2,252) | $ 3,324 |

| (Dollars in millions)<br>Intangible asset class: | At December 31, 2010<br>Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|
| Capitalized software | $ 1,558 | $ (726) | $ 831 |
| Client relationships | 1,709 | (647) | 1,062 |
| Completed technology | 2,111 | (688) | 1,422 |
| In-process R&D | 21 | (0) | 21 |
| Patents/trademarks | 211 | (71) | 140 |
| Other(a) | 39 | (28) | 11 |
| Total | $ 5,649 | $ (2,161) | $ 3,488 |

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

The net carrying amount of intangible assets decreased $165 million during the first quarter of 2011, primarily due to amortization. The aggregate intangible amortization expense was $310 million and $286 million for the quarters ended March 31, 2011 and 2010, respectively. In addition, in the first quarter, the company retired $220 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, 2011:

| (Dollars in millions) | Capitalized Software | Acquired Intangibles | Total |
|---|---|---|---|
| 2011 (for Q2-Q4) | $ 399 | $ 458 | $ 857 |
| 2012 | 312 | 551 | 863 |
| 2013 | 105 | 509 | 613 |
| 2014 | 7 | 367 | 374 |

| | | |
|---|---|---|
| 2015 | 258 | 258 |

The changes in the goodwill balances by reportable segment, for the quarter ended March 31, 2011 and for the year ended December 31, 2010 are as follows:

| **(Dollars in millions)**<br>**Segment** | **Balance 01/01/11** | **Goodwill Additions** | **Purchase Price Adjustments** | **Divestitures** | **Foreign Currency Translation And Other Adjustments** | **Balance 3/31/11** |
|---|---|---|---|---|---|---|
| Global Business Services | $ 4,329 | $ | $ (0) | $ | $ 92 | $ 4,421 |
| Global Technology Services | 2,704 | | (0) | | 33 | 2,736 |
| Software | 16,963 | | (7) | | 156 | 17,112 |
| Systems and Technology | 1,139 | | (1) | | 1 | 1,139 |
| Total | $ 25,136 | $ | $ (9) | $ | $ 280 | $ 25,408 |

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

| (Dollars in millions) Segment | Balance 01/01/10 | Goodwill Additions | Purchase Price Adjustments | Divestitures | Foreign Currency Translation And Other Adjustments | Balance 12/31/10 |
|---|---|---|---|---|---|---|
| Global Business Services | $ 4,042 | $ 252 | $ 0 | $ | $ 35 | $ 4,329 |
| Global Technology Services | 2,777 | 32 | (1) | | (104) | 2,704 |
| Software | 12,605 | 4,095 | (52) | | 315 | 16,963 |
| Systems and Technology | 766 | 375 | (1) | | (1) | 1,139 |
| Total | $ 20,190 | $ 4,754 | $ (54) | $ | $ 245 | $ 25,136 |

Purchase price adjustments recorded in the first quarter of 2011 and full year 2010 were related to acquisitions that were completed on or prior to December 31, 2010 or December 31, 2009, respectively, and were still subject to the measurement period that ends at the earlier of 12 months from the acquisition date or when information becomes available. There were no goodwill impairment losses recorded during the first quarter of 2011 or the full year 2010 and the company has no accumulated impairment losses.

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

| (Dollars in millions) | Liability as of 01/01/2011 | Payments | Other Adjustments* | Liability as of 3/31/2011 |
|---|---|---|---|---|
| Current: | | | | |
| Workforce | $ 45 | $ (12) | $ 3 | $ 36 |
| Space | 8 | (4) | 1 | 5 |
| Total Current | $ 53 | $ (16) | $ 4 | $ 41 |
| Noncurrent: | | | | |
| Workforce | $ 395 | $ | $ 27 | $ 422 |
| Space | 4 | | | 4 |
| Total Noncurrent | $ 399 | $ | $ 27 | $ 426 |

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

**14. Contingencies:** As a company with a substantial employee population and with clients in more than 170 countries, IBM is involved, either as plaintiff or defendant, in a variety of ongoing claims, demands, suits, investigations, tax matters and proceedings that arise from time to time in the ordinary course of its business. The company is a leader in the information technology industry and, as such, has been and will continue to be subject to claims challenging its 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, partners, clients, current or former employees, government and regulatory agencies, stockholders and representatives of the locations in which the company does business. Some of the actions to which the company is party may involve particularly complex technical issues, and some actions may raise novel questions under the laws of the various jurisdictions in which these matters arise.

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

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

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by the SCO Group (SCO v. IBM). The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T s UNIX IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company s distribution of AIX and Dynix and contribution of code to Linux. The company has asserted counterclaims, including breach of contract, violation of the Lanham Act, unfair competition, intentional torts, unfair and deceptive trade practices, breach of the General Public License that governs open source distributions, promissory estoppel and copyright infringement. Motions for summary judgment were heard in March 2007, and the court has not yet issued its decision. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed. On August 25, 2009, the U.S. Bankruptcy Court for the District of Delaware approved the appointment of a Chapter 11 Trustee of SCO. The court in another suit, the SCO Group, Inc. v. Novell, Inc., held a trial in March 2010. The jury found that Novell is the owner of UNIX and UnixWare copyrights; the judge subsequently ruled that SCO is obligated to recognize Novell s waiver of SCO s claims against IBM and Sequent for breach of UNIX license agreements. In July 2010, SCO filed an appeal in connection with this matter.

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

The company is a defendant in an action filed on December 14, 2009 in the United States District Court for the Western District of Texas by Neon, alleging that the company has interfered with Neon s efforts to license its zPrime software. It seeks damages and injunctive relief. In late January 2010, IBM filed its answer to Neon s complaint and asserted counterclaims against Neon. The case is set for trial in June 2011.

The company is a defendant in an action filed on April 2, 2009 in the United States District Court for the Eastern District of Texas by ACQIS LLC (Acqis), which alleges that certain IBM products infringe certain patents relating generally to modular computing devices. Acqis seeks damages and injunctive relief. The trial took place in February 2011, and in late February, the jury found in favor of Acqis and awarded damages in the amount of $9 million. Both parties have submitted post-trial motions, and the deadline for appeal is 30 days after the court s ruling on all such motions.

The company was a defendant in an action filed on February 5, 2010 in the United States District Court for the Eastern District of Virginia by TecSec, Inc., which alleged that certain IBM products infringe certain patents relating generally to encryption. TecSec sought damages and injunctive relief. The case was set for trial in March 2011. In late February 2011, the court granted IBM s motion for summary judgment of non-infringement, and final judgment has been entered in favor of IBM. Plaintiff filed a notice of appeal in late March.

The company is a co-defendant in numerous purported class actions filed on and after March 18, 2011 in federal and state courts in California in connection with an information technology outsourcing agreement between Health Net, Inc. and IBM. The complaints allege numerous and different causes of action, including for violation of the California Confidentiality of Medical Information Act, unfair competition, invasion of privacy, negligence, bailment and conversion, in connection with plaintiffs having been notified that certain of their personal information is believed to be contained on hard drives that are unaccounted for at one of Health Net s data centers in California. Plaintiffs in these cases seek damages, as well as injunctive and declaratory relief. IBM has also received a request for information regarding this matter from the California Attorney General.

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

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. The trial in the High Court is expected to begin in May 2012. In addition, IBM UK is a defendant in approximately 275 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 and are currently stayed pending resolution of the above-referenced High Court proceedings. In a separate but related proceeding, in March 2011, the Trustee of the IBM UK Trust was granted leave to initiate a claim before the High Court in London against IBM UK and one representative beneficiary of the UK Trust membership, seeking an order modifying certain documents and terms relating to retirement provisions in IBM UK s largest defined benefit plan dating back to 1983. The High Court is expected to address this claim at the same time it considers the above-referenced claims in the proceedings initiated in May 2010.

In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid-rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG electronics, which has since been dissolved, effective January, 2005) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Debarment orders were imposed at different times, covering a period of no more than a year from the date of issuance, which barred IBM Korea from doing business directly with certain government-controlled entities in Korea. All debarment orders have since expired and when they were in force did not prohibit IBM Korea from selling products and services to business partners who sold to government-controlled entities in Korea. In addition, the U.S. Department of Justice and the Securities and Exchange Commission (SEC) have both contacted the company in connection with this matter. In March 2008, the company received a request from the SEC for additional information. In March 2011, the company announced that it has agreed to settle a civil enforcement action with the SEC relating to activities by employees of IBM Korea, LG IBM, IBM (China) Investment Company Limited and IBM Global Services (China) Co., Ltd., during the period from 1998 through 2009, allegedly in violation of the Foreign Corrupt Practices Act of 1977. As part of the settlement, IBM has consented to the entry of a judgment relating to the books and records and internal control provisions of the securities laws. IBM has also agreed to pay a total of $10 million, categorized by the SEC as follows: (i) $5.3 million, representing profits gained as a result of the conduct alleged in the SEC s complaint, (ii) prejudgment interest on that amount of $2.7 million, and (iii) a civil penalty of $2 million. The settlement is subject to court approval.

The company is a defendant in numerous actions filed after January 1, 2008 in the Supreme Court for the State of New York, county of Broome, on behalf of hundreds of plaintiffs. The complaints allege numerous and different causes of action, including for negligence and recklessness, private nuisance and trespass. Plaintiffs in these cases seek medical monitoring and claim damages in unspecified amounts for a variety of personal injuries and property damages allegedly arising out of the presence of groundwater contamination and vapor intrusion of groundwater contaminants into certain structures in which plaintiffs reside or resided, or conducted business, allegedly resulting from the release of chemicals into the environment by the company at its former manufacturing and development facility in Endicott. These complaints also seek punitive damages in an unspecified amount. At a hearing in March 2011, the Court indicated that the first trial in these cases would not take place before October 2012.

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

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Along with many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian authorities regarding non-income tax assessments and non-income tax litigation matters. These matters include claims for taxes on the importation of computer software. In November 2008, the company won a significant case in the Superior Chamber of the federal administrative tax court in Brazil, and in late July 2009, the company received written confirmation

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

regarding this decision. The total potential amount related to the remaining matters for all applicable years is approximately $650 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

The company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and proceedings are reviewed at least quarterly and provisions are taken or adjusted to reflect the impact and status of settlements, rulings, advice of counsel and other information pertinent to a particular matter. Any recorded liabilities, including any changes to such liabilities for the quarter ended March 31, 2011, were not material to the Consolidated Financial Statements. Based on its experience, the company believes that the damage amounts claimed in the matters previously referred to are not a meaningful indicator of the potential liability. Claims, suits, investigations and proceedings are inherently uncertain and it is not possible to predict the ultimate outcome of the matters previously discussed. While the company will continue to defend itself vigorously, it is possible that the company s business, financial condition, results of operations or cash flows could be affected in any particular period by the resolution of one or more of these matters.

Whether any losses, damages or remedies finally determined in any such claim, suit, investigation or proceeding could reasonably have a material effect on the company s business, financial condition, results of operations or cash flows will depend on a number of variables, including: the timing and amount of such losses or damages; the structure and type of any such remedies; the significance of the impact any such losses, damages or remedies may have in the Consolidated Financial Statements; and the unique facts and circumstances of the particular matter which may give rise to additional factors.

**15. Commitments:** The company s extended lines of credit to third-party entities include unused amounts of $3,671 million and $3,415 million at March 31, 2011 and December 31, 2010, 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 $2,963 million and $2,825 million at March 31, 2011 and December 31, 2010, 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 non-financial contractual obligations and certain income taxes. In each of these circumstances, payment by the company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party s claims. While typically indemnification provisions do not include a contractual maximum on the company s payment, the company s obligations under these agreements may be limited in terms of time and/or nature of claim, and in some instances, the company may have recourse against third parties for certain payments made by the company.

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

In addition, the company guarantees certain loans and financial commitments. The maximum potential future payment under these financial guarantees was $47 million and $48 million at March 31, 2011 and December 31, 2010, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position was not material.

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

**Standard Warranty Liability**

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

| (Dollars in millions) | 2011 | 2010 |
|---|---|---|
| Balance at January 1 | $ 375 | $ 316 |
| Current period accruals | 93 | 94 |
| Accrual adjustments to reflect actual experience | 3 | 2 |
| Charges incurred | (105) | (100) |
| Balance at March 31 | $ 366 | $ 312 |

**Extended Warranty Liability**

| (Dollars in millions) | 2011 | 2010 |
|---|---|---|
| Aggregate deferred revenue at January 1 | $ 670 | $ 665 |
| Revenue deferred for new extended warranty contracts | 66 | 66 |
| Amortization of deferred revenue | (84) | (79) |
| Other* | 5 | (8) |
| Aggregate deferred revenue at March 31 | $ 658 | $ 644 |
| | | |
| Current portion | $ 319 | $ 297 |
| Noncurrent portion | 338 | 347 |
| Aggregate deferred revenue at March 31 | $ 658 | $ 644 |

* Other primarily consists of foreign currency translation adjustments.

**16. Subsequent Events:** On April 26, 2011, the company announced that the Board of Directors approved a quarterly dividend of $0.75 per common share. The dividend is payable June 10, 2011 to stockholders of record on May 10, 2011. The dividend declaration represents an increase of $0.10 and is 15 percent higher than the prior quarterly dividend of $0.65 per common share.

On April 26, 2011, the company announced that the Board of Directors authorized $8 billion in additional funds for use in the company s common stock repurchase program.

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**ITEM 2.**

**MANAGEMENT S DISCUSSION AND ANALYSIS**

**OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**
**FOR THE THREE MONTHS ENDED MARCH 31, 2011**

**Snapshot**

Financial Results Summary:

| (Dollars in millions except per share amounts) For the three months ended March 31: | | 2011 | | 2010 | Yr. to Yr. Percent/ Margin Change |
|---|---|---|---|---|---|
| Revenue | $ | 24,607 | $ | 22,857 | 7.7%* |
| Gross profit margin | | 44.1% | | 43.6% | 0.5Pts. |
| Total expense and other income | $ | 7,041 | $ | 6,462 | 9.0% |
| Total expense and other income to revenue ratio | | 28.6% | | 28.3% | 0.3Pts. |
| Provision for income taxes | $ | 954 | $ | 914 | 4.4% |
| Net income | $ | 2,863 | $ | 2,601 | 10.1% |
| Net income margin | | 11.6% | | 11.4% | 0.3Pts. |
| Earnings per share: | | | | | |
| Assuming dilution | $ | 2.31 | $ | 1.97 | 17.3% |
| Basic | $ | 2.34 | $ | 2.00 | 17.0% |
| Weighted-average shares outstanding: | | | | | |
| Assuming dilution | | 1,240.0 | | 1,321.6 | (6.2)% |
| Basic | | 1,222.2 | | 1,301.2 | (6.1)% |
| | | **3/31/11** | | **12/31/10** | |
| Assets | $ | 112,960 | $ | 113,452 | (0.4)% |
| Liabilities | $ | 90,185 | $ | 90,279 | (0.1)% |
| Equity | $ | 22,776 | $ | 23,172 | (1.7)% |

* 5.0 percent adjusted for currency

Currency:

The references to adjusted for currency or at constant currency in the Management Discussion are made so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. Financial results adjusted for currency are calculated by translating current period activity in local currency using the comparable prior year period s currency conversion rate. This approach is used for countries where the functional currency is the local country currency.

Operating (non-GAAP) Earnings:

In an effort to provide better transparency into the operational results of the business, the company separated business results into operating and non-operating categories beginning January 1, 2011. Operating earnings is a non-GAAP measure that excludes the effects of certain acquisition-related charges and retirement-related costs, and their related tax impacts. For acquisitions, operating earnings exclude the amortization of purchased intangible assets and acquisition-related charges such as in-process research and development, transaction costs, applicable restructuring and related expenses and tax charges related to acquisition integration. For retirement-related costs, the company has characterized 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 non-pension postretirement benefit plan interest cost, expected return on plan assets, amortized actuarial gains/losses, the impacts of any plan curtailments/settlements and multi-employer plan costs, pension insolvency costs and other costs. Non-operating costs are primarily related to changes in pension plan assets and liabilities which are tied to financial market performance and the company considers these costs to be outside the operational performance of the business.

**Management Discussion (continued)**

Overall, the company believes that providing investors with a view of operating earnings as described above provides increased transparency and clarity into both the operational results of the business and the performance of the company s pension plans; improves visibility to management decisions and their impacts on operational performance; enables better comparison to peer companies; and, allows the company to provide a long-term strategic view of the business going forward. For its 2015 earnings per share road map, the company is utilizing an operating view to establish its objectives and track its progress. Effective January 1, 2011, the company s segment financial results and performance reflect operating earnings, consistent with the company s management and measurement system.

The following table provides the company s non-GAAP operating earnings for the first quarter of 2011 and 2010.

| **(Dollars in millions except per share amounts)**<br>**For the three months ended March 31:** | | **2011** | | **2010** | **Yr. to Yr. Percent/ Margin Change** |
|---|---|---|---|---|---|
| Net income as reported | $ | 2,863 | $ | 2,601 | 10.1% |
| Adjustments (net of tax): | | | | | |
| Acquisition-related charges | | 117 | | 82 | 42.7 |
| Non-operating retirement-related costs/(income) | | 10 | | (45) | nm |
| Operating (non-GAAP) earnings* | $ | 2,990 | $ | 2,638 | 13.3% |
| Diluted operating (non-GAAP) earnings per share: | $ | 2.41 | $ | 2.00 | 20.5% |

* See pages 61 and 62 for a more detailed reconciliation of net income to operating earnings.

nm not meaningful

Financial Performance Summary:

In the first quarter of 2011, the company delivered strong financial results highlighted by revenue growth of 7.7 percent (5 percent adjusted for currency), continued margin expansion and double-digit diluted earnings per share growth of 17.3 percent as reported and 20.5 percent on an operating (non-GAAP) basis. The company generated approximately $4 billion in cash from operations in the quarter enabling significant shareholder returns - almost $5 billion in common stock repurchases and dividends in the period. With this start to the year, in April 2011, the company increased its expectation for full year earnings per share.

Revenue performance in the first quarter was driven by Systems and Technology, Software and Global Services. Segment performance was led by Systems and Technology which increased revenue 18.7 percent (16 percent adjusted for currency) with double-digit growth as reported in every brand, led by System z mainframe and Power Systems offerings. Software revenue increased 5.8 percent as reported, however, excluding the divested PLM operations, revenue improved 9.6 percent (8 percent adjusted for currency) driven by key branded middleware. Total Global Services revenue increased 6.2 percent (3 percent adjusted for currency) in the first quarter versus the prior year, an improved constant currency growth rate compared to the fourth quarter of 2010. Services revenue was led by total outsourcing revenue which increased 6.8 percent (4 percent adjusted for currency).

In the first quarter, the company s key growth plays also had excellent performance. Total revenue from the growth markets increased 17.5 percent (12 percent adjusted for currency) driven by the BRIC countries (Brazil, Russia, India and China) which increased 25.6 percent (22 percent adjusted for currency). Overall, in the first quarter, the company had almost 40 countries within the growth markets which increased revenue at a double-digit rate, adjusted for currency, compared to the prior year. Business analytics revenue increased 20 percent year to year with strong contribution from both software offerings and the consulting business. Revenue from the company s cloud computing offerings was 5 times first quarter 2010 revenue and smarter planet revenues increased approximately 20 percent in the first quarter as the company is applying information technology outside its traditional market areas.

The consolidated gross margin increased 0.5 points versus the first quarter of 2010 to 44.1 percent. The operating (non-GAAP) gross margin increased 0.8 points to 44.5 percent. The improvement in gross margin was broad based, led by Systems and Technology which improved by 4.7 points year to year. Software, Global Business Services and Global Financing also delivered improved gross margins in the first quarter.

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**Management Discussion (continued)**

Total expense and other (income) increased 9.0 percent in the first quarter compared to the prior year. Total operating (non-GAAP) expense and other (income) increased 8.2 percent compared to the first quarter of 2010. Expense growth in the quarter was in line with revenue growth in the period and supported the overall revenue performance. The year-to-year key drivers for both categories were approximately:

- Base expense, 4 points
- Acquisitions*, 4 points
- Currency**, 1 point

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* Includes acquisitions completed in prior 12-month period.
** Reflects impacts of translation and hedging programs.

Pre-tax income grew 8.6 percent and the pre-tax margin was 15.5 percent, an increase of 0.1 points versus the first quarter of 2010. Net income increased 10.1 percent and the net income margin of 11.6 percent improved 0.3 points year to year. The effective tax rate for the first quarter was 25.0 percent, compared with 26.0 percent in the prior year. Operating (non-GAAP) pre-tax income grew 12.1 percent and the pre-tax margin was 16.2 percent, an increase of 0.6 points versus the prior year. Operating (non-GAAP) net income increased 13.3 percent and the operating (non-GAAP) net income margin of 12.1 percent increased 0.6 points versus the prior year. The operating (non-GAAP) effective tax rate was 25.0 percent versus 25.8 percent in the first quarter of 2010.

Diluted earnings per share improved 17.3 percent reflecting the growth in net income and the benefits of the common stock repurchase program. In the first quarter, the company repurchased 25 million shares of its common stock. Diluted earnings per share of $2.31 increased $0.34 from the prior year. Operating (non-GAAP) diluted earnings per share of $2.41 increased $0.41 versus the first quarter of 2010 driven by the following factors:

| | | | |
|---|---|---|---|
| • | Revenue increase at actual rates: | $ | 0.15 |
| • | Margin expansion: | $ | 0.11 |
| • | Common stock repurchases: | $ | 0.15 |

In the first quarter, the improvement in earnings per share was balanced with contribution from all the key drivers revenue growth, margin expansion and the effective use of cash consistent with the 2015 Road Map.

At March 31, 2011, the company s balance sheet and liquidity positions remain strong and are well-positioned to support the company s full year objectives. Cash and marketable securities at quarter end were $13,245 million. Key drivers in the balance sheet and total cash flows are highlighted below.

Total assets decreased $491 million ($1,999 million adjusted for currency) from December 31, 2010 driven by:

- Decreases in total receivables ($2,861 million), short-term marketable securities ($508 million) and investment and sundry assets ($398 million), partially offset by;
- Increased cash and cash equivalents ($2,102 million), prepaid pension assets ($720 million) and goodwill ($272 million).

Total liabilities decreased $95 million ($1,056 million adjusted for currency) from December 31, 2010 driven by:

- Decreases in taxes ($1,686 million), accounts payable ($1,057 million) and compensation and benefits ($582 million), partially offset by;
- Increased total debt ($1,632 million) and deferred income ($1,298 million).

Total equity of $22,776 million decreased $397 million from December 31, 2010 as a result of:

- Increased treasury stock ($3,917 million) driven by share repurchases, partially offset by;
- Higher retained earnings ($2,058 million), common stock ($860 million) and higher foreign currency translation adjustments ($535 million).

The company generated $3,792 million in cash flow provided by operating activities, a decrease of $644 million compared to the first quarter of 2010, driven primarily by higher net income tax payments ($766 million) in the first quarter of 2011 versus 2010. Net cash provided by investing activities of $498 million increased $1,197 million primarily due to the

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**Management Discussion (continued)**

net benefit of $495 million from purchases and sales of marketable securities and other investments in the first quarter of 2011 versus 2010 and a decrease in cash used for acquisitions of $773 million. Net cash used in financing activities of $2,314 million decreased $1,053 million compared to the prior year primarily due to a decrease in net cash to settle debt ($706 million) and higher short-term borrowings ($461 million).

In January 2011, the company disclosed that it is expecting GAAP earnings of at least $12.56 and operating (non-GAAP) earnings of at least $13.00 per diluted share for the full year 2011. In April 2011, the company increased its expectation for GAAP earnings per diluted share to at least $12.73 and its expectation for operating (non-GAAP) earnings per diluted share to at least $13.15 for the full year.

Japan:

On March 11, 2011, a magnitude 9.0 earthquake and tsunami occurred in the northeast region of Japan, resulting in numerous casualties and extensive damage throughout the region. The company was able to confirm that all of its employees were safe following the disasters.

The company s operations in Japan represented approximately 11 percent of total consolidated revenues in 2009 and 2010, respectively, and include over 200 site locations in the country. Damage occurred at certain company owned sites, consisting primarily of interior building damage, and an immaterial charge was recorded in the first quarter 2011 financial results. The charge was not netted against anticipated insurance recoveries as it was below the company s policy deductible.

As a result of the disasters, nuclear power plants were damaged causing radiation leakage and an evacuation zone to be established near the Fukushima power plant. None of the company s locations are within the current 12-19 mile Fukushima evacuation zone, although the company has locations within a 50-75 mile radius of the power plant. The nuclear power plant issue has resulted in rolling blackouts, which, although suspended in mid-April, are anticipated to restart later in the second quarter and perhaps beyond. Powerful aftershocks have also caused electrical outages. Certain company locations have been impacted by these power outages. The company is mitigating potential impacts to customers and its own operations through the use of generators and temporary backups. The cost of these activities will be ongoing and could increase based on the demand for diesel fuel, temporary space and other conditions. Overall, these costs are not expected to be material to the company s financial results.

The company experienced no losses resulting from damage to inventory or Global Financing lease-related assets that were insurable by the company. The company also assessed any potential credit risk related to customer receivables and concluded there were no material changes required.

The majority of the company s revenues in Japan are services related. These revenues are predominantly annuity-based and are therefore more stable through various market conditions. Within the quarter, the company experienced some deterioration in March, but it was not much different than the dynamics seen through February. There was not a significant change in the trajectory of the business in the quarter.

Supply of components used in certain of the company s hardware products are produced by Japanese manufacturers. In the first quarter, there was no material impact to the Systems and Technology business due to supply issues, and based on the company s current assessment, it is not anticipating any significant issues through the second quarter. In addition, the company does not anticipate any significant issues in its services business with regard to subcontractor availability and other supply issues.

Going forward, any business interruption and other earthquake related damages will be aggregated and assessed for recovery under the company s insurance coverage, subject to policy deductibles.

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**Management Discussion (continued)**

**Quarter in Review**

*Results of Operations*

Segment Details

The following is an analysis of the first-quarter 2011 versus first-quarter 2010 reportable segment external revenue and gross margin results. Segment pre-tax income includes transactions between the segments that are intended to reflect an arms-length transfer price and excludes certain unallocated corporate items.

| (Dollars in millions)<br>For the three months ended March 31: | 2011 | 2010* | Yr. to Yr. Percent/Margin Change | Yr. to Yr. Percent Change Adjusted for Currency |
|---|---|---|---|---|
| Revenue: | | | | |
| Global Technology Services | $ 9,863 | $ 9,306 | 6.0% | 2.9% |
| Gross margin | 33.8% | 34.2% | (0.5)pts. | |
| Global Business Services | 4,710 | 4,410 | 6.8% | 3.3% |
| Gross margin | 27.4% | 27.2% | 0.2pts. | |
| Software | 5,308 | 5,018 | 5.8% | 4.4% |
| Gross margin | 87.0% | 85.6% | 1.5pts. | |
| Systems and Technology | 4,019 | 3,385 | 18.7% | 16.4% |
| Gross margin | 37.8% | 33.1% | 4.7pts. | |
| Global Financing | 516 | 537 | (4.0)% | (6.2)% |
| Gross margin | 53.5% | 49.8% | 3.7pts. | |
| Other | 190 | 200 | (4.6)% | (6.0)% |
| Gross margin | (41.3)% | (35.7)% | (5.6)pts. | |
| Total consolidated revenue | $ 24,607 | $ 22,857 | 7.7% | 5.0% |
| Operating (non-GAAP) gross profit | $ 10,957 | $ 9,996 | 9.6% | |
| Operating (non-GAAP) gross margin | 44.5% | 43.7% | 0.8pts. | |
| Non-operating adjustments: | | | | |
| Amortization of acquired intangible assets | (85) | (55) | | |
| Retirement-related (costs)/income | (14) | 35 | | |
| Total consolidated gross profit | $ 10,858 | $ 9,976 | 8.8% | |
| Total consolidated gross margin | 44.1% | 43.6% | 0.5pts. | |

* Reclassified to conform with 2011 presentation.

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

| | Revenue | | Pre-tax income | |
|---|---|---|---|---|
| **For the three months ended March 31:** | **2011** | **2010** | **2011** | **2010*** |
| Global Technology Services | 40.4% | 41.1% | 29.0% | 25.5% |
| Global Business Services | 19.3 | 19.5 | 15.0 | 11.8 |
| Total Global Services | 59.7 | 60.5 | 44.0 | 37.3 |
| Software | 21.7 | 22.1 | 40.7 | 56.6 |
| Systems and Technology | 16.5 | 14.9 | 3.1 | (5.2) |
| Global Financing | 2.1 | 2.4 | 12.2 | 11.4 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

* Reclassified to conform with 2011 presentation.

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**Management Discussion (continued)**

The workforce rebalancing charges recorded in the first quarter of 2010 and 2011 and the first quarter 2010 PLM transaction gain impacted the year-to-year results of the company s reportable segments. Workforce rebalancing charges were incurred in every segment in both periods. The PLM transaction gain ($591 million) was recorded in Software in the first quarter of 2010. In the segment analysis below and in the Global Financing analysis on page 56, each segment s pre-tax income and pre-tax margin is presented on an as-reported basis and on a basis normalized for these actions in both years to provide a better perspective of the underlying operational performance of the segments.

Global Services

The Global Services segments, Global Technology Services (GTS) and Global Business Services (GBS), had combined revenue of $14,573 million in the first quarter, an increase of 6.2 percent (3 percent adjusted for currency) year to year. The combined constant currency revenue growth rate year to year in the first quarter of 2011 improved 1 point sequentially compared to the fourth quarter of 2010. Total outsourcing revenue of $6,850 million increased 6.8 percent (4 percent adjusted for currency) driven by revenue from backlog and new sales into existing base accounts. Total transactional revenue of $5,878 million increased 6.4 percent (3 percent adjusted for currency). The estimated Global Services backlog was $142 billion at March 31, 2011, an increase of $8 billion ($1.5 billion adjusted for currency) compared to the March 31, 2010 level and flat (decrease of $3 billion adjusted for currency) compared to the December 31, 2010 level. Adjusted for currency, the year-to-year increase in backlog was driven by an increase in the opening backlog, lower levels of erosion and growth in the base accounts. Backlog for the outsourcing businesses was estimated to be $95 billion at March 31, 2011, an increase of $4 billion (decrease of $0.5 billion adjusted for currency) from March 31, 2010 and a decrease of $1 billion ($3 billion adjusted for currency) from December 31, 2010.

| **(Dollars in millions)**<br>**For the three months ended March 31:** | | **2011** | | **2010*** | **Yr. to Yr. Percent Change** | **Yr. to Yr. Percent Change Adjusted for Currency** |
|---|---|---|---|---|---|---|
| Global Services external revenue: | $ | 14,573 | $ | 13,716 | 6.2% | 3.1% |
| Global Technology Services | $ | 9,863 | $ | 9,306 | 6.0% | 2.9% |
| Outsourcing | | 5,794 | | 5,454 | 6.2 | 3.1 |
| Integrated Technology Services | | 2,224 | | 2,073 | 7.3 | 4.0 |
| Maintenance | | 1,845 | | 1,779 | 3.7 | 1.3 |
| Global Business Services | $ | 4,710 | $ | 4,410 | 6.8% | 3.3% |
| Outsourcing | | 1,055 | | 958 | 10.1 | 6.2 |
| Consulting and Systems Integration | | 3,654 | | 3,452 | 5.9 | 2.5 |

* Reclassified to conform with 2011 presentation of Outsourcing and Consulting and Systems Integration revenue within GBS.

Global Technology Services revenue increased 6.0 percent (3 percent adjusted for currency) versus the first quarter of 2010. GTS Outsourcing revenue increased 6.2 percent (3 percent adjusted for currency). The revenue growth rate year to year in the first quarter of 2011 improved 2 points at constant currency compared to the fourth quarter of 2010, driven primarily by increased revenue from backlog and double-digit growth in add-on business in the base Strategic Outsourcing accounts. The growth markets continued to drive strong performance in GTS Outsourcing with revenue up 18.4 percent (11 percent adjusted for currency) in the first quarter. Integrated Technology Services (ITS) revenue increased 7.3 percent (4 percent adjusted for currency) in the first quarter also driven by the growth markets where revenue increased 16.1 percent (11 percent adjusted for currency).

Global Business Services revenue increased 6.8 percent (3 percent adjusted for currency) versus the first quarter of 2010 and delivered growth in both outsourcing and the transactional businesses. Application Outsourcing revenue, which accounted for approximately 20 percent of total GBS revenue in the first quarter of 2011, increased 10.1 percent (6 percent adjusted for currency). Consulting and Systems Integration, which includes Consulting, Application Management Services systems integration and the U.S. Federal business, had revenue growth in the first quarter of 5.9 percent (2 percent adjusted for currency). Geographically, revenue performance, adjusted for currency, was led by North America with growth of 6 percent. From an industry sector perspective, GBS revenue growth in the first quarter was led by Distribution, General Business and Communications. GBS continued to have strong performance in its growth initiatives in the first quarter with revenue growth of over 30 percent in business analytics.

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**Management Discussion (continued)**

| (Dollars in millions)<br>For the three months ended March 31: | 2011 | 2010+ | Yr. to Yr. Percent/ Margin Change |
|---|---|---|---|
| Global Technology Services: | | | |
| External gross profit | $ 3,330 | $ 3,186 | 4.5% |
| External gross profit margin | 33.8% | 34.2% | (0.5)pts. |
| Pre-tax income | $ 1,238 | $ 957 | 29.3% |
| Pre-tax margin | 12.2% | 9.9% | 2.2pts. |
| Pre-tax income normalized* | $ 1,354 | $ 1,230 | 10.1% |
| Pre-tax margin normalized | 13.3% | 12.8% | 0.5pts. |
| Global Business Services: | | | |
| External gross profit | $ 1,290 | $ 1,199 | 7.7% |
| External gross profit margin | 27.4% | 27.2% | 0.2pts. |
| Pre-tax income | $ 640 | $ 445 | 43.6% |
| Pre-tax margin | 13.0% | 9.7% | 3.4pts. |
| Pre-tax income normalized** | $ 685 | $ 574 | 19.5% |
| Pre-tax margin normalized | 14.0% | 12.4% | 1.5pts. |

* Excludes $116 million and $273 million of workforce rebalancing charges in the first quarter of 2011 and 2010, respectively.

** Excludes $45 million and $128 million of workforce rebalancing charges in the first quarter of 2011 and 2010, respectively.

\+ Reclassified to conform with 2011 presentation.

GTS gross profit increased 4.5 percent compared to the first quarter of 2010, with gross profit margin declining 0.5 points to 33.8 percent. A margin decline in outsourcing was partially offset by gross margin expansion in ITS and Maintenance. On a normalized basis, segment pre-tax income growth was better than balanced with revenue growth and increased 10.1 percent with a pre-tax margin expansion of 0.5 points versus the first quarter of 2010.

GBS gross profit increased 7.7 percent and gross margin expanded 0.2 points to 27.4 percent in the first quarter of 2011. On a normalized basis, segment pre-tax profit increased 19.5 percent with pre-tax margin expansion of 1.5 points compared to the first quarter of 2010. The margin expansion was driven by improved utilization, delivery excellence and improved spending management.

Global Services Backlog

Total estimated Global Services backlog at March 31, 2011 was $142 billion, an increase of $8 billion ($1.5 billion adjusted for currency) compared to the March 31, 2010 balance. The estimated Outsourcing backlog at March 31, 2011 was $95 billion, an increase of $4 billion (decrease of $0.5 billion adjusted for currency) versus the prior year period. The year-to-year backlog growth was driven by an increase in the opening backlog, lower levels of erosion, growth in the company s base accounts and currency fluctuations.

In the first quarter, outsourcing revenue driven from backlog increased over 3 percent and revenue from sales into existing base accounts also increased, driving the total growth in outsourcing revenue, at constant currency, of 4 percent compared to the first quarter of 2010.

| **(Dollars in billions)**<br>**For the three months ended March 31:** | **2011** | **2010** | **Yr. to Yr. Change** | **Yr. to Yr. Change Adjusted For Currency** |
|---|---|---|---|---|
| Backlog: | | | | |
| Total Backlog | $ 142.2 | $ 134.0 | $ 8.2 | $ 1.5 |
| Outsourcing Backlog | $ 95.5 | $ 91.3 | $ 4.2 | $ (0.5) |

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

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**Management Discussion (continued)**

Global Services signings are management s initial estimate of the value of a client s commitment under a Global 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.

Signings include GTS Outsourcing, ITS, GBS Outsourcing and Consulting and Systems Integration contracts. Contract extensions and increases in scope are treated as signings only to the extent of the incremental new value. Maintenance 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 billions)<br>For the three months ended March 31: | 2011 | 2010* | Yr. to Yr. Change | Yr. to Yr. Change Adjusted For Currency |
|---|---|---|---|---|
| Outsourcing signings | $ 4.7 | $ 6.4 | (26.5)% | (29.9)% |
| Transactional signings | 5.8 | 5.8 | (0.9) | (4.8) |
| Total signings | $ 10.5 | $ 12.3 | (14.3)% | (17.9)% |

* Reclassified to conform with 2011 presentation.

Software

| (Dollars in millions)<br>For the three months ended March 31: | 2011 | 2010* | Yr. to Yr. Percent Change | Yr. to Yr. Percent Change Adjusted for Currency |
|---|---|---|---|---|
| Software external revenue: | $ 5,308 | $ 5,018 | 5.8% | 4.4% |
| Middleware: | $ 4,348 | $ 4,004 | 8.6% | 7.2% |
| Key Branded Middleware: | 3,252 | 2,809 | 15.7 | 14.2 |
| WebSphere Family | | | 51.5 | 49.9 |
| Information Management | | | 12.7 | 11.4 |
| Lotus | | | 0.6 | (1.5) |
| Tivoli | | | 7.9 | 6.2 |
| Rational | | | 4.7 | 2.5 |

| | | | | |
|---|---|---|---|---|
| Other middleware | 1,096 | 1,194 | (8.2) | (9.2) |
| Operating systems | 542 | 499 | 8.6 | 7.2 |
| Other | 418 | 515 | (18.9) | (20.0) |

* Reclassified to conform with 2011 presentation.

Software revenue of $5,308 million increased 5.8 percent (4 percent adjusted for currency) in the first quarter of 2011 compared to the first quarter of 2010. Adjusting for the divested PLM operations, revenue grew at 9.6 percent (8 percent adjusted for currency) in the first quarter of 2011. Software revenue growth was led by business analytics, storage management and business integration as well as contribution from Netezza, a recent acquisition completed in November 2010. The software business continues to benefit from the company s growth initiatives, with revenue from the growth markets up 20 percent (16 percent adjusted for currency), and business analytics revenue up 15 percent (14 percent adjusted for currency).

Key Branded Middleware revenue increased 15.7 percent (14 percent adjusted for currency) and gained share for the 14th straight quarter as the business continues to extend its lead in the middleware market. Gartner, Inc. again named the company the worldwide market share leader in the application infrastructure and middleware segment with market share nearly double that of the nearest competitor. Software revenue continues to mix to the faster growing branded middleware which accounted for 61 percent of total software revenue in the first quarter. Revenue growth in the first quarter was led by WebSphere and Information Management.

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**Management Discussion (continued)**

WebSphere revenue increased 51.5 percent (50 percent adjusted for currency) and gained share in the first quarter of 2011. Application Servers and Business Integration, two of the largest product sets in WebSphere, each grew nearly 30 percent year to year. Sterling Commerce, Unica and Coremetrics were also strong contributors to WebSphere s performance.

Information Management revenue increased 12.7 percent (11 percent adjusted for currency) in the first quarter of 2011. Business analytics software revenue was up double digits for the sixth consecutive quarter. Distributed Database products had a strong quarter with double-digit growth in its base business, complemented by Netezza performance. Netezza s transactional volumes increased 50 percent versus the pre-acquisition prior year period.

Tivoli revenue increased 7.9 percent (6 percent adjusted for currency) in the first quarter of 2011 compared to the first quarter of 2010. Tivoli Storage management software had revenue growth of 19.6 percent (18 percent adjusted for currency), driven by growth of over 60 percent in software for XIV storage products.

Rational revenue increased 4.7 percent (3 percent adjusted for currency) in the first quarter of 2011. Rational s Jazz-based products grew 64 percent (61 percent adjusted for currency), the fifth consecutive quarter of year-to-year growth of over 50 percent.

Operating systems revenue increased 8.6 percent (7 percent adjusted for currency) in the first quarter of 2011, driven primarily by Power Systems related products.

Other software revenue decreased 18.9 percent (20 percent adjusted for currency) year over year, due primarily to the divestiture of the PLM operations in the first quarter of 2010.

| **(Dollars in millions)**<br>**For the three months ended March 31:** | **2011** | **2010**** | **Yr. to Yr. Percent/ Margin** |
|---|---|---|---|