



## Dear IBM Investor:

The cover of our report to you last year asked: “What will we make of this moment?”

This was the critical and urgent decision that we — and our clients — faced. Would we seize upon the major shifts that are reordering our industry and opening up vast new applications of information technology?

In my letter, I described our answer:

- IBM would help transform industries and professions with data.
- We would remake enterprise IT for the era of cloud.
- We would reimagine work by helping clients build systems of engagement, underpinned by the imperative of security.

At the same time, we would address significant challenges in some of our businesses, principally hardware.

We knew we faced a critical year of transformation. It proved to be just that. The work of transforming IBM continues, and much remains to be done. But I am pleased to report that we made significant progress and built momentum in 2014.

In this letter I will describe what we have done, and continue to do, to transform and differentiate your company and to position ourselves for leadership in the new era now taking shape.



**VIRGINIA M. ROMETTY**  
Chairman, President  
and Chief Executive Officer

### Continuing to move to higher value

Information technology is one of the most dynamic, fast-changing and fiercely competitive industries in the world, characterized by relentless cycles of innovation and commoditization. Our choice is clear: We pursue a model of high-value innovation, rather than commodity technology, products and services. Our commitment to this model compels us to reinvent businesses continually; grow new ones organically and through acquisitions; and occasionally divest businesses that do not fit our profile.

You see all of this reflected in our 2014 results — a dynamic shift of our portfolio underneath our \$92.8 billion in revenue, \$21 billion in operating pre-tax income and operating earnings per share of \$16.53 from continuing operations.

Consider that we completed or announced the divestiture of three businesses in 2014 that a year earlier drove \$7 billion in revenue, but lost about \$500 million in profit — what I call “empty calories.” At the same time, we are making significant investments in line with the strategy I described to you last year.

Throughout the year you saw the bold moves we made:

- \$1 billion to accelerate the commercialization of IBM Watson, bringing cognitive computing to more clients and partners in more industries.
- \$1.2 billion to expand our SoftLayer cloud centers around the world. We expect to have 46 locations by the end of 2015.
- \$1 billion to create IBM Bluemix, our cloud platform-as-a-service for software developers.
- Further scaling our global IBM Cloud business through partnerships with SAP and Tencent.

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2014

**\$92.8 billion**

Revenue

**\$21 billion**

Operating pre-tax  
income

**\$16.53**

Operating EPS

- IBM Watson Analytics, offering powerful cognitive and visually intuitive analytics in the palm of your hand.
- A landmark partnership with Apple to bring mobility to the enterprise and reimagine the work of professionals.
- A strategic alliance with Twitter to bring an entire new category of Big Data to business.

These investments will contribute to the strong growth we are seeing in our strategic imperatives, which deliver high value and now represent a significant part of IBM. Together, cloud, analytics, mobile, social and security generated \$25 billion of revenue in 2014, growing by 16 percent. Five years ago, these businesses represented just 13 percent of our revenue. Today, that has risen to 27 percent of IBM's revenue.

**Big Data and analytics.** Our analytics business grew 7 percent to \$17 billion in 2014. We are driving growth by helping our clients integrate all data sources — structured and unstructured — and apply a range of analytics — descriptive, predictive and prescriptive. We combine this capability with deep knowledge of industries and professions. Our analytics portfolio draws upon more than 30 acquisitions and includes nine Analytics Solutions Centers with an ecosystem of more than 6,000 business partners. Further, we are creating the next stage of Big Data and analytics with cognitive computing.

**Cloud.** Our cloud business is growing rapidly — up 60 percent to \$7 billion in 2014, with “as-a-service” at \$3 billion, up nearly 80 percent and exiting the year with a run rate of \$3.5 billion. IBM Cloud is set apart by focusing on hybrid environments optimized for data and security, shaped by our knowledge of the requirements of enterprise clients.

For example, the planetwide footprint of cloud centers that we are building will provide clients the combination of global and localized data access and security that they need. This is unmatched in the industry.

**Engagement, underpinned by security.** In mobile, our growth more than tripled in 2014. Going forward, we expect this to benefit from the apps from our strategic alliance with Apple and our global network of digital design studios. Further, IBM is the global leader in enterprise security, grounded not only in technology and our 3,700 patents, but in our experience-based understanding of the changing nature of the challenge. Enterprises and institutions discover that they cannot wall out attackers. Twenty-first century security is a Big Data problem — which is why our security business, with unequalled data and analytics capability, grew 19 percent in 2014.

At the same time that we have been growing new businesses, we have been reinventing our core franchises. Last year we promised to address challenges in our Systems and Technology business. We did so in 2014, with hardware going from losses in the first half to nearly \$400 million of profit in the fourth quarter alone. That is a remarkable swing.

In transforming this business, we took several important actions:

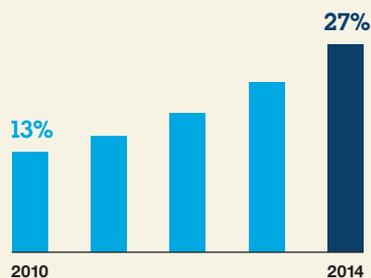
- We sold our x86 server business and announced the divestiture of our commercial semiconductor technology business.
- We committed \$3 billion over the next five years to the development of next-generation semiconductor technologies.

## Engines of Growth: IBM's Strategic Imperatives

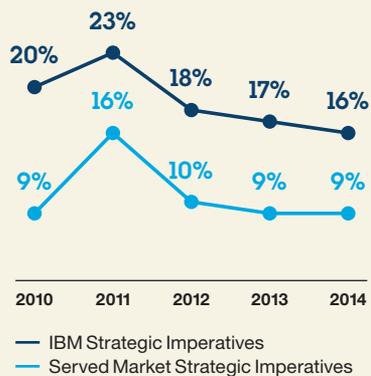
Today, our strategic imperatives have become a significant part of IBM. Together, cloud, analytics, mobile, social and security represented **27 percent** of IBM's revenue in 2014. IBM generated more than 3,000 patents in these areas in 2014 and remains differentiated in our ability to integrate these technologies with our clients' core business processes, data and systems.

In 2014, our strategic imperatives generated **\$25B** in revenue, growing by 16 percent.

STRATEGIC IMPERATIVE REVENUE MIX



STRATEGIC IMPERATIVE REVENUE GROWTH VS THE MARKET\*



\* Data reflects actual currency rates.

- We introduced major technological advances with POWER8 and software defined storage — built for cloud and Big Data.
- In January 2015 we launched our new z13 mainframe. Built for the mobile era, it processes massive volumes of transactions while tapping back-office data and simultaneously applying real-time analytics for deeper insights and fraud detection.
- Historically, we kept our industry-leading Power technology all to ourselves. Today, we see greater value by enabling an OpenPOWER ecosystem, which allows partners to innovate and build on the Power technology. Launched in 2013, the OpenPOWER Foundation began with five members and now stands at more than 100 around the world. The U.S. Department of Energy recently awarded IBM a long-term, \$325 million contract to create future supercomputers based on OpenPOWER technology.

All of this speaks to the enduring quality of IBM as a high-value innovation company. Last year we again spent about 6 percent of our revenue on research and development — and the ratio within our software business is double that. We invested \$4 billion on capital expenditures. IBMers are prolific innovators. For the 22nd straight year, we earned the most U.S. patents of any organization, averaging 20 a day.

## 2015: Our transformation continues

Our direction is clear. We remain confident in our strategy, and we have made much progress. In 2015 we will build on our momentum:

### **1. We will shift an additional \$4 billion of spending to data, cloud and engagement this year, aimed at deepening our differentiation in the marketplace.**

In February we introduced innovations to make hybrid cloud a reality for the enterprise. We are also growing our portfolio of industry-specific analytics solutions in areas ranging from counter-fraud and oil and gas exploration, to airline maintenance and the Internet of Things. And we began the year by establishing a number of business units focused on markets and industries being transformed by our strategic imperatives: IBM Commerce, IBM Analytics, IBM Security and IBM Cloud. We have announced plans for an IBM Healthcare unit.

### **2. We will continue to bring innovation to our core franchises — innovation highly valued by our clients.**

I previously mentioned the entirely refreshed line of mainframes, IBM Power Systems and storage. We will continue to apply breakthroughs from IBM Research to our products and services. In software, we will accelerate our march to “as-a-service.” In services, we will deploy advanced automation to delivery. And we will continue helping new and existing outsourcing clients transform their infrastructure and processes by leveraging IBM’s hybrid cloud platform. This was an important differentiator in helping us to sign nearly 50 contracts worth greater

“IBM lives at the intersection of technology and business. This enables us to change the way the world works, and in so doing, to be essential to our clients and to society.”

than \$100 million in 2014 and to maintain a services backlog of \$128 billion.

These core franchises also provide the foundation for future innovation and growth. One example is our partnership with Apple. Together, we are placing powerful analytics capabilities in the hands of professionals. These apps are integrated with critical business systems, work flows and data sets. That’s what enables an airline attendant to rebook a flight while en route; a financial advisor to model a portfolio in the client’s living room; an in-store sales assistant to act as a trusted fashion advisor; or an emergency responder to have real-time situation-risk awareness, including live video.

**3. We believe open ecosystems and partnerships are key to our future innovation.** This is a significant new element of our growth strategy. We will add to and scale partnerships with companies like Apple, Twitter, SAP, Tencent and now, SoftBank. Also, the IBM Watson Ecosystem is rapidly expanding, with 4,000 companies in the pipeline.

Together, these actions will make IBM an even higher-value business. We expect our strategic imperatives of cloud, analytics, mobile, social and security to continue growing by double digits and to become a greater percentage of IBM. We will remain the enterprise leader in these markets.

Finally, we will continue to return substantial value to you, our owners, through dividends and gross share repurchases. Last year, these were \$4.3 billion and \$13.7 billion, respectively. In 2014 we marked our 19th consecutive year of raising our dividend and our 99th year of paying one.

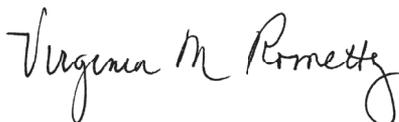
## An essential company

So I come back to this moment, full of rapid change, but even more opportunity — and to IBM's unique purpose as an enterprise.

IBM lives at the intersection of technology and business. This enables us to change the way the world works, and in so doing, to be essential to our clients and to society. We work with 90 percent of the world's top banks, 9 of the top 10 oil and gas companies, 40 of the top 50 retailers and 92 of the top 100 healthcare organizations. IBM systems manage banking, reservations, transportation, retail, trading and healthcare systems. Our mainframes alone process 75 percent of the world's business data.

Today we are building upon this foundation to create an entirely new generation of critical systems. IBM's clients are unclogging city traffic, exploring a cure for cancer, improving the safety of food supplies, reducing risk, and serving their own customers, employees, citizens and patients with greater levels of understanding, personalization and intimacy. A new world is taking shape before our eyes, remade by data, rewritten in code and growing smarter every day.

This is the work that energizes me and all of my fellow IBMers. I am deeply grateful to the IBM team for bringing us here, and to you, our shareholders, for your support. I hope you share our excitement about your company's path and the shared opportunity we have, together, to do something that is truly essential.



Virginia M. Rometty  
Chairman, President and Chief Executive Officer

This letter includes selected references to certain non-GAAP financial measures that are made to facilitate a comparative view of the company's ongoing operational performance. This letter also includes certain historical information on strategic imperatives revenue which has been measured on a consistent basis. For information about the company's financial results related to operating pre-tax income and operating earnings per share, on a continuing operations basis, which are non-GAAP measures, see the company's 2014 Annual Report, which is Exhibit 13 to the Form 10-K submitted to the SEC on February 24, 2015. For reconciliation and other information concerning these items refer to page 45 of the company's 2014 Annual Report.

## **What We Are Making of this Moment:**

### A year of transformation

One year ago, we described our strategy to lead a rapidly reordering information technology industry. We said that a new era was driving the reinvention of all enterprises — including our own. And we committed to accelerate that transformation.

In the year that followed, the pace of change picked up, and we made much progress. In the following pages, we share highlights of that story — some of the ways we are:

- Transforming industries and professions with data.
- Remaking enterprise IT for the era of cloud.
- Reimagining work through mobile and social technologies.
- Rethinking the challenge of security.
- Creating new infrastructure for a new era.

# Transforming industries and professions with data

To mine and refine the world's vast new natural resource of Big Data requires a **new class of advanced analytics**. IBM's unmatched analytics capabilities draw upon more than 30 acquisitions and include nine Analytics Solutions Centers with an ecosystem of more than 6,000 business partners. Our global leadership in analytics was also key to last year's alliance between **IBM and Twitter**. Together, we will help enterprises unlock insights from the 500 million Tweets generated every day — bringing a whole new category of data to the enterprise and using it to develop unique solutions for financial services, consumer products, retail and more.

## THE WORLD'S FIRST COGNITIVE SYSTEM: IBM WATSON

IBM Watson enables entirely new kinds of discovery, as well as new ways for humans and computers to work together. In 2014 we turned this technology breakthrough into a thriving, multidimensional business. Through the cloud-based **IBM Watson Ecosystem**, developers and partners can now embed cognitive computing APIs (application program interfaces) into their apps. Since November 2014, **6,800 developers** have built more than **7,000 cognitive apps**. Finally, IBM Watson Analytics brings intuitive visualization and predictive analytics to every business user.

## IBM WATSON SOLUTIONS AND APPLICATIONS

A growing portfolio of Watson applications is **extending the expertise of leading professionals** — wealth managers, researchers, retailers and more — to their peers around the world. For example, doctors at Bumrungrad International Hospital in Bangkok treat 1.1 million patients from 190 countries each year, and will be using **IBM Watson for Oncology**, trained by Memorial Sloan Kettering Cancer Center, to plan the most effective treatments based on each cancer patient's profile.

### IBM Watson for Oncology

#### Treatment Plan Options

Select a clinical trial at Memorial Sloan Kettering	Chemotherapy followed by endocrine therapy
Chemotherapy followed by surgery	
Chemotherapy followed by endocrine therapy and radiation therapy	Chemotherapy
Support followed up with radiation therapy	
Operative system management	<input checked="" type="checkbox"/> CMF (Cyclophosphamide / Methotrexate / Fluorouracil)
Select a clinical trial at Memorial Sloan Kettering	
Select a clinical trial at Memorial Sloan Kettering	<input type="checkbox"/> TC (Docetaxel / Cyclophosphamide)

Business analytics  
revenue was  
**\$17B**  
in 2014

Business analytics  
revenue increased  
**7%**  
in 2014

**\$1B**  
investment in IBM  
Watson, including  
\$100 million dedicated  
to venture capital  
to support start-ups

IBM Watson doubled  
its client base  
every quarter in 2014.  
It now spans

**17**  
industries in  
24 countries



# Remaking enterprise IT for the era of cloud

INTERNET OF THINGS



QUESTION AND ANSWER  
(IBM WATSON)



SPEECH TO TEXT  
(IBM WATSON)



TRADEOFF ANALYTICS  
(IBM WATSON)



TIME SERIES DATABASE



CLOUDANT NoSQL DB



DASHDB



GEOSPATIAL ANALYTICS



Cloud  
revenue was  
**\$7B**  
in 2014

Cloud revenue  
increased  
**60%**  
in 2014

**46**  
IBM Cloud data  
centers worldwide  
will be in place  
by the end of 2015

**\$4B**  
invested in software-  
as-a-service  
acquisitions for  
business professionals

IBM's cloud business has grown rapidly, thanks to increasing client demand for high-value solutions across public, private and hybrid clouds. **Cloud revenue grew 60 percent**, to \$7 billion, in 2014. One reason for this growth is that we understand the data and architectural requirements of enterprise clients. In 2014 we **globally scaled our hybrid cloud platform** with new data centers. These feature our SoftLayer "pod" design, giving clients local access to virtual and bare metal servers, all integrated with low-latency networking capabilities. IBM's cloud footprint is designed for a business IT future that will be both global and local.

#### IBM BLUEMIX

We are investing \$1 billion in IBM Bluemix to give developers cloud-based tools to design, deploy and manage enterprise-grade apps at start-up speed. It is offered on the **IBM Cloud marketplace**, which features nearly 500 IBM and third-party cloud services.

#### FORGING PARTNERSHIPS

Our partnership with **SAP** is delivering world-leading enterprise applications as services on the IBM Cloud. And our alliance with Chinese Internet giant **Tencent** will bring cloud-based transformation to that country's growing enterprise economy.

#### MAKING HYBRID REAL FOR THE ENTERPRISE

Major innovations for hybrid cloud, introduced in February 2015, offer clients **control, visibility and security** as they use open standards to break down barriers among environments. As we advance IBM's leadership in this space, more than half of our cloud development team is devoted to hybrid cloud services and platforms on open standards.

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# Reimagining work

Mobile and social technologies are changing the way organizations engage with the world, and especially with individuals — consumers, employees, patients, students and citizens. This means reimagining work itself — the ways in which professionals in any field do their jobs. That's why enterprises are now building **new systems of engagement**, infused with their unique expertise and integrated with their critical business systems and data sets. Enabling people to work smarter means putting more **real-time information** and decision-making power literally in the palms of their hands, integrated securely with business processes and workflow.

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## IBM MOBILEFIRST

Drawing upon thousands of patents in mobile and social, our IBM MobileFirst solutions, built for the cloud, provide more than 5,000 enterprise clients with **security, data and analytics integration** and end-to-end device management. Our mobile revenue more than tripled in 2014.

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## IBM INTERACTIVE EXPERIENCE

Reimagining work also means transforming how products and services are created, delivered and used. We are globally expanding our hybrid consulting and digital agency services to help clients create **new, personalized models of engagement** through data and design. The 10 new IBM Interactive Experience studios allow clients to work side-by-side with researchers and consultants, as well as experts in experience design, mobile and digital marketing.

# NO. 1

IBM Interactive Experience is the world's largest digital agency

We now have

# 6,000

IBM mobile consultants and experts

# 100

industry specific IBM MobileFirst for iOS apps to be developed

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## APPLE + IBM

Apple and IBM are developing intuitive business apps for professionals across multiple industries — from flight crews and retailers, to bankers, financial advisors, insurance agents, government caseworkers and law enforcement officers. We currently have 14 **IBM MobileFirst for iOS** apps in market, and many more are planned by the end of 2015. Built exclusively for iPhone and iPad, these apps are delivered in a security-rich environment, embedded with analytics and linked to core enterprise processes.

# Rethinking the challenge of security

Cybersecurity attacks can go undetected for months. Security for complex, 21st century enterprises is no longer only about building “firewalls” to keep intruders out. It’s now a Big Data problem — which is why IBM is the **global leader in enterprise IT security**. Our unique analytics capabilities anticipate and protect against a fluid threat landscape and a new generation of organized cybercriminals. IBM’s intelligent immune systems can detect even the smallest anomalies, in time to protect an organization’s vital data.

#### SECURITY ANALYTICS

Our security software and services help clients protect against advanced threats. We offer analytics, fraud protection, identity and access management, and leading application, data and infrastructure security capabilities — as well as cloud and mobile solutions to help clients innovate without increasing risk. For example, in 2014 IBM introduced the **Threat Protection System** which includes an end-to-end architecture of analytics and forensics software that helps organizations continuously prevent, detect and respond to ongoing and sophisticated cyberattacks, and in many cases, eliminate the threat before the damage has occurred.

#### SECURITY OPERATIONS CENTERS

Over the past decade, we have spent nearly \$2 billion on security research and development resulting in 3,700 security-related patents. Our 10 global **Security Operations Centers** manage and monitor 15 billion events daily. We help protect more than 10,000 clients worldwide.

# 15B

events monitored  
and managed  
each day

Security revenue  
increased

# 19%

in 2014

Double-digit  
revenue growth  
in security for

# 9

straight quarters

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# Creating new infrastructure for a new era

With the onset of **real-time Big Data**, hybrid clouds and an increasingly mobile economy, companies' IT infrastructures face unprecedented demands. The world's leading banks, oil and gas companies, retailers, healthcare organizations and more rely on IBM to run their systems of record, manage their data, help to ensure their security and integrate their applications and processes. Our hardware and software foundation is essential to their business — and to ours. Which is why we continuously reinvent our core. During the last 18 months, we have **reimagined the mainframe** for the tremendous growth of mobile workloads, created a breakout **IBM Power Systems** strategy focused on open innovation, developed next-generation **software defined storage** technology and made strategic moves across our portfolio to combine the strengths of middleware, servers and storage for a modern IT backbone. At the same time, we exited businesses that do not offer similar opportunities for innovation and growth.

One z13 mainframe  
can perform

**30,000**

transactions per  
second

IBM software defined  
storage can reduce  
storage costs by up to

**90%**

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### IBM z13

The new z13, launched in January 2015, reinvents the mainframe for the growing mobile economy. Capable of processing **2.5 billion transactions a day**, it incorporates real-time encryption and analytics to exceed consumers' expectations for security, speed and response time.

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### POWER8

IBM debuted new Power Systems servers that allow data centers to manage Big Data with unprecedented speed, on an open server platform. Built on IBM's POWER8 technology, **IBM Power Systems** servers are the result of a \$2.4 billion investment and three-plus years of development, leveraging the innovations in hundreds of IBM patents.

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### OPENPOWER

Through the **OpenPOWER Foundation**, industry leaders are building innovative, custom systems based on the POWER architecture for fully optimized industry and workload-specific solutions. Today, the OpenPOWER Foundation has more than 100 members, including founders Google, IBM, Mellanox, NVIDIA, Tyan and new member Rackspace.

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### SOFTWARE DEFINED STORAGE

Leveraging more than 700 patents in this space, the **IBM Spectrum Storage** portfolio helps clients unify their storage management, store data of all types, and flexibly deploy storage either as software, as an appliance or as a cloud-based service.

**Financial Highlights**

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts)

	2014	2013
<b>For the year ended December 31:</b>		
Revenue	\$ 92,793	\$ 98,367
Net income	\$ 12,022	\$ 16,483
Income from continuing operations	\$ 15,751	\$ 16,881
Operating (non-GAAP) earnings*	\$ 16,702	\$ 18,356
Earnings per share of common stock (continuing operations)		
Assuming dilution	\$ 15.59	\$ 15.30
Basic	\$ 15.68	\$ 15.42
Diluted operating (non-GAAP)*	\$ 16.53	\$ 16.64
Net cash provided by operating activities	\$ 16,868	\$ 17,485
Capital expenditures, net	3,779	3,768
Share repurchases	13,679	13,859
Cash dividends paid on common stock	4,265	4,058
Per share of common stock	4.25	3.70
<b>At December 31:</b>		
Cash, cash equivalents and marketable securities	\$ 8,476	\$ 11,066
Total assets	117,532	126,223
Working capital	9,822	11,196
Total debt	40,804	39,718
Total equity	12,014	22,929
Common shares outstanding (in millions)	991	1,054
Market capitalization	\$158,920	\$197,772
Stock price per common share	\$ 160.44	\$ 187.57

\* See pages 45 and 46 for a reconciliation of net income to operating earnings.

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## OVERVIEW

The financial section of the International Business Machines Corporation (IBM or the company) 2014 Annual Report includes the Management Discussion, the Consolidated Financial Statements and the Notes to Consolidated Financial Statements. This Overview is designed to provide the reader with some perspective regarding the information contained in the financial section.

## Organization of Information

- The Management Discussion is designed to provide readers with an overview of the business and a narrative on the company's financial results and certain factors that may affect its future prospects from the perspective of the company's management. The "Management Discussion Snapshot," beginning on page 23, presents an overview of the key performance drivers in 2014.
- Beginning with the "Year in Review" on page 33, the Management Discussion contains the results of operations for each reportable segment of the business and a discussion of the company's financial position and cash flows. Other key sections within the Management Discussion include: "Looking Forward" on page 64, and "Liquidity and Capital Resources" on page 65.
- Global Financing is a reportable segment that is measured as a stand-alone entity. A separate "Global Financing" section is included in the Management Discussion beginning on page 73.
- The Consolidated Financial Statements are presented on pages 80 through 85. These statements provide an overview of the company's income and cash flow performance and its financial position.
- The Notes follow the Consolidated Financial Statements. Among other items, the Notes contain the company's accounting policies (pages 86 through 96), acquisitions and divestitures (pages 97 through 102), detailed information on specific items within the financial statements, certain contingencies and commitments (pages 122 to 124) and retirement-related plans information (pages 131 to 145).
- The Consolidated Financial Statements and the Notes have been prepared in accordance with accounting principles generally accepted in the United States (GAAP).
- In October 2014, the company announced a definitive agreement to divest its Microelectronics business. The assets and liabilities of the Microelectronics business are reported as held for sale at December 31, 2014. The operating results of the Microelectronics business are reported as discontinued operations. Prior periods have been reclassified to conform to this presentation in the Management Discussion, the Consolidated Financial Statements and the Notes, where applicable, to allow for a meaningful comparison of continuing operations.
- The references to "adjusted for currency" or "at constant currency" in the Management Discussion do not include operational impacts that could result from fluctuations in foreign currency rates. Certain financial results are adjusted

based on a simple mathematical model that translates current period results in local currency using the comparable prior year period's currency conversion rate. This approach is used for countries where the functional currency is the local country currency. This information is provided so that certain financial results can be viewed without the impact of fluctuations in foreign currency rates, thereby facilitating period-to-period comparisons of business performance. See "Currency Rate Fluctuations" on page 71 for additional information.

- Within the financial statements and tables in this Annual Report, certain columns and rows may not add due to the use of rounded numbers for disclosure purposes. Percentages reported are calculated from the underlying whole-dollar numbers.

## Operating (non-GAAP) Earnings

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

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

## FORWARD-LOOKING AND CAUTIONARY STATEMENTS

Certain statements contained in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Any forward-looking statement in this Annual Report speaks only as of the date on which it is made; the company assumes no obligation to update or revise any such statements. Forward-looking statements are based on the company's current assumptions regarding future business and financial performance; these statements, by their nature, address matters that are uncertain to different degrees. Forward-looking statements involve a number of risks, uncertainties and other factors that could cause actual results to be materially different, as discussed more fully elsewhere in this Annual Report and in the company's filings with the Securities and Exchange Commission (SEC), including the company's 2014 Form 10-K filed on February 24, 2015.

## MANAGEMENT DISCUSSION SNAPSHOT

(\$ and shares in millions except per share amounts)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent/Margin Change
Revenue	\$ 92,793	\$ 98,367	(5.7)%*
Gross profit margin	50.0%	49.5%	0.5 pts.
Total expense and other (income)	\$ 26,421	\$ 28,440	(7.1)%
Total expense and other (income)-to-revenue ratio	28.5%	28.9%	(0.4) pts.
Income from continuing operations before income taxes	\$ 19,986	\$ 20,244	(1.3)%
Provision for income taxes from continuing operations	\$ 4,234	\$ 3,363	25.9%
Income from continuing operations	\$ 15,751	\$ 16,881	(6.7)%
Income from continuing operations margin	17.0%	17.2%	(0.2) pts.
Loss from discontinued operations, net of tax	\$ (3,729)	\$ (398)	NM
Net income	\$ 12,022	\$ 16,483	(27.1)%
Earnings per share from continuing operations:			
Assuming dilution	\$ 15.59	\$ 15.30	1.9%
Consolidated earnings per share—assuming dilution	\$ 11.90	\$ 14.94	(20.3)%
Weighted-average shares outstanding			
Assuming dilution	1,010.0	1,103.0	(8.4)%
Assets**	\$117,532	\$126,223	(6.9)%
Liabilities**	\$105,518	\$103,294	2.2%
Equity**	\$ 12,014	\$ 22,929	(47.6)%

\* (4.0) percent adjusted for currency; (1.5) percent adjusted for divestitures and currency.

\*\* At December 31.

NM—Not meaningful

The following table provides the company's operating (non-GAAP) earnings for 2014 and 2013.

(\$ in millions except per share amounts)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
Net income as reported	\$12,022	\$16,483	(27.1)%
Loss from discontinued operations, net of tax	(3,729)	(398)	NM
Income from continuing operations	\$15,751	\$16,881	(6.7)%
Non-operating adjustments (net of tax):			
Acquisition-related charges	670	747	(10.3)
Non-operating retirement-related costs/(income)	280	729	(61.5)
Operating (non-GAAP) earnings*	\$16,702	\$18,356	(9.0)%
Diluted operating (non-GAAP) earnings per share	\$ 16.53	\$ 16.64	(0.7)%

\* See pages 45 and 46 for a more detailed reconciliation of net income to operating earnings.

NM—Not meaningful

In 2014, the company reported \$92.8 billion in revenue, and delivered \$20.0 billion in pre-tax income and diluted earnings per share from continuing operations of \$15.59 as reported and \$16.53 on an operating (non-GAAP) basis. The results of continuing operations exclude a net loss from discontinued operations of \$3.7 billion in 2014 and \$0.4 billion in 2013 related to the expected divestiture of the Microelectronics business. On a consolidated basis, net income in 2014 was \$12.0 billion, with diluted earnings per share of \$11.90. The company generated \$16.9 billion in cash from operations and \$12.4 billion in free cash flow in 2014 enabling shareholder returns of \$17.9 billion in gross common stock repurchases and dividends.

Total consolidated revenue decreased 5.7 percent as reported and 1 percent adjusted for divestitures (3 points) and currency (2 points) in 2014 versus 2013. In 2014, the company divested its industry standard server and customer care businesses. The company's strategy is focused on leading in the areas with the most value in enterprise information technology (IT), and in 2014 the company made tremendous progress in repositioning its portfolio and making investments to shift into these areas.

The company's portfolio includes: strategic imperatives for growth, recurring core franchises and high value transactional businesses. These areas of the portfolio span across all of the company's business segments. Each area of the portfolio has different business model characteristics and objectives. The company's results in 2014 reflected these characteristics.

First, the company has a set of strategic imperatives for growth that are focused on the market shifts in data, cloud and engagement. The model for these combined strategic imperatives is to deliver double-digit revenue growth, with high contribution from Software, which drives a more profitable business mix. In 2014, revenue from cloud, analytics, mobile, social and security solutions

combined increased 16 percent with double-digit growth in each quarter. In total, the strategic imperatives generated \$25 billion in revenue, which represented approximately 27 percent of total revenue. Business analytics revenue of \$17 billion increased 7 percent year to year with growth led by the consulting business as the company helps clients extract value from their data. Cloud revenue of \$7 billion was up 60 percent year to year as client demand grows for higher-value cloud solutions across public, private and hybrid clouds. Cloud delivered as a service revenue increased approximately 75 percent to \$3 billion in 2014, and exited the year with an annual run rate of \$3.5 billion. Cloud revenue also includes the company's foundational offerings where it provides software, hardware and services to clients to build private clouds. In engagement, the mobile business more than tripled year to year with strong growth in MobileFirst driven by the integrated portfolio of offerings. In addition, Social was up 3 percent and Security increased 19 percent year to year.

The company is continuing to shift its investments and resources to the strategic imperatives and solutions that address clients' most critical needs. During 2014, the company spent approximately 6 percent of revenue in research and development and invested approximately \$4 billion on capital investments—supporting actions in a number of areas that will yield financial benefits in the future. For example:

- Launched Bluemix, the company's cloud platform-as-a-service for the enterprise.
- Investing to globally expand the SoftLayer cloud datacenters.
- Investing to bring Watson's capabilities to the enterprise and building a partner ecosystem, effectively creating a market for cognitive computing.
- Introduced cloud application innovations around Watson Analytics and Verse.
- Launched POWER8, and building the OpenPOWER consortium.
- Formed a partnership with Apple for enterprise mobility, with Twitter for big data, and with SAP and Tencent for cloud.

The recurring core franchises include the annuity businesses, and the highly recurring portions of the transactions business, such as mainframe revenue from the largest clients. This content has annuity characteristics, and in many cases, it supports mission critical processes for clients. The model for these combined businesses is to have stable revenue, with improving margins. In 2014, revenue was down approximately 3 percent with a modest decline in margin. The decline was primarily driven by the mainframe product cycle and currency.

The company's high-value transactional businesses include project-based work in services, transactional software, Power Systems and Storage—in areas other than the strategic imperatives. The objective for these businesses is to optimize the business model and maintain margins. In 2014, revenue declined year to year, with gross margins over 40 percent. Performance reflected the

secular challenges faced in some parts of the hardware business as the company works through the transitions resulting from the actions taken to reposition the hardware business for high value.

In 2014, the company divested businesses that no longer fit its strategic profile—industry standard servers, customer care business process outsourcing services and the announced divestiture of the Microelectronics business. These three businesses generated approximately \$7 billion of revenue when reported in 2013, but had a pre-tax loss of approximately \$500 million. The divestitures reduce revenue but improve the company's profit profile, consistent with the shift to higher value.

From a segment perspective, Global Services revenue declined 3.5 percent as reported, but increased 1 percent adjusted for the divestitures (2 points) and currency (2 points). Global Technology Services (GTS) declined 3.7 percent as reported, but increased 2 percent adjusted for the divestitures (3 points) and currency (3 points) with growth in Outsourcing and Integrated Technology Services. Global Business Services revenue decreased 3.1 percent (1 percent adjusted for currency) with Application Outsourcing revenue down 8 percent (6 percent adjusted for currency). Software revenue declined 1.9 percent (1 percent adjusted for currency). Total middleware revenue was flat as reported, but increased 1 percent at constant currency. Systems and Technology revenue decreased 23.0 percent as reported and 17 percent adjusted for the divested industry standard server business (5 points) and currency (1 point). Performance reflected the impact of the System z product cycle as well as declines in Power Systems and Storage. In 2014, the company took significant actions to reposition the Systems and Technology business for higher value, and reinforced its commitment to driving innovation in high-end systems and storage.

From a geographic perspective, revenue in the major markets declined 4.3 percent as reported and 1 percent adjusted for the divestitures (2 points) and currency (1 point). Growth markets revenue decreased 9.9 percent as reported and 3 percent adjusted for the divestitures (3 points) and currency (4 points) compared to the prior year. Within the growth markets, the BRIC countries (Brazil, Russia, India and China) decreased 10.7 percent as reported and 5 percent adjusted for divestitures (3 points) and currency (3 points).

The consolidated gross profit margin of 50.0 percent improved 0.5 points year to year. The operating (non-GAAP) gross margin of 50.6 percent increased 0.1 points compared to the prior year primarily driven by an improved mix toward Software.

Total expense and other (income) decreased 7.1 percent in 2014 versus the prior year. Total operating (non-GAAP) expense and other (income) decreased 6.3 percent compared to the prior year.

The year-to-year drivers were approximately:

	<b>Total Consolidated</b>	<b>Operating (non-GAAP)</b>
• Currency*	(1) point	(1) point
• Acquisitions**	2 points	2 points
• Base expense	(8) points	(7) points

\* Reflects impacts of translation and hedging programs.

\*\* Includes acquisitions completed in prior 12-month period; operating (non-GAAP) is net of non-operating acquisition-related charges.

The reported base expense reflects not only the ongoing run rate of the business, but also the impact of divestitures and workforce rebalancing charges. The company recorded pre-tax gains of \$1.6 billion in 2014 related to the divestitures of the industry standard server (\$1.4 billion) and customer care (\$0.2 billion) businesses. Workforce rebalancing charges in 2014 were \$1.5 billion, an increase of \$0.4 billion year to year. Excluding the gains from the divested businesses and the impact of workforce rebalancing charges, operating (non-GAAP) base expense decreased 3 points year to year versus the 7 point as reported decrease. Within base expense, the company is continuing to shift resources and spending to areas with the most opportunity—including Watson, SoftLayer, Bluemix and support of strategic partnerships, including the Apple partnership.

Pre-tax income from continuing operations decreased 1.3 percent and the pre-tax margin was 21.5 percent, an increase of 1.0 points versus 2013. The continuing operations effective tax rate for 2014 was 21.2 percent, an increase of 4.6 points versus the prior year primarily driven by benefits in the 2013 rate associated with discrete items. Income from continuing operations of \$15.8 billion decreased 6.7 percent and the net income margin was 17.0 percent, a decrease of 0.2 points versus 2013. Losses from discontinued operations, net of tax, were \$3.7 billion in 2014 compared to \$0.4 billion 2013. Net income of \$12.0 billion decreased \$4.5 billion year to year. Operating (non-GAAP) pre-tax income from continuing operations decreased 4.4 percent year to year and the operating (non-GAAP) pre-tax margin from continuing operations improved 0.3 points to 22.8 percent versus the prior year. Operating (non-GAAP) income from continuing operations of \$16.7 billion decreased 9.0 percent and the operating (non-GAAP) income margin from continuing operations of 18.0 percent decreased 0.7 points. The operating (non-GAAP) effective tax rate from continuing operations in 2014 was 21.0 percent versus 17.0 percent in 2013.

Diluted earnings per share from continuing operations of \$15.59 increased 1.9 percent year to year reflecting the benefits of the common stock repurchase program. In 2014, the company repurchased 71.5 million shares of its common stock. Operating (non-GAAP) diluted earnings per share of \$16.53 decreased 0.7 percent versus the prior year driven primarily by the impacts of decreased revenue and the higher tax rate, partially offset by the impact of share repurchases. Diluted earnings per share from discontinued operations was (\$3.69) in 2014 compared to (\$0.36) in 2013.

At December 31, 2014, the company continued to have the financial flexibility to support the business over the long term. Cash and marketable securities at year end was \$8.5 billion, a decrease of \$2.6 billion from December 31, 2013. Key drivers in the balance sheet and total cash flows were:

Total assets decreased \$8.7 billion (\$2.7 billion adjusted for currency) from December 31, 2013 driven by:

- Decreases in prepaid pension assets (\$3.4 billion), property, plant and equipment (\$3.1 billion) driven primarily by the expected divestiture of the Microelectronics business (\$2.4 billion), cash and cash equivalents (\$2.2 billion) and total receivables (\$1.7 billion); partially offset by
- Increased deferred taxes (\$2.2 billion).

Total liabilities increased \$2.2 billion (\$7.0 billion adjusted for currency) from December 31, 2013 driven by:

- Increases in pension liabilities (\$2.0 billion) and total debt (\$1.1 billion).

Total equity of \$12.0 billion decreased \$10.9 billion from December 31, 2013 as a result of:

- Increased treasury stock (\$13.5 billion) primarily from share repurchases, and increased losses in accumulated other comprehensive income/(loss) (\$6.3 billion), driven primarily by the year-end remeasurement of the retirement-related liabilities; partially offset by
- Higher retained earnings (\$7.8 billion) and higher common stock (\$1.1 billion).

The company generated \$16.9 billion in cash flow provided by operating activities, a decrease of \$0.6 billion when compared to 2013, driven primarily by a higher level of cash tax payments (\$1.7 billion). Net cash used in investing activities of \$3.0 billion was \$4.3 billion lower than 2013, primarily due to a decrease in cash used for acquisitions (\$2.4 billion) and an increase in cash provided from divestitures (\$2.1 billion). Net cash used in financing activities of \$15.5 billion increased \$5.6 billion compared to the prior year, driven primarily by lower net cash proceeds from total debt (\$5.2 billion).

In 2014, the company made significant progress in its continuing transformation, investing to position the business for the longer term. In January 2015, the company disclosed that it is expecting GAAP earnings in the range of \$14.35 to \$15.10 and operating (non-GAAP) earnings between \$15.75 and \$16.50 per diluted share from continuing operations for 2015. The company also stated that it expects free cash flow in 2015 to be relatively flat compared to 2014.

For the first quarter of 2015, the company expects mid single-digit earnings per share growth from continuing operations, primarily driven by the large workforce rebalancing charge that was recorded in the first quarter of 2014.

## DESCRIPTION OF BUSINESS

*Please refer to IBM's Annual Report on Form 10-K filed with the SEC on February 24, 2015 for a more detailed version of this Description of Business, especially Item 1A, entitled "Risk Factors."*

The company creates value for clients through integrated solutions and products that leverage: data, information technology, deep expertise in industries and business processes, and a broad ecosystem of partners and alliances. IBM solutions typically create value by enabling new capabilities for clients that transform their businesses and help them engage with their customers and employees in new ways. These solutions draw from an industry-leading portfolio of consulting and IT implementation services, cloud and cognitive offerings, and enterprise systems and software; all bolstered by one of the world's leading research organizations.

### Strategy

In a time of unprecedented technological change, IBM's strategy remains one of innovation and a constant drive to deliver higher value for our clients.

Key tenets of the company's strategy include:

**1. Our strategic imperatives:** Data, cloud and engagement are fundamentally transforming the IT industry, the company and our clients' businesses. The tremendous growth of data is redefining today's competitive advantage. With data as the world's new "natural resource," it is fundamentally transforming industries and professions. Yet as with all natural resources, only by refining data into actionable insights through analytics does it become valuable to the customer's business. Cloud computing—the delivery of IT and business processes as digital services—offers opportunities for enterprises to reinvent not just their operations, but their entire business model and approaches to innovation. Engagement, including mobile and social technologies, is profoundly changing how people interact and the way work gets done. Finally, these transformations are all supported and protected by high levels of security to ensure privacy and integrity of action. These three imperatives—data, cloud and engagement—are the foundation of IBM's strategy today and its vision for the future.

**2. Our unique strength:** Our ability to connect new technologies with the systems currently running today's enterprises is a key value-added service and market differentiator for IBM. Clients today want more than just adopting new technologies—they want IBM to fuse new solutions with their existing systems. This "bringing together" is what the company calls Hybrid Cloud, and IBM is uniquely able to bring this value to its clients.

**3. Our migration to higher levels of business value:** Clients look to IBM to solve their business challenges and opportunities rather than just providing technology. Our evolution over decades—from hardware to software and services, and increasingly to full-fledged business solutions—reflects this critical shift in meeting client needs. IBM brings together the full breadth of its integrated offerings and industry expertise to be essential to its clients and deliver higher value.

## 1. Our Strategic Imperatives

### Data: transforming industries and professions

Fueled by the proliferation of mobile devices, social media and the infusion of technology into virtually all aspects of business, data is the world's new natural resource. Without powerful analytics, however, it is just data.

Across all industries, enterprises are working hard to harvest new insights from the explosion of available data—the new basis for today's competitive advantage. The advantage for enterprises increases as they apply more sophisticated approaches to refining their data, turning them into insights that are actionable and add value. The advent of cognitive computing, which mirrors the same cognitive process that people use every day to understand the world around them, is profoundly redefining the relationship between humans and information. Cognitive systems learn, navigate the language and protocols of expert communities, and communicate in natural language.

IBM has invested more than \$26 billion, including over \$17 billion on more than 30 acquisitions, to build its capabilities in big data and analytics. One third of IBM Research's spending is focused on data, analytics and cognitive computing.

In 2014, IBM reported nearly \$17 billion in business analytics revenue, and the company established the Watson Group to develop and commercialize cognitive computing innovations. The company has committed a \$1 billion investment to Watson, including \$100 million dedicated to venture investments to support start-ups building cognitive apps through the Watson Developer Zone on Bluemix. The company is also making Watson more widely available through the Watson Ecosystem, which has grown to more than 160 partners with nearly 4,000 future partners seeking to build a new generation of cognitive apps. IBM also launched Watson Analytics, a breakthrough natural language-based cognitive service that provides instant access to powerful predictive and visual analytic tools for businesses. Through Watson Analytics, IBM is extending analytics to the end user, not just the data scientist. IBM's goal is to give every business professional access to advanced cognitive-powered predictive analytics, coupled with new forms of data.

In addition in 2014, the company made bold moves by establishing key alliances. In the data space, the company announced a ground-breaking partnership with Twitter to incorporate Twitter's massive data streams into IBM's cloud-based analytics, customer engagement platforms and consulting services. Enterprises will now be able to understand customer sentiment more deeply and anticipate sudden shifts in moods and markets by tapping into the Twitter data in powerful new ways. This capability will also allow clients to integrate Twitter data into their own cloud services and mobile apps.

### Cloud: reinventing IT

Cloud is at the heart of the digital revolution. No enterprise is untouched by this revolution and the shifts are occurring rapidly.

Enterprises are benefitting from cloud by using it to transform their IT and business processes into digital services. Much has been written about how cloud enables the sharing of infrastructure—this is true. However the real promise of cloud is much more profound. By forcing greater levels of standards up and down the technology value chain, new products and services, and even entire business models, are able to be created in weeks rather than months or years.

Cloud is a catalyst for innovation. IBM has invested more than \$8 billion to acquire 18 companies related to cloud, and is investing more than \$1 billion to expand its global footprint to 40 datacenters worldwide. IBM now has more than 120 software-as-a-service (SaaS) offerings, and IBM Cloud supports 24 of the top 25 Fortune 500 companies, driving \$7 billion of revenue for cloud-based solutions in 2014.

- SoftLayer is the foundation for IBM's expansive infrastructure-as-a-service portfolio. It offers bare metal, private cloud and virtual server instances, which means it can cover many different workloads with unprecedented performance. SoftLayer offers a built-in private network which can handle huge capacity and gives users the ability to isolate public/private networks with controls for access and location of data.
- Bluemix is IBM's platform-as-a-service, built on the open standards foundation of Cloud Foundry and powered by SoftLayer's cloud infrastructure. SoftLayer offers cloud-based services, APIs and leading third-party services to developers in an integrated platform. Bluemix also allows them to mix and match different tools to build apps in the cloud for mobile, Web, big data and analytics—to name just a few.
- IBM Cloud marketplace brings together the company's vast portfolio of cloud capabilities, delivering a self-service, digital experience for developers, IT and business leaders. Visitors have access to a growing portfolio of cloud capabilities from IBM and qualified third-party vendors. Open integration including pre-built APIs and hybrid options enable enterprise integration and composable business models.

The IBM Cloud is the most powerful choice for enterprise-grade environments—bringing unparalleled levels of security, performance and scalability. As a result, in 2014, IBM formed a strategic alliance with SAP to run its business applications on IBM's cloud.

### Engagement: re-imagining work

Social, mobile and unprecedented access to data are changing how individuals and institutions work together. A new class of customer has emerged: one who is empowered with knowledge, enriched by networks and expects value in return for sharing information. Enterprises must create a systematic approach to engage these newly empowered customers through more personalized interactions. IBM calls these new forms of interactions “engagement”—and includes social collaboration and mobile—both underpinned by high levels of security.

In 2014, the mobile, social and security portfolio generated double-digit growth with mobile revenue more than tripling versus 2013, security revenue up 19 percent and social business growing 3 percent. In addition, IBM has acquired 23 companies related to mobile, social and security.

On the mobile front, IBM and Apple formed an historic partnership to transform enterprise mobility as we know it today. Together, IBM and Apple are joining forces to bring the ease-of-use of personal apps to the enterprise environment. Together, the two companies are bringing the first wave of industry-specific apps to the market—targeting the needs of individual workers and helping to solve long-standing industry challenges.

In addition, MobileFirst remains IBM's unified approach to help clients and partners deliver best-in-class mobile solutions, take advantage of more commercial opportunities and provide a superior customer experience.

On the social collaboration front, in 2014, IDC named IBM the worldwide market share leader in Enterprise Social Software for the fifth consecutive year.<sup>(1)</sup> In addition, IBM Verse, powered by IBM analytics and advanced search, is a new cloud-based messaging and social collaboration solution to manage the workday. It provides a seamless user experience across social networking, meetings, chat, documents, mail, and an array of intelligent, security-rich and engaging social apps on mobile devices or the Web.

Security is a boardroom-level issue. It is also a key enabler for the continued growth of data, cloud and engagement. Enterprises—and their clients—demand that these activities be secure as a requirement for participation.

The magnitude, sophistication and complexity of today's security threats are growing. With the proliferation of data on mobile devices, in social media and in the cloud, breaches are more visible and occur on a heightened scale. IBM Security solutions use sophisticated analytics to identify and thwart attacks in real time—protecting our clients' information, processes and people.

IBM Security brings to our clients high-end consulting, advanced fraud and threat protection, identity and access management, application and data security, mobile and cloud security, network and end-point protection with services for cloud.

<sup>(1)</sup> IDC Worldwide Enterprise Social Networks 2014–2018 Forecast and 2013 Vendor Shares, July 23, 2014.

## 2. Our Unique Strength

Data, cloud and engagement are powerful forces changing the landscape of technology and businesses. However, enterprise clients need more. Enterprises need to bring this new world of technology together with the existing systems that currently run their businesses if they are to capture their full value. This combination is what we refer to as Hybrid Cloud.

Without bringing these worlds together, these new technologies become “islands” within the enterprise. For example, a business that invests in a social media platform engages with and captures the sentiment of individual customers. These can be valuable interactions. However, much deeper insight into the needs and wants of an individual customer comes when combining the social media interactions with the historical purchase and engagement records of that customer—as stored in existing systems. By combining these insights, the enterprise personalizes interactions in ways that are relevant and meaningful to that customer.

IBM is unique in bringing this Hybrid world to its clients with our unparalleled strength in both the existing and the new worlds of IT.

IBM supports its clients’ mission critical processes, and remains the “go-to” platform for the enterprise. For example, more than 90 percent of the top 100 banks and the top 25 U.S. retailers run on IBM systems. In addition, nearly half of the Fortune 100 companies outsource IT operations to IBM. The company’s leadership in enterprise computing provides the foundation for strategic partnerships as leading companies want to work with IBM, as evidenced by the Apple, SAP, Twitter and Tencent partnerships announced in 2104.

Combine this with the company’s strength in the new worlds of data, cloud and engagement—and IBM brings a unique and important capability to the market.

## 3. Our Migration to Higher Value

Technology by itself does not create value for a business. Technology enables a business to achieve its aspirations by facilitating richer interactions with clients and ecosystems, by unlocking deeper insight and by enabling faster actions.

IBM has continuously evolved its mission to deliver increasingly higher levels of business value to its clients. Starting primarily as a hardware company, IBM has added a rich portfolio of software and services to add higher value.

This next phase of IBM’s transformation will realize the full breadth of the portfolio by bringing higher-value added solutions to our clients. Examples include:

- Using predictive analytics to reduce customer attrition rates through the IBM Customer Data solution.
- Detecting fraudulent claims before payments are made through the IBM Counter Fraud solution.
- Preventing costly and unscheduled downtime of equipment through early detection of anomalies with the IBM Predictive Asset Optimization solution.

The focus on integrated solutions will make IBM a stronger partner with its clients as the company takes another step in its continuous evolution to higher levels of value.

## Summary

One constant throughout IBM’s over 100-year history has been the need to continually transform the company in an ever-changing industry. Our industry, our clients—and IBM itself—is in the midst of such a fundamental transformation.

This is a transformation of unparalleled growth and promise:

- The promise of technology to bring extraordinary levels of insight to human endeavors through advances in analytics and cognitive computing.
- The promise of the cloud as a catalyst for innovation, freeing enterprises to focus more on the uses of technology rather than just the technology itself.
- The promise of enterprises engaging with their customers, their employees and their business partners through richer, more personalized means.
- All underscored by security to help protect the integrity of every interaction.

We are excited about the prospects for growth and value for our clients—and for IBM—and we look forward to helping our clients transform their businesses for the future.

## Business Model

The company’s business model is built to support two principal goals: helping enterprise clients to become more innovative, efficient and competitive through the application of business insight and IT solutions; and providing long-term value to shareholders. The business model has been developed over time through strategic investments in capabilities and technologies that have superior long-term growth and profitability prospects based on the value they deliver to clients.

The company’s global capabilities include services, software, systems, fundamental research and related financing. The broad mix of businesses and capabilities are combined to provide integrated solutions to the company’s clients.

The business model is dynamic, adapting to the continuously changing market and economic environment. The company continues to divest certain businesses and strengthen its position through strategic organic investments and acquisitions in higher-value areas. In addition, the company has transformed itself into a globally integrated enterprise which has improved overall productivity and is driving investment and expanding participation in markets with significant long-term opportunity.

This business model, supported by the company’s financial model, has enabled the company to deliver strong earnings, cash flows and returns to shareholders over the long term.

## Business Segments and Capabilities

The company’s major operations consists of five business segments: Global Technology Services and Global Business Services, which the company collectively calls Global Services, Software, Systems and Technology and Global Financing.

*Global Services*: is a critical component of the company's strategy of providing IT infrastructure and business insight and solutions to clients. While solutions often include industry-leading IBM software and systems, other suppliers' products are also used if a client solution requires it. Approximately 60 percent of external Global Services segment revenue is annuity based, coming primarily from outsourcing and maintenance arrangements. The Global Services backlog provides a solid revenue base entering each year. Within Global Services, there are two reportable segments: Global Technology Services and Global Business Services.

**Global Technology Services (GTS)** primarily provides IT infrastructure and business process services, creating business value for clients through unique technology and IP integrated services within its global delivery model. By leveraging insights and experience drawn from IBM's global scale, skills and technology, with applied innovation from IBM Research, clients gain access to leading-edge, high-quality services with improved productivity, flexibility, cost and outcomes.

#### GTS Capabilities

*Strategic Outsourcing*: delivers comprehensive IT outsourcing services dedicated to transforming clients' existing infrastructures to consistently deliver improved quality, flexibility, risk management and financial value. The company integrates long-standing expertise in service management and technology with the ability to exploit the power of new technologies from IBM systems and software, such as cloud computing, analytics and virtualization, to deliver high performance, innovation and improved ability to achieve business objectives.

*Global Process Services*: included within Strategic Outsourcing, delivers a range of offerings consisting of standardized through transformational solutions including processing platforms and business process outsourcing. These services deliver improved business results to clients through the strategic change and/or operation of the client's business processes, applications and infrastructure. Global Process Services will be integrated within Global Business Services beginning in 2015.

*Integrated Technology Services*: delivers a portfolio of project-based and managed services that enable clients to transform and optimize their IT environments by driving efficiency, flexibility and productivity, while reducing costs. The standardized portfolio is built around key assets and patented software, and incorporates best practices and proven methodologies that ensure predictive quality of delivery, security and compliance.

*Cloud*: delivers a comprehensive set of cloud services ranging from assisting clients with building their own private clouds, to building customized dedicated managed clouds, to allowing clients to leverage standardized cloud infrastructure services from the SoftLayer and Cloud Managed Services offerings, to creating hybrid environments linking their private and public workloads together. This portfolio of cloud offerings spans across the GTS business lines.

*Technology Support Services (Maintenance Services)*: delivers a complete line of support services from product maintenance through solution support to maintain and improve the availability of clients' IT infrastructures.

**Global Business Services (GBS)** has the mission to deliver predictable business outcomes to the company's clients across two primary business areas: Consulting and Systems Integration and Application Management Services. These professional services deliver business value and innovation to clients through solutions which leverage industry and business process expertise. The role of GBS is to drive initiatives that integrate IBM content and solutions and drive the progress of the company's strategic imperatives. As clients transform themselves in response to market trends like big data, social and mobile computing, GBS helps clients use these technologies to reinvent relationships with their customers and realize new standards of efficacy and efficiency in the internal processes, data and applications that they use to run their businesses.

#### GBS Capabilities

*Consulting and Systems Integration*: delivering client value with solutions in Strategy and Transformation, Application Innovation Services, Enterprise Applications and Smarter Analytics. Consulting is also focused on bringing to market client solutions that drive Smarter Commerce, Cloud, Mobile and Social Business.

*Application Management Services*: delivers application management, maintenance and support services for packaged software, as well as custom and legacy applications. Value is delivered through advanced capabilities in areas such as application testing and modernization, cloud application services, the company's highly differentiated globally integrated capability model, industry knowledge and the standardization and automation of application management.

**Software** consists primarily of middleware and operating systems software. Middleware software enables clients to integrate systems, processes and applications across a standard software platform to improve their business results, solve critical problems and gain competitive advantage within their industries. IBM middleware is designed on open standards, making it easier to integrate disparate business applications, developed by different methods and implemented at different times. Operating systems are the software engines that run computers. Approximately 70 percent of external Software segment revenue is annuity based, coming from recurring license charges, software sold "as a service" and ongoing post-contract support. The remaining revenue relates to one-time charge (OTC) arrangements in which clients pay one, up-front payment for a perpetual license. Typically, the sale of OTC software includes one year of post-contract support. Clients can also purchase ongoing post-contract support after the first year, which includes unspecified product upgrades and technical support.

### Software Capabilities

*WebSphere:* delivers capabilities that enable organizations to run high-performance business applications. With these applications, clients can integrate and manage business processes across their organizations with the flexibility and agility they need to respond to changing conditions. Built on services-oriented architecture (SOA), and open standards support for cloud, mobile and social interactions, the WebSphere platform enables enterprises to extend their reach and optimize interactions with their key constituents. Smarter Commerce software helps companies better manage and improve each step of their value chain and capitalize on opportunities for profitable growth, efficiency and increased customer loyalty.

*Information Management:* enables clients to integrate, manage and analyze enormous amounts of data from a large variety of sources in order to gain competitive advantage and improve their business outcomes. With this approach, clients can extract real value out of their data and use it to make better business decisions. IBM's middleware and integrated solutions include advanced database management, information integration, data governance, enterprise content management, data warehousing, business analytics and intelligence, predictive analytics and big data analytics.

*Watson Solutions:* the first commercially available cognitive computing platform that has the ability to interact in natural language, processing vast amounts of big data, and learning from its interactions with people and computers. As an advisor, Watson is able to sift through and understand large amounts of data delivering insights with unprecedented speeds and accuracy.

*Tivoli:* helps clients optimize the value they get from their infrastructures and technology assets through greater visibility, control and automation across their end-to-end business operations. These asset management solutions foster integrated service delivery for cloud and datacenter management, enterprise endpoint and mobile device management, asset and facilities management, and storage management. Tivoli includes security systems software that provides clients with a single security intelligence platform that enables them to better secure all aspects of their enterprise and prevent security breaches.

*Workforce Solutions:* enables businesses to connect people and processes for more effective communication and increased productivity through collaboration, messaging and social networking software. By remaining at the forefront of collaboration tools, IBM's social business offerings help organizations reap real benefits associated with social networking, as well as create a more efficient and effective workforce.

*Rational:* supports software development for both IT and complex embedded system solutions, with a portfolio of products and solutions supporting DevOps and Smarter Product Development, transforming the way lines of business, development and operations work together to deliver innovation via software.

*Mobile:* spans middleware and offers customers true end-to-end mobile solutions across platform and application development, mobile security, and mobile device management. Leveraging powerful analytics and usage data, customers are provided with the ability to have more compelling interactions with their clients and workforce, increasing touchpoints and deepening relationships. The mobile offerings provide the ability to increase workforce productivity through enhanced collaboration, improved knowledge sharing and increased response speed.

In January 2015, the company made several changes designed to more effectively align its key capabilities and resources to its strategic imperatives. These changes will enable the company to respond more quickly to critical client agendas and drive higher value. Across Software, the company is transitioning its portfolio to capture growth and continue to drive innovation. The focus will be centered around analytics, security, and commerce—similar to the action the company implemented in 2014 with Watson—utilizing its software assets to improve speed and agility in bringing integrated solutions to its clients.

**Systems and Technology (STG)** provides clients with innovative infrastructure technologies to help meet the new requirements of data, cloud and engagement—from deploying advanced analytics, to moving to digital service delivery with the cloud, and securing mobile transaction processing. Approximately half of Systems and Technology's server and storage sales transactions are through the company's business partners; with the balance direct to end-user clients. In addition, Systems and Technology provides leading semiconductor technology, products and packaging solutions for IBM's own advanced technology needs.

### Systems and Technology Capabilities

*Servers:* a range of high-performance systems designed to address capacity, security, speed and compute power needs for businesses, organizations and technical computing applications. After the divestiture of the System x industry standard server business, the portfolio includes System z, a trusted enterprise platform for integrating data, transactions and insight, and Power Systems, a system designed from the ground up for big data, optimized for scale-out cloud and Linux, and delivering open innovation with OpenPOWER. The company is also a founding member of the OpenPOWER foundation, a group of industry-leading companies working together to develop high-performance compute solutions based on the IBM POWER architecture.

*Storage:* data storage products and solutions that allow clients to retain and manage rapidly growing, complex volumes of digital information. These solutions address critical client requirements for information retention and archiving, security, compliance and storage optimization including data deduplication, availability and virtualization. The portfolio consists of a broad range of software defined storage solutions, disk and tape storage systems and Flash storage and solutions.

*Technology:* the company's continued leadership in systems requires ongoing investments in semiconductor and material science research and development that drives innovation that matters for our clients. In 2014, the company announced a definitive agreement to divest its Microelectronics business and manufacturing operations. This transaction is expected to close in 2015.

**Global Financing** facilitates IBM clients' acquisition of information technology systems, software and services by providing financing solutions in the areas where the company has the expertise. The financing arrangements are predominantly for products or services that are critical to the end users' business operations. These financing contracts are entered into after a comprehensive credit evaluation and are secured by legal contracts. As a captive financier, Global Financing has the benefit of both deep knowledge of its client base and a clear insight into the products and services financed. These factors allow the business to effectively manage two of the major risks, credit and residual value, associated with financing while generating strong returns on equity. Global Financing also maintains a long term partnership with the companies' clients through various stages of IT asset life cycle—from initial purchase and technology upgrades to asset disposition decisions.

#### **Global Financing Capabilities**

*Client Financing:* lease and loan financing to end users and internal clients for terms up to seven years. Assets financed are primarily IT products and services where the company has expertise. Internal financing is predominantly in support of Global Services' long-term client service contracts. Global Financing also factors a selected portion of the company's accounts receivable, primarily for cash management purposes. All internal financing arrangements are at arm's-length rates and are based upon market conditions.

*Commercial Financing:* short-term inventory and accounts receivable financing to dealers and remarketers of IBM and OEM products.

*Remanufacturing and Remarketing:* used equipment is returned from lease transactions, or may be surplus equipment internally or externally purchased. These assets may be refurbished or upgraded and sold or leased to new or existing clients both externally or internally. Externally remarketed equipment revenue represents sales or leases to clients and resellers. Internally remarketed equipment revenue primarily represents used equipment that is sold internally to Systems and Technology and Global Services. Systems and Technology may also sell the equipment that it purchases from Global Financing to external clients.

#### **IBM Worldwide Organizations**

The following worldwide organizations play key roles in IBM's delivery of value to its clients:

- Sales and Distribution
- Research, Development and Intellectual Property
- Integrated Supply Chain

#### **Sales and Distribution**

IBM has a significant global presence, operating in more than 175 countries, with an increasingly broad-based geographic distribution of revenue. The company's Sales and Distribution organization manages the IBM global footprint, with dedicated country-based operating units focused on delivering unique value and superior experiences for clients. Within these units, client relationship professionals work with integrated teams of consultants, product specialists and delivery fulfillment teams to enable clients' business growth and innovation. These teams deliver value by understanding the clients' businesses and needs, and then bring together capabilities from across IBM and an extensive network of Business Partners to develop and implement solutions.

By combining global expertise with local experience, IBM's geographic structure enables dedicated management focus for local clients, speed in addressing new market opportunities and timely investments in emerging opportunities. The geographic units align industry-skilled resources to serve clients' agendas. IBM extends capabilities to mid-market client segments by leveraging industry skills with marketing, Inside Sales and local Business Partner resources.

The company continues to invest to capture the long-term opportunity in key growth markets around the world—China, India and countries within Southeast Asia, Eastern Europe, the Middle East, Africa and Latin America. The company's major markets include the G7 countries of Canada, France, Germany, Italy, Japan, the United States (U.S.) and the United Kingdom (UK) plus Austria, the Bahamas, Belgium, the Caribbean region, Cyprus, Denmark, Finland, Greece, Iceland, Ireland, Israel, Malta, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.

#### **Research, Development and Intellectual Property**

IBM's research and development (R&D) operations differentiate the company from its competitors. IBM annually invests approximately 6 percent of total revenue for R&D, focusing on high-growth, high-value opportunities. IBM Research works with clients and the company's business units through global labs on near-term and mid-term innovations. It contributes many new technologies to IBM's portfolio every year and helps clients address their most difficult challenges. IBM Research also explores the boundaries of science and technology—from nanotechnology to future systems, big data analytics, secure clouds and to IBM Watson, a "cognitive" learning system.

IBM Research also focuses on differentiating IBM's services businesses, providing new capabilities and solutions. It has the world's largest mathematics department of any public company, enabling IBM to create unique analytic solutions and actively engage with clients on their toughest challenges.

In February 2015, the company announced a new IBM Research lab to be located in South Africa. This will be IBM Research's 13th global lab.

In 2014, IBM was awarded more U.S. patents than any other company for the 22nd consecutive year. IBM's 7,534 patents awarded in 2014 represent a diverse range of inventions poised to enable significant innovations that will position the company to compete and lead in the emerging opportunities represented by cloud, big data and analytics, security, social and mobile. These inventions also will advance the new era of cognitive systems where machines will learn, reason and interact with people in more natural ways. It was the most U.S. patents ever awarded to one company in a single year.

The company continues to actively seek intellectual property (IP) protection for its innovations, while increasing emphasis on other initiatives designed to leverage its IP leadership. Some of IBM's technological breakthroughs are used exclusively in IBM products, while others are licensed and may be used in IBM products and/or the products of the licensee. While the company's various proprietary IP rights are important to its success, IBM believes its business as a whole is not materially dependent on any particular patent or license, or any particular group of patents or licenses. IBM owns or is licensed under a number of patents, which vary in duration, relating to its products.

### **Integrated Supply Chain**

IBM has an extensive integrated supply chain, procuring materials and services globally. In 2014, the company also managed approximately \$21.8 billion in procurement spending for its clients through the Global Process Services organization. The supply, manufacturing and logistics operations are integrated in one operating unit that has optimized inventories over time. Simplifying and streamlining internal processes has improved sales force productivity and operational effectiveness and efficiency. Supply chain resiliency enables IBM to reduce its risk during marketplace changes.

The company continues to derive business value from its own globally integrated supply chain providing a strategic advantage for the company to create value for clients. IBM leverages its supply chain expertise for clients through its supply chain business transformation outsourcing service to optimize and help operate clients' end-to-end supply chain processes, from procurement to logistics. Utilizing analytics, mobile, cloud and social—with numerous projects, has allowed the integrated supply chain to drive positive business outcomes for the company and its clients.

## YEAR IN REVIEW

### Results of Continuing Operations

#### Segment Details

The following is an analysis of the 2014 versus 2013 reportable segment results. The table below presents each reportable segment's external revenue and gross margin results. Segment pre-tax income includes transactions between segments that are intended to reflect an arm's-length transfer price and excludes certain unallocated corporate items; see note T, "Segment Information," on pages 145 to 150 for additional information.

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent/ Margin Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Revenue</b>				
Global Technology Services	<b>\$37,130</b>	\$38,551	(3.7)%	1.6%*
Gross margin	<b>38.3%</b>	38.1%	0.2 pts.	
Global Business Services	<b>17,825</b>	18,396	(3.1)%	(1.1)%
Gross margin	<b>30.8%</b>	30.9%	0.0 pts.	
Software	<b>25,434</b>	25,932	(1.9)%	(0.9)%
Gross margin	<b>88.6%</b>	88.8%	(0.2) pts.	
Systems and Technology	<b>9,996</b>	12,988	(23.0)%	(16.8)%*
Gross margin	<b>39.5%</b>	40.8%	(1.3) pts.	
Global Financing	<b>2,034</b>	2,022	0.6%	3.0%
Gross margin	<b>49.4%</b>	45.6%	3.7 pts.	
Other	<b>374</b>	478	(21.7)%	(20.4)%
Gross margin	<b>(215.0)%</b>	(195.6)%	(19.4) pts.	
<b>Total consolidated revenue</b>	<b>\$92,793</b>	\$98,367	(5.7)%	(1.5)%*
<b>Total consolidated gross profit</b>				
	<b>\$46,407</b>	\$48,684	(4.7)%	
Total consolidated gross margin	<b>50.0%</b>	49.5%	0.5 pts.	
Non-operating adjustments				
Amortization of acquired intangible assets	<b>416</b>	388	7.2%	
Acquisition-related charges	<b>—</b>	5	(100.0)%	
Retirement-related costs/(income)	<b>173</b>	629	(72.4)%	
<b>Operating (non-GAAP) gross profit</b>	<b>\$46,996</b>	\$49,706	(5.5)%	
Operating (non-GAAP) gross margin	<b>50.6%</b>	50.5%	0.1 pts.	

\* Adjusted for divestitures and currency.

### Global Services

In 2014, the Global Services segments, Global Technology Services (GTS) and Global Business Services (GBS), delivered revenue of \$54,954 million, a decrease of 3.5 percent as reported, but an increase of 1 percent adjusted for the divestitures of the customer care and industry standard server businesses (2 points) and currency (2 points). Pre-tax income decreased 8.4 percent and the

pre-tax margin decreased 0.8 points to 16.5 percent. Total outsourcing revenue of \$24,520 million decreased 6.3 percent as reported, but was flat year to year when adjusted for currency (2 points) and the divestitures (4 points). Total transactional revenue of \$23,581 million decreased 0.4 percent, but increased 2 percent adjusted for currency.

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Global Services external revenue</b>	<b>\$54,954</b>	\$56,947	(3.5)%	0.7%*
Global Technology Services	<b>\$37,130</b>	\$38,551	(3.7)%	1.6%*
Outsourcing	<b>20,770</b>	22,060	(5.8)	1.2*
Integrated Technology Services	<b>9,506</b>	9,380	1.3	3.7
Maintenance	<b>6,853</b>	7,111	(3.6)	(0.1)*
Global Business Services	<b>\$17,825</b>	\$18,396	(3.1)%	(1.1)%
Outsourcing	<b>3,750</b>	4,097	(8.5)	(6.1)
Consulting and Systems Integration	<b>14,075</b>	14,298	(1.6)	0.4

\* Adjusted for divestitures and currency.

Global Technology Services revenue of \$37,130 million decreased 3.7 percent as reported in 2014 compared to the prior year, but increased 2 percent adjusted for currency (3 points) and the divestitures (3 points). Integrated Technology Services (ITS) revenue grew 1.3 percent (4 percent adjusted for currency) compared to 2013. The SoftLayer platform, which provides highly differentiated solutions for clients looking to deploy across public, private or hybrid clouds all unified on one platform, had strong performance. Throughout the year, SoftLayer attracted new workloads to the platform and the company is investing to expand its datacenter footprint globally. GTS Outsourcing revenue decreased 5.8 percent as reported in 2014, but increased 1 percent adjusted for currency (2 points) and the divestitures (5 points). Growth was driven by performance from the substantial new contracts brought on during 2013. In 2014, clients continued to sign large outsourcing engagements that leverage the company's cloud, business analytics and mobile solutions. Maintenance revenue decreased 3.6 percent but was flat year to year adjusted for the divestiture of the industry standard server business (1 point) and currency (2 points).

Global Business Services revenue of \$17,825 million decreased 3.1 percent (1 percent adjusted for currency) compared to the prior year. Consulting and Systems Integration (C&SI) revenue declined 1.6 percent as reported, but was flat adjusted for currency in 2014. There was strong growth in the practices that are highly differentiated in the marketplace which address cloud, analytics, mobile and social, offset by declines in the more traditional parts of the portfolio, such as back office implementations. As the new offerings continue to become a larger part of the portfolio they will contribute more meaningfully to the revenue performance. In

July, the company announced a strategic partnership with Apple to deliver a new class of "enterprise ready" MobileFirst business applications for iOS combining mobility and analytics. In the fourth quarter of 2014, the first applications were launched with additional applications focused on healthcare, energy and utilities expected in the first quarter of 2015. GBS Outsourcing revenue decreased 8.5 percent (6 percent adjusted for currency) in 2014, but had sequential improvement in the year-to-year growth rate in the last two quarters of the year adjusted for currency. Throughout the year, performance was impacted by pricing pressure and client renegotiations, as well as a reduction in elective projects.

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent/ Margin Change
<b>Global Services</b>			
Global Technology Services			
External gross profit	<b>\$14,237</b>	\$14,691	(3.1)%
External gross profit margin	<b>38.3%</b>	38.1%	0.2 pts.
Pre-tax income	<b>\$ 6,340</b>	\$ 6,983	(9.2)%
Pre-tax margin	<b>16.7%</b>	17.6%	(1.0) pts.
Global Business Services			
External gross profit	<b>\$ 5,493</b>	\$ 5,676	(3.2)%
External gross profit margin	<b>30.8%</b>	30.9%	0.0 pts.
Pre-tax income	<b>\$ 2,999</b>	\$ 3,214	(6.7)%
Pre-tax margin	<b>16.3%</b>	16.8%	(0.5) pts.

GTS gross profit margin increased 0.2 points to 38.3 percent in 2014. Pre-tax income decreased 9.2 percent to \$6,340 million and the pre-tax margin declined 1.0 points to 16.7 percent compared to the prior year. While there was a benefit from the pre-tax gain of \$202 million related to the customer care divestiture in 2014, this benefit was offset by investments in areas like new resiliency centers, additional security skills and the SoftLayer cloud hub expansion, plus the lost profit from the divested businesses. Overall, the profit performance in GTS reflects the actions that the company has taken to transform the business. The company has invested in its strategic imperatives to accelerate growth, continued to optimize its delivery platform through workforce rebalancing and broader use of automation, and divested businesses, all impacting the year-to-year results. While these actions all have near-term impacts to profit, they position the business more effectively going forward and will enable it to deliver more value to clients.

GBS gross profit margin of 30.8 percent was flat year to year compared to 2013. Pre-tax income decreased 6.7 percent to \$2,999 million and the pre-tax margin declined 0.5 points to 16.3 percent. In 2014, profit was impacted by lower revenue on a relatively fixed cost base. In areas where the company has strong

differentiation, such as solutions that address the strategic imperatives, there was good growth and gross margin performance. However, in the more traditional parts of the portfolio, there was continued price and profit pressure. The company will continue to invest in the strategic imperatives and accelerate the transition to global delivery. Additionally, Global Process Services, the business process outsourcing business, will be integrated with GBS beginning in 2015 to create a seamless end-to-end business transformation capability for clients.

### Global Services Backlog

The estimated Global Services backlog at December 31, 2014 was \$128 billion. This included a backlog reduction in 2014 of \$3.7 billion associated with the customer care and industry standard server divestitures. Adjusting for the divested businesses, backlog was down 7.5 percent as reported, but flat adjusted for currency year to year. The estimated transactional backlog at December 31, 2014 decreased 7.6 percent (1 percent adjusted for currency) from the December 31, 2013 levels. The estimated outsourcing backlog decreased 11.0 percent as reported, but increased 1 percent adjusted for the customer care divestiture (4 points) and currency (8 points).

(\$ in billions)

At December 31:	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Backlog</b>				
Total backlog	<b>\$128.4</b>	\$142.8	(10.1)%	(2.9)%
Adjusted for divested businesses			(7.5)	(0.2)
Outsourcing backlog	<b>80.8</b>	90.8	(11.0)	(3.3)
Adjusted for customer care			(7.1)	0.8

Total Global Services backlog includes GTS Outsourcing, ITS, GBS Outsourcing, Consulting and Systems Integration and Maintenance. Outsourcing backlog includes GTS Outsourcing and GBS Outsourcing. Transactional backlog includes ITS and Consulting and Systems Integration. Total 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.

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.

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>For the year ended December 31:</b>				
<b>Total signings</b>	<b>\$51,569</b>	\$63,203	(18.4)%	(15.7)%
Outsourcing signings	\$26,517	\$35,027	(24.3)%	(21.1)%
Transactional signings	25,052	28,176	(11.1)	(8.9)

## Software

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>For the year ended December 31:</b>				
<b>Software external revenue</b>	<b>\$25,434</b>	\$25,932	(1.9)%	(0.9)%
Middleware	\$21,474	\$21,557	(0.4)%	0.6%
Key Branded Middleware	17,098	17,322	(1.3)	(0.2)
WebSphere Family			2.7	3.5
Information Management			(4.1)	(3.0)
Workforce Solutions			(6.1)	(5.1)
Tivoli			2.0	3.0
Rational			(3.3)	(1.3)
Other middleware	4,376	4,235	3.3	4.2
Operating systems	2,119	2,447	(13.4)	(12.6)
Other	1,841	1,929	(4.5)	(3.7)

Software revenue of \$25,434 million decreased 1.9 percent (1 percent adjusted for currency) in 2014 compared to the prior year. Middleware decreased 0.4 percent (increased 1 percent adjusted for currency) while operating systems were down 13.4 percent (13 percent adjusted for currency). The decline in operating systems impacted total software revenue growth year to year at constant currency by approximately 1 point. The company had solid growth in many of its solution areas, including security, mobile and cloud. In addition, across the software brands, software-as-a-service (SaaS) offerings grew rapidly throughout the year, increasing approximately 50 percent compared to 2013. In the first quarter of 2014, the company launched Bluemix, a cloud platform-as-a-service for the enterprise and, during the year, the Software business completed five acquisitions adding to its capabilities in mobile, cloud and security. Across Software, the company is transitioning its portfolio to capture growth areas while continuing to drive innovation in its core franchises. It is growing and building capabilities in emerging areas like SaaS, mobile and security. Performance in 2014 reflected business model changes that impacted the transactional revenue growth. Given clients' substantial investment in the IBM software platform, the company has

been providing more flexibility on how clients deploy its software acquired through enterprise licensing agreements. This enables clients to more effectively manage their capacity and commit to the company's platforms for the long term, however, it does impact period transactional revenue.

Key branded middleware revenue, which accounted for 67 percent of total Software revenue in 2014, decreased 1.3 percent (flat percent adjusted for currency) compared to the prior year. While there was growth in several strategic areas like cloud, mobile and security, other parts of the portfolio declined on a year-to-year basis.

WebSphere revenue increased 2.7 percent (4 percent adjusted for currency) in 2014 compared to the prior year. Revenue performance was driven by growth in Application Server, Business Integration and Commerce offerings. In Commerce, there was strong momentum in Commerce-as-a-service, which includes the acquisitions of Silverpop and Aspera. MobileFirst, the comprehensive portfolio of mobile software and services that enable clients to manage, integrate and leverage mobile devices, contributed to the significant growth of the company's mobile business.

Information Management revenue decreased 4.1 percent (3 percent adjusted for currency) in 2014 compared to the prior year. With the acquisition of Cloudant, the company has added database-as-a-service capability. Cloudant extends the company's mobile and cloud platforms by enabling developers to easily and quickly create next-generation mobile and Web-based applications.

Workforce Solutions revenue decreased 6.1 percent (5 percent adjusted for currency) in 2014 compared to the prior year. Performance has been impacted by the transition from on premise Notes to SaaS offerings. The company is working to transform this business and build recurring revenue streams from the SaaS offerings.

Tivoli revenue increased 2.0 percent (3 percent adjusted for currency) in 2014 compared to the prior year. Year-to-year revenue growth was driven by security software, which grew at double digit rates again this year. As cybersecurity threats are a key issue faced by all customers, these strong results are being driven in part by incremental requirements for security with the expansion into cloud and mobile computing.

Rational revenue decreased 3.3 percent (1 percent adjusted for currency) in 2014 year over year.

Operating systems revenue decreased 13.4 percent (13 percent adjusted for currency) in 2014 compared to 2013. This decline was primarily driven by declines in Power Systems.

## Systems and Technology

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Systems and Technology external revenue</b>	<b>\$9,996</b>	\$12,988	(23.0)%	(16.8)%*
System z			(23.3)%	(22.6)%
Power Systems			(18.9)	(18.2)
Storage			(12.0)	(11.0)
System x			(35.1)	(34.9)

\* Adjusted for divestitures and currency.

Systems and Technology (STG) revenue of \$9,996 million decreased 23.0 percent as reported in 2014, 17 percent adjusted for the divestiture of the industry standard server business (5 points) and currency (1 point). In 2013, the STG business reported a profit decline of \$1,653 million compared to 2012. During 2014, the company worked to reposition this business and to stabilize profit. It divested the industry standard server business and announced the divestiture of the Microelectronics business. Performance in 2014 reflected year-to-year declines related to the System z product cycle as well as declines in Power Systems and Storage. STG grew profit in the fourth quarter, and was profitable for the year. Profit performance year to year was impacted by the divestiture and currency, in addition to the revenue impacts.

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent/ Margin Change
<b>Software</b>			
External gross profit	<b>\$22,533</b>	\$23,032	(2.2)%
External gross profit margin	<b>88.6%</b>	88.8%	(0.2)pts.
Pre-tax income	<b>\$10,699</b>	\$11,106	(3.7)%
Pre-tax margin	<b>37.0%</b>	38.1%	(1.2)pts.

Software gross profit decreased 2.2 percent, with a gross profit margin of 88.6 percent. Software pre-tax income decreased 3.7 percent year to year and pre-tax margin declined 1.2 points. Across software, the company continues to drive innovation and capture growth areas, integrating analytics and security capabilities that are needed to operate seamlessly in a hybrid environment. For example, the company is introducing several new offerings that further enable its analytics portfolio in a cloud environment. It recently announced IBM Verse, a cloud based email and collaboration offering that integrates Watson capabilities. This type of continued innovation in offerings, together with expanding services on the Bluemix platform-as-a-service, will better allow customers to move to a hybrid environment.

mobile, security and cloud to address the needs clients see in their businesses. These capabilities span from real-time insights to real-time fraud detection in a system that can consistently run at 100-percent utilization with 100-percent uptime. The company continues to innovate on the platform to address client needs and extend its leadership in high-end systems, a core franchise that has nearly doubled in installed capacity over the last five years.

Power Systems revenue decreased 18.9 percent (18 percent adjusted for currency) in 2014 compared to the prior year. Although down year to year, there was sequential improvement in the year-to-year revenue growth rate at constant currency in the last two quarters of the year. The company has repositioned Power which is not only a systems business, but also an open chip processor and an IP income opportunity through the OpenPOWER foundation. In June, scale-out systems based on POWER8 were introduced and high-end POWER8-based enterprise systems were announced in October. These newly announced systems are highly scalable and can handle the most data intensive, mission critical applications in the industry. In addition, the company saw continued expansion of the OpenPOWER consortium, now with over 80 members, 14 of which are in greater China. Since the establishment of the consortium a year ago, several offerings have been introduced by consortium members based on the POWER architecture. In addition, the company has initiated a strategic partnership with Suzhou PowerCore, which intends to use POWER architecture to develop and market processors for servers in China.

Storage revenue decreased 12.0 percent (11 percent adjusted for currency) in 2014 compared to the prior year. However, at constant currency, it delivered sequential improvement in the year-to-year growth rate over the last three quarters of 2014. Full-year performance included strong contribution from FlashSystem and the Storwize portfolio. However, this was more than offset by weakness in high-end disk and the continued wind-down of the legacy storage-related OEM business.

(\$ in millions)

<b>For the year ended December 31:</b>	<b>2014</b>	2013	Yr.-to-Yr. Percent/ Margin Change
<b>Systems and Technology</b>			
External gross profit	<b>\$3,945</b>	\$5,299	(25.6)%
External gross profit margin	<b>39.5%</b>	40.8%	(1.3) pts.
Pre-tax income	<b>\$ 34</b>	\$ 213	(84.1)%
Pre-tax margin	<b>0.3%</b>	1.6%	(1.3) pts.

Systems and Technology's gross profit margin of 39.5 percent decreased 1.3 points versus the prior year. The decrease was driven by lower margins in Power Systems (1.3 points) and Storage (0.9 points), partially offset by an increase due to mix (0.7 points), driven by the divestiture of the industry standard server business. Pre-tax income decreased \$179 million or 84.1 percent and pre-tax margin decreased 1.3 points in 2014 versus the prior year.

In 2014, the company took significant actions to reposition its Systems and Technology business for higher value, and reinforced its commitment to driving innovation in high-end systems and storage. It repositioned Power through the development of the POWER8 systems which are built for cloud and big data, and it made available the POWER8 architecture through the OpenPOWER consortium to build an open ecosystem and an IP opportunity. The company is divesting its Microelectronics business with future chip supply coming from an at-scale provider, and has committed \$3 billion of investment over five years in the next era of chip technology as it strengthens its semiconductor research and development and systems innovation. The company also divested System x, the industry standard server business, and announced the z13, the new generation of the mainframe. With its portfolio repositioned and the introduction of the new mainframe, this business segment should now see profit leverage going forward.

### Global Financing

See pages 73 through 77 for an analysis of Global Financing's segment results.

## Geographic Revenue

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

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency*
<b>Total revenue</b>	<b>\$92,793</b>	\$98,367	(5.7)%	(1.5)%
Geographies	<b>\$92,326</b>	\$97,800	(5.6)%	(1.5)%
Americas	<b>41,410</b>	43,249	(4.3)	(0.8)
Europe/Middle East/Africa	<b>30,700</b>	31,628	(2.9)	(0.6)
Asia Pacific	<b>20,216</b>	22,923	(11.8)	(4.1)
Major markets			(4.3)%	(1.0)%
Growth markets			(9.9)%	(3.2)%
BRIC countries			(10.7)%	(4.5)%

\* Adjusted for divestitures and currency.

Total geographic revenue of \$92,326 million decreased 5.6 percent as reported and 1 percent adjusted for divestitures (2 points) and currency (2 points) in 2014 compared to the prior year. In total, major market countries decreased 4.3 percent as reported and 1 percent adjusted for divestitures (2 points) and currency (1 point). Growth market countries decreased 9.9 percent as reported and 3 percent adjusted for divestitures (3 points) and currency (4 points) compared to 2013.

The year-to-year decline in growth markets revenue adjusted for currency and the divestitures reflected growth in the Latin American and Europe growth markets, more than offset by decreased revenue in the Asia Pacific growth markets. The Latin American growth market countries decreased 1.0 percent as reported, but grew 8 percent adjusted for divestitures (2 points) and currency (7 points). Within Latin America, Brazil decreased 3.1 percent as reported, but grew 4 percent adjusted for divestitures (1 point) and currency (6 points). There was also growth in most other Latin American countries at constant currency. European growth markets were down 5.3 percent as reported, but increased 1 percent adjusted for divestitures (3 points) and currency (3 points) compared to the prior year. Asia Pacific growth market countries decreased 14.6 percent as reported and 9 percent adjusted for divestitures (3 points) and currency (2 points). This performance was driven by China and several of the other larger growth market countries. China decreased 17.2 percent as reported and 15 percent adjusted for divestitures (3 points) and currency (0 points), but reflected improvement in its sequential year-to-year growth rate in the last quarter of the year with strong software performance and several large mainframe transactions. In the fourth quarter, China revenue decreased 19.9 percent as reported, but declined

1 percent adjusted for currency and divestitures. Australia, India and Korea, which are some of the larger countries within the Asia Pacific growth markets, also declined compared to the prior year. Within the BRIC countries, combined revenue decreased 10.7 percent as reported and 5 percent adjusted for divestitures (3 points) and currency (3 points) compared to the prior year. On an adjusted basis, this performance reflects growth in Brazil and Russia, more than offset by the declines in China and India.

Americas revenue of \$41,410 million decreased 4.3 percent as reported and 1 percent adjusted for divestitures (2 points) and currency (1 point) compared to the prior year. On an adjusted basis, there was increased revenue in the growth markets offset by year-to-year declines in the major market countries. Within the North American major markets, the U.S. declined 4.0 percent as reported and 2 percent adjusted for divestitures (2 points). Canada was down 9.8 percent as reported and 2 percent adjusted for divestitures (1 point) and currency (7 points).

Europe/Middle East/Africa (EMEA) revenue of \$30,700 million decreased 2.9 percent as reported and 1 percent adjusted for divestitures (3 points) and offset by currency (1 point). Major market countries were down 2.6 percent as reported and 1 percent adjusted for divestitures (2 points), offset by currency (1 point). This was offset by growth of 1 percent on an adjusted basis in the growth market countries. Major market performance adjusted for the divestitures and currency included growth in Germany, Italy and Spain, which was more than offset by declines in the UK and France compared to the prior year.

Asia Pacific revenue of \$20,216 million decreased 11.8 percent as reported and 4 percent adjusted for the divested businesses (3 points) and currency (5 points). Japan was down 7.6 percent as reported, but increased 3 percent adjusted for divestitures (3 points) and currency (8 points). On this basis, Japan reflected year-to-year growth in every quarter of 2014. However, this growth was more than offset by declines in the Asia Pacific growth markets.

## Total Expense and Other (Income)

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent/ Margin Change
<b>For the year ended December 31:</b>	<b>2014</b>	2013	
<b>Total consolidated expense and other (income)</b>	<b>\$26,421</b>	\$28,440	(7.1)%
Non-operating adjustments			
Amortization of acquired intangible assets	(374)	(370)	1.2
Acquisition-related charges	(12)	(40)	(70.0)
Non-operating retirement-related (costs)/income	(180)	(433)	(58.4)
<b>Operating (non-GAAP) expense and other (income)</b>	<b>\$25,855</b>	\$27,597	(6.3)%
Total consolidated expense-to-revenue ratio	<b>28.5%</b>	28.9%	(0.4) pts.
Operating (non-GAAP) expense-to-revenue ratio	<b>27.9%</b>	28.1%	(0.2) pts.

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

	Total Consolidated	Operating (non-GAAP)
• Currency*	(1) point	(1) point
• Acquisitions**	2 points	2 points
• Base expense	(8) points	(7) points

\* Reflects impacts of translation and hedging programs.

\*\* Includes acquisitions completed in prior 12-month period; operating (non-GAAP) is net of non-operating acquisition-related charges.

Base expense includes the gains from the divestitures of the industry standard server and customer care businesses, as well as the impact of higher workforce rebalancing charges year to year. Excluding the gains from the divested businesses and the impact of workforce rebalancing, operating (non-GAAP) base expense decreased 3 points year to year versus the 7 point as reported decrease. Within base expense, the company is continuing to shift its resources and spending to the strategic imperatives.

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

## Selling, General and Administrative

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>	<b>2014</b>	2013	
<b>Selling, general and administrative expense</b>	<b>\$18,532</b>	\$19,178	(3.4)%
Selling, general and administrative—other	\$18,532	\$19,178	(3.4)%
Advertising and promotional expense	1,307	1,294	1.1
Workforce rebalancing charges	1,472	1,031	42.7
Retirement-related costs	811	986	(17.8)
Amortization of acquired intangible assets	374	370	1.2
Stock-based compensation	350	435	(19.4)
Bad debt expense	334	156	113.8
<b>Total consolidated selling, general and administrative expense</b>	<b>\$23,180</b>	\$23,451	(1.2)%
Non-operating adjustments			
Amortization of acquired intangible assets	(374)	(370)	1.2
Acquisition-related charges	(11)	(25)	(54.1)
Non-operating retirement-related (costs)/income	(257)	(376)	(31.7)
<b>Operating (non-GAAP) selling, general and administrative expense</b>	<b>\$22,537</b>	\$22,680	(0.6)%

Total selling, general and administrative (SG&A) expense decreased 1.2 percent in 2014 versus 2013. The decrease was primarily driven by the effects of currency (2 points) and lower base expense (1 point), partially offset by acquisition-related spending (2 points). Operating (non-GAAP) SG&A expense decreased 0.6 percent primarily driven by the effects of currency (2 points), partially offset by acquisition-related spending (1 point). Workforce rebalancing charges in 2014 were \$1,472 million, an increase of \$440 million year to year, which resulted in a 2 point year-to-year impact in operating (non-GAAP) SG&A base expense. Bad debt expense increased \$178 million year to year driven by higher specific provision additions, primarily in China and Latin America. The receivables provision coverage was 2.2 percent at December 31, 2014, an increase of 60 basis points from year-end 2013.

## Research, Development and Engineering

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>	<b>2014</b>	2013	
<b>Total consolidated research, development and engineering</b>	<b>\$5,437</b>	\$5,743	(5.3)%
Non-operating adjustment			
Non-operating retirement-related (costs)/income	77	(57)	NM
<b>Operating (non-GAAP) research, development and engineering</b>	<b>\$5,514</b>	\$5,686	(3.0)%

NM—Not meaningful

Research, development and engineering (RD&E) expense in continuing operations was 5.9 percent of revenue in 2014 and 5.8 percent of revenue in 2013. RD&E expense decreased 5.3 percent in 2014 versus 2013 primarily driven by: lower base expense (7 points) and the effects of currency (1 point), partially offset by higher expense due to acquisitions (2 points). Operating (non-GAAP) RD&E expense decreased 3.0 percent in 2014 compared to the prior year, primarily driven by lower base expense (4 points) and the effects of currency (1 point), partially offset by higher expense due to acquisitions (2 points).

### Intellectual Property and Custom Development Income

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
Sales and other transfers of intellectual property	\$283	\$352	(19.7)%
Licensing/royalty-based fees	129	150	(13.9)
Custom development income	330	320	3.1
<b>Total</b>	<b>\$742</b>	<b>\$822</b>	<b>(9.8)%</b>

The timing and amount of Sales and other transfers of IP may vary significantly from period to period depending upon the timing of divestitures, economic conditions, industry consolidation and the timing of new patents and know-how development. There were no significant individual IP transactions in 2014 or 2013.

### Other (Income) and Expense

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
<b>Other (income) and expense</b>			
Foreign currency transaction losses/(gains)	\$ (599)	\$(260)	130.4%
(Gains)/losses on derivative instruments	654	166	293.3
Interest income	(90)	(74)	22.1
Net (gains)/losses from securities and investment assets	(26)	(29)	(11.5)
Other	(1,878)	(137)	NM
<b>Total consolidated other (income) and expense</b>	<b>\$(1,938)</b>	<b>\$(333)</b>	<b>482.4%</b>
Non-operating adjustment			
Acquisition-related charges	(1)	(16)	(94.7)
<b>Operating (non-GAAP) other (income) and expense</b>	<b>\$(1,939)</b>	<b>\$(349)</b>	<b>456.2%</b>

NM—Not meaningful

The increase in income of \$1,605 million year over year was primarily driven by higher gains associated with divestitures (\$1,710 million), driven by the industry standard server (\$1,400 million) and customer care (\$202 million) transactions. Divestiture gains are reflected in Other in the table above.

### Interest Expense

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
Interest expense			
<b>Total</b>	<b>\$484</b>	<b>\$402</b>	<b>20.4%</b>

The increase in interest expense in 2014 versus 2013 was primarily driven by higher average debt levels, partially offset by lower average interest rates. Interest expense is presented in cost of financing in the Consolidated Statement of Earnings only if the related external borrowings are to support the Global Financing external business. Overall interest expense (excluding capitalized interest) in 2014 was \$1,025 million, an increase of \$36 million year to year.

### Stock-Based Compensation

Total pre-tax stock-based compensation cost of \$512 million decreased \$102 million compared to 2013. The decrease was primarily related to performance share units (\$58 million), restricted stock units (\$26 million) and the company's assumption of stock-based awards previously issued by acquired entities (\$18 million). Stock-based compensation cost, and the year-to-year change, was reflected in the following categories: Cost: \$121 million, down \$1 million; SG&A expense: \$350 million, down \$85 million; RD&E expense: \$54 million, down \$3 million and Other (income) and expense: (\$13 million), down \$13 million. The amount of stock-based compensation cost included in the loss from discontinued operations, net of tax, was immaterial.

## Retirement-Related Plans

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

(\$ in millions)

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
<b>Retirement-related plans—cost</b>			
Service cost	\$ 482	\$ 545	(11.5)%
Amortization of prior service cost/(credits)	(114)	(114)	(0.1)
Cost of defined contribution plans	1,253	1,384	(9.5)
<b>Total operating costs</b>	<b>\$ 1,621</b>	<b>\$ 1,815</b>	<b>(10.7)%</b>
Interest cost	3,994	3,728	7.1
Expected return on plan assets	(6,351)	(6,187)	2.7
Recognized actuarial losses	2,467	3,434	(28.2)
Plan amendments/curtailments/settlements	25	0	NM
Multi-employer plan/other costs	218	86	154.5
<b>Total non-operating costs/(income)</b>	<b>\$ 353</b>	<b>\$ 1,062</b>	<b>(66.7)%</b>
<b>Total retirement-related plans—cost</b>	<b>\$ 1,974</b>	<b>\$ 2,876</b>	<b>(31.4)%</b>

NM—Not meaningful

In 2014, total retirement-related plan cost decreased by \$902 million compared to 2013, primarily driven by a decrease in recognized actuarial losses (\$967 million), higher actual return on plan assets (\$165 million) and lower defined contribution plans cost (\$131 million), partially offset by higher interest cost (\$266 million) and higher pension obligations related to litigation (\$139 million).

As discussed in the “Operating (non-GAAP) Earnings” section on page 22, the company characterizes certain retirement-related costs as operating and others as non-operating. Utilizing this characterization, operating retirement-related costs in 2014 were \$1,621 million, a decrease of \$194 million compared to 2013, primarily driven by lower defined contribution plans cost (\$131 million) and decreased service cost (\$63 million). Non-operating costs of \$353 million decreased \$709 million in 2014, compared to the prior year, driven primarily by the decrease in recognized actuarial losses (\$967 million) and higher actual return on plan assets (\$165 million), partially offset by higher interest cost (\$266 million) and higher pension obligations related to litigation (\$139 million).

## Income Taxes

The continuing operations effective tax rate for 2014 was 21.2 percent, an increase of 4.6 points versus the prior year, driven by the following factors:

- The year-to-year impact of factors that benefited the 2013 rate (14.5 points), including completion of the U.S. 2008–2010 tax audit and the associated reserve redeterminations (11.1 points), the retroactive impact of the 2012 American Taxpayer Relief Act (0.7 points), a tax agreement which required a reassessment of certain valuation allowances on deferred tax assets (1.4 points), the resolution of certain non-U.S. tax audits (0.7 points) and newly enacted U.S. state tax legislation (0.6 points); and
- A tax charge related to the sale of the industry standard server business (0.9 points); partially offset by;
- A year-to-year benefit of reduced tax charges related to certain intercompany payments made by foreign subsidiaries and the intercompany licensing of certain IP (3.7 points);
- An increased benefit in the utilization of foreign tax credits (4.7 points); and
- A benefit due to a more favorable geographic mix of pre-tax income in 2014 (2.5 points).

The continuing operations operating (non-GAAP) effective tax rate was 21.0 percent, an increase of 4.0 points versus 2013 principally driven by the same factors described above.

## Earnings Per Share

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

For the year ended December 31:	2014	2013	Yr.-to-Yr. Percent Change
<b>Earnings per share of common stock from continuing operations</b>			
Assuming dilution	\$15.59	\$15.30	1.9%
Basic	\$15.68	\$15.42	1.7%
Diluted operating (non-GAAP)	\$16.53	\$16.64	(0.7)%
<b>Weighted-average shares outstanding (in millions)</b>			
Assuming dilution	1,010.0	1,103.0	(8.4)%
Basic	1,004.3	1,094.5	(8.2)%

Actual shares outstanding at December 31, 2014 and 2013 were 990.5 million and 1,054.4 million, respectively. The average number of common shares outstanding assuming dilution was 93.0 million shares lower in 2014 versus 2013. The decrease was primarily the result of the common stock repurchase program.

## Results of Discontinued Operations

The loss from discontinued operations, net of tax, was \$3.7 billion in 2014 and \$0.4 billion in 2013. The loss in 2014 included a non-recurring pre-tax charge of \$4.7 billion, or \$3.4 billion, net of tax. The charge included an impairment to reflect the fair value less estimated costs to sell the Microelectronics business, which the company initially reported as held for sale at September 30, 2014. The charge also included other estimated costs related to the transaction, including cash consideration expected to be transferred of approximately \$1.5 billion. The cash consideration is expected to be paid over the next three years and will be adjusted down by the amount of the working capital due from GLOBAL-FOUNDRIES, estimated to be \$0.2 billion. In addition, discontinued operations includes the operational net losses from the Microelectronics business of \$0.3 billion in 2014 and \$0.4 billion in 2013. The discontinued operations effective tax rate in 2014 was 30.2 percent compared to 44.8 percent in 2013. The year-to-year decrease in the rate was driven primarily by a one-time tax charge of \$428 million in the third quarter of 2014 in connection with the disposal.

See note C, "Acquisitions/Divestitures," on pages 100 and 101 for additional information regarding the divestiture transaction.

## Financial Position

### Dynamics

At December 31, 2014, the company continued to have the financial flexibility to support the business over the long term. Cash and marketable securities at year end were \$8,476 million. During the year, the company continued to manage the investment portfolio to meet its capital preservation and liquidity objectives.

Total debt of \$40,804 million increased \$1,087 million from prior year-end levels. The commercial paper balance at December 31, 2014, was \$650 million, a decrease of \$1,808 million from the prior year end. Within total debt, \$29,103 million is in support of the Global Financing business which is leveraged at a 7.2 to 1 ratio. The company continues to have substantial flexibility in the market. During 2014, the company completed bond issuances totaling \$6,852 million, with terms ranging from 2 to 10 years, and interest rates ranging from 0.30 to 3.63 percent depending on maturity. The company has consistently generated strong cash flow from operations and continues to have access to additional sources of liquidity through the capital markets and its \$10 billion global credit facility, with 100 percent of the facility available on a same day basis.

Consistent with accounting standards, the company remeasures the funded status of its retirement and postretirement plans at December 31. At December 31, 2014, the overall net underfunded position was \$16,932 million, an increase of \$5,498 million from December 31, 2013 driven by a decrease in discount rates and changes in U.S. mortality rate assumptions, partially offset by strong asset returns worldwide. At year end, the company's qualified defined benefit plans were well funded and the cash requirements related to these plans remain stable going forward at approximately \$600 million per year through 2019. In 2014, the return on the U.S. Personal Pension Plan assets was 10.1 percent and the plan was 102 percent funded at December 31. Overall, global asset returns were 12.2 percent and the qualified defined benefit plans worldwide were 97 percent funded at December 31.

During 2014, the company generated \$16,868 million in cash from operations, a decrease of \$616 million compared to 2013. In addition, the company generated \$12,372 million in free cash flow, a decrease of \$2,649 million versus the prior year. See pages 66 to 67 for additional information on free cash flow. The company returned \$17,944 million to shareholders in 2014, with \$13,679 million in gross share repurchases and \$4,265 million in dividends. In 2014, the company repurchased approximately 71.5 million shares and had approximately \$6.3 billion remaining in share repurchase authorization at year end. The company's cash generation permits the company to invest and deploy capital to areas with the most attractive long-term opportunities.

The assets and debt associated with the Global Financing business are a significant part of the company's financial position. The financial position amounts appearing on page 82 are the consolidated amounts including Global Financing. The amounts appearing in the separate Global Financing section, beginning on page 73, are supplementary data presented to facilitate an understanding of the Global Financing business.

### Working Capital

(\$ in millions)

At December 31:	2014	2013
Current assets	\$49,422	\$51,350
Current liabilities	39,600	40,154
<b>Working capital</b>	<b>\$ 9,822</b>	<b>\$11,196</b>
Current ratio	<b>1.25:1</b>	1.28:1

Working capital decreased \$1,374 million from the year-end 2013 position. The key changes are described below:

Current assets decreased \$1,928 million (an increase of \$1,119 million adjusted for currency), as a result of:

- A decrease of \$2,589 million in cash and cash equivalents and marketable securities; and
- A decline of \$1,375 million (\$734 million adjusted for currency) in trade receivables primarily due to the decline in revenue and improved customer collections; partially offset by

- An increase of \$1,322 million (\$1,378 million adjusted for currency) in other receivables driven by anticipated tax refunds; and
- An increase in deferred taxes of \$394 million (\$507 million adjusted for currency) primarily due to the expected Micro-electronics business divestiture.

Current liabilities decreased \$554 million (an increase of \$1,623 million adjusted for currency), as a result of:

- A decrease in short-term debt of \$1,131 million (\$1,074 million adjusted for currency); and
- A decrease in deferred income of \$680 million (an increase of \$42 million adjusted for currency) driven by currency; partially offset by
- Other accrued expenses and liabilities increases of \$1,265 million (\$1,840 million adjusted for currency) driven by charges and expected payments related to the expected divestiture of the Microelectronics business and workforce rebalancing accruals.

### Cash Flow

The company's cash flows from operating, investing and financing activities, as reflected in the Consolidated Statement of Cash Flows on page 83 are summarized in the table below. These amounts include the cash flows associated with the Global Financing business.

(\$ in millions)		
For the year ended December 31:	2014	2013
Net cash provided by/(used in) continuing operations		
Operating activities	\$ 16,868	\$ 17,485
Investing activities	(3,001)	(7,326)
Financing activities	(15,452)	(9,883)
Effect of exchange rate changes on cash and cash equivalents	(655)	28
<b>Net change in cash and cash equivalents</b>	<b>\$ (2,240)</b>	<b>\$ 304</b>

Net cash provided by operating activities decreased by \$616 million in 2014 driven by the following key factors:

- An increase in income taxes paid of \$1,724 million primarily driven by audit settlement payments and other prior period discrete tax impacts settled in 2014;
- A decrease in cash associated with deferred income of \$814 million due to lower levels of customer prepayments; and
- Performance-related declines within net income; partially offset by
- An increase in cash provided by receivables of \$2,676 million, primarily driven by financing receivables; and
- A decrease in cash payments for performance-related compensation of \$772 million.

Net cash used in investing activities decreased \$4,325 million driven by:

- A decrease in cash used for acquisitions of \$2,401 million; and
- An increase in cash provided by divestitures of \$2,061 million.

Net cash used in financing activities increased \$5,569 million as compared to the prior year driven by the following factors:

- Lower cash from debt transactions (including short-term borrowings) of \$5,177 million; and
- An increase of \$392 million in net cash used for equity transactions impacted by increased dividend payments in 2014.

### Noncurrent Assets and Liabilities

(\$ in millions)		
At December 31:	2014	2013
Noncurrent assets	\$68,110	\$74,873
Long-term debt	\$35,073	\$32,856
Noncurrent liabilities (excluding debt)	\$30,844	\$30,284

The decrease in noncurrent assets of \$6,763 million (\$3,790 million adjusted for currency) was driven by:

- A decrease of \$3,392 million (\$3,260 million adjusted for currency) in prepaid pension assets primarily driven by plan remeasurements;
- A decrease in property, plant and equipment, net of \$3,050 million (\$2,381 million adjusted for currency) primarily driven by a charge of \$2,358 million associated with the expected divestiture of the Microelectronics business; and
- A decrease of \$1,646 million (\$917 million adjusted for currency) in long term financing receivables; partially offset by
- An increase in deferred taxes of \$1,757 million (\$2,054 million adjusted for currency) driven by retirement related plan activity.

Long-term debt increased \$2,218 million (\$3,042 million adjusted for currency) driven by new debt of \$7,657 million offset by reclasses to short-term debt of \$4,809 million.

Other noncurrent liabilities, excluding debt, increased \$561 million (\$2,330 million adjusted for currency) primarily driven by:

- An increase in retirement and nonpension benefit obligations of \$2,019 million (\$3,210 million adjusted for currency) driven by plan remeasurements, partially offset by
- Declines of \$1,041 million (\$708 million adjusted for currency) in other liabilities driven by declines in deferred taxes.

### Debt

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

(\$ in millions)

At December 31:	2014	2013
Total company debt	\$40,804	\$39,718
Total Global Financing segment debt	\$29,103	\$27,504
Debt to support external clients	25,531	24,471
Debt to support internal clients	3,572	3,033
Non-Global Financing debt	11,701	12,214

Global Financing provides financing predominantly for the company's external client assets, as well as for assets under contract by other IBM units. These assets, primarily for Global Services, generate long-term, stable revenue streams similar to the Global Financing asset portfolio. Based on their attributes, these Global Services assets are leveraged with the balance of the Global Financing asset base. The debt analysis above is further detailed in the Global Financing section on pages 76–77.

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

"Core" debt-to-capitalization ratio (excluding Global Financing debt and equity) was 59.4 percent at December 31, 2014 compared to 39.0 percent at December 31, 2013. The ratio was impacted by retirement-related declines in equity of \$6,366 million primarily driven by plan remeasurements, the non-recurring charge

associated with the disposal of the Microelectronics business of \$3,381 million and declines from translation of \$2,074 million due to the strengthening U.S. dollar.

Consolidated debt-to-capitalization ratio at December 31, 2014 was 77.3 percent versus 63.4 percent at December 31, 2013 and was similarly impacted by the retirement plan remeasurements and strengthening of the U.S. dollar as noted above.

### Equity

Total equity decreased by \$10,916 million from December 31, 2013 as a result of an increase in treasury stock of \$13,474 million mainly due to gross common stock repurchases, an increase in other comprehensive losses of \$6,274 million primarily due to retirement plan remeasurements, partially offset by an increase in retained earnings of \$7,751 million. The retirement plan remeasurement impact to other comprehensive losses was driven by: changes in discount rates (\$7.4 billion) and in mortality rate assumptions (\$1.7 billion), partially offset by improved asset returns (\$3.1 billion).

### GAAP Reconciliation

The tables below provide a reconciliation of the company's income statement results as reported under GAAP to its operating earnings presentation which is a non-GAAP measure. The company's calculation of operating (non-GAAP) earnings, as presented, may differ from similarly titled measures reported by other companies. Please refer to the "Operating (non-GAAP) Earnings" section on page 22 for the company's rationale for presenting operating earnings information.

(\$ in millions except per share amounts)

For the year ended December 31, 2014:	GAAP	Acquisition-Related Adjustments	Retirement-Related Adjustments	Operating (non-GAAP)
Gross profit	\$46,407	\$ 416	\$ 173	\$46,996
Gross profit margin	50.0%	0.4 pts.	0.2 pts.	50.6%
SG&A	\$23,180	\$(385)	\$(257)	\$22,537
RD&E	5,437	—	77	5,514
Other (income) and expense	(1,938)	(1)	—	(1,939)
Total expense and other (income)	26,421	(386)	(180)	25,855
Pre-tax income from continuing operations	19,986	803	353	21,142
Pre-tax income margin from continuing operations	21.5%	0.9 pts.	0.4 pts.	22.8%
Provision for income taxes*	\$ 4,234	\$ 133	\$ 73	\$ 4,440
Effective tax rate	21.2%	(0.2) pts.	0.0 pts.	21.0%
Income from continuing operations	\$15,751	\$ 670	\$ 280	\$16,702
Income margin from continuing operations	17.0%	0.7 pts.	0.3 pts.	18.0%
Loss from discontinued operations, net of tax	\$(3,729)	—	\$ —	\$(3,729)
Net income	\$12,022	\$ 670	\$ 280	\$12,973
Diluted earnings per share:				
Continuing operations	\$ 15.59	\$0.66	\$0.28	\$ 16.53
Discontinued operations	\$ (3.69)	\$ —	\$ —	\$ (3.69)

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

(\$ in millions except per share amounts)

	GAAP	Acquisition-Related Adjustments	Retirement-Related Adjustments	Operating (non-GAAP)
<b>For the year ended December 31, 2013:</b>				
Gross profit	\$48,684	\$ 394	\$ 629	\$49,706
Gross profit margin	49.5%	0.4 pts.	0.6 pts.	50.5%
SG&A	\$23,451	\$(394)	\$ (376)	\$22,680
RD&E	5,743	—	(57)	5,686
Other (income) and expense	(333)	(16)	—	(349)
Total expense and other (income)	28,440	(410)	(433)	27,597
Pre-tax income from continuing operations	20,244	804	1,062	22,110
Pre-tax margin from continuing operations	20.6%	0.8 pts.	1.1 pts.	22.5%
Provision for income taxes*	\$ 3,363	\$ 57	\$ 333	\$ 3,753
Effective tax rate	16.6%	(0.4)pts.	0.7 pts.	17.0%
Income from continuing operations	\$16,881	\$ 747	\$ 729	\$18,356
Income margin from continuing operations	17.2%	0.8 pts.	0.7 pts.	18.7%
Loss from discontinued operations, net of tax	\$ (398)	\$ —	\$ —	\$ (398)
Net income	\$16,483	\$ 747	\$ 729	\$17,959
Diluted earnings per share:				
Continuing operations	\$ 15.30	\$0.68	\$ 0.66	\$ 16.64
Discontinued operations	\$ (0.36)	\$ —	\$ —	\$ (0.36)

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

## Consolidated Fourth-Quarter Results

(\$ and shares in millions except per share amounts)

	2014	2013	Yr.-to-Yr. Percent/Margin Change
<b>For the fourth quarter:</b>			
Revenue	\$24,113	\$ 27,385	(11.9)%*
Gross profit margin	53.3%	52.4%	1.0 pts.
Total expense and other (income)	\$ 5,767	\$ 7,235	(20.3)%
Total expense and other (income)-to-revenue ratio	23.9%	26.4%	(2.5) pts.
Income from continuing operations before income taxes	\$ 7,094	\$ 7,102	(0.1)%
Provision for income taxes from continuing operations	\$ 1,580	\$ 885	78.4%
Income from continuing operations	\$ 5,515	\$ 6,216	(11.3)%
Income from continuing operations margin	22.9%	22.7%	0.2 pts.
Loss from discontinued operations, net of tax	(31)	(32)	(1.7)%
Net income	\$ 5,484	\$ 6,185	(11.3)%
Earnings per share from continuing operations:			
Assuming dilution	\$ 5.54	\$ 5.76	(3.8)%
Consolidated earnings per share—assuming dilution	\$ 5.51	\$ 5.73	(3.8)%
Weighted-average shares outstanding			
Assuming dilution	995.4	1,080.0	(7.8)%

\* (7.6) percent adjusted for currency; (2.3) percent adjusted for divestitures and currency.

The following table provides the company's operating (non-GAAP) earnings for the fourth quarter of 2014 and 2013.

(\$ in millions except per share amounts)

	2014	2013	Yr.-to-Yr. Percent Change
<b>For the fourth quarter:</b>			
Net income as reported	\$5,484	\$6,185	(11.3)%
Loss from discontinued operations, net of tax	(31)	(32)	(1.7)
Income from continuing operations	5,515	6,216	(11.3)
Non-operating adjustments (net of tax):			
Acquisition-related charges	186	268	(30.5)
Non-operating retirement-related costs/(income)	84	164	(49.1)
Operating (non-GAAP) earnings*	\$5,785	\$6,649	(13.0)%
Diluted operating (non-GAAP) earnings per share	\$ 5.81	\$ 6.16	(5.7)%

\* See page 52 for a more detailed reconciliation of net income to operating earnings.

### Snapshots

In the fourth quarter of 2014, the company reported \$24.1 billion in revenue and delivered diluted earnings per share from continuing operations of \$5.54 as reported and \$5.81 on an operating (non-GAAP) basis. The results of continuing operations exclude a net loss from discontinued operations of \$31 million related to the announced divestiture of the Microelectronics business. On a consolidated basis, net income in the fourth quarter was \$5.5 billion,

with diluted earnings per share of \$5.51. The company generated \$6.1 billion in cash from operations and \$6.6 billion in free cash flow in the fourth quarter driving shareholder returns of \$1.2 billion in gross common stock repurchases and dividends.

The company's results in the fourth quarter were impacted by the dramatic strengthening of the U.S. dollar which began in September and continued at a rapid pace. In addition, nearly all the currencies moved in an unfavorable direction for the company's business profile and impacted revenue and earnings. Although the company hedges a portion of its cross-border cash flows which defers the impacts of currency movement, it does not eliminate it. The company's hedges are designed to provide stability around the receipt of cash, but there is no year-to-year benefit in the income statement when a currency's direction is sustained over a longer period.

In the fourth quarter, total consolidated revenue decreased 11.9 percent as reported and 2 percent adjusted for currency (5 points) and the divestitures of the industry standard server and customer care businesses (5 points). These impacts represented approximately \$2.8 billion in revenue and a 10-point impact to the year-to-year growth rate. In the fourth quarter, the company continued its strong performance in its strategic imperatives that address the market shifts in data, cloud and engagement. Together they delivered double-digit growth, as they did in every quarter during 2014.

Within the company's segments, Global Services revenue declined 7.8 percent as reported, but was flat year to year adjusted for currency (6 points) and the divestitures (2 points). Global Technology Services revenue decreased 7.6 percent as reported, but increased 2 percent adjusted for currency (6 points) and the divested businesses (4 points) with growth across all business lines. Global Business Services revenue decreased 8.4 percent (3 percent adjusted for currency). Software revenue decreased 6.9 percent (3 percent adjusted for currency). Systems and Technology revenue decreased 39.0 percent as reported and 12 percent adjusted for the industry standard server divestiture (24 points) and currency (3 points), reflecting the end of the product cycle in System z and declines in Power Systems and Storage.

From a geographic perspective, revenue in the major markets declined 10.8 percent as reported and 2 percent adjusted for currency (5 points) and the divestitures (4 points). The growth markets declined 15.7 percent as reported and 2 percent adjusted for the divestitures (9 points) and currency (5 points) compared to the fourth quarter of the prior year. Within the growth markets, the BRIC countries decreased 21.4 percent as reported and 8 percent adjusted for the divestitures (9 points) and currency (4 points).

The consolidated gross profit margin increased 1.0 points versus the fourth quarter of 2013 to 53.3 percent. The operating (non-GAAP) gross margin of 53.9 percent increased 0.6 points year to year driven primarily by improvements in GBS, and a mix away from the low margin industry standard server business.

Total expense and other (income) decreased 20.3 percent in the fourth quarter of 2014 compared to the prior year. Total operating (non-GAAP) expense and other (income) also decreased 20.3 percent year to year. The key drivers of the year-to-year change in total expense and other (income) were approximately:

	Total Consolidated	Operating (non-GAAP)
• Currency*	(5) points	(4) points
• Acquisitions**	1 points	1 points
• Base expense	(17) points	(17) points

\* Reflects impacts of translation and hedging programs.

\*\* Includes acquisitions completed in prior 12-month period; operating (non-GAAP) is net of non-operating acquisition-related charges.

The reported level of expense in the fourth quarter reflected not only the ongoing run rate of the business, but also the impact of the industry standard server divestiture and a charge for workforce rebalancing. The entire year-to-year decline was driven by the combination of the gain on the divestiture and the fact that the expense for the industry standard server business is no longer in the run rate. Adjusting for this divestiture, total operating (non-GAAP) expense and other (income) would have increased approximately 2 percent (6 percent adjusted for currency and acquisitions) including the workforce rebalancing charge of approximately \$580 million, nearly all of which was a year-to-year increase.

Pre-tax income from continuing operations of \$7.1 billion decreased 0.1 percent year to year and the pre-tax margin was 29.4 percent, an increase of 3.5 points versus the fourth quarter of 2013. The continuing operations effective tax rate for the fourth quarter was 22.3 percent, up 9.8 points year to year. This increase was primarily due to a benefit included in the prior year rate associated with the settlement of a U.S. tax audit in the fourth quarter of 2013. Income from continuing operations of \$5.5 billion decreased 11.3 percent year to year and the net income margin was 22.9 percent, an increase of 0.2 points. Net income of \$5.5 billion decreased \$701 million year to year. Operating (non-GAAP) pre-tax income from continuing operations decreased 2.3 percent year to year and the operating (non-GAAP) pre-tax margin was 30.7 percent, an increase of 3.0 points year to year. Operating (non-GAAP) income from continuing operations decreased 13.0 percent and the operating (non-GAAP) income margin of 24.0 percent decreased 0.3 points compared to the prior year. The operating (non-GAAP) effective tax rate from continuing operations was 21.8 percent versus 12.2 percent in the fourth quarter of 2013 driven by the same factor described above.

Diluted earnings per share from continuing operations of \$5.54 decreased 3.8 percent year to year. Operating (non-GAAP) diluted earnings per share of \$5.81 decreased 5.7 percent versus the fourth quarter of 2013. Diluted earnings per share from discontinued operations was (\$0.03) in the fourth quarter of both years. In the fourth quarter of 2014, the company repurchased 0.7 million shares of its common stock.

## Results of Continuing Operations

### Segment Details

The following is an analysis of the fourth quarter of 2014 versus the fourth quarter of 2013 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.

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent/ Margin Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>For the fourth quarter:</b>				
<b>Revenue</b>				
Global Technology Services	\$ 9,167	\$ 9,917	(7.6)%	1.6%*
Gross margin	38.5%	38.8%	(0.3)pts.	
Global Business Services	4,349	4,747	(8.4)%	(3.0)%
Gross margin	32.0%	30.7%	1.4 pts.	
Software	7,578	8,140	(6.9)%	(3.4)%
Gross margin	90.0%	90.5%	(0.6)pts.	
Systems and Technology	2,406	3,947	(39.0)%	(12.2)%*
Gross margin	49.6%	42.2%	7.3 pts.	
Global Financing	532	534	(0.5)%	4.6%
Gross margin	48.7%	43.3%	5.3 pts.	
Other	82	100	(17.7)%	(14.2)%
Gross margin	(401.7)%	(234.8)%	(166.9)pts.	
<b>Total consolidated revenue</b>	<b>\$24,113</b>	<b>\$27,385</b>	<b>(11.9)%</b>	<b>(2.3)%*</b>
<b>Total consolidated gross profit</b>	<b>\$12,862</b>	<b>\$14,337</b>	<b>(10.3)%</b>	
Total consolidated gross margin	53.3%	52.4%	1.0 pts.	
Non-operating adjustments				
Amortization of acquired intangible assets	101	103	(2.0)%	
Acquisition-related charges	—	1	(100.0)%	
Retirement-related costs/(income)	33	154	(78.8)%	
<b>Operating (non-GAAP) gross profit</b>	<b>\$12,996</b>	<b>\$14,596</b>	<b>(11.0)%</b>	
Operating (non-GAAP) gross margin	53.9%	53.3%	0.6 pts.	

\* Adjusted for divestitures and currency.

### Global Services

In the fourth quarter of 2014, the Global Services segments, GTS and GBS, delivered revenue of \$13,516 million, a decrease of 7.8 percent as reported, but flat year to year adjusted for currency (6 points) and the divested customer care and industry standard server businesses (2 points). Pre-tax income in the fourth quarter decreased 25.0 percent and the pre-tax margin decreased 3.5 points to 15.9 percent. Total outsourcing revenue of \$6,042 million decreased 9.3 percent as reported, but flat year to year adjusted for currency (6 points) and the divestitures (3 points). Total transactional revenue of \$5,839 million decreased 5.9 percent (flat adjusted for currency).

Global Technology Services revenue of \$9,167 million decreased 7.6 percent as reported, but increased 2 percent adjusted for currency (6 points) and the divested businesses (4 points). Within GTS, outsourcing revenue of \$5,109 million decreased 9.6 percent as reported, but increased 1 percent adjusted for currency (6 points) and the divestitures (5 points). Clients are continuing to sign large outsourcing engagements that leverage the company's cloud, business analytics and mobile solutions. Clients are using these outsourcing engagements as a way to optimize their IT infrastructure while at the same time enabling new services to their customers. Lufthansa and ABN AMRO, both signings which were over \$1 billion in contract

value, are recent examples of this. ITS revenue of \$2,423 million decreased 1.6 percent from the fourth quarter of the prior year as reported, but increased 4 percent adjusted for currency. The year-to-year increase was driven largely by the company's high-value security, mobility and resiliency offerings. SoftLayer continues to attract new workloads to the platform, and in October, the company announced that IBM was selected by SAP to be the global cloud provider for their enterprise cloud solution. IBM's ability to integrate public and private workloads within its hybrid cloud was a critical differentiator for SAP. The company has continued to expand its datacenter footprint and in the fourth quarter opened cloud centers in Melbourne, Paris, Mexico City, Tokyo and Frankfurt. Maintenance revenue of \$1,635 million decreased 9.2 percent as reported, but was up 1 percent for the quarter, adjusted for currency (6 points) and the industry standard server divestiture (4 points). The GTS gross profit margin of 38.5 percent decreased 0.3 points in the fourth quarter of 2014 compared to prior year. In the fourth quarter, pre-tax income decreased 26.4 percent to \$1,464 million and the pre-tax margin declined 3.9 points to 15.6 percent compared to the prior year. The year-to-year decrease was driven by several key factors. First, GTS lost profit on a year-to-year basis as a result of the customer care and industry standard server divestitures. Second, the fourth quarter workforce rebalancing charge of \$277 million impacted profit. Finally, the company continued to invest in both offerings and operational capabilities. This includes targeted investments in mobility, security and cloud which complement clients' systems-of-record, as well as operational improvements such as the yield from the rebalancing action taken earlier in the year, and more broadly deployed automation in the delivery centers.

Global Business Services revenue of \$4,349 million decreased 8.4 percent (3 percent adjusted for currency) in the fourth quarter of 2014. Consulting and Systems Integration revenue of \$3,416 million declined 8.6 percent (3 percent adjusted for currency) in the fourth quarter. Revenue was down in the traditional back office implementations, particularly in North America. However, the company again had strong double-digit growth in its practices that address cloud, analytics, mobile and security. Through its partnership with Apple, the company released the first 10 Mobile-First for iOS solutions in the fourth quarter. GBS Outsourcing revenue of \$933 million decreased 7.5 percent (2 percent adjusted for currency) in the fourth quarter, reflecting sequential improvement at constant currency compared to the third quarter of 2014. However, performance continued to be impacted by a challenging pricing environment.

The GBS gross profit margin of 32.0 percent expanded 1.4 points in the fourth quarter of 2014 compared to prior year, which is a good indicator of the value its offerings deliver. Pre-tax income decreased 22.0 percent to \$733 million including a 15 point impact from the workforce rebalancing charge, which will pay back in 2015. Pre-tax margin declined 2.7 points to 16.4 percent compared to the prior year. Although the company continued to see a slowdown in back office implementations in the traditional parts of the portfolio, it is investing in strategic partnerships and those should yield benefits in 2015.

## Software

Software revenue of \$7,578 million decreased 6.9 percent (3 percent adjusted for currency) in the fourth quarter compared to the prior year. Middleware decreased 5.6 percent (2 percent adjusted for currency), while operating systems were down 18.8 percent (16 percent adjusted for currency). As expected, there was not a change in trajectory in the fourth quarter and performance was similar to the previous quarter. Total growth reflected a headwind from operating systems, driven by the divestiture of the industry standard server business and Power Systems results. It also reflected business model changes, which impacted transaction revenue growth as customers continue to use the flexibility that has been provided in the deployment of software purchased through enterprise licensing agreements. This flexibility enables clients to optimize their capacity on the company's platform for the long term. There was solid growth in many of the solution areas, including security, mobile and cloud. Security software again grew at a double-digit rate, marking the ninth consecutive quarter of double-digit growth. With cybersecurity threats as one of the key issues that all customers are facing, the company has brought its analytics, big data, research IP, mobile and cloud capabilities together to create security offerings to address this market opportunity. The company's software mobile offerings more than doubled in the quarter, as it leveraged the integrated MobileFirst portfolio, and software-as-a-service offerings were up nearly 50 percent.

Key branded middleware revenue, which accounted for 72 percent of total Software revenue in the fourth quarter of 2014, decreased 6.4 percent (3 percent adjusted for currency) compared to the prior year. Within key branded middleware, WebSphere revenue decreased 6.4 percent (4 percent adjusted for currency). Information Management revenue decreased 9.1 percent (6 percent adjusted for currency). Tivoli revenue decreased 2.4 percent, but was up 1 percent adjusted for currency driven by security software. Workforce Solutions revenue decreased 12.1 percent (8 percent adjusted for currency). Rational revenue increased 4.1 percent (10 percent adjusted for currency) in the fourth quarter with improved year-to-year performance compared to the earlier quarters of 2014.

The Software gross profit margin remained strong at 90.0 percent in the fourth quarter compared to 90.5 percent in fourth quarter of the prior year. Software pre-tax income of \$3,765 million in the fourth quarter decreased 11.2 percent year to year, with a pre-tax margin of 44.7 percent, a decline of 2.3 points. The fourth quarter of 2014 included a workforce rebalancing charge of \$120 million that represented approximately 3 points of the year-to-year decline.

### Systems and Technology

Systems and Technology revenue of \$2,406 million decreased 39.0 percent as reported and 12 percent adjusted for the divestiture of the industry standard server business (24 points) and currency (3 points) in the fourth quarter of 2014, versus the same period in 2013.

System z revenue decreased 25.8 percent (23 percent adjusted for currency), compared to the prior year period. This performance reflected the fact that the product was in the tenth and final quarter of this product cycle. The last 10-quarter cycle was the z10. Comparing the current cycle to that of the z10, program-to-date System z revenue and gross profit is right on top of that cycle. The company continues to innovate on the platform, and in January 2015 announced the z13, the new generation of the IBM mainframe.

Power Systems revenue decreased 13.4 percent (11 percent adjusted for currency) compared to the prior year period which represented a modest sequential improvement at constant currency. Power has been repositioned and is not only a systems business, but also an open chip processor and an IP income opportunity through the OpenPOWER foundation. There was double-digit growth in the low end, driven by entry-level POWER8-based systems, and in the fourth quarter, the company introduced its high-end POWER8 enterprise systems. In addition, the company saw continued expansion of the OpenPOWER consortium, now with over 80 members.

Storage revenue decreased 8.3 percent (5 percent adjusted for currency) in the fourth quarter compared to the prior year period representing a modest sequential improvement compared to the rate in the prior quarter. There was strong growth again in the FlashSystems and Storwize portfolio. This growth was offset by the wind down of the legacy OEM business and continued weakness in high-end disk.

Systems and Technology's gross profit margin of 49.6 percent increased 7.3 points in the fourth quarter of 2014 versus the prior year. The increase was primarily due to mix (7.6 points) driven by the divestiture of the industry standard server business. This improvement was offset by a decrease due to margin. Lower margins in Power Systems (0.8 points) and Storage (0.6 points) were partially offset by higher margins in System z (0.6 points).

Systems and Technology's pre-tax income of \$388 million increased 12.2 percent with a pre-tax margin of 15.5 percent, up 7 points year to year. This performance included a workforce rebalancing charge of \$32 million in the fourth quarter of 2014 which impacted year-to-year growth by approximately 9 points and pre-tax margin in the fourth quarter by approximately 1 point.

### Global Financing

Global Financing revenue of \$532 million was down 0.5 percent due to a decrease in used equipment sales revenue, partially offset by an increase in financing revenue. The Global Financing fourth-quarter pre-tax income decreased 10.8 percent to \$526 million and the pre-tax margin decreased 2.7 points to 47.0 percent. The decrease in pre-tax income was driven by a decrease in gross profit (\$46 million) as well as an increase in financing receivable provisions (\$26 million), partially offset by a reduction in SG&A expenses (\$11 million).

### Geographic Revenue

Total geographic revenue of \$23,990 million decreased 12.0 percent as reported and 2 percent adjusted for divestitures (5 points) and currency (5 points) in the fourth quarter of 2014 compared to the prior year. Major market countries decreased 10.8 percent as reported and 2 percent adjusted for divestitures (4 points) and currency (5 points). Growth market countries decreased 15.7 percent as reported and 2 percent adjusted for divestitures (9 points) and currency (5 points).

In the growth markets, the year-to-year performance adjusted for currency and the divestitures improved by approximately 2 points from the third quarter. This improvement was driven by performance in China which decreased 19.9 percent as reported, but only 1 percent adjusted for divestitures (18 points) and currency (1 point). On an adjusted basis, this represented a significant sequential improvement compared to the prior quarter. China's fourth quarter performance was driven by strength in software and several large mainframe transactions, with four of the company's five largest banking clients in China adding substantial new mainframe capacity. Within the BRIC countries, combined revenue decreased 21.4 percent as reported and 8 percent adjusted for divestitures (9 points) and currency (4 points) in the fourth quarter. On an adjusted basis, this performance was consistent with the third quarter, with the improvement in China offset by weaker performance in Brazil.

Americas revenue of \$11,090 million decreased 9.0 percent as reported and 4 percent adjusted for divestitures (3 points) and currency (2 points) compared to the fourth quarter of 2013. North America declined 8.1 percent as reported and 4 percent adjusted for divestitures (3 points) and currency (1 point). The Latin American growth markets declined 14.7 percent as reported and 4 percent adjusted for divestitures (4 points) and currency (7 points). The decrease in North America was driven by declines in Global Business Services, though signings grew for the second consecutive quarter. Declines in the Latin American growth markets were driven by the weak performance in Brazil.

EMEA revenue of \$8,001 million decreased 12.8 percent as reported, but only 1 percent adjusted for divestitures (5 points) and currency (7 points) year to year in the fourth quarter of 2014. Major market countries were down 13.2 percent as reported and 2 percent adjusted for divestitures (4 points) and currency (7 points). Growth market countries were down 9.7 percent, but were up 7 percent adjusted for divestitures (10 points) and currency (6 points). On an adjusted basis, Europe's overall performance improved from the third quarter. In the major markets, there were improvements in the UK and Italy, and continued growth in Spain. Compared to the prior year, the UK decreased 10.0 percent as reported and 1 percent adjusted for divestitures (7 points) and currency (2 points) compared with a decline of 5 percent on an adjusted basis in the prior quarter. Italy decreased 7.5 percent as reported, but grew 5 percent adjusted for divestitures (3 points) and currency (9 points) compared with a decline of 2 percent on an adjusted basis in the prior quarter. Spain decreased 7.8 percent as reported, but grew 3 percent adjusted for divestitures (2 points) and currency (9 points). The increase in the growth markets when adjusted for currency and the divestitures was driven by strength in the central and eastern European countries.

Asia Pacific fourth quarter revenue decreased 16.7 percent as reported and 2 percent adjusted for divestitures (8 points) and currency (7 points) year over year. Japan decreased 14.5 percent as reported, but grew 2 percent adjusted for divestitures (4 points) and currency (12 points). Asia Pacific growth market countries decreased 18.1 percent as reported and 5 percent adjusted for divestitures (11 points) and currency (3 points) year to year. Although there was improved performance this quarter in China on an adjusted basis, there were continued year-to-year declines in some of the other larger growth market countries.

### Total Expense and Other (Income)

(\$ in millions)

	2014	2013	Yr.-to-Yr. Percent/ Margin Change
<b>For the fourth quarter:</b>			
<b>Total consolidated expense and other (income)</b>	<b>\$5,767</b>	\$7,235	(20.3)%
Non-operating adjustments			
Amortization of acquired intangible assets	(93)	(93)	(0.1)
Acquisition-related charges	(2)	(16)	(87.5)
Non-operating retirement-related (costs)/income	(74)	(104)	(28.5)
<b>Operating (non-GAAP) expense and other (income)</b>	<b>\$5,598</b>	\$7,023	(20.3)%
Total consolidated expense-to-revenue ratio	<b>23.9%</b>	26.4%	(2.5) pts.
Operating (non-GAAP) expense-to-revenue ratio	<b>23.2%</b>	25.6%	(2.4) pts.

Total expense and other (income) decreased 20.3 percent in the fourth quarter with an expense-to-revenue ratio of 23.9 percent compared to 26.4 percent in the fourth quarter of 2013. Total operating (non-GAAP) expense and other (income) also decreased 20.3 percent in the fourth quarter. The decrease in total operating expense and other (income) was primarily driven by lower base expense (17 points) and currency (4 points), partially offset by increased expense from acquisitions over the past 12 months (1 point). The decline in base expense was driven by the gain from the industry standard server divestiture, partially offset by the workforce reduction charge recorded in the fourth quarter. Other (income)/expense included the pre-tax gain from the industry standard server divestiture of \$1.4 billion; while selling, general and administrative expense included the workforce rebalancing change of approximately \$580 million. Additionally, expense associated with the industry standard server business is no longer in the run rate which also contributed to the year-to-year decline in the fourth quarter.

### Results of Discontinued Operations

Loss from discontinued operations, net of tax, was \$31 million in the fourth quarter of 2014 compared to \$32 million in 2013.

### Cash Flow

The company generated \$6,059 million in cash flow provided by operating activities, a decrease of \$468 million compared to the fourth quarter of 2013, driven primarily by declines in operational performance within net income and an increase in cash taxes paid (\$203 million). Net cash used in investing activities of \$1,236 million decreased \$1,666 million compared to the prior year, primarily due to cash proceeds received from the divestiture of the industry standard server business. Net cash used in financing activities of \$5,699 million increased \$2,686 million compared to the prior year primarily due to debt retirements during the quarter, offset by decreased cash used for gross common stock repurchases (\$5,665 million).

### GAAP Reconciliation

The tables below provide a reconciliation of the company's income statement results as reported under GAAP to its operating earnings presentation which is a non-GAAP measure. The company's calculation of operating (non-GAAP) earnings, as presented, may differ from similarly titled measures reported by other companies. Please refer to the "Operating (non-GAAP) Earnings" section on page 22 for the company's rationale for presenting operating earnings information.

(\$ in millions except per share amounts)

	GAAP	Acquisition- Related Adjustments	Retirement- Related Adjustments	Operating (non-GAAP)
<b>For the fourth quarter 2014:</b>				
Gross profit	\$12,862	\$ 101	\$ 33	\$12,996
Gross profit margin	53.3%	0.4 pts.	0.1 pts.	53.9%
SG&A	\$ 6,034	\$ (94)	\$ (95)	\$ 5,845
RD&E	1,320	—	21	1,341
Other (income) and expense	(1,506)	(1)	—	(1,506)
Total expense and other (income)	5,767	(95)	(74)	5,598
Pre-tax income from continuing operations	7,094	196	107	7,398
Pre-tax margin from continuing operations	29.4%	0.8 pts.	0.4 pts.	30.7%
Provision for income taxes*	\$ 1,580	\$ 10	\$ 24	\$ 1,613
Effective tax rate	22.3%	(0.5) pts.	0.0 pts.	21.8%
Income from continuing operations	\$ 5,515	\$ 186	\$ 84	\$ 5,785
Income margin from continuing operations	22.9%	0.8 pts.	0.3 pts.	24.0%
Loss from discontinued operations, net of tax	\$ (31)	\$ —	\$ —	\$ (31)
Net income	\$ 5,484	\$ 186	\$ 84	\$ 5,753
Diluted earnings per share:				
Continuing operations	\$ 5.54	\$0.19	\$0.08	\$ 5.81
Discontinued operations	\$ (0.03)	\$ —	\$ —	\$ (0.03)

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

(\$ in millions except per share amounts)

	GAAP	Acquisition- Related Adjustments	Retirement- Related Adjustments	Operating (non-GAAP)
<b>For the fourth quarter 2013:</b>				
Gross profit	\$14,337	\$ 105	\$ 154	\$14,596
Gross profit margin	52.4%	0.4 pts.	0.6 pts.	53.3%
SG&A	\$ 5,987	\$(101)	\$( 90)	\$ 5,796
RD&E	1,452	—	(14)	1,438
Other (income) and expense	(116)	(8)	—	(124)
Total expense and other (income)	7,235	(109)	(104)	7,023
Pre-tax income from continuing operations	7,102	213	258	7,574
Pre-tax margin from continuing operations	25.9%	0.8 pts.	0.9 pts.	27.7%
Provision for income taxes*	\$ 885	\$ (55)	\$ 94	\$ 925
Effective tax rate	12.5%	(1.1) pts.	0.8 pts.	12.2%
Income from continuing operations	\$ 6,216	\$ 268	\$ 164	\$ 6,649
Income margin from continuing operations	22.7%	1.0 pts.	0.6 pts.	24.3%
Loss from discontinued operations, net of tax	\$ (32)	\$ —	\$ —	\$ (32)
Net income	\$ 6,185	\$ 268	\$ 164	\$ 6,617
Diluted earnings per share:				
Continuing operations	\$ 5.76	\$0.25	\$0.15	\$ 6.16
Discontinued operations	\$ (0.03)	\$ —	\$ —	\$ (0.03)

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

## PRIOR YEAR IN REVIEW

The “Prior Year in Review” section provides a summary of the company’s financial performance in 2013 as compared to 2012. As discussed in the “Organization of Information” section on page 22, 2013 and 2012 financial performance has been reclassified to reflect discontinued operations presentation.

(\$ and shares in millions except per share amounts)

	2013	2012	Yr.-to-Yr. Percent/ Margin Change
<b>For the year ended December 31:</b>			
Revenue	\$ 98,367	\$102,874	(4.4)%*
Gross profit margin	49.5%	49.0%	0.5 pts.
Total expense and other (income)	\$ 28,440	\$ 27,821	2.2%
Total expense and other (income)-to-revenue ratio	28.9%	27.0%	1.9 pts.
Income before income taxes from continuing operations	\$ 20,244	\$ 22,540	(10.2)%
Provision for income taxes from continuing operations	3,363	5,541	(39.3)%
Income from continuing operations	\$ 16,881	\$ 16,999	(0.7)%
Income from continuing operations margin	17.2%	16.5%	0.6 pts.
Loss from discontinued operations, net of tax	\$ (398)	\$ (395)	0.6%
Net income	\$ 16,483	\$ 16,604	(0.7)%
Earnings per share from continuing operations:			
Assuming dilution	\$ 15.30	\$ 14.71	4.0%
Consolidated earnings per share—assuming dilution	\$ 14.94	\$ 14.37	4.0%
Weighted-average shares outstanding:			
Assuming dilution	1,103.0	1,155.4	(4.5)%
Assets**	\$126,223	\$119,213	5.9%
Liabilities**	\$103,294	\$100,229	3.1%
Equity**	\$ 22,929	\$ 18,984	20.8%

\* (2.3) percent adjusted for currency.

\*\* At December 31.

The following table provides the company’s operating (non-GAAP) earnings for 2013 and 2012.

(\$ in millions except per share amounts)

	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
Net income as reported	\$16,483	\$16,604	(0.7)%
Loss from discontinued operations, net of tax	(398)	(395)	0.6
Income from continuing operations	\$16,881	\$16,999	(0.7)%
Non-operating adjustments (net of tax):			
Acquisition-related charges	747	641	16.5
Non-operating retirement-related costs/(income)	729	381	91.2
Operating (non-GAAP) earnings*	\$18,356	\$18,022	1.9%
Diluted operating (non-GAAP) earnings per share	\$ 16.64	\$ 15.60	6.7%

\* See page 63 for a more detailed reconciliation of net income to operating (non-GAAP) earnings.

## Snapshot

In 2013, the company reported revenue of \$98.4 billion, expanded gross and net income margins, and delivered diluted earnings per share from continuing operations growth of 4.0 percent as reported and 6.7 percent on an operating (non-GAAP) basis. The results of continuing operations exclude net losses from discontinued operations of \$0.4 billion in 2013 and 2012, respectively. On a consolidated basis, net income in 2013 was \$16.5 billion, a decrease of 0.7 percent year to year, with diluted earnings per share of \$14.94. The company generated \$17.5 billion in cash from operations and \$15.0 billion in free cash flow driving shareholder returns of \$17.9 billion in gross common stock repurchases and dividends. In 2013, the company continued the transformation of its portfolio to higher value expending \$3.1 billion to acquire 10 companies to expand its capabilities in its key growth areas, in addition to maintaining high levels of investment of \$5.7 billion in total research and development and \$3.8 billion in net capital expenditures.

The company also continued to shift its investments to address the key trends in information technology—social, mobile, big data/ analytics and cloud. Several years ago, the company identified and established objectives for four key growth initiatives—Smarter Planet, business analytics, cloud and growth markets—to address these trends. In 2013, across the business, Smarter Planet, business analytics and cloud had strong performance. Smarter Planet revenue grew about 20 percent compared to 2012, with

strength across all areas, including Smarter Commerce, Smarter Cities, Social Business and industry solutions. Business analytics revenue of \$15.7 billion increased 9 percent year to year, led by Global Business Services and Software. In 2013, the company delivered \$4.4 billion of cloud-based solutions revenue, an increase of 69 percent compared to 2012. In addition, within that content, \$1.7 billion was delivered as a service. Across the company's performance, there was overlap between these initiatives. In total, software made up about half of that combined content. The software content improved the company's business mix and contributed to margin expansion.

Segment revenue was led by Software which increased 1.9 percent (3 percent adjusted for currency) driven by key branded middleware which increased 4.8 percent (6 percent adjusted for currency). The key growth initiatives fueled this performance. Global Business Services returned to revenue growth at constant currency (down 0.9 percent as reported; up 3 percent adjusted for currency) driven by the company's investments in the Digital Front Office. While revenue in Global Technology Services declined 4.2 percent (1 percent adjusted for currency), revenue trajectory improved in the second half. Global Financing revenue improved 0.4 percent (3 percent adjusted for currency) versus 2012. The Software, Global Services and Global Financing businesses all grew pre-tax income and expanded their pre-tax margin in 2013 compared to 2012. Systems and Technology impacted the company's overall performance in 2013. Revenue decreased 19.0 percent (18 percent adjusted for currency) year to year driven by the back end of the mainframe product cycle and business model challenges specific to Power Systems, Storage and System x. Pre-tax income in Systems and Technology decreased \$1.7 billion compared to 2012.

Revenue from the company's growth markets underperformed in 2013, particularly in the second half of the year. For the full year, growth markets revenue decreased 4.9 percent as reported and 2 percent at constant currency.

The consolidated gross profit margin increased 0.5 points versus 2012 to 49.5 percent. The operating (non-GAAP) gross margin of 50.5 percent increased 0.9 points compared to the prior year. The increase in gross margin in 2013 was driven by margin improvements in the Global Services segments and an improved mix driven by Software, partially offset by margin decreases in Systems and Technology.

Total expense and other (income) increased 2.2 percent in 2013 versus 2012. Total operating (non-GAAP) expense and other (income) increased 1.5 percent year to year. The year-to-year drivers were approximately:

	<b>Total Consolidated</b>	<b>Operating (non-GAAP)</b>
• Currency*	(1) point	(1) point
• Acquisitions**	2 points	2 points
• Base expense	1 point	1 point

\* Reflects impacts of translation and hedging programs.

\*\* Includes acquisitions completed in prior 12-month period.

There were several items that had an impact on total expense and other (income) year to year. Workforce rebalancing charges for 2013 were \$1.0 billion compared to \$0.8 billion in 2012. Bad debt expense increased \$0.1 billion year to year driven by higher specific account reserves. In addition, in 2012, the company recorded a gain of approximately \$0.4 billion related to the divestiture of the Retail Store Solutions (RSS) business, and also recorded a charge of approximately \$0.2 billion related to a court ruling in the UK regarding one of IBM's UK defined benefit pension plans. This charge was not included in operating (non-GAAP) expense and other (income). In addition, as a result of certain parts of the business not performing as expected, performance-related compensation in 2013 across both cost and expense was down about \$0.8 billion year to year.

Pre-tax income from continuing operations decreased 10.2 percent and the pre-tax margin was 20.6 percent, a decrease of 1.3 points versus 2012. The continuing operations effective tax rate was 16.6 percent in 2013, a decrease of 8.0 points year to year. Income from continuing operations decreased 0.7 percent year to year and the loss from discontinued operations, net of tax was \$0.4 billion in 2013 flat compared to 2012. Net income decreased 0.7 percent versus 2012. The as reported effective tax rate for 2013 was 15.6 percent, a decrease of 8.6 points year to year driven by an improvement in the ongoing tax rate and discrete tax items, including audit settlements. Operating (non-GAAP) pre-tax income decreased 7.2 percent and the operating (non-GAAP) pretax margin was 22.5 percent, a decrease of 0.7 points versus 2012. Operating (non-GAAP) net income increased 1.9 percent and the operating (non-GAAP) net income margin of 18.7 percent increased 1.2 points versus the prior year. The operating (non-GAAP) effective tax rate was 17.0 percent versus 24.3 percent in 2012 driven by the same factors described above.

Diluted earnings per share from continuing operations improved 4.0 percent year to year reflecting the benefits of the common stock repurchase program. In 2013, the company repurchased approximately 73 million shares of its common stock. Diluted earnings per share from discontinued operations was (\$0.36) in 2013 compared to (\$0.34) in 2012. Total diluted earnings per share of \$14.94 increased \$0.57 from 2012. Operating (non-GAAP) diluted earnings per share of \$16.64 increased \$1.04 versus 2012 driven primarily by margin expansion and common stock repurchases, partially offset by decreased revenue.

At December 31, 2013, the company's balance sheet and liquidity positions were strong and well positioned to support the business over the long term. Cash and marketable securities at year end was \$11.1 billion, consistent with the year-end 2012 balance. Key drivers in the balance sheet and total cash flows are highlighted below.

Total assets increased \$7.0 billion (\$9.3 billion adjusted for currency) from December 31, 2012 driven by:

- Increases in prepaid pension assets (\$4.6 billion), goodwill (\$1.9 billion), and total receivables (\$1.2 billion), partially offset by
- Decreases in deferred taxes (\$0.7 billion).

Total liabilities increased \$3.1 billion (\$4.5 billion adjusted for currency) from December 31, 2012 driven by:

- Increased total debt (\$6.4 billion) and increases in deferred tax liabilities (\$1.3 billion); partially offset by
- Decreased retirement and nonpension postretirement benefit obligations (\$4.2 billion) and decreases in compensation and benefits (\$0.9 billion).

Total equity of \$22.9 billion increased \$3.9 billion from December 31, 2012 as a result of:

- Higher retained earnings (\$12.4 billion), decreased losses in accumulated other comprehensive income/(loss) of \$4.2 billion and increased common stock (\$1.5 billion), partially offset by
- Increased treasury stock (\$14.1 billion) driven by share repurchases.

The company generated \$17.5 billion in cash flow provided by operating activities, a decrease of \$2.1 billion when compared to 2012, primarily driven by operational performance and a net increase in the use of cash for taxes of \$2.2 billion primarily driven by an increase in cash tax payments. Net cash used in investing activities of \$7.3 billion was \$1.7 billion lower than 2012, primarily due to a decrease in cash used associated with the net purchases and sales of marketable securities and other investments (\$1.2 billion) and decreased net capital investments (\$0.5 billion). Net cash used in financing activities of \$9.9 billion was \$2.1 billion lower compared to 2012, primarily due to increased proceeds from net debt (\$4.7 billion), partially offset by increased cash used for gross common stock repurchases (\$1.9 billion).

## Results of Continuing Operations

### Segment Details

The following is an analysis of the 2013 versus 2012 reportable segment results. The table below presents each reportable segment's external revenue and gross margin results. Segment pre-tax income includes transactions between segments that are intended to reflect an arm's-length transfer price and excludes certain unallocated corporate items.

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent/ Margin Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Revenue</b>				
Global Technology Services	\$38,551	\$ 40,236	(4.2)%	(1.4)%
Gross margin	38.1%	36.6%	1.5 pts.	
Global Business Services	18,396	18,566	(0.9)%	2.6%
Gross margin	30.9%	30.0%	0.9 pts.	
Software	25,932	25,448	1.9%	2.9%
Gross margin	88.8%	88.7%	0.1 pts.	
Systems and Technology	12,988	16,034	(19.0)%	(18.2)%
Gross margin	40.8%	43.4%	(2.6) pts.	
Global Financing	2,022	2,013	0.4%	2.8%
Gross margin	45.6%	46.5%	(0.9) pts.	
Other	478	577	(17.1)%	(16.4)%
Gross margin	(195.6)%	(71.6)%	(124.0) pts.	
<b>Total consolidated revenue</b>	<b>\$98,367</b>	<b>\$102,874</b>	<b>(4.4)%</b>	<b>(2.3)%</b>
<b>Total consolidated gross profit</b>	<b>\$48,684</b>	<b>\$ 50,361</b>	<b>(3.3)%</b>	
Total consolidated gross margin	49.5%	49.0%	0.5 pts.	
Non-operating adjustments				
Amortization of acquired intangible assets	388	375	3.5%	
Acquisition-related charges	5	1	NM	
Retirement-related costs/(income)	629	264	138.1%	
<b>Operating (non-GAAP) gross profit</b>	<b>\$49,706</b>	<b>\$ 51,001</b>	<b>(2.5)%</b>	
Operating (non-GAAP) gross margin	50.5%	49.6%	1.0 pts.	

NM—Not meaningful

### Global Services

In 2013, the Global Services segments delivered \$56,947 million of revenue, grew pre-tax income 2.5 percent and expanded pre-tax margin 1.0 points. GBS returned to revenue growth in 2013, at constant currency, leveraging the investments made in the Digital Front Office practices. GTS revenue performance improved during the second half of 2013. Global Services had good performance in the key growth initiatives of Smarter Planet, business analytics and cloud, and continued to invest to expand its capabilities in these

areas. Total outsourcing revenue of \$26,157 million decreased 5.1 percent (2 percent adjusted for currency) and total transactional revenue of \$23,678 million decreased 1.0 percent as reported, but increased 2 percent adjusted for currency year to year. The estimated Global Services backlog was \$143 billion at December 31, 2013, an increase of 1.8 percent (5 percent adjusted for currency) versus the December 31, 2012 balance.

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Global Services external revenue</b>	\$56,947	\$58,802	(3.2)%	(0.2)%
Global Technology Services	\$38,551	\$40,236	(4.2)%	(1.4)%
Outsourcing	22,060	23,344	(5.5)	(2.7)
Integrated Technology Services	9,380	9,550	(1.8)	1.0
Maintenance	7,111	7,343	(3.1)	(0.7)
Global Business Services	\$18,396	\$18,566	(0.9)%	2.6%
Outsourcing	4,097	4,209	(2.6)	1.5
Consulting and Systems Integration	14,298	14,358	(0.4)	2.9

Global Technology Services revenue of \$38,551 million in 2013 decreased 4.2 percent (1 percent adjusted for currency) year to year. From a geographic perspective, revenue declined in North America and Europe, partially offset by growth in Japan, adjusted for currency. GTS Outsourcing revenue decreased 5.5 percent (3 percent adjusted for currency) in 2013. Revenue performance was impacted by a decline in revenue from sales into existing base accounts and by the work done to improve the profitability of restructured low margin contracts. GTS Outsourcing had double-digit signings growth in 2013 and started to realize the benefit from several of the large transformational contract signings in its fourth-quarter 2013 revenue. ITS revenue decreased 1.8 percent as reported, but increased 1 percent adjusted for currency in 2013 compared to 2012. The company continued to shift the ITS business toward higher value managed services such as business continuity, security and cloud. Within the cloud offerings, SoftLayer contributed 2 points of revenue growth to the ITS performance in 2013, and a half-point to total GTS revenue for the year. In January 2014, the company announced plans to invest over \$1.2 billion to double its SoftLayer centers, and with 40 cloud datacenters in 15 countries, the company will have cloud centers in every major geography and key financial center.

Global Business Services revenue of \$18,396 million decreased 0.9 percent as reported, but increased 3 percent at constant currency in 2013 with growth in both GBS Outsourcing and C&SI, adjusted for currency. GBS revenue increased 0.5 percent (4 percent at constant currency) in the second half of the year. On a geographic basis, revenue growth at constant currency was led by North America, Japan and the growth markets, while Europe was flat year to year. GBS delivered double-digit growth in each

of the strategic growth initiatives of business analytics, Smarter Planet and cloud. The company has been investing to build capabilities in these key areas and at year-end 2013 had nearly 20,000 resources in GBS focused on the growing Digital Front Office opportunity. Application Outsourcing revenue decreased 2.6 percent as reported, but increased 2 percent adjusted for currency. C&SI revenue decreased 0.4 percent as reported, but increased 3 percent adjusted for currency. Both lines of business had constant currency revenue growth year to year in the growth markets. In 2013, the GBS backlog grew for the fifth consecutive year at constant currency led by the major markets.

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent/ Margin Change
<b>Global Services</b>			
Global Technology Services			
External gross profit	\$14,691	\$14,740	(0.3)%
External gross profit margin	38.1%	36.6%	1.5 pts.
Pre-tax income	\$ 6,983	\$ 6,961	0.3%
Pre-tax margin	17.6%	16.8%	0.8 pts.
Global Business Services			
External gross profit	\$ 5,676	\$ 5,564	2.0%
External gross profit margin	30.9%	30.0%	0.9 pts.
Pre-tax income	\$ 3,214	\$ 2,983	7.7%
Pre-tax margin	16.8%	15.5%	1.3 pts.

GTS gross profit decreased 0.3 percent in 2013 and the gross profit margin improved 1.5 points year to year with margin expansion in each line of business, as well as in the growth markets and major markets. Pre-tax income increased 0.3 percent year to year and the pre-tax margin expanded 0.8 points to 17.6 percent. The 2013 margin improvement was driven by reductions in performance-related compensation, benefits from the second-quarter 2013 workforce rebalancing activity and efficiency improvements primarily through the company's enterprise productivity initiatives, partially offset by higher year-to-year workforce rebalancing charges.

The GBS gross profit margin expanded 0.9 points in 2013 with improved profit performance in Application Outsourcing. GBS

pre-tax income increased 7.7 percent in 2013 with a pre-tax margin of 16.8 percent, an improvement of 1.3 points year to year. GBS benefited from reductions in performance-related compensation, the company's enterprise productivity initiatives and the second-quarter 2013 workforce rebalancing activity, partially offset by higher year-to-year workforce rebalancing charges. The savings from those actions fuel the investments being made in the key growth initiatives.

The total Global Services business delivered profit growth and margin expansion throughout 2013. Pre-tax income of \$10,197 million in 2013 increased 2.5 percent year to year and the pre-tax margin expanded 1.0 points to 17.4 percent.

## Software

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Software external revenue</b>	\$25,932	\$25,448	1.9%	2.9%
Middleware	\$21,557	\$20,983	2.7%	3.7%
Key Branded Middleware	17,322	16,528	4.8	5.7
WebSphere Family			8.2	9.1
Information Management			2.8	3.7
Workforce Solutions			10.8	11.9
Tivoli			3.9	4.8
Rational			4.9	6.0
Other middleware	4,235	4,455	(4.9)	(3.9)
Operating systems	2,447	2,525	(3.1)	(1.9)
Other	1,929	1,940	(0.6)	0.2

Software revenue of \$25,932 million increased 1.9 percent as reported and 3 percent adjusted for currency in 2013 compared to 2012. The Software business delivered revenue growth, at constant currency, in all four quarters of the year. Revenue continued to mix toward key branded middleware with growth in all five brands. The Software value proposition remained strong for enterprise clients. Customers continued to increase deployment of the company's middleware products and the business invested and gained share in social, mobile, analytics, cloud and security. Across the Software brands, there was strong performance in the growth initiatives that address the key market trends—Smarter Planet, business analytics and cloud.

In January 2014, the company announced a \$1 billion investment in Watson, and it established a new Watson Group within the Software business. This new unit is dedicated to the development and commercialization of cloud-delivered cognitive innovations.

Key branded middleware revenue increased 4.8 percent (6 percent adjusted for currency), with strong performance in the areas of analytics, cloud, mobile, social and security. The faster-growing and higher-value branded middleware accounted for 67 percent of total Software revenue in 2013, an increase of 2 points from 2012.

WebSphere revenue increased 8.2 percent (9 percent adjusted for currency) in 2013 and gained share. Revenue performance was driven by double-digit growth in the Commerce offerings, and growth in Business Integration and the on-premises Application Server business. Mobile contributed strong revenue growth in 2013. MobileFirst, the company's comprehensive portfolio of mobile software and services, was introduced in 2013 and extends value to clients to reach new markets and gain competitive advantage.

Information Management revenue increased 2.8 percent (4 percent adjusted for currency) in 2013 compared to 2012. Performance in 2013 included strong growth in the distributed database offerings, including Netezza, and content management software.

Tivoli revenue increased 3.9 percent (5 percent adjusted for currency) in 2013 and gained share, driven by storage growth and the security solutions portfolio. Tivoli storage revenue was up 7 percent (8 percent adjusted for currency) in 2013. Tivoli security revenue increased 17 percent (19 percent adjusted for currency) and reflected contribution from the acquisition of Trusteer in the third quarter of 2013, which extended Tivoli's data security capabilities further into cloud and mobile environments. The transformation driven by mobile and cloud computing is raising the importance of security for enterprise customers. The company has been building and expanding its security capabilities and at year-end 2013 had 6,000 security experts worldwide, 3,000 patents in security and 25 security laboratories worldwide across software and services.

Workforce Solutions revenue increased 10.8 percent (12 percent adjusted for currency) in 2013. Performance was driven by Kenexa, which provides cloud-based recruiting and talent management solutions.

Operating systems revenue decreased 3.1 percent (2 percent adjusted for currency) in 2013 compared to 2012, driven by declines in Systems z and Power Systems.

## Systems and Technology

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>Systems and Technology external revenue</b>	\$12,988	\$16,034	(19.0)%	(18.2)%
System z			(13.4)%	(12.6)%
Power Systems			(31.4)	(30.7)
System x			(13.5)	(12.7)
Storage			(10.8)	(9.7)
Total Systems and Technology excluding Retail Store Solutions			(17.2)	(16.4)
Retail Store Solutions (Divested in 2012)			(98.2)	(98.2)

Systems and Technology revenue decreased 19.0 percent (18 percent adjusted for currency) in 2013 versus 2012. Adjusting for the divested RSS business, revenue declined 17.2 percent (16 percent adjusted for currency) in 2013. Two issues within the business significantly impacted the segment's revenue and profit performance in 2013. First, STG was dealing with challenges in its hardware business models specific to Power Systems, Storage and x86. In addition, System z revenue was impacted by the product cycle, particularly in the second half, as the company entered the back end of the current mainframe cycle with difficult period-to-period comparisons driving revenue declines.

System z revenue decreased 13.4 percent (13 percent adjusted for currency) in 2013 versus 2012. The decrease was primarily driven by lower revenue in North America, while revenue increased in the growth markets. Millions of instructions per second (MIPS) shipments increased 6 percent in 2013 versus 2012. The increase

(\$ in millions)

For the year ended December 31:	2013	2012	Yr.-to-Yr. Percent/ Margin Change
<b>Software</b>			
External gross profit	\$23,032	\$22,569	2.0%
External gross profit margin	88.8%	88.7%	0.1 pts.
Pre-tax income	\$11,106	\$10,810	2.7%
Pre-tax margin	38.1%	37.6%	0.5 pts.

Software gross profit increased 2.0 percent in 2013, with a gross profit margin of 88.8 percent. Software pre-tax income increased 2.7 percent to \$11.1 billion and the pre-tax margin improved 0.5 points to 38.1 percent. The Software business had another successful year leveraging revenue growth and expense savings, primarily from the company's enterprise productivity initiatives, to drive profit growth and margin expansion. The relative strength of the Software business, fueled by growth in the key growth initiatives, improved the company's business mix and contributed to its operating (non-GAAP) consolidated gross and net margin improvements in 2013.

in MIPS was driven by specialty engines, which increased 17 percent year over year and continued to be more than 50 percent of the total volumes. The decline in System z revenue was expected based on the product's movement through the product cycle in 2013. In the current mainframe cycle, the company has shipped 28 percent more MIPS compared to the same period in the prior cycle. The revenue and gross profit in the current cycle are each about 99 percent of the previous cycle, net of currency. The additional MIPS capacity in the current product cycle is a reflection of the ongoing relevance of the mainframe to clients, and provides the company with financial returns consistent with past cycles.

Power Systems revenue decreased 31.4 percent (31 percent adjusted for currency) in 2013 versus 2012. The Power platform continued to ship significant capacity into the UNIX market, however this was more than offset by significant price performance, resulting in lower revenue. The company has been very successful

in the UNIX market, and took two actions to improve its business model in Power Systems. First, it is making the platform more relevant to clients. To achieve this:

- In the fourth quarter of 2013, the company introduced a new Integrated Facility for Linux offering which enables clients to run Linux workloads in their existing servers. This mirrors the successful strategy the company executed on the System z platform;
- The company will expand its Linux relevance even further with POWER8 in 2014, which will provide additional big data and cloud capabilities; and
- Through the company's OpenPOWER consortium it is making Power technology available to an open development alliance, building an ecosystem around the Power technologies.

Secondly, even with these additional capabilities, the company recognizes that the size of the Power platform will not return to prior revenue levels. The company will take action by right-sizing the business for the demand characteristics it expects.

System x revenue decreased 13.5 percent (13 percent adjusted for currency) in 2013 versus 2012. High-end System x revenue decreased 16 percent (16 percent adjusted for currency) and blades revenue declined 45 percent (45 percent adjusted for currency) in 2013 compared to 2012. The declines in both high-end System x and blade were partially offset by increased revenue driven by Pure Systems.

Storage revenue decreased 10.8 percent (10 percent adjusted for currency) in 2013 versus 2012. The company's flash solutions continued to gain momentum in 2013 with positive revenue

growth. The Storwize products delivered double-digit growth, which were more than offset by declines in legacy OEM mid-range offerings, and declines in high-end offerings driven by significant pricing pressure.

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent/ Margin Change
<b>For the year ended December 31:</b>			
<b>Systems and Technology</b>			
External gross profit	\$5,299	\$6,966	(23.9)%
External gross profit margin	40.8%	43.4%	(2.6) pts.
Pre-tax income	\$ 213	\$1,866	(88.6)%
Pre-tax margin	1.6%	11.2%	(9.6) pts.

The decrease in external gross profit in 2013 versus 2012 was due to lower revenue and a lower overall gross profit margin reflecting the business model challenges. Overall gross margin decreased 2.6 points year to year in 2013 driven by lower margins in Power Systems, System x and Storage as well as a decline due to revenue mix, partially offset by margin improvement in System z.

Systems and Technology's pre-tax income decreased 88.6 percent to \$213 million in 2013. Pre-tax margin decreased 9.6 points in 2013 versus 2012.

### Global Financing

See pages 73 through 77 for an analysis of Global Financing's segment results.

## Geographic Revenue

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

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent Change	Yr.-to-Yr. Percent Change Adjusted for Currency
<b>For the year ended December 31:</b>				
<b>Total revenue</b>	\$98,367	\$102,874	(4.4)%	(2.3)%
Geographies	\$97,800	\$102,268	(4.4)%	(2.2)%
Americas	43,249	44,556	(2.9)	(2.0)
Europe/Middle East/Africa	31,628	31,775	(0.5)	(2.1)
Asia Pacific	22,923	25,937	(11.6)	(2.8)
Major markets			(4.2)%	(2.2)%
Growth markets			(4.9)%	(2.4)%
BRIC countries			(8.2)%	(5.6)%

Total geographic revenue of \$97,800 million decreased 4.4 percent (2 percent adjusted for currency) in 2013. Revenue in the major markets decreased 4.2 percent (2 percent adjusted for currency). Revenue from the growth markets, which represented approximately 23 percent of the total geographic revenue for the year, decreased 4.9 percent on a year-to-year basis (2 percent adjusted for currency). Performance at constant currency in the growth markets was mixed, with year-to-year growth in the first half offset by declines in the second half. The company had strength in Latin America and the Middle East and Africa region. However, declines in some of the larger growth markets, for example China and Australia, impacted the overall performance in the growth markets. Within the BRIC countries of Brazil, Russia, India and China, combined revenue declined 8.2 percent (6 percent adjusted for currency).

Americas revenue decreased 2.9 percent (2 percent adjusted for currency) year to year. The major market countries were down 3.9 percent (4 percent adjusted for currency), partially offset by an increase in the Latin America growth markets of 4.4 percent (9 percent adjusted for currency). Within the major market countries, the U.S. was down 3.4 percent and Canada was down 6.3 percent (3 percent adjusted for currency). Within the growth market countries, Brazil increased 3.3 percent (10 percent adjusted for currency) and Mexico increased 7.8 percent (8 percent adjusted for currency).

Europe/Middle East/Africa revenue decreased 0.5 percent (2 percent adjusted for currency) compared to 2012. The major market countries were down 0.5 percent (3 percent adjusted for currency), while the growth market countries were down 0.6 percent (up 1 percent adjusted for currency). In the major market countries, the UK decreased 1.4 percent (flat adjusted for currency), Germany decreased 0.1 percent (3 percent adjusted for currency), France decreased 1.8 percent (5 percent adjusted for currency), and Italy decreased 2.1 percent (5 percent adjusted for currency). Within the EMEA growth markets, the Middle East and Africa region increased 5.0 percent (11 percent adjusted for currency), but this growth was offset primarily by a decrease in Russia of 22.7 percent (22 percent adjusted for currency).

Asia Pacific revenue decreased 11.6 percent (3 percent adjusted for currency) year to year. Japan revenue decreased 15.2 percent as reported, but increased 4 percent overall and grew in every quarter on a constant currency basis. This growth reflected the benefits of shifting investment and redirection of the company's go-to-market focus to improve performance in Japan. The Asia Pacific growth markets decreased 9.1 percent (7 percent adjusted for currency), with China down 12.2 percent (14 percent adjusted for currency) and Australia down 15.9 percent (10 percent adjusted for currency). During 2013, performance in China was impacted by the process surrounding the implementation of a broad governmental economic reform plan.

## Total Expense and Other (Income)

(\$ in millions)			
	2013	2012	Yr.-to-Yr. Percent/Margin Change
<b>For the year ended December 31:</b>			
<b>Total consolidated expense and other (income)</b>	\$28,440	\$27,821	2.2%
Non-operating adjustments			
Amortization of acquired intangible assets	(370)	(328)	12.9
Acquisition-related charges	(40)	(35)	14.9
Non-operating retirement-related (costs)/income	(433)	(274)	58.3
<b>Operating (non-GAAP) expense and other (income)</b>	\$27,597	\$27,184	1.5%
Total consolidated expense-to-revenue ratio	28.9%	27.0%	1.9 pts.
Operating (non-GAAP) expense-to-revenue ratio	28.1%	26.4%	1.7 pts.

## Selling, General and Administrative

(\$ in millions)			
	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
<b>Selling, general and administrative expense</b>			
Selling, general and administrative—other	\$19,178	\$19,532	(1.8)%
Advertising and promotional expense	1,294	1,339	(3.4)
Workforce rebalancing charges	1,031	784	31.6
Retirement-related costs	986	932	5.8
Amortization of acquired intangible assets	370	328	12.9
Stock-based compensation	435	498	(12.6)
Bad debt expense	156	50	209.8
<b>Total consolidated selling, general and administrative expense</b>	\$23,451	\$23,463	(0.1)%
Non-operating adjustments			
Amortization of acquired intangible assets	(370)	(328)	12.9
Acquisition-related charges	(25)	(22)	13.3
Non-operating retirement-related (costs)/income	(376)	(294)	28.1
<b>Operating (non-GAAP) selling, general and administrative expense</b>	\$22,680	\$22,820	(0.6)%

Total SG&A expense decreased 0.1 percent in 2013 versus 2012. The decrease was primarily driven by the effects of currency (1 point), offset by acquisition-related spending (2 points). Operating (non-GAAP) SG&A expense decreased 0.6 percent primarily driven by the effects of currency (1 point) and lower base spending (1 point), partially offset by acquisition-related spending (1 point). The decrease was driven by lower SG&A—other expense, as the company continued to shift its spending. The company continued to drive productivity across the business, primarily through its enterprise productivity initiatives, and reinvested most of those savings into the business to drive its growth areas. The increase in workforce rebalancing charges was due to actions the company took in the second quarter of 2013. Bad debt expense increased \$106 million in 2013 versus 2012, primarily driven by higher specific account reserves. The accounts receivable provision coverage was 1.6 percent at December 31, 2013, an increase of 20 basis points from year-end 2012.

### Research, Development and Engineering

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
<b>Total consolidated research, development and engineering</b>	\$5,743	\$5,816	(1.3)%
Non-operating adjustment			
Non-operating retirement-related (costs)/income	(57)	20	NM
<b>Operating (non-GAAP) research, development and engineering</b>	\$5,686	\$5,837	(2.6)%

NM—Not meaningful

Total RD&E expense decreased 1.3 percent in 2013 versus 2012, primarily driven by lower base spending (3 points), partially offset by acquisitions (2 points). Operating (non-GAAP) RD&E expense decreased 2.6 percent in 2013 compared to the prior year primarily driven by lower base spending (5 points), partially offset by acquisitions (2 points).

### Intellectual Property and Custom Development Income

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
Sales and other transfers of intellectual property	\$352	\$ 324	8.8%
Licensing/royalty-based fees	150	251	(40.1)
Custom development income	320	500	(36.0)
<b>Total</b>	\$822	\$1,074	(23.5)%

There were no significant individual IP transactions in 2013 or 2012. Custom development income declined 36 percent compared to the prior year due to a reduction in payments from the company's technology alliance partners.

### Other (Income) and Expense

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
<b>Other (income) and expense</b>			
Foreign currency transaction losses/(gains)	\$(260)	\$(240)	8.4%
(Gains)/losses on derivative instruments	166	72	132.5
Interest income	(74)	(109)	(32.2)
Net (gains)/losses from securities and investment assets	(29)	(55)	(48.0)
Other	(137)	(511)	(73.3)
<b>Total consolidated other (income) and expense</b>	\$(333)	\$(843)	(60.5)%
Non-operating adjustment			
Acquisition-related charges	(16)	(13)	17.4
<b>Operating (non-GAAP) other (income) and expense</b>	\$(349)	\$(857)	(59.3)%

The decrease in income of \$510 million in 2013 was primarily driven by lower income from divestitures (\$405 million) driven by the gain associated with the divested RSS business (\$446 million) in 2012 reflected in Other in the table above, and increased losses on derivative instruments (\$95 million) due to foreign currency rate volatility year to year.

### Interest Expense

(\$ in millions)

	2013	2012	Yr.-to-Yr. Percent Change
<b>For the year ended December 31:</b>			
Interest expense			
<b>Total</b>	\$402	\$459	(12.5)%

The decrease in interest expense in 2013 versus 2012 was primarily driven by lower average interest rates, partially offset by higher average debt levels. Overall interest expense, including interest presented in the cost of financing, and excluding capitalized interest, for 2013 was \$989 million, a decrease of \$15 million year to year.

### Income Taxes

The continuing operations effective tax rate for 2013 was 16.6 percent, a decrease of 8.0 points versus the prior year, driven by the following factors:

- A benefit resulting from the completion of the U.S. 2008–2010 tax audit, including associated reserve redeterminations (11.1 points);
- A benefit due to a more favorable geographic mix of pre-tax income in 2013 (2.2 points);
- Benefits from the retroactive impact of the 2012 American Taxpayer Relief Act (0.7 points) and an increase in research and development credits (0.5 points);
- A benefit from a tax agreement which required a reassessment of certain valuation allowances on deferred tax assets (1.4 points); and,
- Benefits from the resolution of certain non-U.S. tax audits (0.7 points) and newly enacted U.S. state tax legislation (0.6 points); partially offset by
- Tax charges related to certain intercompany payments made by foreign subsidiaries and the intercompany licensing of certain IP (8.8 points); and
- The year-over-year impact of the 2012 benefit related to a tax restructuring in Latin America (0.7 points).

The operating (non-GAAP) effective tax rate was 17.0 percent, a decrease of 7.3 points versus 2012 principally driven by the same factors described above.

### Results of Discontinued Operations

Loss from discontinued operations, net of tax was \$398 million in 2013 compared to \$395 million in 2012. The discontinued operations effective tax rate in 2013 was 44.8 percent compared to 38.1 percent in 2012.

### Financial Position

Cash and marketable securities at December 31, 2013 were \$11,066 million, consistent with the prior year-end balance. During the year the company continued to manage the investment portfolio to meet its capital preservation and liquidity objectives.

Total debt of \$39,718 million increased \$6,449 million from the December 31, 2012 level. The commercial paper balance at December 31, 2013, was \$2,458 million, an increase of \$658 million. Within total debt, \$27,504 million was in support of the Global Financing business which was leveraged at a 7.2 to 1 ratio. The company continued to have substantial flexibility in the market. During 2013, the company completed bond issuances totaling \$10,956 million, with terms ranging from 2 to 12 years, and priced from 0.22 to 3.38 percent depending on maturity.

Consistent with accounting standards, the company remeasured the funded status of its retirement and postretirement plans at December 31. At December 31, 2013, the overall net underfunded position was \$11,434 million, a decrease of \$8,756 million from December 31, 2012 driven by the increase in discount rates, primarily in the U.S. At year end, the company's qualified defined benefit plans were well funded and the cash requirements related to these plans remain stable going forward at less than \$700 million per year through 2015. In 2013, the return on the U.S. Personal Pension Plan assets was 7.1 percent and the plan was 109 percent funded. Overall, global asset returns were 7.1 percent and the qualified defined benefit plans worldwide were 102 percent funded.

During 2013, the company generated \$17,485 million in cash from operations, a decrease of \$2,102 million compared to 2012. In addition, the company generated \$15,021 million in free cash flow, a decrease of \$3,164 million versus 2012. The company returned \$17,917 million to shareholders in 2013, with \$13,859 million in gross share repurchases and \$4,058 million in dividends. In 2013 the company repurchased approximately 73 million shares and had approximately \$14.7 billion remaining in share repurchase authorization at year end.

## GAAP Reconciliation

The tables below provide a reconciliation of the company's income statement results as reported under GAAP to its operating earnings presentation which is a non-GAAP measure. The company's calculation of operating (non-GAAP) earnings, as presented, may differ from similarly titled measures reported by other companies. Please refer to the "Operating (non-GAAP) Earnings" section on page 22 for the company's rationale for presenting operating earnings information.

(\$ in millions except per share amounts)

	GAAP	Acquisition-Related Adjustments	Retirement-Related Adjustments	Operating (non-GAAP)
<b>For the year ended December 31, 2013:</b>				
Gross profit	\$48,684	\$ 394	\$ 629	\$49,706
Gross profit margin	49.5%	0.4 pts.	0.6 pts.	50.5%
SG&A	\$23,451	\$(394)	\$(376)	\$22,680
RD&E	5,743	—	(57)	5,686
Other (income) and expense	(333)	(16)	—	(349)
Total expense and other (income)	28,440	(410)	(433)	27,597
Pre-tax income from continuing operations	20,244	804	1,062	22,110
Pre-tax margin from continuing operations	20.6%	0.8 pts.	1.1 pts.	22.5%
Provision for income taxes*	\$ 3,363	\$ 57	\$ 333	\$ 3,753
Effective tax rate	16.6%	(0.4) pts.	0.7 pts.	17.0%
Income from continuing operations	\$16,881	\$ 747	\$ 729	\$18,356
Income margin from continuing operations	17.2%	0.8 pts.	0.7 pts.	18.7%
Loss from discontinued operations, net of tax	\$ (398)	\$ —	\$ —	\$ (398)
Net income	\$16,483	\$ 747	\$ 729	\$17,959
Diluted earnings per share:				
Continuing operations	\$ 15.30	\$0.68	\$ 0.66	\$ 16.64
Discontinued operations	\$ (0.36)	\$ —	\$ —	\$ (0.36)

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

(\$ in millions except per share amounts)

	GAAP	Acquisition-Related Adjustments	Retirement-Related Adjustments	Operating (non-GAAP)
<b>For the year ended December 31, 2012:</b>				
Gross profit	\$50,361	\$ 376	\$ 264	\$51,001
Gross profit margin	49.0%	0.4 pts.	0.3 pts.	49.6%
SG&A	\$23,463	\$(349)	\$(294)	\$22,820
RD&E	5,816	—	20	5,837
Other (income) and expense	(843)	(13)	—	(857)
Total expense and other (income)	27,821	(363)	(274)	27,184
Pre-tax income from continuing operations	22,540	739	538	23,817
Pre-tax margin from continuing operations	21.9%	0.7 pts.	0.5 pts.	23.2%
Provision for income taxes*	\$ 5,541	\$ 98	\$ 156	\$ 5,795
Effective tax rate	24.6%	(0.4) pts.	0.1 pts.	24.3%
Income from continuing operations	\$16,999	\$ 641	\$ 381	\$18,022
Income margin from continuing operations	16.5%	0.6 pts.	0.4 pts.	17.5%
Loss from discontinued operations, net of tax	\$ (395)	\$ —	\$ —	\$ (395)
Net income	\$16,604	\$ 641	\$ 381	\$17,627
Diluted earnings per share:				
Continuing operations	\$ 14.71	\$0.56	\$0.33	\$ 15.60
Discontinued operations	\$ (0.34)	\$ —	\$ —	\$ (0.34)

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

## OTHER INFORMATION

### Looking Forward

The company measures the success of its business model over the long term, not any individual quarter or year. The company's strategies, investments and actions are all taken with an objective of optimizing long-term performance. A long-term perspective ensures that the company is well-positioned to take advantage of major shifts occurring in technology, business and the global economy.

Within the IT industry, there are major shifts occurring—driven by data, cloud and changes in the ways individuals and enterprises are engaging. In 2014, the company had strong performance in its strategic imperatives that are focused on these market shifts. Revenue from the company's cloud, analytics, mobile, social and security solutions together increased 16 percent compared to 2013, including the impacts of currency and the divested industry standard server business. In total, the strategic imperatives generated \$25 billion in revenue, approximately 27 percent of total consolidated revenue, including software content that represented a higher percentage than the overall company. As a result, the strategic imperatives deliver gross profit margins that are better than the consolidated gross profit margin on average. In 2014, the company continued to take significant actions to drive the shift towards its strategic imperatives with targeted investments, as well as moving away from areas that do not support the strategic profile.

The company's strategic direction is clear and compelling, and the company has been successful in shifting to the higher value areas of enterprise IT. The strong revenue growth in the strategic imperatives confirms that, as does the overall profitability of the business. The company expects the industry to continue to shift. The company expects revenue from its strategic imperatives to continue to grow at a double-digit rate. These offerings are as high value as other parts of the business, which continue to manage clients' most critical business processes. As the cloud business gets to scale, and with ongoing productivity improvements across the business, the company expects to have an opportunity to expand margin. In addition, the company expects to continue to allocate its capital efficiently and effectively to investments, and to return value to its shareholders through a combination of dividends and share repurchases. Over the longer term, in considering the opportunities it will continue to develop, the company expects to have the ability to generate low single-digit revenue growth, and with a higher value business mix, high single-digit operating (non-GAAP) earnings per share growth, with free cash flow realization in the 90's percent range. This is a longer term growth trajectory, not an absolute end point or a multi-year objective.

In the near term, there are a few dynamics that are inconsistent with that longer term trajectory. Specifically, in 2015, the company will be managing certain transitions in the business. As an example, while it is fully participating in the shift to cloud, the margins in that business are impacted by the level of investment the company is making, and the fact that the business is not yet at scale. The company expects an improvement in margin in 2015 as the business ramps, but, it will not yet be at scale. In addition,

the company expects a continued impact to its software transaction revenue growth, as customers continue to utilize the flexibility that the company has provided to them, as they commit to the company's platform for the longer term. There are also cyclical considerations. Given the geographic breadth of the business, the company has seen challenges in some of its markets—notably many of the growth markets. The company continues to believe that these are important markets over time, and it continues to invest to capture these opportunities. However, the company is not expecting a robust demand environment in many geographies in 2015. The company also expects a continued impact from currency in 2015. At January 2015 spot rates, the impact to revenue growth is expected to be 5–6 points, but, as with all companies with a similar global business profile, with the dollar strengthening, the company also expects that currency will have a significant translation impact on its profit growth. The company also expects some cyclical benefits in 2015, including the new mainframe product cycle and a full year of POWER8 availability.

Overall, looking forward to 2015, the company expects to continue to grow in many areas of the business. It expects to deliver strong growth in the strategic imperatives and margin expansion, while continuing a high level of investment and hiring, shifting to areas that have the best opportunity. However, in the current currency environment, and considering the impact from the completed divestitures, total revenue as reported is not expected to grow in 2015. The company expects to have less workforce rebalancing charges in 2015 versus 2014, and while it may have certain gains, it does not expect to replicate the \$1.8 billion of gains recorded in 2014, resulting in a net impact to profit growth. Overall, the company expects GAAP earnings per share from continuing operations for 2015 to be in the range of \$14.35 to \$15.10, and operating (non-GAAP) earnings per share to be in the range of \$15.75 to \$16.50. For the first quarter of 2015, the company expects mid single-digit earnings per share growth from continuing operations compared to the first quarter of 2014, primarily driven by the large workforce rebalancing charge that was taken in the prior year. Overall, and most importantly, the company expects to exit 2015 with a higher-value, higher-margin business.

Within the company's earnings per share expectation for 2015, the company is expecting a 2–3 point benefit from share repurchases—less than the impact in 2014. The company enters 2015 with approximately \$6.3 billion of repurchase authorization remaining, and the company is assuming it will utilize the majority of the remaining authorization in 2015. The timing of repurchases will determine the final impact to earnings per share in 2015.

From a segment perspective, the company expects that the launch of the new mainframe, along with the success in POWER8 that the company experienced in the fourth quarter of 2014, will generate momentum in 2015. As a result, excluding the impact of divestitures, the company expects Systems and Technology to deliver revenue growth in the mid-single digits in 2015. Within Global Services, the company has not assumed a revenue

trajectory that requires significant growth within its earnings expectations. As indicated above, the company has established a range for its earnings expectation for 2015. The performance of the Software business is key to this range—the low end of the expected range assumes no improvement in trajectory for the Software business, while the high end of the range assumes a stabilization of the Software business relative to 2014.

The company's free cash flow performance in 2014 compared to the prior year was impacted by operational performance, an increase in cash tax payments and working capital impacts related to the industry standard server divestiture. Looking forward to 2015, at the level of expected profit, the company expects free cash flow to be relatively flat compared to 2014. From a free cash flow to income from continuing operations perspective, free cash flow realization was 79 percent as reported in 2014 and is expected to improve to the mid-80's percent level in 2015. In 2014, realization was impacted by higher cash tax payments and the gain associated with the industry standard server divestiture. While these impacts are not expected to be as significant in 2015, the company expects to increase capital investments by approximately \$0.5 billion in 2015 driven by the continued buildout of the SoftLayer cloud platform. In addition, the company expects impacts to realization in 2015 from the timing of payments related to workforce rebalancing actions taken in 2014 and working capital impacts related to the industry standard server divestiture. Overall, with a year-to-year profit decline expected, and the impacts described from capital investments, workforce rebalancing and working capital, all this results in the expectation that free cash flow will be essentially flat year to year.

The company expects, in the normal course of business, that its effective tax rate and operating (non-GAAP) tax rate will be approximately 20 percent in 2015. The rate will change year to year based on nonrecurring events, such as the settlement of income tax audits and changes in tax laws, as well as recurring factors including the geographic mix of income before taxes, the timing and amount of foreign dividend repatriation, state and local taxes and the effects of various global income tax strategies.

The company expects 2015 pre-tax retirement-related plan cost to be approximately \$2.5 billion, an increase of approximately \$500 million compared to 2014. This estimate reflects current pension plan assumptions at December 31, 2014. Within total retirement-related plan cost, operating retirement-related plan cost is expected to be approximately \$1.6 billion, a decrease of approximately \$100 million versus 2014. Non-operating retirement-related plan cost is expected to be approximately \$900 million, an increase of approximately \$600 million compared to 2014, driven by increased recognized actuarial losses. Cash disbursements for all retirement-related plans are expected to be approximately \$2.7 billion in 2015, an increase of approximately \$100 million compared to 2014. See note S, "Retirement-Related Benefits," on pages 131 to 145 for additional information.

For a discussion of new accounting standards that the company will adopt in future periods, please see note B, "Accounting Changes" beginning on page 96.

## Liquidity and Capital Resources

The company has consistently generated strong cash flow from operations, providing a source of funds ranging between \$16.9 billion and \$19.8 billion per year over the past five years. The company provides for additional liquidity through several sources: maintaining an adequate cash balance, access to global funding sources, a committed global credit facility and other committed and uncommitted lines of credit worldwide. The following table provides a summary of the major sources of liquidity for the years ended December 31, 2010 through 2014.

### Cash Flow and Liquidity Trends

	2014	2013	2012	2011	2010
Net cash from operating activities	\$16.9	\$17.5	\$19.6	\$19.8	\$19.5
Cash and short-term marketable securities	\$ 8.5	\$11.1	\$11.1	\$11.9	\$11.7
Committed global credit facility	\$10.0	\$10.0	\$10.0	\$10.0	\$10.0

The major rating agencies' ratings on the company's debt securities at December 31, 2014 appear in the following table and remain unchanged from December 31, 2013. The company's indenture governing its debt securities and its various credit facilities each contain significant covenants which obligate the company to promptly pay principal and interest, limit the aggregate amount of secured indebtedness and sale and leaseback transactions to 10 percent of the company's consolidated net tangible assets, and restrict the company's ability to merge or consolidate unless certain conditions are met. The credit facilities also include a covenant on the company's consolidated net interest expense ratio, which cannot be less than 2.20 to 1.0, as well as a cross default provision with respect to other defaulted indebtedness of at least \$500 million.

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

The company does not have "ratings trigger" provisions in its debt covenants or documentation, which would allow the holders to declare an event of default and seek to accelerate payments thereunder in the event of a change in credit rating. The company's contractual agreements governing derivative instruments contain standard market clauses which can trigger the termination of the agreement if the company's credit rating were to fall below investment grade. At December 31, 2014, the fair value of those instruments that were in a liability position was \$196 million, before any applicable netting, and this position is subject to fluctuations

in fair value period to period based on the level of the company's outstanding instruments and market conditions. The company has no other contractual arrangements that, in the event of a change in credit rating, would result in a material adverse effect on its financial position or liquidity.

	Standard & Poor's	Moody's Investors Service	Fitch Ratings
Senior long-term debt	AA-	Aa3	A+
Commercial paper	A-1+	Prime-1	F1

The company prepares its Consolidated Statement of Cash Flows in accordance with applicable accounting standards for cash flow presentation on page 83 and highlights causes and events underlying sources and uses of cash in that format on page 44. For the purpose of running its business, the company manages, monitors and analyzes cash flows in a different format.

Management uses a free cash flow measure to evaluate the company's operating results, plan share repurchase levels, evaluate strategic investments and assess the company's ability and need to incur and service debt. Free cash flow is not a defined term under GAAP and it should not be inferred that the entire free cash flow amount is available for discretionary expenditures. The company defines free cash flow as net cash from operating activities less the change in Global Financing receivables and net capital expenditures, including the investment in software. A key objective of the Global Financing business is to generate strong returns on equity. Increasing receivables is the basis for growth in a financing business. Accordingly, management considers Global Financing receivables as a profit-generating investment, not as working capital that should be minimized for efficiency. After considering Global Financing receivables as an investment, the remaining net

operational cash flow less net capital expenditures is viewed by the company as free cash flow.

From the perspective of how management views cash flow, in 2014, after investing \$3.8 billion in capital investments, the company generated free cash flow of \$12.4 billion, a decrease of \$2.6 billion compared to 2013. The decrease was driven by higher cash tax payments (\$1.7 billion), the company's operational performance and changes in working capital associated with the divestiture of the industry standard server business.

In 2014, the company continued to focus its cash utilization on returning value to shareholders including \$4.3 billion in dividends and \$13.0 billion in net stock transactions, including the common stock repurchase program. In addition, \$0.7 billion was utilized for six acquisitions this year.

Over the past five years, the company generated over \$78 billion in free cash flow. During that period, the company invested \$15 billion in strategic acquisitions and returned over \$79 billion to shareholders through dividends and net share repurchases. The company's performance during this period demonstrates that there is fungibility across the elements of share repurchases, dividends and acquisitions. The amount of prospective returns to shareholders in the form of dividends and share repurchases will vary based upon several factors including each year's operating results, capital expenditure requirements, research and development investments and acquisitions, as well as the factors discussed below.

The company's Board of Directors meets quarterly to consider the dividend payment. In the second quarter of 2014, the Board of Directors increased the company's quarterly common stock dividend from \$0.95 to \$1.10 per share.

The table below represents the way in which management reviews cash flow as described above.

(\$ in billions)

For the year ended December 31:	2014	2013	2012	2011	2010
Net cash from operating activities per GAAP	\$ 16.9	\$ 17.5	\$ 19.6	\$ 19.8	\$ 19.5
Less: the change in Global Financing receivables	0.7	(1.3)	(2.9)	(0.8)	(0.7)
Net cash from operating activities, excluding Global Financing receivables	16.2	18.8	22.5	20.7	20.3
Capital expenditures, net	(3.8)	(3.8)	(4.3)	(4.1)	(4.0)
Free cash flow (FCF)	12.4	15.0	18.2	16.6	16.3
Acquisitions	(0.7)	(3.1)	(3.7)	(1.8)	(5.9)
Divestitures	2.4	0.3	0.6	0.0	0.1
Share repurchase	(13.7)	(13.9)	(12.0)	(15.0)	(15.4)
Dividends	(4.3)	(4.1)	(3.8)	(3.5)	(3.2)
Non-Global Financing debt	(1.3)	3.2	0.7	1.7	2.3
Other (includes Global Financing receivables and Global Financing debt)	2.6	2.4	(0.8)	2.3	3.5
<b>Change in cash, cash equivalents and short-term marketable securities</b>	<b>\$ (2.6)</b>	<b>\$ (0.1)</b>	<b>\$ (0.8)</b>	<b>\$ 0.3</b>	<b>\$ (2.3)</b>
<b>FCF as percent of Income from Continuing Operations</b>	<b>79%</b>	<b>89%</b>	<b>107%</b>	<b>103%</b>	<b>108%</b>

Events that could temporarily change the historical cash flow dynamics discussed above include significant changes in operating results, material changes in geographic sources of cash, unexpected adverse impacts from litigation, future pension funding requirements during periods of severe downturn in the capital markets or the timing of tax payments. Whether any litigation has such an adverse impact will depend on a number of variables, which are more completely described in note M, "Contingencies and Commitments," on pages 122 to 124. With respect to pension funding, in 2014, the company contributed \$519 million to its non-U.S. defined benefit plans versus \$507 million in 2013. As highlighted in the Contractual Obligations table, the company expects to make legally mandated pension plan contributions to certain non-U.S. plans of approximately \$3.0 billion in the next five years. The 2015 contributions are currently expected to be approximately \$600 million. Cash disbursements related to all retirement-related plans is expected to be approximately \$2.7 billion in 2015, an increase of approximately \$0.1 billion compared to 2014. Financial market performance could increase the legally mandated minimum contributions in certain non-U.S. countries that require more frequent remeasurement of the funded status. The company is not quantifying any further impact from pension funding because it is not possible to predict future movements in the capital markets or pension plan funding regulations.

The Pension Protection Act of 2006 was enacted into law in 2006, and, among other things, increased the funding requirements for certain U.S. defined benefit plans beginning after

December 31, 2007. No mandatory contribution is required for the U.S. defined benefit plan in 2015 as of December 31, 2014.

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

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

## Contractual Obligations

(\$ in millions)

	Total Contractual Payment Stream	Payments Due In			
		2015	2016-17	2018-19	After 2019
Long-term debt obligations	\$39,708	\$ 4,586	\$10,564	\$ 6,686	\$17,872
Interest on long-term debt obligations	10,437	1,120	2,036	1,437	5,845
Capital (finance) lease obligations	29	13	9	4	2
Operating lease obligations	6,152	1,350	2,149	1,602	1,051
Purchase obligations	1,227	680	437	72	38
Other long-term liabilities:					
Minimum defined benefit plan pension funding (mandated)*	3,000	600	1,200	1,200	—
Excess 401(k) Plus Plan	1,730	71	149	158	1,352
Long-term termination benefits	1,823	733	209	153	728
Tax reserves**	3,642	995			
Divestiture related	2,391	1,344	799	184	65
Other	1,018	134	200	111	574
<b>Total</b>	<b>\$71,157</b>	<b>\$11,625</b>	<b>\$17,751</b>	<b>\$11,607</b>	<b>\$27,527</b>

\* As funded status on plans will vary, obligations for mandated minimum pension payments after 2019 could not be reasonably estimated.

\*\* These amounts represent the liability for unrecognized tax benefits. The company estimates that approximately \$995 million of the liability is expected to be settled within the next 12 months. The settlement period for the noncurrent portion of the income tax liability cannot be reasonably estimated as the timing of the payments will depend on the progress of tax examinations with the various tax authorities; however, it is not expected to be due within the next 12 months.

Total contractual obligations are reported in the previous table excluding the effects of time value and therefore, may not equal the amounts reported in the Consolidated Statement of Financial Position. Certain noncurrent liabilities are excluded from the table above as their future cash outflows are uncertain. This includes deferred taxes, derivatives, deferred income, disability benefits and other sundry items. Certain obligations related to the company's completed divestitures and the definitive agreement to divest its Microelectronics business are included.

Purchase obligations include all commitments to purchase goods or services of either a fixed or minimum quantity that meet any of the following criteria: (1) they are noncancelable, (2) the company would incur a penalty if the agreement was canceled, or (3) the company must make specified minimum payments even if it does not take delivery of the contracted products or services (take-or-pay). If the obligation to purchase goods or services is noncancelable, the entire value of the contract is included in the table above. If the obligation is cancelable, but the company would incur a penalty if canceled, the dollar amount of the penalty is included as a purchase obligation. Contracted minimum amounts specified in take-or-pay contracts are also included in the table as they represent the portion of each contract that is a firm commitment.

In the ordinary course of business, the company enters into contracts that specify that the company will purchase all or a portion of its requirements of a specific product, commodity or service from a supplier or vendor. These contracts are generally entered into in order to secure pricing or other negotiated terms. They do not specify fixed or minimum quantities to be purchased and, therefore, the company does not consider them to be purchase obligations.

Interest on floating-rate debt obligations is calculated using the effective interest rate at December 31, 2014, plus the interest rate spread associated with that debt, if any.

#### Off-Balance Sheet Arrangements

From time to time, the company may enter into off-balance sheet arrangements as defined by SEC Financial Reporting Release 67 (FRR-67), "Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations."

At December 31, 2014, the company had no off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. See the table on page 67 for the company's contractual obligations, and note M, "Contingencies and Commitments," on page 124, for detailed information about the company's guarantees, financial commitments and indemnification arrangements. The company does not have retained interests in assets transferred to unconsolidated entities or other material off-balance sheet interests or instruments.

#### Critical Accounting Estimates

The application of GAAP requires the company to make estimates and assumptions about certain items and future events that directly affect its reported financial condition. The accounting estimates and assumptions discussed in this section are those that the company considers to be the most critical to its financial statements. An accounting estimate is considered critical if both (a) the nature of the estimate or assumption is material due to the levels of subjectivity and judgment involved, and (b) the impact within a reasonable range of outcomes of the estimate and assumption is material to the company's financial condition. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of the company's Board of Directors. The company's significant accounting policies are described in note A, "Significant Accounting Policies," on pages 86 through 96.

A quantitative sensitivity analysis is provided where that information is reasonably available, can be reliably estimated and provides material information to investors. The amounts used to assess sensitivity (e.g., 1 percent, 10 percent, etc.) are included to allow users of the Annual Report to understand a general direction cause and effect of changes in the estimates and do not represent management's predictions of variability. For all of these estimates, it should be noted that future events rarely develop exactly as forecasted, and estimates require regular review and adjustment.

#### Pension Assumptions

For the company's defined benefit pension plans, the measurement of the company's benefit obligation to employees and net periodic pension (income)/cost requires the use of certain assumptions, including, among others, estimates of discount rates and expected return on plan assets.

Changes in the discount rate assumptions would impact the (gain)/loss amortization and interest cost components of the net periodic pension (income)/cost calculation and the projected benefit obligation (PBO). The company decreased the discount rate assumption for the IBM Personal Pension Plan (PPP), a U.S.-based defined benefit plan, by 80 basis points to 3.70 percent on December 31, 2014. This change will increase pre-tax cost and expense recognized in 2015 by an estimated \$272 million. If the discount rate assumption for the PPP had increased by 80 basis points on December 31, 2014, pre-tax cost and expense recognized in 2015 would have decreased by an estimated \$288 million. Changes in the discount rate assumptions would impact the PBO which, in turn, may impact the company's funding decisions if the PBO exceeds plan assets. A 25 basis point increase or decrease in the discount rate would cause a corresponding decrease or increase, respectively, in the PPP's PBO of an estimated \$1.4 billion based upon December 31, 2014 data.

The expected long-term return on plan assets assumption is used in calculating the net periodic pension (income)/cost. Expected returns on plan assets are calculated based on the market-related value of plan assets, which recognizes changes in the fair value of plan assets systematically over a five-year period in the expected return on plan assets line in net periodic pension (income)/cost. The differences between the actual return on plan assets and the expected long-term return on plan assets are recognized over five years in the expected return on plan assets line in net periodic pension (income)/cost and also as a component of actuarial gains/losses, which are recognized over the service lives or life expectancy of the participants, depending on the plan, provided such amounts exceed thresholds which are based upon the benefit obligation or the value of plan assets, as provided by accounting standards.

To the extent the outlook for long-term returns changes such that management changes its expected long-term return on plan assets assumption, each 50 basis point increase or decrease in the expected long-term return on PPP plan assets assumption would have an estimated decrease or increase, respectively, of \$264 million on the following year's pre-tax net periodic pension (income)/cost (based upon the PPP's plan assets at December 31, 2014 and assuming no contributions are made in 2015).

The company may voluntarily make contributions or be required, by law, to make contributions to its pension plans. Actual results that differ from the estimates may result in more or less future company funding into the pension plans than is planned by management. Impacts of these types of changes on the company's pension plans in other countries worldwide would vary depending upon the status of each respective plan.

In addition to the above, the company evaluates other pension assumptions involving demographic factors, such as retirement age and mortality, and updates these assumptions to reflect experience and expectations for the future. Actual results in any given year can differ from actuarial assumptions because of economic and other factors.

For additional information on the company's pension plans and the development of these assumptions, see Note S, "Retirement-Related Benefits," on pages 137 and 138.

### Revenue Recognition

Application of the various accounting principles in GAAP related to the measurement and recognition of revenue requires the company to make judgments and estimates. Specifically, complex arrangements with nonstandard terms and conditions may require significant contract interpretation to determine the appropriate accounting, including whether the deliverables specified in a multiple-deliverable arrangement should be treated as separate units of accounting. Other significant judgments include determining whether IBM or a reseller is acting as the principal in a transaction and whether separate contracts are considered part of one arrangement.

Revenue recognition is also impacted by the company's ability to estimate sales incentives, expected returns and collectibility. The company considers various factors, including a review of specific transactions, the creditworthiness of the customers, historical

experience and market and economic conditions when calculating these provisions and allowances. Evaluations are conducted each quarter to assess the adequacy of the estimates. If these estimates were changed by 10 percent in 2014, net income would have been impacted by \$78 million (excluding Global Financing receivables).

### Costs to Complete Service Contracts

The company enters into numerous service contracts through its Global Services business. During the contractual period, revenue, cost and profits may be impacted by estimates of the ultimate profitability of each contract, especially contracts for which the company uses the percentage-of-completion (POC) method of accounting. If at any time these estimates indicate the POC contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately in cost. The company performs ongoing profitability analyses of its POC-based services contracts in order to determine whether the latest estimates require updating. Key factors reviewed by the company to estimate the future costs to complete each contract are future labor costs, future product costs and expected productivity efficiencies. Contract loss provisions recorded as a component of other accrued expenses and liabilities were approximately \$13 million and \$41 million at December 31, 2014 and 2013, respectively.

### Income Taxes

The company is subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgments are required in determining the consolidated provision for income taxes.

During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. As a result, the company recognizes tax liabilities based on estimates of whether additional taxes and interest will be due. These tax liabilities are recognized when, despite the company's belief that its tax return positions are supportable, the company believes that certain positions may not be fully sustained upon review by tax authorities. The company believes that its accruals for tax liabilities are adequate for all open audit years based on its assessment of many factors, including past experience and interpretations of tax law. This assessment relies on estimates and assumptions, and may involve a series of complex judgments about future events. To the extent that new information becomes available which causes the company to change its judgment regarding the adequacy of existing tax liabilities, such changes to tax liabilities will impact income tax expense in the period in which such determination is made.

Significant judgment is also required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, management considers all available evidence for each jurisdiction including past operating results, estimates of future taxable income and the feasibility of ongoing tax planning strategies. In the event that the company changes its determination as to the amount of deferred tax assets that can be realized, the company will adjust its valuation allowance with a corresponding impact to income tax expense in the period in which such determination is made.

The consolidated provision for income taxes will change period to period based on nonrecurring events, such as the settlement of income tax audits and changes in tax laws, as well as recurring factors including the geographic mix of income before taxes, the timing and amount of foreign dividend repatriation, state and local taxes and the effects of various global income tax strategies.

To the extent that the provision for income taxes increases/decreases by 1 percent of income from continuing operations before income taxes, consolidated net income would have decreased/improved by \$200 million in 2014.

### Valuation of Assets

The application of business combination and impairment accounting requires the use of significant estimates and assumptions. The acquisition method of accounting for business combinations requires the company to estimate the fair value of assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree to properly allocate purchase price consideration between assets that are depreciated and amortized from goodwill and indefinite-lived intangible assets. Impairment testing for assets, other than goodwill and indefinite-lived intangible assets, requires the allocation of cash flows to those assets or group of assets and if required, an estimate of fair value for the assets or group of assets. The company's estimates are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. These valuations require the use of management's assumptions, which would not reflect unanticipated events and circumstances that may occur.

### Valuation of Goodwill

The company reviews goodwill for impairment annually, in the fourth quarter, and whenever events or changes in circumstances indicate the carrying value of goodwill may not be recoverable.

The company assesses qualitative factors in each of its reporting units that carry goodwill including relevant events and circumstances that affect the fair value of reporting units. Examples include, but are not limited to, macroeconomic, industry and market conditions; as well as other individual factors such as:

- A loss of key personnel;
- A significant adverse shift in the operating environment of the reporting unit such as unanticipated competition;
- A significant pending litigation;
- A more likely than not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of; and
- An adverse action or assessment by a regulator.

The company assesses these qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. This quantitative test is required only if the company concludes that it is more likely than not that a reporting unit's fair value is less than its carrying amount.

In the fourth quarter, the company performed its annual goodwill impairment analysis. The qualitative assessment illustrated evidence of a potential impairment triggering event as a result of the financial performance of the Systems and Technology reporting unit. The quantitative analysis resulted in no impairment as the reporting unit's estimated fair value exceeded the carrying amount by over 100 percent.

### Loss Contingencies

The company is currently involved in various claims and legal proceedings. At least quarterly, the company reviews the status of each significant matter and assesses its potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, the company accrues a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, the company reassesses the potential liability related to its pending claims and litigation, and may revise its estimates. These revisions in the estimates of the potential liabilities could have a material impact on the company's results of operations and financial position.

### Global Financing Receivables Allowance for Credit Losses

The Global Financing business reviews its financing receivables portfolio at least quarterly in order to assess collectibility. A description of the methods used by management to estimate the amount of uncollectible receivables is included in note A, "Significant Accounting Policies," on page 95. Factors that could result in actual receivable losses that are materially different from the estimated reserve include sharp changes in the economy, or a significant change in the economic health of a particular client that represents a concentration in Global Financing's receivables portfolio.

To the extent that actual collectibility differs from management's estimates currently provided for by 10 percent, Global Financing's segment pre-tax income and the company's income from continuing operations before income taxes would be higher or lower by an estimated \$58 million (using 2014 data), depending upon whether the actual collectibility was better or worse, respectively, than the estimates.

### Residual Value

Residual value represents the estimated fair value of equipment under lease as of the end of the lease. Residual value estimates impact the determination of whether a lease is classified as operating or capital. Global Financing estimates the future fair value of leased equipment by using historical models, analyzing the current market for new and used equipment, and obtaining forward-looking product information such as marketing plans and technological innovations. Residual value estimates are periodically reviewed and "other than temporary" declines in estimated future residual values are recognized upon identification. Anticipated increases in future residual values are not recognized until the equipment is remarketed.

Factors that could cause actual results to materially differ from the estimates include significant changes in the used-equipment market brought on by unforeseen changes in technology innovations and any resulting changes in the useful lives of used equipment.

To the extent that actual residual value recovery is lower than management's estimates by 10 percent, Global Financing's segment pre-tax income and the company's income from continuing operations before income taxes for 2014 would have been lower by an estimated \$84 million. If the actual residual value recovery is higher than management's estimates, the increase in income will be realized at the end of lease when the equipment is remarketed.

### Currency Rate Fluctuations

Changes in the relative values of non-U.S. currencies to the U.S. dollar affect the company's financial results and financial position. At December 31, 2014, currency changes resulted in assets and liabilities denominated in local currencies being translated into fewer dollars than at year-end 2013. The company uses financial hedging instruments to limit specific currency risks related to financing transactions and other foreign currency-based transactions. Further discussion of currency and hedging appears in note D, "Financial Instruments-Derivative Financial Instruments," on pages 105 through 109.

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

The company translates revenue, cost and expense in its non-U.S. operations at current exchange rates in the reported period. References to "adjusted for currency" or "constant currency" reflect adjustments based upon a simple constant currency mathematical translation of local currency results using the comparable prior period's currency conversion rate. However, this constant currency methodology that the company utilizes to disclose this information does not incorporate any operational actions that management may take in reaction to fluctuating currency rates. Currency movements impacted the company's year-to-year revenue and earnings per share growth in 2014. Based on the currency rate movements in 2014, total revenue decreased 5.7 percent as reported and 4.0 percent at constant currency versus 2013. On an income from continuing operations before income taxes basis, these translation impacts offset by the net impact of hedging activities resulted in a theoretical maximum (assuming no pricing or

sourcing actions) decrease of approximately \$300 million in 2014. The same mathematical exercise resulted in a decrease of approximately \$400 million in 2013. The company views these amounts as a theoretical maximum impact to its as-reported financial results. Considering the operational responses mentioned above, movements of exchange rates, and the nature and timing of hedging instruments, it is difficult to predict future currency impacts on any particular period, but the company believes it could be substantially less than the theoretical maximum given the competitive pressure in the marketplace.

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

The company continues to monitor the economic conditions in Venezuela. In March 2013, the Venezuelan government created a new foreign exchange mechanism called the "Complimentary System of Foreign Currency Acquirement" (or the "SICAD 1"). This system operates similar to an auction system and allows entities in specific sectors to bid for U.S. dollars to be used for specific import transactions. In December 2013, the Venezuelan government published the SICAD 1 rate implied by the transactions settled in these auctions, and issued Exchange Agreement No. 24 which clarified the use of the SICAD 1 mechanism. In January 2014, the government issued Exchange Agreement No. 25, and significantly expanded the transactions that qualify for use of SICAD 1 and stated that a new agency called the National Center of Foreign Commerce (CENCOEX) would assume the role of CADIVI, which historically controlled the sale and purchase of foreign currency in Venezuela. In February 2014, the Venezuelan government signed into law a plan to open a new exchange control mechanism ("SICAD 2"), and indicated that the official rate of 6.3 BsF per USD would increasingly be reserved for the settlement of USD denominated obligations related to purchases of "essential goods and services." In March 2014, the Venezuelan government published operating rules for SICAD 2 in Exchange Agreement No. 27. SICAD 2 began operating on March 24, 2014. In March 2014, the company adopted the SICAD 1 rate of 10.7 BsF per USD. In the first quarter of 2014, the company recorded a pre-tax loss of \$31 million as a result of the devaluation in Other (income) and expense in the Consolidated Statement of Earnings. At December 31, 2014, the company's net asset position in Venezuela was \$42 million. The company's operations in Venezuela comprised less than 1 percent of total 2014, 2013 and 2012 revenue, respectively. In February 2015, the Venezuelan government created a new foreign exchange platform, the Marginal Currency System, or SIMADI. The company will monitor transactions from this new system going forward in 2015.

In January 2014, the Argentinian government devalued its currency from 6 pesos to the U.S. dollar to 8 pesos to the U.S. dollar. This devaluation did not have a material impact given the size of the company's operations in Argentina (less than 1 percent of total 2014 revenue).

## Market Risk

In the normal course of business, the financial position of the company is routinely subject to a variety of risks. In addition to the market risk associated with interest rate and currency movements on outstanding debt and non-U.S. dollar denominated assets and liabilities, other examples of risk include collectibility of accounts receivable and recoverability of residual values on leased assets.

The company regularly assesses these risks and has established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, the company does not anticipate any material losses from these risks.

The company's debt, in support of the Global Financing business and the geographic breadth of the company's operations, contains an element of market risk from changes in interest and currency rates. The company manages this risk, in part, through the use of a variety of financial instruments including derivatives, as described in note D, "Financial Instruments—Derivative Financial Instruments," on pages 105 through 109.

To meet disclosure requirements, the company performs a sensitivity analysis to determine the effects that market risk exposures may have on the fair values of the company's debt and other financial instruments.

The financial instruments that are included in the sensitivity analysis are comprised of the company's cash and cash equivalents, marketable securities, short-term and long-term loans, commercial financing and installment payment receivables, investments, long-term and short-term debt and derivative financial instruments. The company's derivative financial instruments generally include interest rate swaps, foreign currency swaps and forward contracts.

To perform the sensitivity analysis, the company assesses the risk of loss in fair values from the effect of hypothetical changes in interest rates and foreign currency exchange rates on market-sensitive instruments. The market values for interest and foreign currency exchange risk are computed based on the present value of future cash flows as affected by the changes in rates that are attributable to the market risk being measured. The discount rates used for the present value computations were selected based on market interest and foreign currency exchange rates in effect at December 31, 2014 and 2013. The differences in this comparison are the hypothetical gains or losses associated with each type of risk.

Information provided by the sensitivity analysis does not necessarily represent the actual changes in fair value that the company would incur under normal market conditions because, due to practical limitations, all variables other than the specific market risk factor are held constant. In addition, the results of the model are constrained by the fact that certain items are specifically excluded from the analysis, while the financial instruments relating to the financing or hedging of those items are included by definition. Excluded items include short-term and long-term receivables from sales-type and direct financing leases, forecasted foreign currency cash flows and the company's net investment in foreign operations. As a consequence, reported changes in the values of some of the financial instruments impacting the results of the sensitivity analysis are not matched with the offsetting changes in the values of the items that those instruments are designed to finance or hedge.

The results of the sensitivity analysis at December 31, 2014 and 2013, are as follows:

### Interest Rate Risk

At December 31, 2014, a 10 percent decrease in the levels of interest rates with all other variables held constant would result in a decrease in the fair value of the company's financial instruments of \$123 million as compared with a decrease of \$322 million at December 31, 2013. A 10 percent increase in the levels of interest rates with all other variables held constant would result in an increase in the fair value of the company's financial instruments of \$119 million as compared to an increase of \$300 million at December 31, 2013. Changes in the relative sensitivity of the fair value of the company's financial instrument portfolio for these theoretical changes in the level of interest rates are primarily driven by changes in the company's debt maturities, interest rate profile and amount.

### Foreign Currency Exchange Rate Risk

At December 31, 2014, a 10 percent weaker U.S. dollar against foreign currencies, with all other variables held constant, would result in an increase in the fair value of the company's financial instruments of \$872 million as compared with an increase of \$1,340 million at December 31, 2013. Conversely, a 10 percent stronger U.S. dollar against foreign currencies, with all other variables held constant, would result in a decrease in the fair value of the company's financial instruments of \$872 million compared with a decrease of \$1,340 million at December 31, 2013. The change in impact from 2013 to 2014 was comprised of: a decrease in assets (\$123 million), an increase in debt (\$362 million) and an increase in derivatives (\$230 million).

### Financing Risks

See the "Description of Business" on page 31 for a discussion of the financing risks associated with the Global Financing business and management's actions to mitigate such risks.

## Cybersecurity

The company's approach on cybersecurity leverages its ability to adapt to a changing environment, as well as the depth and breadth of its global capabilities, both in terms of its offerings to clients and its internal approaches to risk management. The company has commercial solutions that deliver identity and access management, data security, application security, network security and endpoint security. IBM's solutions include a security intelligence dashboard that can collect information on customer IT security events and provide detailed information to customers about potential threats and security posture. The company's services businesses offer professional solutions for security from assessment to deployment. In addition, the company offers managed and outsourced security solutions from multiple security operations centers around the world. Finally, security is embedded in a multitude of IBM offerings through secure engineering processes and by critical functions (encryption, access control, etc.) in servers, storage, software, services and other solutions.

From an enterprise perspective, IBM implements a multi-faceted risk-management approach to identify and address cybersecurity risks. The company has established policies and procedures that provide the foundation by which IBM's infrastructure and data are managed. IBM performs ongoing assessments regarding its technical controls and its methods for identifying emerging risks related to cybersecurity. The company uses a layered approach with overlapping controls to defend against cybersecurity attacks on networks, end-user devices, datacenters and applications. The company also has a global incident response process to respond to cybersecurity threats. In addition, the company utilizes a combination of online training, educational tools, and other awareness initiatives to foster a culture of security awareness and responsibility among its workforce.

## Employees and Related Workforce

For the year ended December 31:	2014	2013	2012	Yr.-to-Yr. Percent Change	
				2014-13	2013-12
IBM/wholly owned subsidiaries	379,592*	431,212	434,246	(12.0)%	(0.7)%
Less-than-wholly owned subsidiaries	8,862	9,018	8,009	(1.7)	12.6
Complementary	24,321	23,555	24,740	3.3	(4.8)

\* Reflects reduction of approximately 35,000 resources due to divestitures in 2014.

As a globally integrated enterprise, the company operates in more than 175 countries and is continuing to shift its business to the higher value segments of enterprise IT. The decrease in total resources from 2013 to 2014 was primarily due to divestitures in 2014, which drove a reduction of approximately 35,000 resources. The company continues to remix its skills and resource needs to match the best opportunities in the marketplace.

The complementary workforce is an approximation of equivalent full-time employees hired under temporary, part-time and limited-term employment arrangements to meet specific business needs in a flexible and cost-effective manner.

## GLOBAL FINANCING

Global Financing is a reportable segment that is measured as a stand-alone entity.

In 2014, the Global Financing business remained focused on its core competencies—providing IT financing to the company's clients and business partners. For the year, Global Financing delivered external revenue of \$2,034 million and total revenue of \$4,522 million, and expanded gross margin. Total pre-tax income of \$2,189 million increased 0.8 percent compared to 2013 and return on equity was 36.8 percent.

In addition to the overall health of the economy and its impact on corporate IT budgets, key drivers of Global Financing's results are interest rates and originations. Interest rates directly impact

Global Financing's business by increasing or decreasing both financing revenue and the associated borrowing costs. Originations, which determine the asset base of Global Financing's annuity-like business, are impacted by IBM's non-Global Financing sales and services volumes and Global Financing's participation rates. Participation rates are the propensity of IBM's clients to finance their transactions through Global Financing in lieu of paying IBM up-front cash or financing through a third party.

## Results of Operations

(\$ in millions)

For the year ended December 31:	2014	2013	2012
External revenue	\$2,034	\$2,022	\$2,013
Internal revenue	2,488	2,282	2,060
Total revenue	4,522	4,304	4,073
Cost	1,428	1,417	1,400
Gross profit	\$3,094	\$2,888	\$2,673
Gross profit margin	68.4%	67.1%	65.6%
Pre-tax income	\$2,189	\$2,171	\$2,034
After-tax income*	\$1,462	\$1,456	\$1,362
Return on equity*	36.8%	40.6%	41.0%

\* See page 77 for the details of the after-tax income and return on equity calculation.

Total revenue in 2014 increased \$218 million versus 2013 as a result of:

- An increase in internal revenue of 9.0 percent driven by an increase in used equipment sales revenue (up 11.1 percent to \$2,080 million); partially offset by a decrease in financing revenue (down 0.7 percent to \$408 million); and
- An increase in external revenue of 0.6 percent (up 3 percent adjusted for currency) driven by an increase in financing revenue (up 3.4 percent to \$1,543 million), partially offset by a decrease in used equipment sales revenue (down 7.2 percent to \$491 million).

The decrease in internal financing revenue was primarily due to lower asset yields, partially offset by an increase in the average asset balance. The increase in external financing revenue was due to a higher average asset balance, partially offset by lower asset yields and a decrease in remarketing lease revenue. Global Financing gross profit increased 7.2 percent compared to 2013 due to an increase in used equipment sales gross profit, partially offset by a decrease in financing gross profit. The gross profit margin increased 1.3 points due to an increase in the equipment sales margin, partially offset by a decrease in the financing margin.

Total revenue in 2013 increased \$232 million versus 2012 as a result of:

- An increase in internal revenue of 10.8 percent driven by an increase in used equipment sales revenue (up 20.0 percent to \$1,871 million), partially offset by a decrease in financing revenue (down 17.9 percent to \$411 million); and
- An increase in external revenue of 0.4 percent (3 percent adjusted for currency) driven by an increase in financing revenue (up 1.4 percent to \$1,493 million), partially offset by a decrease in used equipment sales revenue (down 2.3 percent to \$528 million).

The decrease in internal financing revenue was primarily due to lower asset yields and a decrease in remarketing lease revenue. The increase in external financing revenue was due to a higher average asset balance, partially offset by lower asset yields and a decrease in remarketing lease revenue. Global Financing gross profit in 2013 increased 8.0 percent compared to 2012 due to an increase in used equipment sales gross profit, partially offset by a decrease in financing gross profit. The gross profit margin increased 1.5 points due to an increase in equipment sales margins, partially offset by a shift in mix toward lower margin used equipment sales.

Global Financing pre-tax income increased 0.8 percent in 2014 versus 2013, following an increase of 6.8 percent in 2013 versus 2012. The increase in 2014 was driven by the increase in gross profit (\$207 million), partially offset by increases in financing receivables provisions (\$155 million) and SG&A expenses (\$32 million). The increase in 2013 was driven by the increase in gross profit (\$215 million), partially offset by increases in financing receivables provisions (\$60 million) and SG&A expenses (\$20 million). The increase in financing receivable provisions in 2014 was due to higher specific reserve requirements, primarily in China and Latin America. At December 31, 2014, the overall allowance for credit losses coverage rate was 1.9 percent, an increase of 70 basis points year over year.

The decreases in return on equity from 2013 to 2014 and 2012 to 2013 were driven by higher average equity balances.

## Financial Condition

### Balance Sheet

(\$ in millions)

At December 31:	2014	2013
Cash and cash equivalents	\$ 1,538	\$ 1,446
Net investment in sales-type and direct financing leases	8,263	9,739
Equipment under operating leases:		
External clients <sup>(a)</sup>	774	947
Client loans	14,290	14,297
Total client financing assets	23,327	24,982
Commercial financing receivables	8,424	8,541
Intercompany financing receivables <sup>(b)(c)</sup>	4,611	4,216
Other receivables	368	352
Other assets	577	601
<b>Total assets</b>	<b>\$38,845</b>	<b>\$40,138</b>
Intercompany payables <sup>(b)</sup>	\$ 3,631	\$ 5,766
Debt <sup>(d)</sup>	29,103	27,504
Other liabilities	2,094	3,043
Total liabilities	34,828	36,314
Total equity	4,017	3,825
<b>Total liabilities and equity</b>	<b>\$38,845</b>	<b>\$40,138</b>

<sup>(a)</sup> Includes intercompany markup, priced on an arm's-length basis, on products purchased from the company's product divisions, which is eliminated in IBM's consolidated results.

<sup>(b)</sup> Entire amount eliminated for purposes of IBM's consolidated results and therefore does not appear on page 82.

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

<sup>(d)</sup> Global Financing debt is comprised of intercompany loans and external debt. A portion of Global Financing debt is in support of the company's internal business, or related to intercompany markup embedded in the Global Financing assets.

### Sources and Uses of Funds

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

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

In addition to the actions previously described, in certain circumstances, the company may take mitigation actions to transfer credit risk to third parties.

At December 31, 2014, substantially all financing assets were IT related assets, and approximately 59 percent of the total external portfolio was with investment grade clients with no direct exposure to consumers.

### Originations

The following are total financing originations:

(\$ in millions)			
For the year ended December 31:	2014	2013	2012
<b>Client financing</b>	<b>\$15,099</b>	\$15,792	\$16,277
<b>Commercial financing</b>	<b>43,664</b>	41,027	36,944
<b>Total</b>	<b>\$58,762</b>	\$56,819	\$53,222

In 2014, cash collection of commercial financing and client financing assets exceeded new financing originations. This resulted in a net decline in total financing assets from December 2013. The increase in originations in 2014 versus 2013, and in 2013 versus 2012, was due to improving volumes in commercial financing. Internal loan financing with Global Services is executed under a loan facility and is not considered originations.

Cash generated by Global Financing in 2014 was deployed to pay intercompany payables and dividends to IBM as well as business partners and OEM suppliers. Intercompany payables declined in 2014 due to lower IBM volumes and shorter settlement terms, which are in line with external suppliers.

### Global Financing Receivables and Allowances

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

(\$ in millions)		
At December 31:	2014	2013
<b>Gross financing receivables</b>	<b>\$31,007</b>	\$32,319
Specific allowance for credit losses	484	279
Unallocated allowance for credit losses	96	113
<b>Total allowance for credit losses</b>	<b>580</b>	392
<b>Net financing receivables</b>	<b>\$30,427</b>	\$31,928
Allowance for credit losses coverage	1.9%	1.2%

### Roll Forward of Global Financing Receivables Allowance for Credit Losses

(\$ in millions)				
January 1, 2014	Allowance Used*	Additions/(Reductions)	Other**	December 31, 2014
<b>\$392</b>	<b>\$(26)</b>	<b>\$240</b>	<b>\$(25)</b>	<b>\$580</b>

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

\*\* Primarily represents translation adjustments.

The percentage of Global Financing receivables reserved was 1.9 percent at December 31, 2014, and 1.2 percent at December 31, 2013. Specific reserves increased 74 percent from \$279 million at December 31, 2013, to \$484 million at December 31, 2014. Unallocated reserves decreased 15 percent from \$113 million at December 31, 2013, to \$96 million at December 31, 2014, primarily due to the decrease in gross financing receivables and a shift in gross financing receivables reserves from general to specific coverage.

Global Financing's bad debt expense was an increase of \$240 million for 2014, compared to an increase of \$85 million for 2013. The year-to-year increase in bad debt expense was due to higher specific reserve requirements, primarily in China and Latin America, in the current year.

### Residual Value

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

Global Financing optimizes the recovery of residual values by selling assets sourced from lease returns, leasing used equipment to new clients, or extending lease arrangements with current clients. Sales of equipment include equipment returned off of a lease, surplus internal equipment, or used equipment purchased externally. These sales represented 56.9 percent and 55.8 percent of Global Financing's revenue in 2014 and 2013, respectively. The gross profit margins on these sales were 64.9 percent and 58.3 percent in 2014 and 2013, respectively. The increase in the gross profit margin was driven by a margin increase in internal equipment sales and a shift in mix toward higher margin internal equipment sales.

The table below presents the recorded amount of unguaranteed residual value for sales-type, direct financing and operating leases at December 31, 2014 and 2013. In addition, the table presents the residual value as a percentage of the related original amount financed and a run out of when the unguaranteed residual value assigned to equipment on leases at December 31, 2014 is expected to be returned to the company. In addition to the unguaranteed residual value, on a limited basis, Global Financing will obtain guarantees of the future value of the equipment to be returned at end of lease. While primarily focused on IBM products, guarantees are also obtained for certain OEM products. These third-party guarantees are included in minimum lease payments as provided for by accounting standards in the determination of lease classifications

for the covered equipment and provide protection against risk of loss arising from declines in equipment values for these assets.

The residual value guarantee increases the minimum lease payments that are utilized in determining the classification of a lease as a sales-type lease, direct financing lease or operating lease. The aggregate asset values associated with the guarantees of sales-type leases were \$503 million and \$479 million for the financing transactions originated during the years ended December 31, 2014 and 2013, respectively. In 2014, the residual value guarantee program resulted in the company recognizing approximately \$378 million of revenue that would otherwise have recognized in future periods as operating lease revenue. If the company had chosen to not participate in a residual value guarantee program in 2014 and prior years, the 2014 impact would be substantially mitigated by the effect of prior year asset values being recognized as operating lease revenue in the current year. The aggregate asset values associated with the guarantees of direct financing leases were \$204 million and \$218 million for the financing transactions originated during the years ended December 31, 2014 and 2013, respectively. The associated aggregate guaranteed future values at the scheduled end of lease were \$25 million and \$29 million for the financing transactions originated during the years ended December 31, 2014 and 2013, respectively. The cost of guarantees was \$2 million and \$3 million for the years ended December 31, 2014 and 2013, respectively.

### Unguaranteed Residual Value

(\$ in millions)

	Total		Estimated Run Out of 2014 Balance			
	2013	2014	2015	2016	2017	2018 and Beyond
<b>At December 31:</b>						
Sales-type and direct financing leases	\$ 736	\$ 671	\$122	\$187	\$224	\$138
Operating leases	200	166	56	55	40	15
<b>Total unguaranteed residual value</b>	\$ 936	\$ 837	\$178	\$242	\$264	\$153
Related original amount financed	\$17,642	\$15,636				
Percentage	5.3%	5.4%				

### Debt

<b>At December 31:</b>	2014	2013
Debt-to-equity ratio	7.2x	7.2x

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

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

expense relating to debt supporting Global Financing's external client and internal business is included in the "Global Financing Results of Operations" on page 73 and in note T, "Segment Information," on pages 145 to 150.

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

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

(\$ in millions)

	December 31, 2014	December 31, 2013
<b>Global Financing Segment</b>	<b>\$29,103</b>	\$27,504
Debt to support external clients	\$25,531	\$24,471
Debt to support internal clients	3,572	3,033
<b>Non-Global Financing Segments</b>	<b>11,701</b>	12,214
Debt supporting operations	15,274	15,247
Intercompany activity	(3,572)	(3,033)
<b>Total company debt</b>	<b>\$40,804</b>	\$39,718

### Liquidity and Capital Resources

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

### Return on Equity

(\$ in millions)

At December 31:	2014	2013
Numerator		
Global Financing after-tax income <sup>(a)*</sup>	\$1,462	\$1,456
Denominator		
Average Global Financing equity <sup>(b)**</sup>	\$3,973	\$3,585
Global Financing return on equity <sup>(a)/(b)</sup>	36.8%	40.6%

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

\*\* Average of the ending equity for Global Financing for the last five quarters.

### Looking Forward

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

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

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

The economy could impact the credit quality of the Global Financing receivables portfolio and therefore the level of provision for credit losses. Global Financing will continue to apply rigorous credit policies in both the origination of new business and the evaluation of the existing portfolio. Global Financing has historically been able to manage residual value risk both through insight into the company's product cycles, as well as through its remarketing business.

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

## Management Responsibility for Financial Information

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. An important element of the control environment is an ongoing internal audit program. Our system also contains self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

To assure the effective administration of internal controls, we carefully select and train our employees, develop and disseminate written policies and procedures, provide appropriate communication channels and foster an environment conducive to the effective functioning of controls. We believe that it is essential for the company to conduct its business affairs in accordance with the highest ethical standards, as set forth in the IBM Business Conduct Guidelines. These guidelines, translated into numerous languages, are distributed to employees throughout the world, and reemphasized through internal programs to assure that they are understood and followed.

The Audit Committee of the Board of Directors is composed solely of independent, non-management directors, and is responsible for recommending to the Board the independent registered public accounting firm to be retained for the coming year, subject to stockholder ratification. The Audit Committee meets periodically and privately with the independent registered public accounting firm, with the company's internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.

## Management's Report on Internal Control Over Financial Reporting

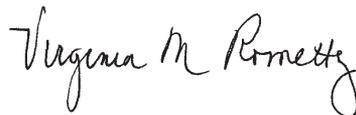
Management is responsible for establishing and maintaining adequate internal control over financial reporting of the company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

The company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the criteria established in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of December 31, 2014.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, is retained to audit IBM's Consolidated Financial Statements and the effectiveness of the internal control over financial reporting. Its accompanying report is based on audits conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States).



**Virginia M. Rometty**

Chairman, President and Chief Executive Officer  
February 24, 2015



**Martin J. Schroeter**

Senior Vice President and Chief Financial Officer  
February 24, 2015

**To the Stockholders and Board of  
Directors of International Business  
Machines Corporation:**

In our opinion, the accompanying Consolidated Financial Statements appearing on pages 80 through 150 present fairly, in all material respects, the financial position of International Business Machines Corporation and its subsidiaries at December 31, 2014 and 2013 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting appearing on page 78. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



**PricewaterhouseCoopers LLP**

New York, New York

February 24, 2015

**Consolidated Statement of Earnings**

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts)

For the year ended December 31:	Notes	2014	2013*	2012*
<b>Revenue</b>				
Services		\$55,673	\$57,655	\$ 59,453
Sales		35,063	38,666	41,381
Financing		2,057	2,047	2,040
<b>Total revenue</b>	T	<b>92,793</b>	98,367	102,874
<b>Cost</b>				
Services		36,034	37,564	39,166
Sales		9,312	11,009	12,260
Financing		1,040	1,110	1,087
<b>Total cost</b>		<b>46,386</b>	49,683	52,513
<b>Gross profit</b>		<b>46,407</b>	48,684	50,361
<b>Expense and other (income)</b>				
Selling, general and administrative		23,180	23,451	23,463
Research, development and engineering	O	5,437	5,743	5,816
Intellectual property and custom development income		(742)	(822)	(1,074)
Other (income) and expense		(1,938)	(333)	(843)
Interest expense	D&J	484	402	459
<b>Total expense and other (income)</b>		<b>26,421</b>	28,440	27,821
<b>Income from continuing operations before income taxes</b>		<b>19,986</b>	20,244	22,540
Provision for income taxes	N	4,234	3,363	5,541
<b>Income from continuing operations</b>		<b>15,751</b>	16,881	16,999
Loss from discontinued operations, net of tax	C	(3,729)	(398)	(395)
<b>Net income</b>		<b>\$12,022</b>	\$16,483	\$ 16,604
<b>Earnings/(loss) per share of common stock</b>				
<b>Assuming dilution</b>				
Continuing operations	P	\$ 15.59	\$ 15.30	\$ 14.71
Discontinued operations	P	(3.69)	(0.36)	(0.34)
<b>Total</b>	P	<b>\$ 11.90</b>	\$ 14.94	\$ 14.37
<b>Basic</b>				
Continuing operations	P	\$ 15.68	\$ 15.42	\$ 14.88
Discontinued operations	P	(3.71)	(0.36)	(0.35)
<b>Total</b>	P	<b>\$ 11.97</b>	\$ 15.06	\$ 14.53
<b>Weighted-average number of common shares outstanding</b>				
Assuming dilution		1,010,000,480	1,103,042,156	1,155,449,317
Basic		1,004,272,584	1,094,486,604	1,142,508,521

\* Reclassified to reflect discontinued operations presentation.

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

(\$ in millions)

For the year ended December 31:	Notes	2014	2013	2012
<b>Net income</b>		<b>\$12,022</b>	\$16,483	\$16,604
<b>Other comprehensive income/(loss), before tax</b>				
<b>Foreign currency translation adjustments</b>	L	<b>(1,636)</b>	(1,335)	(44)
<b>Net changes related to available-for-sale securities</b>	L			
Unrealized gains/(losses) arising during the period		<b>(29)</b>	(4)	8
Reclassification of (gains)/losses to net income		<b>5</b>	(8)	(42)
Subsequent changes in previously impaired securities arising during the period		<b>0</b>	4	20
<b>Total net changes related to available-for-sale securities</b>		<b>(24)</b>	(8)	(14)
<b>Unrealized gains/(losses) on cash flow hedges</b>	L			
Unrealized gains/(losses) arising during the period		<b>958</b>	43	32
Reclassification of (gains)/losses to net income		<b>(97)</b>	(166)	(253)
<b>Total unrealized gains/(losses) on cash flow hedges</b>		<b>861</b>	(123)	(220)
<b>Retirement-related benefit plans</b>	L			
Prior service costs/(credits)		<b>1</b>	16	—
Net (losses)/gains arising during the period		<b>(9,799)</b>	5,369	(7,489)
Curtailments and settlements		<b>24</b>	(3)	(2)
Amortization of prior service (credits)/costs		<b>(114)</b>	(114)	(148)
Amortization of net (gains)/losses		<b>2,531</b>	3,499	2,457
<b>Total retirement-related benefit plans</b>		<b>(7,357)</b>	8,767	(5,182)
<b>Other comprehensive income/(loss), before tax</b>	L	<b>(8,156)</b>	7,301	(5,460)
<b>Income tax (expense)/benefit related to items of other comprehensive income</b>	L	<b>1,883</b>	(3,144)	1,587
<b>Other comprehensive income/(loss)</b>	L	<b>(6,274)</b>	4,157	(3,874)
<b>Total comprehensive income</b>		<b>\$ 5,748</b>	\$20,641	\$12,731

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

**Consolidated Statement of Financial Position**

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts)

<b>At December 31:</b>	Notes	<b>2014</b>	2013
<b>Assets</b>			
Current assets			
Cash and cash equivalents		\$ 8,476	\$ 10,716
Marketable securities	D	0	350
Notes and accounts receivable—trade (net of allowances of \$336 in 2014 and \$291 in 2013)		9,090	10,465
Short-term financing receivables (net of allowances of \$452 in 2014 and \$308 in 2013)	F	19,835	19,787
Other accounts receivable (net of allowances of \$40 in 2014 and \$36 in 2013)		2,906	1,584
Inventories	E	2,103	2,310
Deferred taxes	N	2,044	1,651
Prepaid expenses and other current assets		4,967	4,488
<b>Total current assets</b>		<b>49,422</b>	51,350
Property, plant and equipment	G	39,034	40,475
Less: Accumulated depreciation	G	28,263	26,654
Property, plant and equipment—net	G	10,771	13,821
Long-term financing receivables (net of allowances of \$126 in 2014 and \$80 in 2013)	F	11,109	12,755
Prepaid pension assets	S	2,160	5,551
Deferred taxes	N	4,808	3,051
Goodwill	I	30,556	31,184
Intangible assets—net	I	3,104	3,871
Investments and sundry assets	H	5,603	4,639
<b>Total assets</b>		<b>\$ 117,532</b>	\$ 126,223
<b>Liabilities and equity</b>			
Current liabilities			
Taxes	N	\$ 5,084	\$ 4,633
Short-term debt	D&J	5,731	6,862
Accounts payable		6,864	7,461
Compensation and benefits		4,031	3,893
Deferred income		11,877	12,557
Other accrued expenses and liabilities		6,013	4,748
<b>Total current liabilities</b>		<b>39,600</b>	40,154
Long-term debt	D&J	35,073	32,856
Retirement and nonpension postretirement benefit obligations	S	18,261	16,242
Deferred income		3,691	4,108
Other liabilities	K	8,892	9,934
<b>Total liabilities</b>		<b>105,518</b>	103,294
Contingencies and commitments	M		
Equity	L		
IBM stockholders' equity			
Common stock, par value \$.20 per share, and additional paid-in capital		52,666	51,594
Shares authorized: 4,687,500,000			
Shares issued (2014—2,215,209,574; 2013—2,207,522,548)			
Retained earnings		137,793	130,042
Treasury stock, at cost (shares: 2014—1,224,685,815; 2013—1,153,131,611)		(150,715)	(137,242)
Accumulated other comprehensive income/(loss)		(27,875)	(21,602)
<b>Total IBM stockholders' equity</b>		<b>11,868</b>	22,792
Noncontrolling interests	A	146	137
<b>Total equity</b>		<b>12,014</b>	22,929
<b>Total liabilities and equity</b>		<b>\$ 117,532</b>	\$ 126,223

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

(\$ in millions)

For the year ended December 31:	2014	2013	2012
<b>Cash flows from operating activities</b>			
Net income	\$ 12,022	\$ 16,483	\$ 16,604
Adjustments to reconcile net income to cash provided by operating activities			
Depreciation	3,145	3,327	3,392
Amortization of intangibles	1,347	1,351	1,284
Stock-based compensation	512	614	688
Deferred taxes	(237)	(1,610)	797
Net (gain)/loss on asset sales and other	(1,535)	(236)	(729)
Loss on microelectronics business disposal	3,381	—	—
Change in operating assets and liabilities, net of acquisitions/divestitures			
Receivables (including financing receivables)	1,270	(1,407)	(2,230)
Retirement related	(655)	294	(1,008)
Inventories	(39)	(57)	280
Other assets/other liabilities	(1,886)	(747)	733
Accounts payable	(456)	(529)	(224)
<b>Net cash provided by operating activities</b>	<b>16,868</b>	<b>17,485</b>	<b>19,586</b>
<b>Cash flows from investing activities</b>			
Payments for property, plant and equipment	(3,740)	(3,623)	(4,082)
Proceeds from disposition of property, plant and equipment	404	372	410
Investment in software	(443)	(517)	(635)
Purchases of marketable securities and other investments	(2,338)	(4,608)	(4,109)
Proceeds from disposition of marketable securities and other investments	2,493	4,873	3,142
Non-operating finance receivables—net	(1,078)	(1,063)	(608)
Acquisition of businesses, net of cash acquired	(656)	(3,056)	(3,722)
Divestiture of businesses, net of cash transferred	2,357	297	599
<b>Net cash used in investing activities</b>	<b>(3,001)</b>	<b>(7,326)</b>	<b>(9,004)</b>
<b>Cash flows from financing activities</b>			
Proceeds from new debt	8,180	16,353	12,242
Payments to settle debt	(4,644)	(10,013)	(9,549)
Short-term borrowings/(repayments) less than 90 days—net	(1,753)	621	(441)
Common stock repurchases	(13,679)	(13,859)	(11,995)
Common stock transactions—other	709	1,074	1,540
Cash dividends paid	(4,265)	(4,058)	(3,773)
<b>Net cash used in financing activities</b>	<b>(15,452)</b>	<b>(9,883)</b>	<b>(11,976)</b>
Effect of exchange rate changes on cash and cash equivalents	(655)	28	(116)
Net change in cash and cash equivalents	(2,240)	304	(1,511)
Cash and cash equivalents at January 1	10,716	10,412	11,922
<b>Cash and cash equivalents at December 31</b>	<b>\$ 8,476</b>	<b>\$ 10,716</b>	<b>\$ 10,412</b>
<b>Supplemental data</b>			
Income taxes paid—net of refunds received	\$ 5,748	\$ 4,024	\$ 3,169
Interest paid on debt	\$ 1,061	\$ 982	\$ 1,009
Capital lease obligations	\$ 2	\$ 14	\$ 10

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

**Consolidated Statement of Changes in Equity**

International Business Machines Corporation and Subsidiary Companies

(\$ in millions)

	Common Stock and Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders' Equity	Non- Controlling Interests	Total Equity
<b>2012</b>							
Equity, January 1, 2012	\$48,129	\$104,857	\$(110,963)	\$(21,885)	\$ 20,138	\$ 97	\$ 20,236
Net income plus other comprehensive income/(loss)							
Net income		16,604			16,604		16,604
Other comprehensive income/(loss)				(3,874)	(3,874)		(3,874)
Total comprehensive income/(loss)					\$ 12,731		\$ 12,731
Cash dividends paid—common stock		(3,773)			(3,773)		(3,773)
Common stock issued under employee plans (15,091,320 shares)	1,532				1,532		1,532
Purchases (2,406,007 shares) and sales (2,746,169 shares) of treasury stock under employee plans—net		(48)	(160)		(208)		(208)
Other treasury shares purchased, not retired (61,246,371 shares)			(12,008)		(12,008)		(12,008)
Changes in other equity	448				448		448
Changes in noncontrolling interests						27	27
<b>Equity, December 31, 2012</b>	<b>\$50,110</b>	<b>\$117,641</b>	<b>\$(123,131)</b>	<b>\$(25,759)</b>	<b>\$ 18,860</b>	<b>\$124</b>	<b>\$ 18,984</b>

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

(\$ in millions)

	Common Stock and Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders' Equity	Non- Controlling Interests	Total Equity
<b>2013</b>							
Equity, January 1, 2013	\$50,110	\$117,641	\$(123,131)	\$(25,759)	\$ 18,860	\$124	\$ 18,984
Net income plus other comprehensive income/(loss)							
Net income		16,483			16,483		16,483
Other comprehensive income/(loss)				4,157	4,157		4,157
Total comprehensive income/(loss)					\$ 20,641		\$ 20,641
Cash dividends paid—common stock		(4,058)			(4,058)		(4,058)
Common stock issued under employee plans (9,961,389 shares)	1,216				1,216		1,216
Purchases (1,666,069 shares) and sales (1,849,883 shares) of treasury stock under employee plans—net		(25)	(117)		(142)		(142)
Other treasury shares purchased, not retired (73,121,942 shares)			(13,993)		(13,993)		(13,993)
Changes in other equity	268				268		268
Changes in noncontrolling interests						13	13
<b>Equity, December 31, 2013</b>	<b>\$51,594</b>	<b>\$130,042</b>	<b>\$(137,242)</b>	<b>\$(21,602)</b>	<b>\$ 22,792</b>	<b>\$137</b>	<b>\$ 22,929</b>

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

(\$ in millions)

	Common Stock and Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders' Equity	Non- Controlling Interests	Total Equity
<b>2014</b>							
Equity, January 1, 2014	\$51,594	\$130,042	\$(137,242)	\$(21,602)	\$ 22,792	\$137	\$ 22,929
Net income plus other comprehensive income/(loss)							
Net income		12,022			12,022		12,022
Other comprehensive income/(loss)				(6,274)	(6,274)		(6,274)
Total comprehensive income/(loss)					\$ 5,748		\$ 5,748
Cash dividends paid—common stock		(4,265)			(4,265)		(4,265)
Common stock issued under employee plans (7,687,026 shares)	977				977		977
Purchases (1,313,569 shares) and sales (1,264,232 shares) of treasury stock under employee plans—net		(6)	(79)		(85)		(85)
Other treasury shares purchased, not retired (71,504,867 shares)			(13,395)		(13,395)		(13,395)
Changes in other equity	95				95		95
Changes in noncontrolling interests						8	8
<b>Equity, December 31, 2014</b>	<b>\$52,666</b>	<b>\$137,793</b>	<b>\$(150,715)</b>	<b>\$(27,875)</b>	<b>\$ 11,868</b>	<b>\$146</b>	<b>\$ 12,014</b>

Amounts may not add due to rounding.

The accompanying notes on pages 86 through 150 are an integral part of the financial statements.

## NOTE A. SIGNIFICANT ACCOUNTING POLICIES

### 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).

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.

On October 20, 2014, the company announced a definitive agreement to divest its Microelectronics business and manufacturing operations to GLOBALFOUNDRIES. The assets and liabilities of the Microelectronics business are reported as held for sale at December 31, 2014. The operating results of the Microelectronics business have been reported as discontinued operations. Prior periods have been reclassified to conform to this presentation to allow for a meaningful comparison of continuing operations. Refer to note C, "Acquisitions/Divestitures," for additional information on the transaction.

Noncontrolling interest amounts of \$6 million, \$7 million and \$11 million, net of tax, for the years ended December 31, 2014, 2013 and 2012, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

### Principles of Consolidation

The Consolidated Financial Statements include the accounts of IBM and its controlled subsidiaries, which are primarily majority owned. Any noncontrolling interest in the equity of a subsidiary is reported in Equity in the Consolidated Statement of Financial Position. Net income and losses attributable to the noncontrolling interest is reported as described above in the Consolidated Statement of Earnings. The accounts of variable interest entities (VIEs) are included in the Consolidated Financial Statements, if required. Investments in business entities in which the company does not have control, but has the ability to exercise significant influence over operating and financial policies, are accounted for using the equity method and the company's proportionate share of income or loss is recorded in other (income) and expense. The accounting policy for other investments in equity securities is on page 95 within "Marketable Securities." Equity investments in non-publicly traded entities are primarily accounted for using the cost method. All intercompany transactions and accounts have been eliminated in consolidation.

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts of assets, liabilities, revenue, costs, expenses and other comprehensive income/(loss) (OCI) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management's best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. See "Critical Accounting Estimates" on pages 68 to 71 for a discussion of the company's critical accounting estimates.

### Revenue

The company recognizes revenue when it is realized or realizable and earned. The company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable and collectibility is reasonably assured. Delivery does not occur until products have been shipped or services have been provided to the client, risk of loss has transferred to the client, and either client acceptance has been obtained, client acceptance provisions have lapsed, or the company has objective evidence that the criteria specified in the client acceptance provisions have been satisfied. The sales price is not considered to be fixed or determinable until all contingencies related to the sale have been resolved.

The company recognizes revenue on sales to solution providers, resellers and distributors (herein referred to as "resellers") when the reseller has: economic substance apart from the company, credit risk, title and risk of loss to the inventory; and, the fee to the company is not contingent upon resale or payment by the end user, the company has no further obligations related to bringing about resale or delivery and all other revenue recognition criteria have been met.

The company reduces revenue for estimated client returns, stock rotation, price protection, rebates and other similar allowances. (See Schedule II, "Valuation and Qualifying Accounts and Reserves" included in the company's Annual Report on Form 10-K). Revenue is recognized only if these estimates can be reasonably and reliably determined. The company bases its estimates on historical results taking into consideration the type of client, the type of transaction and the specifics of each arrangement. Payments made under cooperative marketing programs are recognized as an expense only if the company receives from the client an identifiable benefit sufficiently separable from the product sale whose fair value can be reasonably and reliably estimated. If the company does not receive an identifiable benefit sufficiently separable from the product sale whose fair value can be reasonably estimated, such payments are recorded as a reduction of revenue.

Revenue from sales of third-party vendor products or services is recorded net of costs when the company is acting as an agent between the client and the vendor, and gross when the company

is a principal to the transaction. Several factors are considered to determine whether the company is an agent or principal, most notably whether the company is the primary obligor to the client, or has inventory risk. Consideration is also given to whether the company adds meaningful value to the vendor's product or service, was involved in the selection of the vendor's product or service, has latitude in establishing the sales price or has credit risk.

The company reports revenue net of any revenue-based taxes assessed by governmental authorities that are imposed on and concurrent with specific revenue-producing transactions. In addition to the aforementioned general policies, the following are the specific revenue recognition policies for multiple-deliverable arrangements and for each major category of revenue.

### Multiple-Deliverable Arrangements

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

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

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

Revenue from the company's business analytics, mobile, security, social and cloud offerings follow the specific revenue recognition policies for multiple deliverable arrangements and for each major category of revenue depending on the type of offering which can be comprised of services, hardware and/or software.

### Services

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

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

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

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

The company performs ongoing profitability analyses of its services contracts accounted for under the POC method in order to determine whether the latest estimates of revenues, costs and profits require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately. For non-POC method services contracts, any losses are recorded as incurred.

In some services contracts, the company bills the client prior to recognizing revenue from performing the services. Deferred income of \$6,352 million and \$7,153 million at December 31, 2014 and 2013, respectively, is included in the Consolidated Statement of Financial Position. In other services contracts, the company performs the services prior to billing the client. Unbilled accounts receivable of \$1,833 million and \$2,053 million at December 31, 2014 and 2013, respectively, is included in notes and accounts receivable-trade in the Consolidated Statement of Financial Position.

Billings usually occur in the month after the company performs the services or in accordance with specific contractual provisions. Unbilled receivables are expected to be billed within four months.

#### Hardware

The company's hardware offerings include the sale or lease of system servers, storage solutions and the sale of semiconductors. The company also offers installation services for its more complex hardware products.

Revenue from hardware sales and sales-type leases is recognized when risk of loss has transferred to the client and there are no unfulfilled company obligations that affect the client's final acceptance of the arrangement. Any cost of standard warranties and remaining obligations that are inconsequential or perfunctory are accrued when the corresponding revenue is recognized. Revenue from rentals and operating leases is recognized on a straight-line basis over the term of the rental or lease.

#### Software

Revenue from perpetual (one-time charge) license software is recognized at the inception of the license term if all revenue recognition criteria have been met. Revenue from term (recurring license charge) license software is recognized on a straight-line basis over the period that the client is entitled to use the license. Revenue from post-contract support, which may include unspecified upgrades on a when-and-if-available basis, is recognized on a straight-line basis over the period such items are delivered. Revenue from software hosting or software-as-a-service arrangements is recognized as the service is delivered, generally on a straight-line basis, over the longer of the term of the arrangement or the expected period of the customer relationship. In software hosting arrangements, the rights provided to the customer (e.g., ownership of a license, contract termination provisions and the feasibility of the customer to operate the software) are considered in determining whether the arrangement includes a license. In arrangements which include a software license, the associated revenue is recognized according to whether the license is perpetual or term, subject to the guidance above.

In multiple-deliverable arrangements that include software that is more than incidental to the products or services as a whole (software multiple-deliverable arrangements), software and software-related elements are accounted for in accordance with software revenue recognition guidance. Software-related elements include software products and services for which a software deliverable is essential to its functionality. Tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are not within the scope of software revenue recognition guidance and are accounted for based on other applicable revenue recognition guidance.

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

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

If any one of these criteria is not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element and there is VSOE of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative VSOE of fair value. There may be cases, however, in which there is VSOE of fair value of the undelivered item(s) but no such evidence for the delivered item(s). In these cases, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration less the aggregate VSOE of fair value of the undelivered elements.

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

## Financing

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

## Best Estimate of Selling Price

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

When the company is unable to establish selling price using VSOE or TPE, the company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the company would transact a sale if the product or service were sold on a stand-alone basis. Due to the fact that the company sells its products and services on a stand-alone basis, and therefore has established VSOE for its products and services offerings, the company uses BESP to determine the relative selling price for a product or service in a multiple-deliverable arrangement on an infrequent basis. An example of when BESP would be used is when the company sells a new product, for which VSOE and TPE does not yet exist, in a multiple-deliverable arrangement prior to selling the new product on a stand-alone basis.

The company determines BESP by considering multiple factors including, but not limited to, overall market conditions, including geographic or regional specific factors, competitive positioning, competitor actions, internal costs, profit objectives and pricing practices. The determination of BESP is a formal process that includes review and approval by the company's management. In addition, the company regularly reviews VSOE and TPE for its products and services, in addition to BESP.

## Services Costs

Recurring operating costs for services contracts, including costs related to bid and proposal activities, are recognized as incurred. For fixed-price design and build contracts, the costs of external hardware and software accounted for under the POC method are deferred and recognized based on the labor costs incurred to date, as a percentage of the total estimated labor costs to fulfill the contract. Certain eligible, nonrecurring costs incurred in the initial phases of outsourcing contracts are deferred and subsequently amortized. These costs consist of transition and setup costs related to the installation of systems and processes and are amortized on a straight-line basis over the expected period of benefit, not to exceed the term of the contract. Additionally, fixed assets associated with outsourcing contracts are capitalized and depreciated on a straight-line basis over the expected useful life of the asset. If an asset is contract specific, then the depreciation period is the shorter of the useful life of the asset

or the contract term. Amounts paid to clients in excess of the fair value of acquired assets used in outsourcing arrangements are deferred and amortized on a straight-line basis as a reduction of revenue over the expected period of benefit not to exceed the term of the contract. The company performs periodic reviews to assess the recoverability of deferred contract transition and setup costs. This review is done by comparing the estimated minimum remaining undiscounted cash flows of a contract to the unamortized contract costs. If such minimum undiscounted cash flows are not sufficient to recover the unamortized costs, an impairment loss is recognized.

Deferred services transition and setup costs were \$2,230 million and \$2,402 million at December 31, 2014 and 2013, respectively. Amortization of deferred services transition and setup costs was estimated at December 31, 2014 to be \$738 million in 2015, \$525 million in 2016, \$388 million in 2017, \$250 million in 2018 and \$329 million thereafter.

Deferred amounts paid to clients in excess of the fair value of acquired assets used in outsourcing arrangements were \$64 million and \$89 million at December 31, 2014 and 2013, respectively. Amortization of deferred amounts paid to clients in excess of the fair value of acquired assets is recorded as an offset of revenue and was estimated at December 31, 2014 to be \$27 million in 2015, \$15 million in 2016, \$7 million in 2017, \$6 million in 2018 and \$8 million thereafter. In situations in which an outsourcing contract is terminated, the terms of the contract may require the client to reimburse the company for the recovery of unbilled accounts receivable, unamortized deferred costs incurred to purchase specific assets utilized in the delivery of services and to pay any additional costs incurred by the company to transition the services.

## Software Costs

Costs that are related to the conceptual formulation and design of licensed software programs are expensed as incurred to research, development and engineering expense; costs that are incurred to produce the finished product after technological feasibility has been established are capitalized as an intangible asset. Capitalized amounts are amortized on a straight-line basis over periods ranging up to three years and are recorded in software cost within cost of sales. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are charged to software cost within cost of sales as incurred.

The company capitalizes certain costs that are incurred to purchase or to create and implement internal-use software programs, including software coding, installation, testing and certain data conversions. These capitalized costs are amortized on a straight-line basis over periods ranging up to two years and are recorded in selling, general and administrative expense.

## Product Warranties

The company offers warranties for its hardware products that generally range up to three years, with the majority being either one or three years. Estimated costs for warranty terms standard to the deliverable are recognized when revenue is recorded for the related deliverable. The company estimates its warranty costs standard to the deliverable based on historical warranty claim experience and estimates of future spending, and applies this estimate to the revenue stream for products under warranty. Estimated future costs for warranties applicable to revenue recognized in the current period are charged to cost of sales. The warranty liability is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates. Costs from fixed-price support or maintenance contracts, including extended warranty contracts, are recognized as incurred.

Revenue from separately priced extended warranty contracts is initially recorded as deferred income and subsequently recognized on a straight-line basis over the delivery period. Changes in deferred income for extended warranty contracts, and in the warranty liability for standard warranties, which are included in other accrued expenses and liabilities and other liabilities in the Consolidated Statement of Financial Position, are presented in the following tables:

### Standard Warranty Liability

(\$ in millions)

	2014	2013
Balance at January 1	\$ 376	\$ 394
Current period accruals	240	346
Accrual adjustments to reflect experience*	(120)	22
Charges incurred	(298)	(387)
<b>Balance at December 31</b>	<b>\$ 197</b>	<b>\$ 376</b>

\* Includes an adjustment of \$(125 million) in 2014 related to the industry standard server divestiture.

### Extended Warranty Liability (Deferred Income)

(\$ in millions)

	2014	2013
Balance at January 1	\$ 579	\$ 606
Revenue deferred for new extended warranty contracts	298	305
Amortization of deferred revenue*	(316)	(324)
Other**	(24)	(8)
<b>Balance at December 31</b>	<b>\$ 536</b>	<b>\$ 579</b>
Current portion	\$ 254	\$ 284
Noncurrent portion	282	295
<b>Balance at December 31</b>	<b>\$ 536</b>	<b>\$ 579</b>

\* Includes an adjustment of \$(21 million) in 2014 related to the industry standard server divestiture.

\*\* Other consists primarily of foreign currency translation adjustments.

## Shipping and Handling

Costs related to shipping and handling are recognized as incurred and included in cost in the Consolidated Statement of Earnings.

## Expense and Other Income

### Selling, General and Administrative

Selling, general and administrative (SG&A) expense is charged to income as incurred. Expenses of promoting and selling products and services are classified as selling expense and include such items as compensation, advertising, sales commissions and travel. General and administrative expense includes such items as compensation, legal costs, office supplies, non-income taxes, insurance and office rental. In addition, general and administrative expense includes other operating items such as an allowance for credit losses, workforce rebalancing charges for contractually obligated payments to employees terminated in the ongoing course of business, acquisition costs related to business combinations, amortization of certain intangible assets and environmental remediation costs.

### Advertising and Promotional Expense

The company expenses advertising and promotional costs as incurred. Cooperative advertising reimbursements from vendors are recorded net of advertising and promotional expense in the period in which the related advertising and promotional expense is incurred. Advertising and promotional expense, which includes media, agency and promotional expense, was \$1,307 million, \$1,294 million and \$1,339 million in 2014, 2013 and 2012, respectively, and is recorded in SG&A expense in the Consolidated Statement of Earnings.

### Research, Development and Engineering

Research, development and engineering (RD&E) costs are expensed as incurred. Software costs that are incurred to produce the finished product after technological feasibility has been established are capitalized as an intangible asset.

### Intellectual Property and Custom Development Income

The company licenses and sells the rights to certain of its intellectual property (IP) including internally developed patents, trade secrets and technological know-how. Certain IP transactions to third parties are licensing/royalty-based and others are transaction-based sales and other transfers. Licensing/royalty-based fees involve transfers in which the company earns the income over time, or the amount of income is not fixed or determinable until the licensee sells future related products (i.e., variable royalty, based upon licensee's revenue). Sales and other transfers typically include transfers of IP whereby the company has fulfilled its obligations and the fee received is fixed or determinable at the transfer date. The company also enters into cross-licensing arrangements of patents, and income from these arrangements is recorded when earned. In addition, the company earns income from certain custom development projects for strategic technology

partners and specific clients. The company records the income from these projects when the fee is realized and earned, is not refundable and is not dependent upon the success of the project.

#### **Other (Income) and Expense**

Other (income) and expense includes interest income (other than from Global Financing external transactions), gains and losses on certain derivative instruments, gains and losses from securities and other investments, gains and losses from certain real estate transactions, foreign currency transaction gains and losses, gains and losses from the sale of businesses, other than reported as discontinued operations, and amounts related to accretion of asset retirement obligations.

#### **Business Combinations and Intangible Assets Including Goodwill**

The company accounts for business combinations using the acquisition method and accordingly, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree are recorded at their acquisition date fair values. Goodwill represents the excess of the purchase price over the fair value of net assets, including the amount assigned to identifiable intangible assets. The primary drivers that generate goodwill are the value of synergies between the acquired entities and the company and the acquired assembled workforce, neither of which qualifies as a separately identifiable intangible asset. Goodwill recorded in an acquisition is assigned to applicable reporting units based on expected revenues. Identifiable intangible assets with finite lives are amortized over their useful lives. Amortization of completed technology is recorded in Cost, and amortization of all other intangible assets is recorded in SG&A expense. Acquisition-related costs, including advisory, legal, accounting, valuation and other costs, are expensed in the periods in which the costs are incurred. The results of operations of acquired businesses are included in the Consolidated Financial Statements from the acquisition date.

#### **Impairment**

Long-lived assets, other than goodwill and indefinite-lived intangible assets, are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The impairment test is based on undiscounted cash flows and, if impaired, the asset is written down to fair value based on either discounted cash flows or appraised values. Goodwill and indefinite-lived intangible assets are tested annually, in the fourth quarter, for impairment and whenever changes in circumstances indicate an impairment may exist. Goodwill is tested at the reporting unit level which is the operating segment, or a business, which is one level below that operating segment (the "component" level) if discrete financial information is prepared and regularly reviewed by management at the segment level. Components are aggregated as a single reporting unit if they have similar economic characteristics.

#### **Depreciation and Amortization**

Property, plant and equipment are carried at cost and depreciated over their estimated useful lives using the straight-line method. The estimated useful lives of certain depreciable assets are as follows: buildings, 30 to 50 years; building equipment, 10 to 20 years; land improvements, 20 years; plant, laboratory and office equipment, 2 to 20 years; and computer equipment, 1.5 to 5 years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the related lease term, rarely exceeding 25 years.

Capitalized software costs incurred or acquired after technological feasibility has been established are amortized over periods ranging up to 3 years. Capitalized costs for internal-use software are amortized on a straight-line basis over periods ranging up to 2 years. Other intangible assets are amortized over periods between 1 and 7 years.

#### **Environmental**

The cost of internal environmental protection programs that are preventative in nature are expensed as incurred. When a cleanup program becomes likely, and it is probable that the company will incur cleanup costs and those costs can be reasonably estimated, the company accrues remediation costs for known environmental liabilities. The company's maximum exposure for all environmental liabilities cannot be estimated and no amounts are recorded for environmental liabilities that are not probable or estimable.

#### **Asset Retirement Obligations**

Asset retirement obligations (ARO) are legal obligations associated with the retirement of long-lived assets. These liabilities are initially recorded at fair value and the related asset retirement costs are capitalized by increasing the carrying amount of the related assets by the same amount as the liability. Asset retirement costs are subsequently depreciated over the useful lives of the related assets. Subsequent to initial recognition, the company records period-to-period changes in the ARO liability resulting from the passage of time in interest expense and revisions to either the timing or the amount of the original expected cash flows to the related assets.

#### **Defined Benefit Pension and Nonpension Postretirement Benefit Plans**

The funded status of the company's defined benefit pension plans and nonpension postretirement benefit plans (retirement-related benefit plans) is recognized in the Consolidated Statement of Financial Position. The funded status is measured as the difference between the fair value of plan assets and the benefit obligation at December 31, the measurement date. For defined benefit pension plans, the benefit obligation is the projected benefit obligation (PBO), which represents the actuarial present value of benefits expected to be paid upon retirement based on employee services already rendered and estimated future compensation levels. For the nonpension postretirement benefit plans, the benefit obligation is the accumulated postretirement benefit obligation (APBO), which represents the actuarial present value of postretirement

benefits attributed to employee services already rendered. The fair value of plan assets represents the current market value of assets held in an irrevocable trust fund, held for the sole benefit of participants, which are invested by the trust fund. Overfunded plans, with the fair value of plan assets exceeding the benefit obligation, are aggregated and recorded as a prepaid pension asset equal to this excess. Underfunded plans, with the benefit obligation exceeding the fair value of plan assets, are aggregated and recorded as a retirement and nonpension postretirement benefit obligation equal to this excess.

The current portion of the retirement and nonpension postretirement benefit obligations represents the actuarial present value of benefits payable in the next 12 months exceeding the fair value of plan assets, measured on a plan-by-plan basis. This obligation is recorded in compensation and benefits in the Consolidated Statement of Financial Position.

Net periodic pension and nonpension postretirement benefit cost/(income) is recorded in the Consolidated Statement of Earnings and includes service cost, interest cost, expected return on plan assets, amortization of prior service costs/(credits) and (gains)/losses previously recognized as a component of OCI and amortization of the net transition asset remaining in accumulated other comprehensive income/(loss) (AOCI). Service cost represents the actuarial present value of participant benefits earned in the current year. Interest cost represents the time value of money cost associated with the passage of time. Certain events, such as changes in the employee base, plan amendments and changes in actuarial assumptions, result in a change in the benefit obligation and the corresponding change in OCI. The result of these events is amortized as a component of net periodic cost/(income) over the service lives or life expectancy of the participants, depending on the plan, provided such amounts exceed thresholds which are based upon the benefit obligation or the value of plan assets. Net periodic cost/(income) is recorded in Cost, SG&A and RD&E in the Consolidated Statement of Earnings based on the employees' respective functions.

(Gains)/losses and prior service costs/(credits) not recognized as a component of net periodic cost/(income) in the Consolidated Statement of Earnings as they arise are recognized as a component of OCI in the Consolidated Statement of Comprehensive Income. Those (gains)/losses and prior service costs/(credits) are subsequently recognized as a component of net periodic cost/(income) pursuant to the recognition and amortization provisions of applicable accounting guidance. (Gains)/losses arise as a result of differences between actual experience and assumptions or as a result of changes in actuarial assumptions. Prior service costs/(credits) represent the cost of benefit changes attributable to prior service granted in plan amendments.

The measurement of benefit obligations and net periodic cost/(income) is based on estimates and assumptions approved by the company's management. These valuations reflect the terms of the plans and use participant-specific information such as compensation, age and years of service, as well as certain assumptions, including estimates of discount rates, expected return on plan assets, rate of compensation increases, interest crediting rates and mortality rates.

## Defined Contribution Plans

The company's contribution for defined contribution plans is recorded when the employee renders service to the company. The charge is recorded in Cost, SG&A and RD&E in the Consolidated Statement of Earnings based on the employees' respective functions.

## Stock-Based Compensation

Stock-based compensation represents the cost related to stock-based awards granted to employees. The company measures stock-based compensation cost at the grant date, based on the estimated fair value of the award and recognizes the cost on a straight-line basis (net of estimated forfeitures) over the employee requisite service period. The company estimates the fair value of stock options using a Black-Scholes valuation model. The company also grants its employees Restricted Stock Units (RSUs), including Retention Restricted Stock Units (RRSUs) and Performance Share Units (PSUs). RSUs are stock awards granted to employees that entitle the holder to shares of common stock as the award vests, typically over a one- to five-year period. The fair value of the awards is determined and fixed on the grant date based on the company's stock price, adjusted for the exclusion of dividend equivalents. Stock-based compensation cost is recorded in Cost, SG&A, and RD&E in the Consolidated Statement of Earnings based on the employees' respective functions.

The company records deferred tax assets for awards that result in deductions on the company's income tax returns, based on the amount of compensation cost recognized and the statutory tax rate in the jurisdiction in which it will receive a deduction. Differences between the deferred tax assets recognized for financial reporting purposes and the actual tax deduction reported on the income tax return are recorded in additional paid-in capital (if the tax deduction exceeds the deferred tax asset) or in the Consolidated Statement of Earnings (if the deferred tax asset exceeds the tax deduction and no additional paid-in capital exists from previous awards).

## Income Taxes

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the tax effect of temporary differences between asset and liability amounts that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. Valuation allowances are recognized to reduce deferred tax assets to the amount that will more likely than not be realized. In assessing the need for a valuation allowance, management considers all available evidence for each jurisdiction including past operating results, estimates of future taxable income and the feasibility of ongoing tax planning strategies. When the company changes its determination as to the amount of deferred tax assets that can be realized, the valuation allowance is adjusted with a corresponding impact to income tax expense in the period in which such determination is made.

The company recognizes tax liabilities when, despite the company's belief that its tax return positions are supportable, the company believes that certain positions may not be fully sustained upon review by tax authorities. Benefits from tax positions are measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon settlement. The current portion of tax liabilities is included in taxes and the noncurrent portion of tax liabilities is included in other liabilities in the Consolidated Statement of Financial Position. To the extent that new information becomes available which causes the company to change its judgment regarding the adequacy of existing tax liabilities, such changes to tax liabilities will impact income tax expense in the period in which such determination is made. Interest and penalties, if any, related to accrued liabilities for potential tax assessments are included in income tax expense.

### Translation of Non-U.S. Currency Amounts

Assets and liabilities of non-U.S. subsidiaries that have a local functional currency are translated to United States (U.S.) dollars at year-end exchange rates. Translation adjustments are recorded in OCI. Income and expense items are translated at weighted-average rates of exchange prevailing during the year.

Inventories, property, plant and equipment—net and other non-monetary assets and liabilities of non-U.S. subsidiaries and branches that operate in U.S. dollars are translated at the approximate exchange rates prevailing when the company acquired the assets or liabilities. All other assets and liabilities denominated in a currency other than U.S. dollars are translated at year-end exchange rates with the transaction gain or loss recognized in other (income) and expense. Income and expense items are translated at the weighted-average rates of exchange prevailing during the year. These translation gains and losses are included in net income for the period in which exchange rates change.

### Derivative Financial Instruments

Derivatives are recognized in the Consolidated Statement of Financial Position at fair value and are reported in prepaid expenses and other current assets, investments and sundry assets, other accrued expenses and liabilities or other liabilities. Classification of each derivative as current or noncurrent is based upon whether the maturity of the instrument is less than or greater than 12 months. To qualify for hedge accounting, the company requires that the instruments be effective in reducing the risk exposure that they are designated to hedge. For instruments that hedge cash flows, hedge designation criteria also require that it be probable that the underlying transaction will occur. Instruments that meet established accounting criteria are formally designated as hedges. These criteria demonstrate that the derivative is expected to be highly effective at offsetting changes in fair value or cash flows of the underlying exposure both at inception of the hedging relationship and on an ongoing basis. The method of assessing hedge effectiveness and measuring hedge ineffectiveness is formally documented at hedge inception. The company assesses hedge effectiveness and measures hedge ineffectiveness at least quarterly throughout the designated hedge period.

Where the company applies hedge accounting, the company designates each derivative as a hedge of: (1) the fair value of a recognized financial asset or liability, or of an unrecognized firm commitment (fair value hedge attributable to interest rate or foreign currency risk); (2) the variability of anticipated cash flows of a forecasted transaction, or the cash flows to be received or paid related to a recognized financial asset or liability (cash flow hedge attributable to interest rate or foreign currency risk); or (3) a hedge of a long-term investment (net investment hedge) in a foreign operation. In addition, the company may enter into derivative contracts that economically hedge certain of its risks, even though hedge accounting does not apply or the company elects not to apply hedge accounting. In these cases, there exists a natural hedging relationship in which changes in the fair value of the derivative, which are recognized currently in net income, act as an economic offset to changes in the fair value of the underlying hedged item(s).

Changes in the fair value of a derivative that is designated as a fair value hedge, along with offsetting changes in the fair value of the underlying hedged exposure, are recorded in earnings each period. For hedges of interest rate risk, the fair value adjustments are recorded as adjustments to interest expense and cost of financing in the Consolidated Statement of Earnings. For hedges of currency risk associated with recorded financial assets or liabilities, derivative fair value adjustments are recognized in other (income) and expense in the Consolidated Statement of Earnings. Changes in the fair value of a derivative that is designated as a cash flow hedge are recorded, net of applicable taxes, in OCI, in the Consolidated Statement of Comprehensive Income. When net income is affected by the variability of the underlying cash flow, the applicable offsetting amount of the gain or loss from the derivative that is deferred in AOCI is released to net income and reported in interest expense, Cost, SG&A expense or other (income) and expense in the Consolidated Statement of Earnings based on the nature of the underlying cash flow hedged. Effectiveness for net investment hedging derivatives is measured on a spot-to-spot basis. The effective portion of changes in the fair value of net investment hedging derivatives and other non-derivative financial instruments designated as net investment hedges are recorded as foreign currency translation adjustments in OCI. Changes in the fair value of the portion of a net investment hedging derivative excluded from the effectiveness assessment are recorded in interest expense. If the underlying hedged item in a fair value hedge ceases to exist, all changes in the fair value of the derivative are included in net income each period until the instrument matures. When the derivative transaction ceases to exist, a hedged asset or liability is no longer adjusted for changes in its fair value except as required under other relevant accounting standards. Derivatives that are not designated as hedges, as well as changes in the fair value of derivatives that do not effectively offset changes in the fair value of the underlying hedged item throughout the designated hedge period (collectively, "ineffectiveness"), are recorded in net income for each period and are primarily reported in other (income)

and expense. When a cash flow hedging relationship is discontinued, the net gain or loss in AOCI must generally remain in AOCI until the item that was hedged affects earnings. However, when it is probable that a forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period thereafter, the net gain or loss in AOCI must be reclassified into earnings immediately. The company reports cash flows arising from derivative financial instruments designated as fair value or cash flow hedges consistent with the classification of cash flows from the underlying hedged items that these derivatives are hedging. Accordingly, the cash flows associated with derivatives designated as fair value or cash flow hedges are classified in cash flows from operating activities in the Consolidated Statement of Cash Flows. Cash flows from derivatives designated as net investment hedges and derivatives that do not qualify as hedges are reported in cash flows from investing activities in the Consolidated Statement of Cash Flows. For currency swaps designated as hedges of foreign currency denominated debt (included in the company's debt risk management program as addressed in note D, "Financial Instruments," on pages 105 through 109), cash flows directly associated with the settlement of the principal element of these swaps are reported in payments to settle debt in cash flows from financing activities in the Consolidated Statement of Cash Flows.

## Financial Instruments

In determining the fair value of its financial instruments, the company uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. See note D, "Financial Instruments," on pages 104 to 105 for further information. All methods of assessing fair value result in a general approximation of value, and such value may never actually be realized.

## Fair Value Measurement

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

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

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

When available, the company uses unadjusted quoted market prices in active markets to measure the fair value and classifies such items within Level 1. If quoted market prices are not available, fair value is based upon internally developed models that use

current market-based or independently sourced market parameters such as interest rates and currency rates. Items valued using internally generated models are classified according to the lowest level input or value driver that is significant to the valuation.

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

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

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

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

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

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

## Cash Equivalents

All highly liquid investments with maturities of three months or less at the date of purchase are considered to be cash equivalents.

## Marketable Securities

Debt securities included in current assets represent securities that are expected to be realized in cash within one year of the balance sheet date. Long-term debt securities that are not expected to be realized in cash within one year and alliance equity securities are included in investments and sundry assets. Debt and marketable equity securities are considered available for sale and are reported at fair value with unrealized gains and losses, net of applicable taxes, in OCI. The realized gains and losses for available-for-sale securities are included in other (income) and expense in the Consolidated Statement of Earnings. Realized gains and losses are calculated based on the specific identification method.

In determining whether an other-than-temporary decline in market value has occurred, the company considers the duration that, and extent to which, the fair value of the investment is below its cost, the financial condition and near-term prospects of the issuer or underlying collateral of a security; and the company's intent and ability to retain the security in order to allow for an anticipated recovery in fair value. Other-than-temporary declines in fair value from amortized cost for available-for-sale equity and debt securities that the company intends to sell or would more likely than not be required to sell before the expected recovery of the amortized cost basis are charged to other (income) and expense in the period in which the loss occurs. For debt securities that the company has no intent to sell and believes that it more likely than not will not be required to sell prior to recovery, only the credit loss component of the impairment is recognized in other (income) and expense, while the remaining loss is recognized in OCI. The credit loss component recognized in other (income) and expense is identified as the amount of the principal cash flows not expected to be received over the remaining term of the debt security as projected using the company's cash flow projections.

## Inventories

Raw materials, work in process and finished goods are stated at the lower of average cost or market. Cash flows related to the sale of inventories are reflected in net cash provided by operating activities in the Consolidated Statement of Cash Flows.

## Allowance for Credit Losses

Receivables are recorded concurrent with billing and shipment of a product and/or delivery of a service to customers. A reasonable estimate of probable net losses on the value of customer receivables is recognized by establishing an allowance for credit losses.

## Notes and Accounts Receivable—Trade

An allowance for uncollectible trade receivables is estimated based on a combination of write-off history, aging analysis and any specific, known troubled accounts.

## Financing Receivables

Financing receivables include sales-type leases, direct financing leases and loans. Leases are accounted for in accordance with lease accounting standards. Loan receivables are financial assets recorded at amortized cost which approximates fair value. The

company determines its allowances for credit losses on financing receivables based on two portfolio segments: lease receivables and loan receivables. The company further segments the portfolio into two classes: major markets and growth markets.

When calculating the allowances, the company considers its ability to mitigate a potential loss by repossessing leased equipment and by considering the current fair market value of any other collateral. The value of the equipment is the net realizable value. The allowance for credit losses for capital leases, installment sales and customer loans includes an assessment of the entire balance of the capital lease or loan, including amounts not yet due. The methodologies that the company uses to calculate its receivables reserves, which are applied consistently to its different portfolios, are as follows:

**Individually Evaluated**—The company reviews all financing receivables considered at risk on a quarterly basis. The review primarily consists of an analysis based upon current information available about the client, such as financial statements, news reports, published credit ratings, current market-implied credit analysis, as well as the current economic environment, collateral net of repossession cost and prior collection history. For loans that are collateral dependent, impairment is measured using the fair value of the collateral when foreclosure is probable. Using this information, 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.

**Collectively Evaluated**—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. Factors that could result in actual receivable losses that are materially different from the estimated reserve include sharp changes in the economy, or a significant change in the economic health of a particular client that represents a concentration in the company's receivables portfolio.

## Other Credit-Related Policies

**Non-Accrual**—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 (impaired loans or nonperforming leases) 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. Cash collections are first applied as a reduction to principal outstanding. Any cash received in excess of principal payments outstanding is recognized as interest income. Receivables may be removed from non-accrual status, if appropriate, based upon changes in client circumstances.

**Write Off**—Receivable losses are charged against the allowance when management believes the uncollectibility of the receivable is confirmed. Subsequent recoveries, if any, are credited to the allowance.

**Past Due**—The company views receivables as past due when payment has not been received after 90 days, measured from the original billing date.

**Impaired Loans**—As stated above, the company evaluates all financing receivables considered at-risk, including loans, for impairment on a quarterly basis. 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 as appropriate. Client loans are primarily for software and services and are unsecured. These loans are subjected to credit analysis to evaluate the associated risk and, when deemed necessary, actions are taken to mitigate risks in the loan agreements which include covenants to protect against credit deterioration during the life of the obligation.

### Estimated Residual Values of Lease Assets

The recorded residual values of lease assets are estimated at the inception of the lease to be the expected fair value of the assets at the end of the lease term. The company periodically reassesses the realizable value of its lease residual values. Any anticipated increases in specific future residual values are not recognized before realization through remarketing efforts. Anticipated decreases in specific future residual values that are considered to be other-than-temporary are recognized immediately upon identification and are recorded as an adjustment to the residual value estimate. For sales-type and direct-financing leases, this reduction lowers the recorded net investment and is recognized as a loss charged to financing income in the period in which the estimate is changed, as well as an adjustment to unearned income to reduce future-period financing income.

### Common Stock

Common stock refers to the \$.20 par value per share capital stock as designated in the company's Certificate of Incorporation. Treasury stock is accounted for using the cost method. When treasury stock is reissued, the value is computed and recorded using a weighted-average basis.

### Earnings Per Share of Common Stock

Earnings per share (EPS) is computed using the two-class method. The two-class method determines EPS for each class of common stock and participating securities according to dividends and dividend equivalents and their respective participation rights in undistributed earnings. Basic EPS of common stock is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted EPS of common stock is computed on the basis of the weighted-average

number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, stock awards and convertible notes.

## NOTE B. ACCOUNTING CHANGES

### New Standards to be Implemented

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

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

### Standards Implemented

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

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

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

In February 2013, the FASB issued additional guidance regarding reclassifications out of AOCI. The guidance requires entities to report the effect of significant reclassifications out of AOCI on the respective line items in net income unless the amounts are not reclassified in their entirety to net income. For amounts that are not required to be reclassified in their entirety to net income in the same reporting period, entities are required to cross-reference other disclosures that provide additional detail about those amounts. For the company, the new guidance was effective on a prospective basis for all interim and annual periods beginning January 1, 2013 with early adoption permitted. The company adopted the guidance in its December 31, 2012 financial statements. There was no impact in the consolidated financial results as the guidance related only to additional disclosures.

In July 2012, the FASB issued amended guidance that simplifies how entities test indefinite-lived intangible assets other than goodwill for impairment. After an assessment of certain qualitative factors, if it is determined to be more likely than not that an indefinite-lived intangible asset is impaired, entities must perform the quantitative impairment test. Otherwise, the quantitative test is optional. The amended guidance was effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The company adopted this guidance for its 2012 impairment testing of indefinite-lived intangible assets performed in the fourth quarter. There was no impact in the consolidated financial results.

## NOTE C. ACQUISITIONS/DIVESTITURES

### Acquisitions

Purchase price consideration for all acquisitions, as reflected in the tables in this note, is paid primarily in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

#### 2014

In 2014, the company completed six acquisitions at an aggregate cost of \$608 million.

The Software segment completed acquisitions of five privately held companies: in the first quarter, Aspera, Inc. (Aspera) and Cloudant, Inc. (Cloudant); in the second quarter, Silverpop Systems, Inc. (Silverpop) and Cognea Group Pty LTD (Cognea); and in the third quarter, CrossIdeas Srl (CrossIdeas). Global Technology Services (GTS) completed one acquisition: in the third quarter, Lighthouse Security Group, LLC (Lighthouse), a privately held company.

The following table reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of December 31, 2014:

#### 2014 Acquisitions

(\$ in millions)	Amortization Life (in Years)	Total Acquisitions
Current assets		<b>\$ 56</b>
Fixed assets/noncurrent assets		<b>39</b>
Intangible assets		
Goodwill	N/A	<b>442</b>
Completed technology	5-7	<b>68</b>
Client relationships	7	<b>77</b>
Patents/trademarks	1-7	<b>18</b>
Total assets acquired		<b>701</b>
Current liabilities		<b>(26)</b>
Noncurrent liabilities		<b>(67)</b>
Total liabilities assumed		<b>(93)</b>
<b>Total purchase price</b>		<b>\$608</b>

N/A—Not applicable

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings. Aspera's technology helps make cloud computing faster, more predictable and more cost effective for big data transfers such as

enterprise storage, sharing virtual images or accessing the cloud for increased computing capacity. Cloudant will extend the company's mobile and cloud platform by enabling developers to easily and quickly create next generation mobile and Web-based applications. Silverpop is a provider of cloud-based capabilities that deliver personalized customer engagements in highly scalable environments. Cognea offers personalized artificial intelligence capabilities designed to serve as an intuitive interface between human users and data-driven information. CrossIdeas delivers next-generation identity and access governance capabilities to help mitigate access risks and segregation of duty violations. Lighthouse is a provider of cloud-enabled managed identity and access management solutions.

The overall weighted-average life of the identified amortizable intangible assets acquired is 6.8 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$442 million has been assigned to the Software (\$430 million) and Global Technology Services (\$11 million) segments. It is expected that approximately 1 percent of the goodwill will be deductible for tax purposes. All acquisitions were for 100 percent of the acquired companies.

## 2013

In 2013, the company completed 10 acquisitions at an aggregate cost of \$3,219 million.

### 2013 Acquisitions

(\$ in millions)

	Amortization Life (in Years)	SoftLayer	Other Acquisitions
Current assets		\$ 80	\$ 97
Fixed assets/noncurrent assets		300	41
Intangible assets			
Goodwill	N/A	1,285	961
Completed technology	5–7	290	181
Client relationships	6–7	245	97
In-process R&D	N/A	2	—
Patents/trademarks	2–7	75	32
Total assets acquired		2,277	1,408
Current liabilities		(56)	(61)
Noncurrent liabilities		(244)	(105)
Total liabilities assumed		(300)	(166)
<b>Total purchase price</b>		<b>\$1,977</b>	<b>\$1,242</b>

N/A—Not applicable

**SoftLayer Technologies, Inc. (SoftLayer)**—On July 3, 2013, the company completed the acquisition of 100 percent of the privately held company, SoftLayer, a cloud computing infrastructure provider based in Dallas, Texas, for cash consideration of \$1,977 million. SoftLayer joined the company's new cloud services unit, which combined SoftLayer with IBM SmartCloud into a global platform. Goodwill of \$1,285 million has been assigned to the Global Technology Services (\$1,246 million) and Software (\$39 million) segments. At the acquisition date, it was expected that none of the goodwill would be deductible for tax purposes. The overall weighted-average useful life of the identified intangible assets acquired is 7.0 years.

**Other Acquisitions**—The Software segment completed acquisitions of eight privately held companies: in the first quarter, StoredIQ Inc. (StoredIQ) and Star Analytics, Inc. (Star Analytics); in the second quarter, UrbanCode Inc. (UrbanCode); and in the third quarter, Trusteer, Ltd. (Trusteer) and Daeja Image Systems, Ltd. (Daeja); and in the fourth quarter, Xtify, Inc. (Xtify), The Now Factory and Fiberlink Communications (Fiberlink). Systems and Technology (STG) completed one acquisition: in the third quarter, CSL International (CSL), a privately held company. All acquisitions in 2013 were for 100 percent of the acquired companies.

The following table reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of December 31, 2013.

In addition to SoftLayer, each acquisition further complemented and enhanced the company's portfolio of product and services offerings. The acquisition of StoredIQ advances the company's efforts to help clients derive value from big data. The combination of the company's and Star Analytics' software advances the company's business analytics initiatives. UrbanCode automates the delivery of software, helping businesses quickly release and update mobile, social, big data and cloud applications. CSL deepens the consolidation cloud capabilities by offering simplified management of the virtualization environment. Trusteer extends the company's data security capabilities further into the cloud, mobile and end-point security space. Daeja delivers software that helps employees across all industries, especially data intensive ones such as banking, insurance and healthcare, get faster access to critical business information, and complements the company's big data capabilities. Xtify is a leading provider of cloud-based mobile messaging tools that help organizations improve mobile sales, drive in-store traffic and engage customers with personalized offers. The Now Factory is a provider of analytics software that helps communications service providers (CSPs) deliver better customer experiences and drive new revenue opportunities. Fiberlink is a mobile management and security company, that supports the company's expanding vision for enterprise mobility management, which encompasses secure transactions between businesses, partners, and customers.

For the "Other Acquisitions," the overall weighted-average life of the identified amortizable intangible assets acquired is 6.6 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$961 million has been assigned to the Software (\$948 million) and Systems and Technology (\$13 million) segments. At the acquisition dates, it was expected that approximately 2 percent of the goodwill would be deductible for tax purposes.

The table below reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of December 31, 2012.

## 2012 Acquisitions

(\$ in millions)

	Amortization Life (in Years)	Kenexa	Other Acquisitions
Current assets		\$ 133	\$ 278
Fixed assets/noncurrent assets		98	217
Intangible assets			
Goodwill	N/A	1,014	1,880
Completed technology	3–7	169	403
Client relationships	4–7	179	194
In-process R&D	N/A	—	11
Patents/trademarks	1–7	39	37
Total assets acquired		1,632	3,020
Current liabilities		(93)	(143)
Noncurrent liabilities		(188)	(264)
Total liabilities assumed		(281)	(407)
<b>Total purchase price</b>		<b>\$1,351</b>	<b>\$2,613</b>

N/A—Not applicable

## 2012

In 2012, the company completed 11 acquisitions at an aggregate cost of \$3,964 million.

**Kenexa Corporation (Kenexa)**—On December 3, 2012, the company completed the acquisition of 100 percent of Kenexa, a publicly held company, for cash consideration of \$1,351 million. Kenexa, a leading provider of recruiting and talent management solutions, brings a unique combination of cloud-based technology and consulting services that integrates both people and processes, providing solutions to engage a smarter, more effective workforce across their most critical business functions. Goodwill of \$1,014 million was assigned to the Software (\$771 million) and Global Technology Services (GTS) (\$243 million) segments. As of the acquisition date, it was expected that approximately 10 percent of the goodwill would be deductible for tax purposes. The overall weighted-average useful life of the identified intangible assets acquired was 6.5 years.

**Other Acquisitions**—The Software segment also completed eight other acquisitions: in the first quarter, Green Hat Software Limited (Green Hat), Emptoris Inc. (Emptoris) and Worklight, Inc. (Worklight), all privately held companies, and DemandTec, Inc. (DemandTec), a publicly held company; in the second quarter, Varicent Software Inc. (Varicent), Vivisimo Inc. (Vivisimo) and Tealeaf Technology Inc. (Tealeaf), all privately held companies; and in the third quarter, Butterfly Software, Ltd. (Butterfly), a privately held company. STG completed two acquisitions: in the first quarter, Platform Computing Corporation (Platform Computing), a privately held company; and in the third quarter, Texas Memory Systems (TMS), a privately held company. All acquisitions in 2012 were for 100 percent of the acquired companies.

Each acquisition further complemented and enhanced the company's portfolio of product and services offerings. Green Hat helps customers improve the quality of software applications by enabling developers to use cloud computing technologies to conduct testing of a software application prior to its delivery. Emptoris expands the company's cloud-based analytics offerings that provide supply chain intelligence leading to better inventory management and cost efficiencies. Worklight delivers mobile application management capabilities to clients across a wide range of industries. The acquisition enhanced the company's comprehensive mobile portfolio, which is designed to help global corporations leverage the proliferation of all mobile devices—from laptops and smartphones to tablets. DemandTec delivers cloud-based analytics software to help organizations improve their price, promotion and product mix within the broad context of enterprise commerce. Varicent's software automates and analyzes data across sales, finance, human resources and IT departments to uncover trends and optimize sales performance and operations. Vivisimo software automates the discovery of big data, regardless of its format or where it resides, providing decision makers with a view of key business information necessary to drive new initiatives. Tealeaf provides a full suite of customer experience management software, which analyzes interactions on websites and mobile devices. Butterfly offers storage planning software and storage migration tools, helping companies save storage space, operational time, IT budget and power consumption. Platform Computing's focused technical and distributed computing management software helps clients create, integrate and manage shared computing environments that are used in compute-and-data intensive applications such as simulations, computer modeling and analytics. TMS designs and sells high-performance solid state storage solutions.

For the "Other Acquisitions," the overall weighted-average life of the identified amortizable intangible assets acquired is 6.6 years. These identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$1,880 million was assigned to the Software (\$1,412 million), Global Business Services (GBS) (\$5 million), GTS (\$21 million) and STG (\$443 million) segments. As of the acquisition dates, it was expected that approximately 15 percent of the goodwill would be deductible for tax purposes.

## Divestitures

### 2014

**Microelectronics**—On October 20, 2014, IBM and GLOBALFOUNDRIES announced a definitive agreement in which GLOBALFOUNDRIES will acquire the company's Microelectronics business, including existing semiconductor manufacturing assets and operations in East Fishkill, New York and Essex Junction, Vermont. The commercial OEM business to be acquired by GLOBALFOUNDRIES includes custom logic and specialty foundry, manufacturing and related operations.

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

The transaction will be completed as soon as is practical, subject to the satisfaction of regulatory requirements, customary closing conditions and any other required approvals. The transaction is expected to close in 2015.

In the third quarter of 2014, the company recorded a pre-tax charge of \$4.7 billion related to the expected sale of the Microelectronics disposal group, which was part of the Systems and Technology reportable segment. The pre-tax charge reflected the fair value less the estimated cost of selling the disposal group including an impairment to the semiconductor long-lived assets of \$2.4 billion, \$1.5 billion representing the cash consideration expected to be transferred to GLOBALFOUNDRIES and \$0.8 billion of other related costs. The asset impairment was reflected in property, plant and equipment, net and the other estimated costs of disposal were reflected in other accrued expenses and liabilities and other liabilities in the Consolidated Statement of Financial Position at September 30, 2014. These estimates may be adjusted, and the company may incur additional charges prior to the closing of the transaction. All assets and liabilities of the business are reported as held for sale at December 31, 2014. The cash consideration is expected to be transferred over three years with \$750 million transferred at the closing date. The actual net cash related to the transaction will be adjusted by the amount of the working capital due from GLOBALFOUNDRIES, estimated to be \$200 million.

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

Summarized financial information for discontinued operations is shown below.

(\$ in millions)			
For the year ended December 31:	2014	2013	2012
Total revenue	\$ 1,335	\$1,384	\$1,633
Loss from discontinued operations, before tax	(619)	(720)	(638)
Loss on disposal, before tax	(4,726)	—	—
Total loss from discontinued operations, before income taxes	(5,346)	(720)	(638)
Provision (benefit) for income taxes	(1,617)	(322)	(243)
<b>Loss from discontinued operations, net of tax</b>	<b>\$(3,729)</b>	<b>\$ (398)</b>	<b>\$ (395)</b>

The assets and liabilities at December 31, 2014 presented below are classified as held for sale.

(\$ in millions)		
At December 31:	2014	2013
Assets:		
Accounts receivable	\$245	\$ 166
Inventory	380	481
Property, plant & equipment, net	—	2,322
Other assets	92	90
<b>Total assets</b>	<b>\$717</b>	<b>\$3,059</b>
Liabilities:		
Accounts payable	\$177	\$ 172
Deferred income	87	84
Other liabilities	163	20
<b>Total liabilities</b>	<b>\$427</b>	<b>\$ 276</b>

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

IBM and Lenovo have entered into a strategic relationship which will include a global OEM and reseller agreement for sales of IBM's industry-leading entry and midrange Storwize disk storage systems, tape storage systems, General Parallel File System software, SmartCloud Entry offering, and elements of IBM's system software, including Systems Director and Platform Computing

solutions. Effective with the initial closing of the transaction, Lenovo has assumed related customer service and maintenance operations. IBM will continue to provide maintenance delivery and warranty services on Lenovo's behalf for an extended period of time. In addition, as part of the transaction agreement, the company will provide Lenovo with certain transition services, including IT and supply chain services. The initial term for these transition services ranges from less than one year to three years. Lenovo can renew certain services for an additional year.

The transaction will be completed in phases. The initial closing occurred on October 1, 2014. A subsequent closing occurred in most other countries in which there was a large business footprint on December 31, 2014. The remaining countries are expected to close in early 2015.

The company expects to recognize a total pre-tax gain on the sale of approximately \$1.5 billion, which does not include associated costs related to transition and performance-based costs. Net of these charges, the pre-tax gain is approximately \$1.2 billion, of which \$1.1 billion was recorded in the fourth quarter of 2014. The balance of the gain is expected to be recognized in 2019 upon conclusion of the maintenance delivery agreement.

The company's industry standard server business is reported in the Systems and Technology segment, and the associated maintenance operations are part of the Global Technology Services segment. In 2013, this combined business delivered approximately \$4.6 billion of revenue and was essentially breakeven on a pre-tax income basis.

The classification of the industry standard server business as held for sale at September 30, 2014 was based on meeting all of the criteria for such classification in the applicable accounting guidance. While the company met certain criteria for held for sale classification in prior periods, it did not meet the criteria that the disposal group was available for immediate sale in its present condition until September 30, 2014. Prior to that date, the company was engaged in the regulatory review process and in the activities necessary to separate the tangible assets and prepare such assets for sale. At December 31, 2014, the assets and liabilities remaining as held for sale were immaterial.

In addition, at September 30, 2014, the company concluded that the industry standard server systems business did not meet the criteria for discontinued operations reporting. The disposal group consists of the industry standard server systems business and associated maintenance operations. The industry standard server systems business constitutes a component under accounting guidance, while the maintenance operations do not meet the definition of a component. Due to the significance of the continuing cash flows with the disposal group after the transaction closes, the company did not meet the criteria to report the industry standard server systems business as a discontinued operation.

**Others**—On June 30, 2014, the company completed the divestitures of its solidDB suite of products to UNICOM Systems, Inc. and its Human Capital Management business line in France to Sopra Group.

On August 31, 2014, the company completed the divestiture of its Cognos Finance product to UNICOM Systems, Inc.

On September 30, 2014, the company completed the divestitures of its IMS Tools Suite of products to Rocket Software, Inc., its Sterling Transportation Management System to Kewill Inc., and its ILOG JViews and Elixir Visualization products to Rogue Wave Software, Inc.

On December 31, 2014, the company completed the divestiture of its Focal Point and PurifyPlus product suite to UNICOM Systems, Inc.

All of the above transactions closed in 2014 and the financial terms related to these transactions were not material. Overall, the company recorded a pre-tax gain of \$132 million related to these transactions in 2014.

### 2013

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

The initial closing of the transaction was completed on January 31, 2014, with subsequent closings occurring in 2014. In the fourth quarter of 2014, the company continued to work toward resolution of the required final balance sheet adjustments. A charge in the amount of \$10 million was recorded to reflect the expected resolution. For the full year of 2014, the company recorded a pre-tax gain of \$202 million related to this transaction.

**Others**—In the first quarter of 2013, the company completed the divestiture of its Showcase Reporting product set to Help/Systems. Showcase Reporting, which was acquired by the company through the SPSS acquisition in 2009, is an enterprise-class business intelligence platform that enables customers to build and manage analytical reporting environments.

In the fourth quarter of 2013, the company completed two divestitures, the Applicazioni Contabili Gestionali (ACG) business and the Cognos Application Development Tools (ADT) business.

The ACG business was purchased by TeamSystem. The ACG product is an Italian Enterprise Resource Planning solution for small- and medium-sized companies. The Cognos ADT business was purchased by UNICOM Systems, Inc. The Cognos ADT product suite represents a legacy family of products that provide application development environments that would enable programmers to develop COBOL applications at a higher productivity level.

Financial terms of each transaction did not have a material impact in the consolidated financial results.

### 2012

**Retail Stores**—On April 17, 2012, the company announced that it had signed a definitive agreement with Toshiba TEC for the sale of its Retail Store Solutions business. As part of the transaction, the company agreed to transfer the maintenance business to Toshiba TEC within three years of the original closing of the transaction.

In the fourth quarter of 2014, the company completed the fourth phase of the transfer of the maintenance workforce to Toshiba. A subsequent wave closing is scheduled to be completed in the first quarter of 2015. The parts and inventory transfer to Toshiba will commence in the first quarter of 2015 and is expected to be completed by the third quarter of 2015. The workforce transfer and an assessment of the ongoing contractual terms of the overall transaction resulted in the recognition of an additional pre-tax gain of \$6 million in the fourth quarter of 2014.

The company expects to close the final phase of the divestiture in the third quarter of 2015. Overall, the company expects to recognize a cumulative total pre-tax gain on the sale of approximately \$517 million, of which \$511 million has been recognized through December 31, 2014.

**NOTE D.**  
**FINANCIAL INSTRUMENTS**

**Fair Value Measurements**

**Financial Assets and Liabilities Measured at Fair Value on a Recurring Basis**

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

(\$ in millions)

<b>At December 31, 2014:</b>	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Cash equivalents <sup>(1)</sup>				
Time deposits and certificates of deposit	\$ —	\$3,517	\$—	\$3,517
Commercial paper	—	764	—	764
Money market funds	662	—	—	662
U.S. government securities	—	410	—	410
Other securities	—	6	—	6
<b>Total</b>	<b>662</b>	<b>4,697</b>	<b>—</b>	<b>5,359<sup>(5)</sup></b>
Debt securities—noncurrent <sup>(2)</sup>	1	8	—	9
Trading security investments <sup>(2)</sup>	74	—	—	74
Available-for-sale equity investments <sup>(2)</sup>	243	—	—	243
Derivative assets <sup>(3)</sup>				
Interest rate contracts	—	633	—	633
Foreign exchange contracts	—	775	—	775
Equity contracts	—	24	—	24
<b>Total</b>	<b>—</b>	<b>1,432</b>	<b>—</b>	<b>1,432<sup>(6)</sup></b>
<b>Total assets</b>	<b>\$980</b>	<b>\$6,138</b>	<b>\$—</b>	<b>\$7,118<sup>(6)</sup></b>
<b>Liabilities</b>				
Derivative liabilities <sup>(4)</sup>				
Foreign exchange contracts	—	177	—	177
Equity contracts	—	19	—	19
<b>Total liabilities</b>	<b>\$ —</b>	<b>\$ 196</b>	<b>\$—</b>	<b>\$ 196<sup>(6)</sup></b>

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

<sup>(2)</sup> Included within investments and sundry assets in the Consolidated Statement of Financial Position.

<sup>(3)</sup> 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, 2014 were \$751 million and \$681 million, respectively.

<sup>(4)</sup> 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, 2014 were \$165 million and \$31 million, respectively.

<sup>(5)</sup> Available-for-sale securities with carrying values that approximate fair value.

<sup>(6)</sup> 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 \$97 million each.

(\$ in millions)

At December 31, 2013:	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Cash equivalents <sup>(1)</sup>				
Time deposits and certificates of deposit	\$ —	\$4,754	\$—	\$4,754
Commercial paper	—	1,507	—	1,507
Money market funds	1,728	—	—	1,728
Other securities	—	8	—	8
<b>Total</b>	<b>1,728</b>	<b>6,269</b>	<b>—</b>	<b>7,997<sup>(6)</sup></b>
Debt securities—current <sup>(2)</sup>	—	350	—	350 <sup>(6)</sup>
Debt securities—noncurrent <sup>(3)</sup>	1	7	—	9
Available-for-sale equity investments <sup>(3)</sup>	18	—	—	18
Derivative assets <sup>(4)</sup>				
Interest rate contracts	—	308	—	308
Foreign exchange contracts	—	375	—	375
Equity contracts	—	36	—	36
<b>Total</b>	<b>—</b>	<b>719</b>	<b>—</b>	<b>719<sup>(7)</sup></b>
<b>Total assets</b>	<b>\$1,747</b>	<b>\$7,345</b>	<b>\$—</b>	<b>\$9,092<sup>(7)</sup></b>
<b>Liabilities</b>				
Derivative liabilities <sup>(5)</sup>				
Interest rate contracts	\$ —	\$ 13	\$—	\$ 13
Foreign exchange contracts	—	484	—	484
Equity contracts	—	4	—	4
<b>Total liabilities</b>	<b>\$ —</b>	<b>\$ 501</b>	<b>\$—</b>	<b>\$ 501<sup>(7)</sup></b>

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

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

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

<sup>(4)</sup> 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, 2013 were \$318 million and \$401 million, respectively.

<sup>(5)</sup> 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, 2013 were \$375 million and \$126 million, respectively.

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

<sup>(7)</sup> 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 \$251 million each.

During the year ended December 31, 2014, the company transferred trading security investments valued at \$74 million from Level 2 to Level 1 due to the expiration of certain regulatory restrictions. There were no transfers between Levels 1 and 2 for the year ended December 31, 2013.

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

#### Short-Term Receivables and Payables

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

#### Loans and Long-Term Receivables

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities. At December 31, 2014 and 2013, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

#### 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 \$35,073 million.

and \$32,856 million and the estimated fair value is \$37,524 million and \$34,555 million at December 31, 2014 and 2013, respectively. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

### Debt and Marketable Equity Securities

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

(\$ in millions)

	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>At December 31, 2014:</b>				
Debt securities—noncurrent <sup>(1)</sup>	\$ 7	\$3	\$—	\$ 9
Available-for-sale equity investments <sup>(1)</sup>	\$272	\$2	\$31	\$243

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

(\$ in millions)

	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>At December 31, 2013:</b>				
Debt securities—noncurrent <sup>(1)</sup>	\$ 7	\$1	\$—	\$ 9
Available-for-sale equity investments <sup>(1)</sup>	\$20	\$2	\$ 4	\$18

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

During the fourth quarter of 2014, the company acquired equity securities in conjunction with the sale of the industry standard server business which are classified as available-for-sale securities. Gross unrealized losses related to available-for-sale securities of \$31 million were recorded in the Consolidated Statement of Financial Position.

Based on an evaluation of available evidence as of December 31, 2014, the company believes that unrealized losses on debt and available-for-sale equity securities are temporary and do not represent an other-than-temporary impairment.

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

(\$ in millions)

<b>For the year ended December 31:</b>	2014	2013	2012
Proceeds	\$21	\$41	\$112
Gross realized gains (before taxes)	0	13	45
Gross realized losses (before taxes)	5	5	1

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

During the first quarter of 2014, the company acquired equity securities in conjunction with the sale of the customer care business which are classified as trading securities. At December 31, 2014, unrealized gains related to trading securities of \$21 million were recorded in other (income) and expense in the Consolidated Statement of Earnings.

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

(\$ in millions)

<b>For the year ended December 31:</b>	2014	2013
Net unrealized gains/(losses) arising during the period	\$(18)	\$ 0
Net unrealized (gains)/losses reclassified to net income	3	(5)

The contractual maturities of substantially all available-for-sale debt securities are less than one year at December 31, 2014.

### Derivative Financial Instruments

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

related cost of debt. For foreign currency exposures, derivatives are used to better manage the cash flow volatility arising from foreign exchange rate fluctuations.

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

The company is also a party to collateral security arrangements with most of its major derivative counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds. Posting thresholds can be fixed or can vary based on credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at December 31, 2014 and 2013 was \$21 million and \$216 million, respectively, for which no collateral was posted at either date. 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 December 31, 2014 and 2013 was \$1,432 million and \$719 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 \$97 million and \$251 million at December 31, 2014 and 2013, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at December 31, 2014 and 2013, this exposure was reduced by \$487 million and \$29 million of cash collateral, respectively, received by the company. At December 31, 2014 and 2013, the net exposure related to derivative assets recorded in the Statement of Financial Position was \$817 million and \$439 million, respectively. At December 31, 2014 and 2013, the net amount related to derivative liabilities recorded in the Statement of Financial Position was \$99 million and \$250 million, respectively.

In the Consolidated Statement of Financial Position, the company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. No amount was recognized in other receivables at December 31, 2014 and 2013 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral

totaled \$487 million and \$29 million at December 31, 2014 and 2013, respectively. The company restricts the use of cash collateral received to rehypothecation, and therefore reports it in prepaid expenses and other current assets in the Consolidated Statement of Financial Position. No amount was rehypothecated at December 31, 2014 and 2013. At December 31, 2014 the company held \$31 million in non-cash collateral in U.S. Treasury securities, and at December 31, 2013, no non-cash collateral was held.

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 December 31, 2014 and 2013, the total notional amount of the company's interest rate swaps was \$5.8 billion and \$3.1 billion, respectively. The weighted-average remaining maturity of these instruments at December 31, 2014 and 2013 was approximately 8.7 years and 10.6 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 December 31, 2014 and 2013.

At December 31, 2014 and 2013, net gains of approximately \$1 million (before taxes), respectively, were recorded in AOCI in connection with cash flow hedges of the company's borrowings. Within these amounts, less than \$1 million of gains, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying transactions.

## Foreign Exchange Risk

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

A large portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment in foreign subsidiaries to reduce the volatility in stockholders' equity caused by changes in foreign currency exchange rates in the functional currency of major foreign subsidiaries with respect to the U.S. dollar. The company also uses cross-currency swaps and foreign exchange forward contracts for this risk management purpose. At December 31, 2014 and 2013, the total notional amount of derivative instruments designated as net investment hedges was \$2.2 billion and \$3.0 billion, respectively. The weighted-average remaining maturity of these instruments at December 31, 2014 and 2013 was approximately 0.2 and 0.4 years, respectively.

### Anticipated Royalties and Cost Transactions

The company's operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company is hedging its exposure to the variability in future cash flows is four years. At December 31, 2014 and 2013, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was \$9.3 billion and \$10.2 billion, respectively, with a weighted-average remaining maturity of 0.7 years for both periods.

At December 31, 2014 and 2013, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net gains of \$602 million and net losses of \$252 million (before taxes), respectively, in AOCI. Within these amounts \$572 million of gains and \$166 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 hedges its exposure to the variability in future cash flows is approximately seven years. At December 31, 2014, no instruments relating to this program were outstanding. At December 31, 2013, the total notional amount of cross currency swaps designated as cash flow hedges of foreign currency denominated debt was \$1.2 billion.

At December 31, 2014 and 2013, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of \$2 million and net losses of \$9 million (before taxes) in AOCI, respectively. Within these amounts, less than \$1 million and \$3 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying exposure.

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

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company's nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than one year. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At December 31, 2014 and 2013, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$13.1 billion and \$14.7 billion, respectively.

### Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company's own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in 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 December 31, 2014 and 2013, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.3 billion for both periods.

## Other Risks

The company may hold warrants to purchase shares of common stock in connection with various investments that are deemed derivatives because they contain net share or net cash settlement provisions. The company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any warrants qualifying as derivatives outstanding at December 31, 2014 and 2013.

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company may utilize credit default swaps to economically hedge its credit exposures. 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 December 31, 2014 and 2013.

The company is exposed to market volatility on certain investment securities. The company may utilize options or forwards to economically hedge its market exposure. The derivatives are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. At December 31, 2014, the total notional amount of derivative instruments in economic hedges of investment securities was \$0.1 billion. No amounts were outstanding under this program at December 31, 2013.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of December 31, 2014 and 2013, as well as for the years ended December 31, 2014, 2013 and 2012, respectively.

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

(\$ in millions)

	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
	Balance Sheet Classification	2014	2013	Balance Sheet Classification	2014	2013
<b>At December 31:</b>						
Designated as hedging instruments:						
Interest rate contracts	Prepaid expenses and other current assets	\$ 5	\$ —	Other accrued expenses and liabilities	\$ 0	\$ 0
	Investments and sundry assets	628	308	Other liabilities	—	13
Foreign exchange contracts	Prepaid expenses and other current assets	632	187	Other accrued expenses and liabilities	50	331
	Investments and sundry assets	17	26	Other liabilities	21	112
	<b>Fair value of derivative assets</b>	<b>\$1,281</b>	\$522	<b>Fair value of derivative liabilities</b>	<b>\$ 72</b>	\$ 456
Not designated as hedging instruments:						
Foreign exchange contracts	Prepaid expenses and other current assets	\$ 90	\$ 94	Other accrued expenses and liabilities	\$ 101	\$ 40
	Investments and sundry assets	37	67	Other liabilities	4	1
Equity contracts	Prepaid expenses and other current assets	24	36	Other accrued expenses and liabilities	14	4
	Investments and sundry assets	0	—	Other liabilities	5	—
	<b>Fair value of derivative assets</b>	<b>\$ 151</b>	\$197	<b>Fair value of derivative liabilities</b>	<b>\$ 125</b>	\$ 45
Total debt designated as hedging instruments						
	Short-term debt	N/A	N/A		\$ 0	\$ 190
	Long-term debt	N/A	N/A		\$7,766	\$6,111
<b>Total</b>		<b>\$1,432</b>	\$719		<b>\$7,963</b>	\$6,802

N/A—Not applicable

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

(\$ in millions)

	Consolidated Statement of Earnings Line Item	Gain/(Loss) Recognized in Earnings					
		Recognized on Derivatives <sup>(1)</sup>			Attributable to Risk Being Hedged <sup>(2)</sup>		
		2014	2013	2012	2014	2013	2012
<b>For the year ended December 31:</b>							
Derivative instruments in fair value hedges <sup>(5)</sup>							
Interest rate contracts	Cost of financing	\$ 231	\$(109)	\$ 65	\$(127)	\$202	\$ 59
	Interest expense	206	(74)	55	(114)	138	50
Derivative instruments not designated as hedging instruments <sup>(1)</sup>							
Foreign exchange contracts	Other (income) and expense	(776)	(328)	(311)	N/A	N/A	N/A
Interest rate contracts	Other (income) and expense	34	—	—	N/A	N/A	N/A
Equity contracts	SG&A expense	51	164	110	N/A	N/A	N/A
	Other (income) and expense	(9)	—	—	N/A	N/A	N/A
<b>Total</b>		<b>\$(263)</b>	<b>\$(347)</b>	<b>\$ (81)</b>	<b>\$(241)</b>	<b>\$340</b>	<b>\$108</b>

(\$ in millions)

	Effective Portion Recognized in OCI	2013	2012	Consolidated Statement of Earnings Line Item	Gain/(Loss) Recognized in Earnings and Other Comprehensive Income					
					Effective Portion Reclassified from AOCI			Ineffectiveness and Amounts Excluded from Effectiveness Testing <sup>(3)</sup>		
					2014	2013	2012	2014	2013	2012
<b>For the year ended December 31:</b>										
Derivative instruments in cash flow hedges										
Interest rate contracts	\$ —	\$ —	\$ —	Interest expense	\$ (1)	\$ —	\$ (6)	\$—	\$—	\$—
Foreign exchange contracts	958	43	32	Other (income) and expense	98	162	237	(1)	0	3
				Cost of sales	(15)	(34)	7	—	—	—
				SG&A expense	15	39	16	—	—	—
Instruments in net investment hedges <sup>(4)</sup>										
Foreign exchange contracts	1,136	173	(26)	Interest expense	—	—	—	0	3	11
<b>Total</b>	<b>\$2,095</b>	<b>\$216</b>	<b>\$ 6</b>		<b>\$ 97</b>	<b>\$167</b>	<b>\$253</b>	<b>\$(1)</b>	<b>\$ 3</b>	<b>\$14</b>

<sup>(1)</sup> 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.

<sup>(2)</sup> 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.

<sup>(3)</sup> The amount of gain/(loss) recognized in income represents ineffectiveness on hedge relationships.

<sup>(4)</sup> Instruments in net investment hedges include derivative and non-derivative instruments.

<sup>(5)</sup> For the year ended December 31, 2014, fair value hedges resulted in a gain of \$4 million in ineffectiveness. There were no amounts recorded as ineffectiveness on fair value hedges for the year ended December 31, 2013.

N/A—Not applicable

For the 12 months ending December 31, 2014, 2013 and 2012, 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.

## NOTE E. INVENTORIES

(\$ in millions)

At December 31:	2014	2013
Finished goods	\$ 430	\$ 444
Work in process and raw materials	1,674	1,866
<b>Total</b>	<b>\$2,103</b>	<b>\$2,310</b>

## NOTE F. FINANCING RECEIVABLES

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

(\$ in millions)

At December 31:	2014	2013
Current		
Net investment in sales-type and direct financing leases	\$ 3,781	\$ 4,004
Commercial financing receivables	8,423	8,541
Client loan and installment payment receivables (loans)	7,631	7,243
<b>Total</b>	<b>\$19,835</b>	<b>\$19,787</b>
Noncurrent		
Net investment in sales-type and direct financing leases	\$ 4,449	\$ 5,700
Client loan and installment payment receivables (loans)	6,660	7,055
<b>Total</b>	<b>\$11,109</b>	<b>\$12,755</b>

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 \$671 million and \$737 million at December 31, 2014 and 2013, respectively, and is reflected net of unearned income of \$517 million and \$672 million, and net of the allowance for credit losses of \$165 million and \$123 million at those dates, respectively. Scheduled maturities of minimum lease payments outstanding at December 31, 2014, expressed as a percentage of the total, are approximately: 2015, 49 percent; 2016, 28 percent; 2017, 16 percent; 2018, 6 percent; and 2019 and beyond, 2 percent.

Commercial financing receivables, net of allowance for credit losses of \$17 million and \$23 million at December 31, 2014 and 2013, respectively, relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and OEM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan and installment payment receivables (loans), net of allowance for credit losses of \$396 million and \$242 million at December 31, 2014 and 2013, respectively, are loans that are provided primarily to clients to finance the purchase of hardware, software and services. Payment terms on these financing arrangements are generally for terms up to seven years.

Client loan receivables and installment payment receivables financing contracts are 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 nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were \$642 million and \$769 million at December 31, 2014 and 2013, respectively. These borrowings are included in note J, "Borrowings," on pages 115 to 117.

The company did not have any financing receivables held for sale as of December 31, 2014 and 2013.

## 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 December 31, 2014 and 2013. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio into two classes: major markets and growth markets.

(\$ in millions)

At December 31, 2014:	Major Markets	Growth Markets	Total
<b>Financing receivables</b>			
Lease receivables	\$ 5,702	\$ 1,943	\$ 7,645
Loan receivables	10,049	4,639	14,687
<b>Ending balance</b>	<b>\$15,751</b>	<b>\$6,581</b>	<b>\$22,332</b>
Collectively evaluated for impairment	\$15,665	\$6,156	\$21,821
Individually evaluated for impairment	\$ 86	\$ 425	\$ 511
<b>Allowance for credit losses:</b>			
<b>Beginning balance at January 1, 2014</b>			
Lease receivables	\$ 42	\$ 80	\$ 123
Loan receivables	95	147	242
<b>Total</b>	<b>\$ 137</b>	<b>\$ 228</b>	<b>\$ 365</b>
Write-offs	(18)	(6)	(24)
Provision	3	240	243
Other	(12)	(11)	(23)
<b>Ending balance at December 31, 2014</b>	<b>\$ 111</b>	<b>\$ 450</b>	<b>\$ 561</b>
Lease receivables	\$ 32	\$ 133	\$ 165
Loan receivables	\$ 79	\$ 317	\$ 396
Collectively evaluated for impairment	\$ 42	\$ 39	\$ 81
Individually evaluated for impairment	\$ 69	\$ 411	\$ 480

(\$ in millions)

	Major Markets	Growth Markets	Total
<b>At December 31, 2013:</b>			
<b>Financing receivables</b>			
Lease receivables	\$ 6,796	\$2,200	\$ 8,996
Loan receivables	10,529	4,012	14,542
<b>Ending balance</b>	<b>\$17,325</b>	<b>\$6,212</b>	<b>\$23,537</b>
Collectively evaluated for impairment	\$17,206	\$6,013	\$23,219
Individually evaluated for impairment	\$ 119	\$ 199	\$ 318
<b>Allowance for credit losses:</b>			
<b>Beginning balance at January 1, 2013</b>			
Lease receivables	\$ 59	\$ 55	\$ 114
Loan receivables	121	84	204
<b>Total</b>	<b>\$ 180</b>	<b>\$ 138</b>	<b>\$ 318</b>
Write-offs	(23)	(10)	(33)
Provision	(21)	105	84
Other	1	(6)	(5)
<b>Ending balance at December 31, 2013</b>	<b>\$ 137</b>	<b>\$ 228</b>	<b>\$ 365</b>
Lease receivables	\$ 42	\$ 80	\$ 123
Loan receivables	\$ 95	\$ 147	\$ 242
Collectively evaluated for impairment	\$ 45	\$ 48	\$ 93
Individually evaluated for impairment	\$ 93	\$ 179	\$ 272

When determining the allowances, financing receivables are evaluated either on an individual or a collective basis. For individually evaluated receivables, the company determines the expected cash flow for the receivable and calculates an estimate of the potential loss and the probability of loss. For those accounts in which the loss is probable, the company records a specific reserve. In addition, the company records an unallocated reserve that is 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

The following table presents the recorded investment in financing receivables which were on non-accrual status at December 31, 2014 and 2013.

(\$ in millions)

	2014	2013
<b>At December 31:</b>		
Major markets	<b>\$ 13</b>	\$ 25
Growth markets	<b>40</b>	34
<b>Total lease receivables</b>	<b>\$ 53</b>	\$ 59
Major markets	<b>\$ 27</b>	\$ 40
Growth markets	<b>151</b>	92
<b>Total loan receivables</b>	<b>\$178</b>	\$132
<b>Total receivables</b>	<b>\$231</b>	\$191

### 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 a non-accrual status. The following tables present impaired client loan receivables at December 31, 2014 and 2013.

(\$ in millions)

	Recorded Investment	Related Allowance
<b>At December 31, 2014:</b>		
Major markets	<b>\$ 54</b>	<b>\$ 47</b>
Growth markets	<b>299</b>	<b>293</b>
<b>Total</b>	<b>\$353</b>	<b>\$340</b>

(\$ in millions)

	Recorded Investment	Related Allowance
<b>At December 31, 2013:</b>		
Major markets	\$ 79	\$ 67
Growth markets	122	116
<b>Total</b>	<b>\$201</b>	<b>\$183</b>

(\$ in millions)

	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
<b>For the year ended December 31, 2014:</b>			
Major markets	<b>\$ 68</b>	<b>\$0</b>	<b>\$—</b>
Growth markets	<b>208</b>	<b>0</b>	<b>—</b>
<b>Total</b>	<b>\$276</b>	<b>\$0</b>	<b>\$—</b>

(\$ in millions)

	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
<b>For the year ended December 31, 2013:</b>			
Major markets	\$ 76	\$0	\$0
Growth markets	97	0	0
<b>Total</b>	<b>\$173</b>	<b>\$0</b>	<b>\$0</b>

### Credit Quality Indicators

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

The tables present the gross recorded investment for each class of receivables, by credit quality indicator, at December 31, 2014 and 2013. Receivables with a credit quality indicator ranging from AAA to BBB- are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company may take to transfer credit risk to third parties.

### Lease Receivables

(\$ in millions)

At December 31, 2014:	Major Markets	Growth Markets
Credit rating		
AAA-AA-	\$ 563	\$ 46
A+-A-	1,384	178
BBB+-BBB-	1,704	900
BB+-BB	1,154	272
BB--B+	470	286
B-B-	372	176
CCC+-D	55	85
<b>Total</b>	<b>\$5,702</b>	<b>\$1,943</b>

### Loan Receivables

(\$ in millions)

At December 31, 2014:	Major Markets	Growth Markets
Credit rating		
AAA-AA-	\$ 993	\$ 110
A+-A-	2,438	425
BBB+-BBB-	3,003	2,148
BB+-BB	2,034	649
BB--B+	827	683
B-B-	655	420
CCC+-D	98	203
<b>Total</b>	<b>\$10,049</b>	<b>\$4,639</b>

At December 31, 2014, the industries which made up Global Financing's receivables portfolio consisted of: Financial (40 percent), Manufacturing (14 percent), Government (13 percent), Services (9 percent), Retail (8 percent), Communications (6 percent), Healthcare (5 percent) and Other (5 percent).

### Lease Receivables

(\$ in millions)

At December 31, 2013:	Major Markets	Growth Markets
Credit rating		
AAA-AA-	\$ 743	\$ 68
A+-A-	1,513	168
BBB+-BBB-	2,111	957
BB+-BB	1,393	350
BB--B+	595	368
B-B-	365	214
CCC+-D	76	74
<b>Total</b>	<b>\$6,796</b>	<b>\$2,200</b>

### Loan Receivables

(\$ in millions)

At December 31, 2013:	Major Markets	Growth Markets
Credit rating		
AAA-AA-	\$ 1,151	\$ 125
A+-A-	2,344	307
BBB+-BBB-	3,271	1,745
BB+-BB	2,158	638
BB--B+	922	672
B-B-	565	391
CCC+-D	118	134
<b>Total</b>	<b>\$10,529</b>	<b>\$4,012</b>

At December 31, 2013, the industries which made up Global Financing's receivables portfolio consisted of: Financial (39 percent), Government (14 percent), Manufacturing (14 percent), Retail (8 percent), Services (8 percent), Healthcare (6 percent), Communications (6 percent) and Other (4 percent).

## Past Due Financing Receivables

(\$ in millions)

	Total Past Due > 90 Days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
<b>At December 31, 2014:</b>				
Major markets	\$ 6	\$ 5,696	\$ 5,702	\$ 6
Growth markets	32	1,911	1,943	14
<b>Total lease receivables</b>	<b>\$38</b>	<b>\$ 7,607</b>	<b>\$ 7,645</b>	<b>\$20</b>
Major markets	\$ 9	\$10,040	\$10,049	\$ 9
Growth markets	35	4,603	4,639	18
<b>Total loan receivables</b>	<b>\$44</b>	<b>\$14,643</b>	<b>\$14,687</b>	<b>\$27</b>
<b>Total</b>	<b>\$82</b>	<b>\$22,250</b>	<b>\$22,332</b>	<b>\$47</b>

\* Does not include accounts that are fully reserved.

(\$ in millions)

	Total Past Due > 90 Days*	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
<b>At December 31, 2013:</b>				
Major markets	\$ 6	\$ 6,789	\$ 6,796	\$ 5
Growth markets	19	2,181	2,200	11
<b>Total lease receivables</b>	<b>\$25</b>	<b>\$ 8,970</b>	<b>\$ 8,996</b>	<b>\$16</b>
Major markets	\$ 9	\$10,520	\$10,529	\$ 6
Growth markets	34	3,979	4,012	18
<b>Total loan receivables</b>	<b>\$43</b>	<b>\$14,499</b>	<b>\$14,542</b>	<b>\$25</b>
<b>Total</b>	<b>\$68</b>	<b>\$23,469</b>	<b>\$23,537</b>	<b>\$41</b>

\* Does not include accounts that are fully reserved.

## Troubled Debt Restructurings

The company assessed all restructurings that occurred on or after January 1, 2013 and determined that there were no significant troubled debt restructurings for the years ended December 31, 2013 and 2014.

## NOTE G. PROPERTY, PLANT AND EQUIPMENT

(\$ in millions)

<b>At December 31:</b>	2014	2013
Land and land improvements	\$ 667	\$ 706
Buildings and building improvements	9,524	9,680
Plant, laboratory and office equipment	27,388	28,169
Plant and other property—gross	37,578	38,555
Less: Accumulated depreciation	27,500	25,576
Plant and other property—net	10,078	12,979
Rental machines	1,456	1,920
Less: Accumulated depreciation	763	1,078
Rental machines—net	693	842
<b>Total—net</b>	<b>\$10,771</b>	<b>\$13,821</b>

## NOTE H. INVESTMENTS AND SUNDRY ASSETS

(\$ in millions)

<b>At December 31:</b>	2014	2013
Deferred transition and setup costs and other deferred arrangements*	\$1,527	\$1,652
Derivatives—noncurrent	681	401
Alliance investments		
Equity method	98	110
Non-equity method	496	200
Prepaid software	332	352
Long-term deposits	300	316
Other receivables	509	174
Employee benefit-related	356	392
Prepaid income taxes	518	305
Other assets	788	738
<b>Total</b>	<b>\$5,603</b>	<b>\$4,639</b>

\* Deferred transition and setup costs and other deferred arrangements are related to Global Services client arrangements. See note A, "Significant Accounting Policies," on page 89 for additional information.

## NOTE I. INTANGIBLE ASSETS INCLUDING GOODWILL

### Intangible Assets

The following table details the company's intangible asset balances by major asset class.

(\$ in millions)

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
<b>At December 31, 2014:</b>			
Intangible asset class			
Capitalized software	\$1,375	\$ (679)	\$ 696
Client relationships	2,208	(1,271)	937
Completed technology	2,831	(1,533)	1,298
In-process R&D	—	—	—
Patents/trademarks	374	(214)	161
Other*	18	(6)	12
<b>Total</b>	<b>\$6,806</b>	<b>\$(3,702)</b>	<b>\$3,104</b>

(\$ in millions)

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
<b>At December 31, 2013:</b>			
Intangible asset class			
Capitalized software	\$1,494	\$ (699)	\$ 794
Client relationships	2,148	(977)	1,171
Completed technology	2,910	(1,224)	1,687
In-process R&D	13	—	13
Patents/trademarks	358	(154)	204
Other*	7	(5)	2
<b>Total</b>	<b>\$6,930</b>	<b>\$(3,059)</b>	<b>\$3,871</b>

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

The net carrying amount of intangible assets decreased \$768 million during the year ended December 31, 2014, primarily due to amortization, partially offset by intangible asset additions resulting from acquisitions. There was no impairment of intangible assets recorded in 2014 and 2013. The aggregate intangible amortization expense was \$1,347 million and \$1,351 million for the years ended December 31, 2014 and 2013, respectively. In addition, in 2014 and 2013, respectively, the company retired \$724 million and \$1,177 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 December 31, 2014:

(\$ in millions)

	Capitalized Software	Acquired Intangibles	Total
2015	\$420	\$648	\$1,068
2016	211	605	816
2017	65	494	559
2018	—	349	349
2019	—	210	210

## Goodwill

The changes in the goodwill balances by reportable segment, for the years ended December 31, 2014 and 2013, are as follows:

(\$ in millions)

Segment	Balance January 1, 2014	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation and Other Adjustments	Balance December 31, 2014
Global Business Services	\$ 4,334	\$ —	\$ 0	\$ 0	\$(248)	\$ 4,086
Global Technology Services	4,129	11	20	(54)	(109)	3,998
Software	21,121	430	(17)	(19)	(516)	21,000
Systems and Technology	1,601	—	—	(110)	(19)	1,472
<b>Total</b>	<b>\$31,184</b>	<b>\$442</b>	<b>\$ 4</b>	<b>\$(183)</b>	<b>\$(891)</b>	<b>\$30,556</b>

(\$ in millions)

Segment	Balance January 1, 2013	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation and Other Adjustments	Balance December 31, 2013
Global Business Services	\$ 4,357	\$ —	\$ 0	\$(3)	\$ (21)	\$ 4,334
Global Technology Services	2,916	1,246	17	—	(50)	4,129
Software	20,405	987	11	(4)	(279)	21,121
Systems and Technology	1,568	13	33	—	(14)	1,601
<b>Total</b>	<b>\$29,247</b>	<b>\$2,246</b>	<b>\$61</b>	<b>\$(7)</b>	<b>\$(363)</b>	<b>\$31,184</b>

Purchase price adjustments recorded in 2014 and 2013 were related to acquisitions that were completed on or prior to December 31, 2013 or December 31, 2012, 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 in 2014 or 2013 and the company has no accumulated goodwill impairment losses.

## NOTE J. BORROWINGS

### Short-Term Debt

(\$ in millions)

At December 31:	2014	2013
Commercial paper	\$ 650	\$2,458
Short-term loans	480	551
Long-term debt—current maturities	4,601	3,854
<b>Total</b>	<b>\$5,731</b>	<b>\$6,862</b>

The weighted-average interest rate for commercial paper at both December 31, 2014 and 2013 was 0.1 percent. The weighted-average interest rates for short-term loans was 4.0 percent and 5.1 percent at December 31, 2014 and 2013, respectively.

## Long-Term Debt

### Pre-Swap Borrowing

(\$ in millions)

At December 31:	Maturities	2014	2013
U.S. dollar notes and debentures (average interest rate at December 31, 2014):			
0.97%	2015–2016	\$ 9,254	\$ 6,456**
4.73%	2017–2018	6,835	8,465
2.19%	2019–2021	6,555	6,206
1.88%	2022	1,000	1,000
3.38%	2023	1,500	1,500
3.63%	2024	2,000	—
7.00%	2025	600	600
6.22%	2027	469	469
6.50%	2028	313	313
5.88%	2032	600	600
8.00%	2038	83	83
5.60%	2039	745	745
4.00%	2042	1,107	1,107
7.00%	2045	27	27
7.13%	2096	316	316
		<b>31,404</b>	<b>27,887</b>
Other currencies (average interest rate at December 31, 2014, in parentheses):			
Euros (1.85%)	2015–2025	5,463	5,894
Pound sterling (2.75%)	2017–2020	1,176	1,254
Japanese yen (0.5%)	2017–2019	733	1,057
Swiss francs (3.8%)	2015–2020	162	181
Canadian (2.2%)	2017	432	471
Other (10.1%)	2015–2017	367	291
		<b>39,737</b>	<b>37,036</b>
Less: net unamortized discount		853	872
Add: fair value adjustment*		792	546
		<b>39,675</b>	<b>36,710</b>
Less: current maturities		4,601	3,854
<b>Total</b>		<b>\$35,073</b>	<b>\$32,856</b>

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

\*\* Includes \$17 million of debt securities issued by IBM International Group Capital, LLC, an indirect 100-percent owned finance subsidiary of the company, which matured in the first half of 2014. Debt securities issued by IBM International Group Capital, LLC are fully and unconditionally guaranteed by the company.

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

as well as a cross default provision with respect to other defaulted indebtedness of at least \$500 million.

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

## Post-Swap Borrowing (Long-Term Debt, Including Current Portion)

(in millions)

For the year ended December 31:	2014		2013	
	Amount	Average Rate	Amount	Average Rate
Fixed-rate debt	\$27,255	3.09%	\$30,123	3.07%
Floating-rate debt*	12,420	0.82%	6,587	0.87%
<b>Total</b>	<b>\$39,675</b>		\$36,710	

\*Includes \$5,839 million in 2014 and \$3,106 million in 2013 of notional interest rate swaps that effectively convert fixed-rate long-term debt into floating-rate debt. (See note D, "Financial Instruments," on pages 105 through 109).

Pre-swap annual contractual maturities of long-term debt outstanding at December 31, 2014, are as follows:

(\$ in millions)

	Total
2015	\$ 4,600
2016	5,331
2017	5,242
2018	2,621
2019	4,069
2020 and beyond	17,874
<b>Total</b>	<b>\$39,737</b>

## Interest on Debt

(\$ in millions)

For the year ended December 31:	2014	2013	2012
Cost of financing	\$ 542	\$ 587	\$ 545
Interest expense	484	405	470
Net investment derivative activity	0	(3)	(11)
Interest capitalized	4	22	18
<b>Total interest paid and accrued</b>	<b>\$1,030</b>	\$1,011	\$1,022

Refer to the related discussion on page 148 in note T, "Segment Information," for total interest expense of the Global Financing segment. See note D, "Financial Instruments," on pages 105 through 109 for a discussion of the use of currency and interest rate swaps in the company's debt risk management program.

## Lines of Credit

In 2014, the company extended the term of its five-year, \$10 billion Credit Agreement (the "Credit Agreement") by one year to November 10, 2019. The total expense recorded by the company related to this global credit facility was \$5.4 million in 2014, \$5.4 million in 2013 and \$5.3 million in 2012. The Credit Agreement permits the company and its Subsidiary Borrowers to borrow up to \$10 billion on a revolving basis. Borrowings of the Subsidiary Borrowers will be unconditionally backed by the company. The company may also, upon the agreement of either existing lenders, or of the additional banks not currently party to the Credit Agreement, increase the commitments under the Credit Agreement up to an additional \$2.0 billion. Subject to certain terms of the Credit Agreement, the company and Subsidiary Borrowers may borrow, prepay and reborrow amounts under the Credit Agreement at any time during the Credit Agreement. Interest rates on borrowings under the Credit Agreement will be based on prevailing market interest rates, as further described in the Credit Agreement. The Credit Agreement contains customary representations and warranties, covenants, events of default, and indemnification provisions. The company believes that circumstances that might give rise to breach of these covenants or an event of default, as specified in the Credit Agreement, are remote. As of December 31, 2014, there were no borrowings by the company, or its subsidiaries, under the Credit Agreement.

The company also has other committed lines of credit in some of the geographies which are not significant in the aggregate. Interest rates and other terms of borrowing under these lines of credit vary from country to country, depending on local market conditions.

## NOTE K. OTHER LIABILITIES

(\$ in millions)

At December 31:	2014	2013
Income tax reserves	\$3,146	\$3,189
Excess 401(k) Plus Plan	1,658	1,673
Disability benefits	675	699
Derivative liabilities	31	126
Special restructuring actions	431	440
Workforce reductions	469	500
Deferred taxes	288	1,741
Other taxes payable	17	186
Environmental accruals	240	231
Warranty accruals	91	171
Asset retirement obligations	136	129
Acquisition related	50	205
Divestiture related*	1,124	40
Other	536	604
<b>Total</b>	<b>\$8,892</b>	<b>\$9,934</b>

\* Primarily includes accruals in 2014 related to the expected divestiture of the Micro-electronics business.

In response to changing business needs, the company periodically takes workforce reduction actions to improve productivity, cost competitiveness and to rebalance skills. The noncurrent contractually obligated future payments associated with these activities are reflected in the workforce reductions caption in the previous table.

In addition, the company executed certain special restructuring-related actions prior to 2006. The previous table provides the noncurrent liabilities associated with these special actions. Current liabilities are included in other accrued expenses and liabilities in the Consolidated Statement of Financial Position and were immaterial at December 31, 2014.

The noncurrent liabilities are workforce accruals related to terminated employees who are no longer working for the company who were granted annual payments to supplement their incomes in certain countries. Depending on the individual country's legal requirements, these required payments will continue until the former employee begins receiving pension benefits or passes away.

The company employs extensive internal environmental protection programs that primarily are preventive in nature. The company also participates in environmental assessments and cleanups at a number of locations, including operating facilities, previously owned facilities and Superfund sites. The company's maximum exposure for all environmental liabilities cannot be estimated and no amounts have been recorded for non-ARO environmental liabilities that are not probable or estimable. The total amounts accrued for non-ARO environmental liabilities, including amounts

classified as current in the Consolidated Statement of Financial Position, that do not reflect actual or anticipated insurance recoveries, were \$254 million and \$245 million at December 31, 2014 and 2013, respectively. Estimated environmental costs are not expected to materially affect the consolidated financial position or consolidated results of the company's operations in future periods. However, estimates of future costs are subject to change due to protracted cleanup periods and changing environmental remediation regulations.

As of December 31, 2014, the company was unable to estimate the range of settlement dates and the related probabilities for certain asbestos remediation AROs. These conditional AROs are primarily related to the encapsulated structural fireproofing that is not subject to abatement unless the buildings are demolished and non-encapsulated asbestos that the company would remediate only if it performed major renovations of certain existing buildings. Because these conditional obligations have indeterminate settlement dates, the company could not develop a reasonable estimate of their fair values. The company will continue to assess its ability to estimate fair values at each future reporting date. The related liability will be recognized once sufficient additional information becomes available. The total amounts accrued for ARO liabilities, including amounts classified as current in the Consolidated Statement of Financial Position were \$180 million and \$160 million at December 31, 2014 and 2013, respectively.

## NOTE L. EQUITY ACTIVITY

The authorized capital stock of IBM consists of 4,687,500,000 shares of common stock with a \$.20 per share par value, of which 990,523,759 shares were outstanding at December 31, 2014 and 150,000,000 shares of preferred stock with a \$.01 per share par value, none of which were outstanding at December 31, 2014.

### Stock Repurchases

The Board of Directors authorizes the company to repurchase IBM common stock. The company repurchased 71,504,867 common shares at a cost of \$13,395 million, 73,121,942 common shares at a cost of \$13,993 million and 61,246,371 common shares at a cost of \$12,008 million in 2014, 2013 and 2012, respectively. These amounts reflect transactions executed through December 31 of each year. Actual cash disbursements for repurchased shares may differ due to varying settlement dates for these transactions. At December 31, 2014, \$6,264 million of Board common stock repurchase authorization was available. The company plans to purchase shares on the open market or in private transactions from time to time, depending on market conditions.

## Other Stock Transactions

The company issued the following shares of common stock as part of its stock-based compensation plans and employees stock purchase plan: 7,687,026 shares in 2014, 9,961,389 shares in 2013, and 15,091,320 shares in 2012. The company issued 1,264,232 treasury shares in 2014, 1,849,883 treasury shares in 2013 and 2,746,169 treasury shares in 2012, as a result of restricted stock unit releases and exercises of stock options by employees of certain acquired businesses and by non-U.S. employees. Also, as part of the

company's stock-based compensation plans, 1,313,569 common shares at a cost of \$236 million, 1,666,069 common shares at a cost of \$336 million and 2,406,007 common shares at a cost of \$468 million in 2014, 2013 and 2012, respectively, were remitted by employees in order to satisfy minimum statutory tax withholding requirements. These amounts are included in the treasury stock balance in the Consolidated Statement of Financial Position and the Consolidated Statement of Changes in Equity.

## Reclassifications and Taxes Related to Items of Other Comprehensive Income

(\$ in millions)

	Before Tax Amount	Tax (Expense)/ Benefit	Net of Tax Amount
<b>For the year ended December 31, 2014:</b>			
<b>Other comprehensive income/(loss)</b>			
<b>Foreign currency translation adjustments</b>	<b>\$(1,636)</b>	<b>\$ (438)</b>	<b>\$(2,074)</b>
<b>Net changes related to available-for-sale securities</b>			
Unrealized gains/(losses) arising during the period	\$ (29)	\$ 11	\$ (18)
Reclassification of (gains)/losses to other (income) and expense	5	(2)	3
Subsequent changes in previously impaired securities arising during the period	0	0	0
<b>Total net changes related to available-for-sale securities</b>	<b>\$ (24)</b>	<b>\$ 9</b>	<b>\$ (15)</b>
<b>Unrealized gains/(losses) on cash flow hedges</b>			
Unrealized gains/(losses) arising during the period	\$ 958	\$ (341)	\$ 618
Reclassification of (gains)/losses to:			
Cost of sales	15	(7)	9
SG&A expense	(15)	6	(9)
Other (income) and expense	(98)	38	(60)
Interest expense	1	0	0
<b>Total unrealized gains/(losses) on cash flow hedges</b>	<b>\$ 861</b>	<b>\$ (304)</b>	<b>\$ 557</b>
<b>Retirement-related benefit plans<sup>(1)</sup></b>			
Prior service costs/(credits)	\$ 1	\$ 0	\$ 1
Net (losses)/gains arising during the period	(9,799)	3,433	(6,366)
Curtailments and settlements	24	(7)	17
Amortization of prior service (credits)/cost	(114)	41	(73)
Amortization of net (gains)/losses	2,531	(852)	1,678
<b>Total retirement-related benefit plans</b>	<b>\$(7,357)</b>	<b>\$2,615</b>	<b>\$(4,742)</b>
<b>Other comprehensive income/(loss)</b>	<b>\$(8,156)</b>	<b>\$1,883</b>	<b>\$(6,274)</b>

<sup>(1)</sup> These AOCI components are included in the computation of net periodic pension cost. (See note S, "Retirement-Related Benefits," on pages 131 to 145 for additional information.)

(\$ in millions)

	Before Tax Amount	Tax (Expense)/ Benefit	Net of Tax Amount
<b>For the year ended December 31, 2013:</b>			
<b>Other comprehensive income/(loss)</b>			
<b>Foreign currency translation adjustments</b>	\$ (1,335)	\$ (66)	\$ (1,401)
<b>Net changes related to available-for-sale securities</b>			
Unrealized gains/(losses) arising during the period	\$ (4)	\$ 2	\$ (3)
Reclassification of (gains)/losses to other (income) and expense	(8)	2	(5)
Subsequent changes in previously impaired securities arising during the period	4	(1)	3
<b>Total net changes related to available-for-sale securities</b>	\$ (8)	\$ 3	\$ (5)
<b>Unrealized gains/(losses) on cash flow hedges</b>			
Unrealized gains/(losses) arising during the period	\$ 43	\$ (15)	\$ 28
Reclassification of (gains)/losses to:			
Cost of sales	34	(14)	21
SG&A expense	(39)	14	(25)
Other (income) and expense	(162)	62	(99)
Interest expense	0	0	0
<b>Total unrealized gains/(losses) on cash flow hedges</b>	\$ (123)	\$ 47	\$ (76)
<b>Retirement-related benefit plans<sup>(1)</sup></b>			
Prior service costs/(credits)	\$ 16	\$ 0	\$ 16
Net (losses)/gains arising during the period	5,369	(1,974)	3,395
Curtailements and settlements	(3)	1	(2)
Amortization of prior service (credits)/cost	(114)	40	(75)
Amortization of net (gains)/losses	3,499	(1,195)	2,304
<b>Total retirement-related benefit plans</b>	\$ 8,767	\$ (3,128)	\$ 5,639
<b>Other comprehensive income/(loss)</b>	\$ 7,301	\$ (3,144)	\$ 4,157

<sup>(1)</sup> These AOCI components are included in the computation of net periodic pension cost. (See note S, "Retirement-Related Benefits," on pages 131 to 145 for additional information.)

(\$ in millions)

	Before Tax Amount	Tax (Expense)/Benefit	Net of Tax Amount
<b>For the year ended December 31, 2012:</b>			
<b>Other comprehensive income/(loss)</b>			
<b>Foreign currency translation adjustments</b>	\$ (44)	\$ 10	\$ (34)
<b>Net changes related to available-for-sale securities</b>			
Unrealized gains/(losses) arising during the period	\$ 8	\$ (4)	\$ 4
Reclassification of (gains)/losses to other (income) and expense	(42)	17	(25)
Subsequent changes in previously impaired securities arising during the period	20	(8)	12
<b>Total net changes related to available-for-sale securities</b>	\$ (14)	\$ 5	\$ (9)
<b>Unrealized gains/(losses) on cash flow hedges</b>			
Unrealized gains/(losses) arising during the period	\$ 32	\$ (27)	\$ 5
Reclassification of (gains)/losses to:			
Cost of sales	(7)	(6)	(13)
SG&A expense	(16)	4	(12)
Other (income) and expense	(237)	91	(146)
Interest expense	6	(3)	3
<b>Total unrealized gains/(losses) on cash flow hedges</b>	\$ (220)	\$ 59	\$ (161)
<b>Retirement-related benefit plans<sup>(1)</sup></b>			
Net (losses)/gains arising during the period	\$(7,489)	\$2,327	\$(5,162)
Curtailements and settlements	(2)	0	(2)
Amortization of prior service (credits)/cost	(148)	59	(89)
Amortization of net (gains)/losses	2,457	(874)	1,583
<b>Total retirement-related benefit plans</b>	\$(5,182)	\$1,513	\$(3,669)
<b>Other comprehensive income/(loss)</b>	\$(5,460)	\$1,587	\$(3,874)

<sup>(1)</sup> These AOCI components are included in the computation of net periodic pension cost. (See note S, "Retirement-Related Benefits," on pages 131 to 145 for additional information.)

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

(\$ in millions)

	Net Unrealized Gains/(Losses) on Cash Flow Hedges	Foreign Currency Translation Adjustments*	Net Change Retirement-Related Benefit Plans	Net Unrealized Gains/(Losses) on Available-For-Sale Securities	Accumulated Other Comprehensive Income/(Loss)
December 31, 2011	\$ 71	\$ 1,767	\$(23,737)	\$ 13	\$(21,885)
Other comprehensive income before reclassifications	5	(34)	(5,164)	16	(5,177)
Amount reclassified from accumulated other comprehensive income	(167)	0	1,495	(25)	1,303
Total change for the period	(161)	(34)	(3,669)	(9)	(3,874)
December 31, 2012	(90)	1,733	(27,406)	4	(25,759)
Other comprehensive income before reclassifications	28	(1,401)	3,409	0	2,036
Amount reclassified from accumulated other comprehensive income	(103)	0	2,229	(5)	2,121
Total change for the period	(76)	(1,401)	5,639	(5)	4,157
December 31, 2013	(165)	332	(21,767)	(1)	(21,602)
Other comprehensive income before reclassifications	618	(2,074)	(6,348)	(18)	(7,822)
Amount reclassified from accumulated other comprehensive income	(60)	0	1,605	3	1,548
Total change for the period	557	(2,074)	(4,742)	(15)	(6,274)
December 31, 2014	<b>\$ 392</b>	<b>\$(1,742)</b>	<b>\$(26,509)</b>	<b>\$(15)</b>	<b>\$(27,875)</b>

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

## NOTE M. CONTINGENCIES AND COMMITMENTS

### Contingencies

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

The company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Any recorded liabilities, including any changes to such liabilities for the years ended December 31, 2014, 2013 and 2012 were not material to the company's results of continuing operations and financial position.

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

With respect to certain of the claims, suits, investigations and proceedings discussed herein, the company believes at this time that the likelihood of any material loss is remote, given, for example, the procedural status, court rulings, and/or the strength of the company's defenses in those matters. With respect to the remaining claims, suits, investigations and proceedings discussed in this Note, the company is unable to provide estimates of reasonably possible losses or range of losses, including losses in excess of

amounts accrued, if any, for the following reasons. Claims, suits, investigations and proceedings are inherently uncertain, and it is not possible to predict the ultimate outcome of these matters. It is the company's experience that damage amounts claimed in litigation against it are unreliable and unrelated to possible outcomes, and as such are not meaningful indicators of the company's potential liability. Further, the company is unable to provide such an estimate due to a number of other factors with respect to these claims, suits, investigations and proceedings, including considerations of the procedural status of the matter in question, the presence of complex or novel legal theories, and/or the ongoing discovery and development of information important to the matters. The company reviews claims, suits, investigations and proceedings at least quarterly, and decisions are made with respect to recording or adjusting provisions and disclosing reasonably possible losses or range of losses (individually or in the aggregate), to reflect the impact and status of settlement discussions, discovery, procedural and substantive rulings, reviews by counsel and other information pertinent to a particular matter.

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

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

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by the SCO Group (SCO v. IBM). The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T's UNIX IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company's distribution of AIX and Dynix and contribution of code to Linux and the company has asserted counterclaims. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed. The court in another suit, the

SCO Group, Inc. v. Novell, Inc., held a trial in March 2010. The jury found that Novell is the owner of UNIX and UnixWare copyrights; the judge subsequently ruled that SCO is obligated to recognize Novell's waiver of SCO's claims against IBM and Sequent for breach of UNIX license agreements. On August 30, 2011, the Tenth Circuit Court of Appeals affirmed the district court's ruling and denied SCO's appeal of this matter. In June 2013, the Federal Court in Utah granted SCO's motion to reopen the SCO v. IBM case, and proceedings have resumed in that case.

On May 13, 2010, IBM and the State of Indiana (acting on behalf of the Indiana Family and Social Services Administration) sued one another in a dispute over a 2006 contract regarding the modernization of social service program processing in Indiana. The State terminated the contract, claiming that IBM was in breach, and the State is seeking damages. IBM believes the State's claims against it are without merit and is seeking payment of termination amounts specified in the contract. After six weeks of trial, on July 18, 2012, the Indiana Superior Court in Marion County rejected the State's claims in their entirety and awarded IBM \$52 million plus interest and costs. On February 13, 2014, the Indiana Court of Appeals reversed portions of the trial judge's findings, found IBM in material breach, and ordered the case remanded to the trial judge to determine the State's damages, if any. The Indiana Court of Appeals also affirmed approximately \$50 million of the trial court's award of damages to IBM. This matter remains pending in the Indiana courts.

On April 16, 2014, Iusacell SA de C.V. (Iusacell) sued IBM, claiming that IBM made fraudulent misrepresentations that induced Iusacell to enter into an agreement with IBM Mexico. Iusacell claims damages for lost profits. Iusacell's complaint relates to a contractual dispute in Mexico, which is the subject of a pending arbitration proceeding in Mexico initiated by IBM Mexico against Iusacell for breach of the underlying agreement. On November 14, 2014, the District Court in the Southern District of New York granted IBM's motion to stay Iusacell's action against the company pending the arbitration in Mexico between Iusacell and IBM Mexico.

IBM United Kingdom Limited (IBM UK) initiated legal proceedings in May 2010 before the High Court in London against the IBM UK Pensions Trust (the UK Trust) and two representative beneficiaries of the UK Trust membership. IBM UK is seeking a declaration that it acted lawfully both in notifying the Trustee of the UK Trust that it was closing its UK defined benefit plans to future accruals for most participants and in implementing the company's new retirement policy. In April 2014, the High Court acknowledged that the changes made to its UK defined benefit plans were within IBM's discretion, but ruled that IBM breached its implied duty of good faith both in implementing these changes and in the manner in which it consulted with employees. Proceedings to determine remedies were held in July 2014 and in February 2015 the High

Court held that for IBM to make changes to accruals under the plan would require a new consultation of the participants, but to make other changes (including to early retirement policy) would not require such consultation. IBM intends to appeal both the breach and remedies judgments. In addition, IBM UK is a defendant in approximately 290 individual actions brought since early 2010 by participants of the defined benefits plans who left IBM UK. These actions, which allege constructive dismissal and age discrimination, are pending before the Employment Tribunal in Southampton UK.

In a separate but related proceeding, in October 2012, the High Court held that the 1983 Trust Deeds and Rules should be modified to allow certain categories of current IBM UK employees who are members of the C Plan to retire from the age of 60 (rather than from the age of 63) without actuarial reduction of their defined benefit pension. In a supplementary ruling in December 2012, the Court declined to similarly modify the Trust Deeds and Rules for former employees who were C Plan members and who left the company prior to retirement. Neither party appealed these judgments. As a result of the October 2012 ruling, IBM recorded a pre-tax retirement-related obligation of \$162 million in the third quarter of 2012.

On March 24, 2014, in a suit brought by local Works Councils, the Supreme Court of Spain held that IBM Spain's Defined Contribution (DC) Plan implemented in 1993 was null and void, and held that current employees could reinstate their rights to a Defined Benefit (DB) Plan, although with an offset for DC contributions paid to date. The Court held that IBM Spain did not consult with the Works Councils in seeking the voluntary participation of employees in changing the pension scheme, and recommended that IBM Spain and the Works Councils engage in discussions over how to carry out the offset. The ruling is declaratory only. IBM Spain has requested leave to appeal the decision to the Constitutional Court. The matter remains pending in the Spanish courts.

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

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

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

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Along with many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian tax authorities regarding non-income tax assessments and non-income tax litigation matters. The total potential amount related to these matters for all applicable years is approximately \$630 million. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability.

## Commitments

The company's extended lines of credit to third-party entities include unused amounts of \$5,365 million and \$5,028 million at December 31, 2014 and 2013, 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 \$1,816 million and \$1,769 million at December 31, 2014 and 2013, 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 other party harmless against losses arising from a breach of representations and covenants related to such matters as title to assets sold, certain IP rights, specified environmental matters, third-party performance of nonfinancial contractual obligations and certain income taxes. In each of these circumstances, payment by the company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, the procedures of which typically allow the company to challenge the other party's claims. While typically indemnification provisions do not include a contractual maximum on the company's payment, the company's obligations under these agreements may be limited in terms of time and/or nature of claim, and in some instances, the company may have recourse against third parties for certain payments made by the company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to 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 \$46 million and \$44 million at December 31, 2014 and 2013, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position was immaterial.

## NOTE N. TAXES

(\$ in millions)

For the year ended December 31:	2014	2013*	2012*
Income from continuing operations before income taxes			
U.S. operations	\$ 7,509	\$ 7,577	\$10,306
Non-U.S. operations	12,477	12,667	12,234
<b>Total income from continuing operations before income taxes</b>	<b>\$19,986</b>	\$20,244	\$22,540

\* Reclassified to reflect discontinued operations presentation.

The income from continuing operations provision for income taxes by geographic operations is as follows:

(\$ in millions)

For the year ended December 31:	2014	2013*	2012*
U.S. operations	\$2,093	\$1,315	\$2,825
Non-U.S. operations	2,141	2,048	2,716
<b>Total continuing operations provision for income taxes</b>	<b>\$4,234</b>	\$3,363	\$5,541

\* Reclassified to reflect discontinued operations presentation.

The components of the income from continuing operations provision for income taxes by taxing jurisdiction are as follows:

(\$ in millions)			
For the year ended December 31:	2014	2013*	2012*
U.S. federal			
Current	\$ 1,134	\$1,694	\$1,556
Deferred	105	(708)	415
	1,239	986	1,971
U.S. state and local			
Current	541	277	168
Deferred	(105)	(330)	291
	436	(53)	459
Non-U.S.			
Current	2,825	3,067	3,006
Deferred	(266)	(637)	105
	2,559	2,430	3,111
Total continuing operations provision for income taxes	4,234	3,363	5,541
Discontinued operations provision for income taxes	(1,617)	(322)	(243)
Provision for social security, real estate, personal property and other taxes	4,068	4,198	4,331
<b>Total taxes included in net income</b>	<b>\$ 6,685</b>	<b>\$7,238</b>	<b>\$9,629</b>

\* Reclassified to reflect discontinued operations presentation.

A reconciliation of the statutory U.S. federal tax rate to the company's effective tax rate from continuing operations is as follows:

For the year ended December 31:			
	2014	2013*	2012*
Statutory rate	35%	35%	35%
Foreign tax differential	(14)	(13)	(10)
State and local	1	0	1
Domestic incentives	(2)	(3)	(1)
Other	1	(2)	0
<b>Effective rate</b>	<b>21%</b>	<b>17%</b>	<b>25%</b>

Percentages rounded for disclosure purposes.

\* Reclassified to reflect discontinued operations presentation.

The significant components reflected within the tax rate reconciliation above labeled "Foreign tax differential" include the effects of foreign subsidiaries' earnings taxed at rates other than the U.S. statutory rate, foreign export incentives, the U.S. tax impacts of non-U.S. earnings repatriation and any net impacts of intercompany transactions. These items also reflect audit settlements or changes in the amount of unrecognized tax benefits associated with each of these items.

The 2014 continuing operations tax rate increased 4.6 points from 2013 due to the lack of the following 2013 benefits: the completion of the 2008–2010 U.S. tax audit and associated reserve

redeterminations (11.1 points), the retroactive impact of the 2012 American Taxpayer Relief Act (0.7 points), a tax agreement requiring a reassessment of certain valuation allowances on deferred tax assets (1.4 points), the resolution of certain non-U.S. tax audits (0.7 points) and newly enacted U.S. state tax legislation (0.6 points), as well as a tax charge related to the divestiture of the industry standard server business (0.9 points).

These increases were partially offset by benefits due to the following: the year-to-year reduction in tax charges related to certain intercompany payments made by foreign subsidiaries and the licensing of certain intellectual property (3.7 points), the increased utilization of foreign tax credits (4.7 points), and a more favorable geographic mix of pre-tax income in 2014 (2.5 points).

The effect of tax law changes on deferred tax assets and liabilities did not have a material impact on the company's effective tax rate.

The significant components of deferred tax assets and liabilities that are recorded in the Consolidated Statement of Financial Position were as follows:

## Deferred Tax Assets

(\$ in millions)		
At December 31:	2014	2013*
Retirement benefits	\$ 4,795	\$ 3,704
Share-based and other compensation	1,328	1,262
Domestic tax loss/credit carryforwards	858	982
Deferred income	957	964
Foreign tax loss/credit carryforwards	686	651
Bad debt, inventory and warranty reserves	529	592
Depreciation	329	382
Accruals	1,176	322
Other	1,306	1,452
Gross deferred tax assets	11,964	10,311
Less: valuation allowance	646	734
<b>Net deferred tax assets</b>	<b>\$11,318</b>	<b>\$ 9,577</b>

\* Reclassified to conform with 2014 presentation.

## Deferred Tax Liabilities

(\$ in millions)		
At December 31:	2014	2013
Depreciation	\$ 487	\$1,346
Retirement benefits	205	1,219
Goodwill and intangible assets	1,263	1,173
Leases	912	1,119
Software development costs	421	558
Deferred transition costs	374	424
Other	1,111	841
<b>Gross deferred tax liabilities</b>	<b>\$4,773</b>	<b>\$6,680</b>

For income tax return purposes, the company has foreign and domestic loss carryforwards, the tax effect of which is \$579 million, as well as domestic and foreign credit carryforwards of \$965 million. Substantially all of these carryforwards are available for at least two years or are available for 10 years or more.

The valuation allowance at December 31, 2014 principally applies to certain foreign, state and local loss carryforwards that, in the opinion of management, are more likely than not to expire unutilized. However, to the extent that tax benefits related to these carryforwards are realized in the future, the reduction in the valuation allowance will reduce income tax expense.

The amount of unrecognized tax benefits at December 31, 2014 increased by \$646 million in 2014 to \$5,104 million. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

(\$ in millions)	2014	2013	2012
Balance at January 1	\$4,458	\$ 5,672	\$5,575
Additions based on tax positions related to the current year	697	829	401
Additions for tax positions of prior years	586	417	215
Reductions for tax positions of prior years (including impacts due to a lapse in statute)	(579)	(2,201)	(425)
Settlements	(58)	(259)	(94)
<b>Balance at December 31</b>	<b>\$5,104</b>	<b>\$ 4,458</b>	<b>\$5,672</b>

The additions to unrecognized tax benefits related to the current and prior years are primarily attributable to non-U.S. issues, certain tax incentives and credits, divestitures, acquisition-related matters and state issues. The settlements and reductions to unrecognized tax benefits for tax positions of prior years are primarily attributable to currency, non-U.S. audits and impacts due to lapses in statutes of limitation.

In April 2010, the company appealed the determination of the Japan Tax Authorities with respect to certain foreign tax losses. The tax benefit of these losses totals \$1,000 million as of December 31, 2014. The 2014 decrease of \$141 million was driven by currency and has been included in the 2014 reductions for tax positions of prior years. In April 2011, the company received notification that the appeal was denied, and in June 2011, the company filed a lawsuit challenging this decision. In May 2014, the Tokyo District Court ruled in favor of the company. The Japanese government has appealed the ruling to the Tokyo High Court. No final determination has been reached on this matter.

The liability at December 31, 2014 of \$5,104 million can be reduced by \$875 million of offsetting tax benefits associated with the correlative effects of potential transfer pricing adjustments, U.S. tax credits, state income taxes and timing adjustments. The net amount of \$4,229 million, if recognized, would favorably affect the company's effective tax rate. The net amounts at December 31, 2013 and 2012 were \$3,902 million and \$5,099 million, respectively.

Interest and penalties related to income tax liabilities are included in income tax expense. During the year ended December 31, 2014, the company recognized \$216 million in interest expense and penalties; in 2013, the company recognized a benefit of \$93 million in interest expense and penalties, and in 2012, the company recognized \$134 million in interest expense and penalties. The company has \$593 million for the payment of interest and penalties accrued at December 31, 2014, and had \$417 million accrued at December 31, 2013.

Within the next 12 months, the company believes it is reasonably possible that the total amount of unrecognized tax benefits associated with certain positions may be significantly reduced. The potential decrease in the amount of unrecognized tax benefits is primarily associated with the anticipated resolution of the company's U.S. income tax audit for 2011 and 2012, as well as various non-U.S. audits. The company estimates that the unrecognized tax benefits at December 31, 2014 could be reduced by approximately \$1 billion.

The company is subject to taxation in the U.S. and various state and foreign jurisdictions. With respect to major U.S. state and foreign taxing jurisdictions, the company is generally no longer subject to tax examinations for years prior to 2009. The company is no longer subject to income tax examination of its U.S. federal tax return for years prior to 2011. The open years contain matters that could be subject to differing interpretations of applicable tax laws and regulations related to the amount and/or timing of income, deductions and tax credits. Although the outcome of tax audits is always uncertain, the company believes that adequate amounts of tax and interest have been provided for any significant adjustments that are expected to result for these years.

In the fourth quarter of 2013, the company received a draft tax assessment notice for approximately \$866 million (approximately \$850 million at 2014 year-end currency rates) from the Indian Tax Authorities for 2009. The company believes it will prevail on these matters and that this amount is not a meaningful indicator of liability. At December 31, 2014, the company has recorded \$471 million as prepaid income taxes in India. A significant portion of this balance represents cash tax deposits paid over time to protect the company's right to appeal various income tax assessments made by the Indian Tax Authorities.

In the first quarter of 2014, the IRS commenced its audit of the company's U.S. tax returns for 2011 and 2012. The company anticipates that this audit will be completed by the end of 2015.

The company has not provided deferred taxes on \$61.4 billion of undistributed earnings of non-U.S. subsidiaries at December 31, 2014, as it is the company's policy to indefinitely reinvest these earnings in non-U.S. operations. However, the company periodically repatriates a portion of these earnings to the extent that it does not incur an additional U.S. tax liability. Quantification of the deferred tax liability, if any, associated with indefinitely reinvested earnings is not practicable.

**NOTE O.**  
**RESEARCH, DEVELOPMENT AND ENGINEERING**

RD&E expense was \$5,437 million in 2014, \$5,743 million in 2013 and \$5,816 million in 2012. In addition, RD&E expense included in discontinued operations was \$368 million in 2014, \$483 million in 2013 and \$486 million in 2012.

The company incurred total expense of \$5,595 million, \$5,959 million and \$6,034 million in 2014, 2013 and 2012, respectively, for scientific research and the application of scientific advances to

the development of new and improved products and their uses, as well as services and their application. Within these amounts, software-related expense was \$3,064 million, \$3,077 million and \$3,078 million in 2014, 2013 and 2012, respectively.

Expense for product-related engineering was \$211 million, \$267 million and \$268 million in 2014, 2013 and 2012, respectively.

**NOTE P.**  
**EARNINGS PER SHARE OF COMMON STOCK**

The following table presents the computation of basic and diluted earnings per share of common stock.

(\$ in millions except per share amounts)

<b>For the year ended December 31:</b>	<b>2014</b>	2013	2012
Weighted-average number of shares on which earnings per share calculations are based			
<b>Basic</b>	<b>1,004,272,584</b>	1,094,486,604	1,142,508,521
Add—incremental shares under stock-based compensation plans	4,332,155	6,751,240	10,868,426
Add—incremental shares associated with contingently issuable shares	1,395,741	1,804,313	2,072,370
<b>Assuming dilution</b>	<b>1,010,000,480</b>	1,103,042,156	1,155,449,317
Income from continuing operations	\$15,751	\$16,881	\$16,999
Loss from discontinued operations, net of tax	(3,729)	(398)	(395)
<b>Net income on which basic earnings per share is calculated</b>	<b>\$12,022</b>	\$16,483	\$16,604
Income from continuing operations	\$15,751	\$16,881	\$16,999
Net income applicable to contingently issuable shares	(3)	(1)	(1)
<b>Income from continuing operations on which diluted earnings per share is calculated</b>	<b>\$15,749</b>	\$16,880	\$16,998
<b>Loss from discontinued operations, net of tax, on which basic and diluted earnings per share is calculated</b>	<b>(3,729)</b>	(398)	(395)
<b>Net income on which diluted earnings per share is calculated</b>	<b>\$12,020</b>	\$16,483	\$16,603
Earnings/(loss) per share of common stock			
<b>Assuming dilution</b>			
Continuing operations	\$ 15.59	\$ 15.30	\$ 14.71
Discontinued operations	(3.69)	(0.36)	(0.34)
<b>Total</b>	<b>\$ 11.90</b>	\$ 14.94	\$ 14.37
<b>Basic</b>			
Continuing operations	\$ 15.68	\$ 15.42	\$ 14.88
Discontinued operations	(3.71)	(0.36)	(0.35)
<b>Total</b>	<b>\$ 11.97</b>	\$ 15.06	\$ 14.53

Weighted-average stock options to purchase 17,420 common shares in 2014 and 8,797 common shares in 2013 were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the common shares for the full year, and therefore, the effect would have been antidilutive. There were no stock options outstanding in 2012 that were considered antidilutive and not included in the diluted earnings per share calculation.

## NOTE Q. RENTAL EXPENSE AND LEASE COMMITMENTS

Rental expense, including amounts charged to inventories and fixed assets, and excluding amounts previously reserved, was \$1,592 million in 2014, \$1,759 million in 2013 and \$1,767 million in 2012. Within these amounts, rental expense reflected in discontinued operations was \$95 million, \$115 million and \$110 million, in 2014, 2013 and 2012, respectively. Rental expense in agreements with rent holidays and scheduled rent increases is recorded on

a straight-line basis over the lease term. Contingent rentals are included in the determination of rental expense as accruable. The table below depicts gross minimum rental commitments under noncancelable leases, amounts related to vacant space associated with infrastructure reductions, sublease income commitments and capital lease commitments. These amounts reflect activities primarily related to office space, as well as datacenters.

(\$ in millions)

	2015	2016	2017	2018	2019	Beyond 2019
<b>Operating lease commitments</b>						
Gross minimum rental commitments (including vacant space below)	\$1,350	\$1,161	\$988	\$848	\$754	\$1,051
Vacant space	\$ 24	\$ 9	\$ 6	\$ 2	\$ 0	\$ —
Sublease income commitments	\$ 12	\$ 10	\$ 8	\$ 6	\$ 5	\$ 6
<b>Capital lease commitments</b>	\$ 13	\$ 7	\$ 2	\$ 2	\$ 2	\$ 2

## NOTE R. STOCK-BASED COMPENSATION

The following table presents total stock-based compensation cost included in income from continuing operations:

(\$ in millions)

For the year ended December 31:	2014	2013	2012
Cost	\$ 121	\$ 122	\$ 132
Selling, general and administrative	350	435	498
Research, development and engineering	54	57	59
Other (income) and expense*	(13)	—	(1)
Pre-tax stock-based compensation cost	512	614	688
Income tax benefits	(174)	(213)	(240)
<b>Net stock-based compensation cost</b>	<b>\$ 338</b>	<b>\$ 402</b>	<b>\$ 448</b>

\*Reflects the one-time effects related to the divestitures of the customer care and industry standard server businesses in 2014.

The amount of stock-based compensation cost included in discontinued operations, net of tax, was immaterial in all periods.

Total unrecognized compensation cost related to non-vested awards at December 31, 2014 and 2013 was \$874 million and \$995 million, respectively. The amount at December 31, 2014 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 December 31, 2014, 2013 and 2012.

## Incentive Awards

Stock-based incentive awards are provided to employees under the terms of the company's long-term performance plans (the "Plans"). The Plans are administered by the Executive Compensation and Management Resources Committee of the Board of Directors (the "Committee"). Awards available under the Plans principally include restricted stock units, performance share units, stock options or any combination thereof.

The amount of shares originally authorized to be issued under the company's existing Plans was 274 million at December 31, 2014. In addition, certain incentive awards granted under previous plans, if and when those awards were canceled, could be reissued under the company's existing Plans. As such, 66.2 million additional awards were considered authorized to be issued under the company's existing Plans as of December 31, 2014. There were 115.5 million unused shares available to be granted under the Plans as of December 31, 2014.

Under the company's long-standing practices and policies, all awards are approved prior to or on the date of grant. The awards approval process specifies the individual receiving the grant, the number of options or the value of the award, the exercise price or formula for determining the exercise price and the date of grant. All awards for senior management are approved by the Committee. All awards for employees other than senior management are approved by senior management pursuant to a series of delegations that were approved by the Committee, and the grants made pursuant to these delegations are reviewed periodically with the Committee. Awards that are given as part of annual total compensation for senior management and other employees are made on

specific cycle dates scheduled in advance. With respect to awards given in connection with promotions or new hires, the company's policy requires approval of such awards prior to the grant date, which is typically the date of the promotion or the date of hire.

### Stock Awards

Stock awards are made in the form of Restricted Stock Units (RSUs), including Retention Restricted Stock Units (RRSUs), or Performance Share Units (PSUs).

The tables below summarize RSU and PSU activity under the Plans during the years ended December 31, 2014, 2013 and 2012.

### RSUs

	2014		2013		2012	
	Weighted-Average Grant Price	Number of Units	Weighted-Average Grant Price	Number of Units	Weighted-Average Grant Price	Number of Units
Balance at January 1	\$166	8,635,317	\$148	9,841,461	\$129	12,218,601
RSUs granted	172	2,525,947	189	2,541,081	184	2,635,772
RSUs released	157	(2,401,761)	131	(2,952,363)	117	(4,338,787)
RSUs canceled/forfeited	167	(1,025,226)	154	(794,862)	139	(674,125)
<b>Balance at December 31</b>	<b>\$171</b>	<b>7,734,277</b>	<b>\$166</b>	<b>8,635,317</b>	<b>\$148</b>	<b>9,841,461</b>

### PSUs

	2014		2013		2012	
	Weighted-Average Grant Price	Number of Units	Weighted-Average Grant Price	Number of Units	Weighted-Average Grant Price	Number of Units
Balance at January 1	\$178	2,824,294	\$151	3,172,201	\$122	3,686,991
PSUs granted at target	180	1,430,098	195	869,875	185	1,004,003
Additional shares earned above target*	157	29,960	118	152,069	102	550,399
PSUs released	157	(1,027,181)	118	(1,321,784)	102	(1,998,746)
PSUs canceled/forfeited	187	(116,464)	170	(48,067)	131	(70,446)
<b>Balance at December 31**</b>	<b>\$185</b>	<b>3,140,707</b>	<b>\$178</b>	<b>2,824,294</b>	<b>\$151</b>	<b>3,172,201</b>

\* Represents additional shares issued to employees after vesting of PSUs because final performance metrics exceeded specified targets.

\*\* Represents the number of shares expected to be issued based on achievement of grant date performance targets. The actual number of shares issued will depend on final performance against specified targets over the vesting period.

RSUs are stock awards granted to employees that entitle the holder to shares of common stock as the award vests, typically over a one- to five-year period. For RSUs, dividend equivalents are not paid. The fair value of such RSUs is determined and fixed on the grant date based on the company's stock price adjusted for the exclusion of dividend equivalents.

The remaining weighted-average contractual term of RSUs at December 31, 2014, 2013 and 2012 is the same as the period over which the remaining cost of the awards will be recognized, which is approximately three years. The fair value of RSUs granted during the years ended December 31, 2014, 2013 and 2012 was \$434 million, \$481 million and \$486 million, respectively. The total fair value

of RSUs vested and released during the years ended December 31, 2014, 2013 and 2012 was \$378 million, \$386 million and \$509 million, respectively. As of December 31, 2014, 2013 and 2012, there was \$754 million, \$871 million and \$938 million, respectively, of unrecognized compensation cost related to non-vested RSUs. The company received no cash from employees as a result of employee vesting and release of RSUs for the years ended December 31, 2014, 2013 and 2012. In the second quarter of 2011, the company granted equity awards valued at approximately \$1 thousand each to about 400,000 non-executive employees. These awards were made under the Plans and vest in December 2015.

PSUs are stock awards where the number of shares ultimately received by the employee depends on the company's performance against specified targets and typically vest over a three-year period. For PSUs, dividend equivalents are not paid. The fair value of each PSU is determined on the grant date, based on the company's stock price, adjusted for the exclusion of dividend equivalents, and assumes that performance targets will be achieved. Over the performance period, the number of shares of stock that will be issued is adjusted upward or downward based upon the probability of achievement of performance targets. The ultimate number of shares issued and the related compensation cost recognized as expense will be based on a comparison of the final performance metrics to the specified targets. The fair value of PSUs granted at target during the years ended December 31, 2014, 2013 and 2012 was \$257 million, \$170 million and \$186 million, respectively. Total fair value of PSUs vested and released during the years ended December 31, 2014, 2013 and 2012 was \$161 million, \$156 million and \$203 million, respectively.

In connection with vesting and release of RSUs and PSUs, the tax benefits realized by the company for the years ended December 31, 2014, 2013 and 2012 were \$222 million, \$312 million and \$454 million, respectively.

### Stock Options

Stock options are awards which allow the employee to purchase shares of the company's stock at a fixed price. Stock options are granted at an exercise price equal to the company's average high and low stock price on the date of grant. These awards, which generally vest 25 percent per year, are fully vested four years from the date of grant and have a contractual term of 10 years.

The company estimates the fair value of stock options at the date of grant using the Black-Scholes valuation model. Key inputs and assumptions used to estimate the fair value of stock options include the grant price of the award, the expected option term, volatility of the company's stock, the risk-free rate and the company's dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive equity awards, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made by the company.

During the years ended December 31, 2014, 2013 and 2012, the company did not grant stock options.

The following table summarizes option activity under the Plans during the years ended December 31, 2014, 2013 and 2012.

	2014		2013		2012	
	Weighted-Average Exercise Price	Number of Shares Under Option	Weighted-Average Exercise Price	Number of Shares Under Option	Weighted-Average Exercise Price	Number of Shares Under Option
Balance at January 1	\$97	5,622,951	\$94	11,389,721	\$90	20,662,322
Options exercised	97	(3,740,252)	90	(5,585,127)	86	(9,080,170)
Options canceled/expired	95	(131,750)	86	(181,643)	75	(192,431)
<b>Balance at December 31</b>	<b>\$97</b>	<b>1,750,949</b>	<b>\$97</b>	<b>5,622,951</b>	<b>\$94</b>	<b>11,389,721</b>
<b>Exercisable at December 31</b>	<b>\$97</b>	<b>1,750,949</b>	<b>\$97</b>	<b>5,622,951</b>	<b>\$94</b>	<b>11,389,721</b>

The shares under option at December 31, 2014 were in the following exercise price ranges:

Exercise Price Range	Options Outstanding and Exercisable			
	Weighted-Average Exercise Price	Number of Shares Under Option	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life (in Years)
\$85 and under	\$ 83	351,690	\$ 27,409,244	1.2
\$86 and over	100	1,399,259	84,243,181	0.7
	<b>\$ 97</b>	<b>1,750,949</b>	<b>\$111,652,425</b>	<b>0.8</b>

### Exercises of Employee Stock Options

The total intrinsic value of options exercised during the years ended December 31, 2014, 2013 and 2012 was \$323 million, \$614 million and \$1,005 million, respectively. The total cash received from employees as a result of employee stock option exercises for the years ended December 31, 2014, 2013 and 2012 was approximately \$364 million, \$505 million and \$785 million, respectively. In connection with these exercises, the tax benefits realized by

the company for the years ended December 31, 2014, 2013 and 2012 were \$107 million, \$199 million and \$341 million, respectively.

The company settles employee stock option exercises primarily with newly issued common shares and, occasionally, with treasury shares. Total treasury shares held at December 31, 2014 and 2013 were approximately 1,225 million and 1,153 million shares, respectively.

## Acquisitions

In connection with various acquisition transactions, there was an additional 0.5 million shares of stock-based awards, consisting of stock options and restricted stock units, outstanding at December 31, 2014, as a result of the company's assumption of stock-based awards previously granted by the acquired entities. The weighted-average exercise price of these awards was \$56 per share.

## IBM Employees Stock Purchase Plan

The company maintains a non-compensatory Employees Stock Purchase Plan (ESPP). The ESPP enables eligible participants to purchase full or fractional shares of IBM common stock at a 5-percent discount off the average market price on the day of purchase through payroll deductions of up to 10 percent of eligible compensation. Eligible compensation includes any compensation received by the employee during the year. The ESPP provides for offering periods during which shares may be purchased and continues as long as shares remain available under the ESPP, unless terminated earlier at the discretion of the Board of Directors. Individual ESPP participants are restricted from purchasing more than \$25,000 of common stock in one calendar year or 1,000 shares in an offering period.

Employees purchased 1.3 million, 1.5 million and 1.6 million shares under the ESPP during the years ended December 31, 2014, 2013 and 2012, respectively. Cash dividends declared and paid by the company on its common stock also include cash dividends on the company stock purchased through the ESPP. Dividends are paid on full and fractional shares and can be reinvested. The company stock purchased through the ESPP is considered outstanding and is included in the weighted-average outstanding shares for purposes of computing basic and diluted earnings per share.

In July 2014, the "2014 ESPP Reserve" became effective and 25 million additional shares of authorized common stock were reserved and approved for issuance. The 2014 ESPP provides for semi-annual offerings commencing July 1, 2014, and continuing as long as shares remain available under the ESPP, unless terminated earlier at the discretion of the Board of Directors.

Approximately 24.4 million, 2.3 million and 3.8 million shares were available for purchase under the ESPP at December 31, 2014, 2013 and 2012, respectively.

## NOTE S. RETIREMENT-RELATED BENEFITS

### Description of Plans

IBM sponsors defined benefit pension plans and defined contribution plans that cover substantially all regular employees, a supplemental retention plan that covers certain U.S. executives and nonpension postretirement benefit plans primarily consisting of retiree medical and dental benefits for eligible retirees and dependents.

## U.S. Plans

### Defined Benefit Pension Plans

#### *IBM Personal Pension Plan*

IBM provides U.S. regular, full-time and part-time employees hired prior to January 1, 2005 with noncontributory defined benefit pension benefits via the IBM Personal Pension Plan. Prior to 2008, the IBM Personal Pension Plan consisted of a tax qualified (qualified) plan and a non-tax qualified (nonqualified) plan. Effective January 1, 2008, the nonqualified plan was renamed the Excess Personal Pension Plan (Excess PPP) and the qualified plan is now referred to as the Qualified PPP. The combined plan is now referred to as the PPP. The Qualified PPP is funded by company contributions to an irrevocable trust fund, which is held for the sole benefit of participants and beneficiaries. The Excess PPP, which is unfunded, provides benefits in excess of IRS limitations for qualified plans.

Benefits provided to the PPP participants are calculated using benefit formulas that vary based on the participant. The first method uses a five-year, final pay formula that determines benefits based on salary, years of service, mortality and other participant-specific factors. The second method is a cash balance formula that calculates benefits using a percentage of employees' annual salary, as well as an interest crediting rate.

Benefit accruals under the IBM Personal Pension Plan ceased December 31, 2007 for all participants.

#### *U.S. Supplemental Executive Retention Plan*

The company also sponsors a nonqualified U.S. Supplemental Executive Retention Plan (Retention Plan). The Retention Plan, which is unfunded, provides benefits to eligible U.S. executives based on average earnings, years of service and age at termination of employment.

Benefit accruals under the Retention Plan ceased December 31, 2007 for all participants.

### Defined Contribution Plans

#### *IBM 401(k) Plus Plan*

U.S. regular, full-time and part-time employees are eligible to participate in the IBM 401(k) Plus Plan, which is a qualified defined contribution plan under section 401(k) of the Internal Revenue Code. Effective January 1, 2008, under the IBM 401(k) Plus Plan, eligible employees receive a dollar-for-dollar match of their contributions up to 6 percent of eligible compensation for those hired prior to January 1, 2005, and, generally up to 5 percent of eligible compensation for those hired on or after January 1, 2005. In addition, eligible employees receive automatic contributions from the company equal to 1, 2 or 4 percent of eligible compensation based on their eligibility to participate in the PPP as of December 31, 2007. Employees generally receive automatic contributions and matching contributions after the completion of one year of service. Further, through June 30, 2009, IBM contributed transition credits to eligible participants' 401(k) Plus Plan accounts. The amount of the transition credits was based on a participant's age and service as of June 30, 1999.

The company's matching contributions vest immediately and participants are always fully vested in their own contributions. All contributions, including the company match, are made in cash and invested in accordance with participants' investment elections. There are no minimum amounts that must be invested in company stock, and there are no restrictions on transferring amounts out of company stock to another investment choice, other than excessive trading rules applicable to such investments. Effective January 1, 2013, matching and automatic contributions are made once annually at the end of the year. In order to receive such contributions each year, a participant must be employed on December 15 of the plan year. However, if a participant separates from service prior to December 15, and has completed certain service and/or age requirements, then the participant will be eligible to receive such matching and automatic contributions following separation from service.

#### *IBM Excess 401(k) Plus Plan*

Effective January 1, 2008, the company replaced the IBM Executive Deferred Compensation Plan, an unfunded, nonqualified, defined contribution plan, with the IBM Excess 401(k) Plus Plan (Excess 401(k)), an unfunded, nonqualified defined contribution plan. Employees whose eligible compensation is expected to exceed the IRS compensation limit for qualified plans are eligible to participate in the Excess 401(k). The purpose of the Excess 401(k) is to provide benefits that would be provided under the qualified IBM 401(k) Plus Plan if the compensation limits did not apply.

Amounts deferred into the Excess 401(k) are record-keeping (notional) accounts and are not held in trust for the participants. Participants in the Excess 401(k) may invest their notional accounts in investments which mirror the primary investment options available under the 401(k) Plus Plan. Participants in the Excess 401(k) are also eligible to receive company match and automatic contributions on eligible compensation deferred into the Excess 401(k) and on compensation earned in excess of the Internal Revenue Code pay limit once they have completed one year of service. Through June 30, 2009, eligible participants also received transition credits. Amounts deferred into the Excess 401(k), including company contributions are recorded as liabilities in the Consolidated Statement of Financial Position. Effective January 1, 2013, matching and automatic contributions are recorded once annually at the end of the year. In order to receive such contributions each year, a participant must be employed on December 15 of the plan year. However, if a participant separates from service prior to December 15, and has completed certain service and/or age requirements, then the participant will be eligible to receive such matching and automatic contributions following separation from service.

#### **Nonpension Postretirement Benefit Plan**

##### *U.S. Nonpension Postretirement Plan*

The company sponsors a defined benefit nonpension postretirement benefit plan that provides medical and dental benefits to eligible U.S. retirees and eligible dependents, as well as life insurance for eligible U.S. retirees. Effective July 1, 1999, the company established a Future Health Account (FHA) for employees who were more than five years from retirement eligibility. Employees who were within five years of retirement eligibility are covered under the company's prior retiree health benefits arrangements. Under either the FHA or the prior retiree health benefit arrangements, there is a maximum cost to the company for retiree health benefits. Effective January 1, 2014, the company amended the plan to establish a Health Reimbursement Arrangement (HRA) for each Medicare-eligible plan retiree, surviving spouse and long-term disability plan participant who is eligible for company-subsidized coverage and who enrolls in an individual plan under the Medicare Exchange. The company also amended its life insurance plan. Employees retiring on or after January 1, 2015 are not eligible for life insurance.

Since January 1, 2004, new hires, as of that date or later, are not eligible for company-subsidized nonpension postretirement benefits.

#### **Non-U.S. Plans**

Certain subsidiaries and branches outside the United States sponsor defined benefit and/or defined contribution plans that cover substantially all regular employees. The company deposits funds under various fiduciary-type arrangements, purchases annuities under group contracts or provides reserves for these plans. Benefits under the defined benefit plans are typically based either on years of service and the employee's compensation (generally during a fixed number of years immediately before retirement) or on annual credits. The range of assumptions that are used for the non-U.S. defined benefit plans reflect the different economic environments within the various countries.

In addition, certain of the company's non-U.S. subsidiaries sponsor nonpension postretirement benefit plans that provide medical and dental benefits to eligible non-U.S. retirees and eligible dependents, as well as life insurance for certain eligible non-U.S. retirees. However, most non-U.S. retirees are covered by local government-sponsored and -administered programs.

## Plan Financial Information

### Summary of Financial Information

The following table presents a summary of the total retirement-related benefits net periodic (income)/cost recorded in the Consolidated Statement of Earnings.

(\$ in millions)

For the year ended December 31:	U.S. Plans			Non-U.S. Plans			Total		
	2014	2013	2012	2014	2013	2012	2014	2013	2012
Defined benefit pension plans	<b>\$ (833)</b>	\$(223)	\$(526)	<b>\$ 1,267</b>	\$ 1,396	\$ 1,040	<b>\$ 434</b>	\$ 1,173	\$ 515
Retention Plan	<b>15</b>	21	18	<b>—</b>	—	—	<b>15</b>	21	18
Total defined benefit pension plans (income)/cost	<b>\$ (818)</b>	\$(202)	\$(507)	<b>\$ 1,267</b>	\$ 1,396	\$ 1,040	<b>\$ 449</b>	\$ 1,195	\$ 533
IBM 401(k) Plus Plan and non-U.S. plans	<b>\$ 713</b>	\$ 785	\$ 857	<b>\$ 526</b>	\$ 575	\$ 621	<b>\$ 1,239</b>	\$ 1,361	\$ 1,478
Excess 401(k)	<b>14</b>	24	29	<b>—</b>	—	—	<b>14</b>	24	29
Total defined contribution plans cost	<b>\$ 727</b>	\$ 809	\$ 885	<b>\$ 526</b>	\$ 575	\$ 621	<b>\$ 1,253</b>	\$ 1,384	\$ 1,506
Nonpension postretirement benefit plans cost	<b>\$ 206</b>	\$ 218	\$ 268	<b>\$ 66</b>	\$ 79	\$ 82	<b>\$ 272</b>	\$ 298	\$ 350
<b>Total retirement-related benefits net periodic cost</b>	<b>\$ 115</b>	\$ 826	\$ 646	<b>\$ 1,859</b>	\$ 2,051	\$ 1,743	<b>\$ 1,974</b>	\$ 2,876	\$ 2,389

The following table presents a summary of the total PBO for defined benefit pension plans, APBO for nonpension postretirement benefit plans, fair value of plan assets and the associated funded status recorded in the Consolidated Statement of Financial Position.

(\$ in millions)

At December 31:	Benefit Obligations		Fair Value of Plan Assets		Funded Status*	
	2014	2013	2014	2013	2014	2013
<b>U.S. Plans</b>						
Overfunded plans						
Qualified PPP	<b>\$ 54,708</b>	\$ 49,315	<b>\$ 55,772</b>	\$ 53,954	<b>\$ 1,065</b>	\$ 4,639
Underfunded plans						
Excess PPP	<b>\$ 1,602</b>	\$ 1,425	<b>\$ —</b>	\$ —	<b>\$ (1,602)</b>	\$ (1,425)
Retention Plan	<b>334</b>	294	<b>—</b>	—	<b>(334)</b>	(294)
Nonpension postretirement benefit plan	<b>5,053</b>	4,633	<b>16</b>	177	<b>(5,037)</b>	(4,456)
Total underfunded U.S. plans	<b>\$ 6,989</b>	\$ 6,352	<b>\$ 16</b>	\$ 177	<b>\$ (6,973)</b>	\$ (6,175)
<b>Non-U.S. Plans</b>						
Overfunded plans						
Qualified defined benefit pension plans	<b>\$ 16,794</b>	\$ 9,336	<b>\$ 17,888</b>	\$ 10,240	<b>\$ 1,094</b>	\$ 904
Nonpension postretirement benefit plans	<b>11</b>	10	<b>11</b>	11	<b>0</b>	1
Total overfunded non-U.S. plans	<b>\$ 16,804</b>	\$ 9,346	<b>\$ 17,898</b>	\$ 10,251	<b>\$ 1,094</b>	\$ 905
Underfunded plans						
Qualified defined benefit pension plans	<b>\$ 26,278</b>	\$ 32,697	<b>\$ 21,655</b>	\$ 29,223	<b>\$ (4,623)</b>	\$ (3,474)
Nonqualified defined benefit pension plans	<b>6,762</b>	6,587	<b>—</b>	—	<b>(6,762)</b>	(6,587)
Nonpension postretirement benefit plans	<b>806</b>	822	<b>73</b>	81	<b>(733)</b>	(741)
Total underfunded non-U.S. plans	<b>\$ 33,846</b>	\$ 40,106	<b>\$ 21,729</b>	\$ 29,304	<b>\$ (12,118)</b>	\$ (10,802)
<b>Total overfunded plans</b>	<b>\$ 71,512</b>	\$ 58,661	<b>\$ 73,671</b>	\$ 64,205	<b>\$ 2,159</b>	\$ 5,544
<b>Total underfunded plans</b>	<b>\$ 40,836</b>	\$ 46,458	<b>\$ 21,745</b>	\$ 29,481	<b>\$ (19,091)</b>	\$ (16,977)

\* Funded status is recognized in the Consolidated Statement of Financial Position as follows: Asset amounts as prepaid pension assets; (Liability) amounts as compensation and benefits (current liability) and retirement and nonpension postretirement benefit obligations (noncurrent liability).

At December 31, 2014, the company's qualified defined benefit pension plans worldwide were 97 percent funded compared to the benefit obligations, with the U.S. Qualified PPP 102 percent funded. Overall, including nonqualified plans, the company's defined benefit pension plans worldwide were 90 percent funded.

### Defined Benefit Pension and Nonpension Postretirement Benefit Plan Financial Information

The following tables through page 136 represent financial information for the company's retirement-related benefit plans, excluding defined contribution plans. The defined benefit pension plans under U.S. Plans consists of the Qualified PPP, the Excess PPP and the Retention Plan. The defined benefit pension plans and the nonpension postretirement benefit plans under Non-U.S. Plans consists of all plans sponsored by the company's subsidiaries. The

nonpension postretirement benefit plan under U.S. Plan consists of only the U.S. Nonpension Postretirement Benefit Plan.

The tables below present the components of net periodic (income)/cost of the retirement-related benefit plans recognized in the Consolidated Statement of Earnings, excluding defined contribution plans.

(\$ in millions)

	Defined Benefit Pension Plans					
	U.S. Plans			Non-U.S. Plans		
	2014	2013	2012	2014	2013	2012
<b>For the year ended December 31:</b>						
Service cost	\$ —	\$ —	\$ —	\$ 449	\$ 501	\$ 443
Interest cost	2,211	1,980	2,196	1,533	1,524	1,779
Expected return on plan assets	(4,096)	(3,981)	(4,043)	(2,247)	(2,195)	(2,303)
Amortization of transition assets	—	—	—	0	0	0
Amortization of prior service costs/(credits)	10	10	10	(111)	(119)	(154)
Recognized actuarial losses	1,056	1,790	1,331	1,400	1,600	1,027
Curtailments and settlements	—	—	—	26	0	0
Multi-employer plans/other costs*	—	—	—	217	85	247
<b>Total net periodic (income)/cost</b>	<b>\$ (818)</b>	<b>\$ (202)</b>	<b>\$ (507)</b>	<b>\$ 1,267</b>	<b>\$ 1,396</b>	<b>\$ 1,040</b>

(\$ in millions)

	Nonpension Postretirement Benefit Plans					
	U.S. Plan			Non-U.S. Plans		
	2014	2013	2012	2014	2013	2012
<b>For the year ended December 31:</b>						
Service cost	\$ 26	\$ 35	\$ 36	\$ 7	\$10	\$14
Interest cost	187	164	200	63	60	64
Expected return on plan assets	0	(1)	—	(9)	(9)	(9)
Amortization of transition assets	—	—	—	0	0	0
Amortization of prior service costs/(credits)	(7)	—	—	(5)	(5)	(4)
Recognized actuarial losses	0	21	32	11	23	17
Curtailments and settlements	—	—	—	0	0	0
<b>Total net periodic cost</b>	<b>\$206</b>	<b>\$218</b>	<b>\$268</b>	<b>\$66</b>	<b>\$79</b>	<b>\$82</b>

\* The 2014 Non-U.S. plans amount includes \$148 million related to the IBM Spain pension litigation and the 2012 Non-U.S. plans amount includes \$162 million related to the IBM UK pension litigation. See page 136 for additional information.

The following table presents the changes in benefit obligations and plan assets of the company's retirement-related benefit plans, excluding defined contribution plans.

(\$ in millions)

	Defined Benefit Pension Plans				Nonpension Postretirement Benefit Plans			
	U.S. Plans		Non-U.S. Plans		U.S. Plan		Non-U.S. Plans	
	2014	2013	2014	2013	2014	2013	2014	2013
<b>Change in benefit obligation</b>								
Benefit obligation at January 1	\$51,034	\$56,810	\$ 48,620	\$49,319	\$ 4,633	\$ 5,282	\$ 832	\$1,019
Service cost	—	—	449	501	26	35	7	10
Interest cost	2,211	1,980	1,533	1,524	187	164	63	60
Plan participants' contributions	—	—	37	42	61	191	—	—
Acquisitions/divestitures, net	—	—	(90)	89	0	(2)	0	0
Actuarial losses/(gains)	6,968	(4,344)	6,662	(362)	548	(481)	38	(89)
Benefits paid from trust	(3,455)	(3,303)	(1,985)	(1,920)	(388)	(557)	(5)	(6)
Direct benefit payments	(114)	(108)	(465)	(464)	(37)	(43)	(26)	(28)
Foreign exchange impact	—	—	(5,073)	(115)	—	—	(91)	(89)
Medicare/Government subsidies	—	—	—	—	23	30	—	—
Amendments/curtailments/settlements/other	—	—	146	6	0	15	(1)	(44)
<b>Benefit obligation at December 31</b>	<b>\$56,643</b>	<b>\$51,034</b>	<b>\$ 49,834</b>	<b>\$48,620</b>	<b>\$ 5,053</b>	<b>\$ 4,633</b>	<b>\$ 817</b>	<b>\$ 832</b>
<b>Change in plan assets</b>								
Fair value of plan assets at January 1	\$53,954	\$53,630	\$ 39,464	\$38,058	\$ 177	\$ 433	\$ 92	\$ 119
Actual return on plan assets	5,274	3,626	5,579	2,515	0	0	9	5
Employer contributions	—	—	465	449	166	110	0	0
Acquisitions/divestitures, net	—	—	(59)	35	0	—	0	0
Plan participants' contributions	—	—	37	42	61	191	—	—
Benefits paid from trust	(3,455)	(3,303)	(1,985)	(1,920)	(388)	(557)	(5)	(6)
Foreign exchange impact	—	—	(4,049)	121	—	—	(11)	(14)
Amendments/curtailments/settlements/other	—	—	93*	164*	—	—	0	(12)
<b>Fair value of plan assets at December 31</b>	<b>\$55,772</b>	<b>\$53,954</b>	<b>\$ 39,543</b>	<b>\$39,464</b>	<b>\$ 16</b>	<b>\$ 177</b>	<b>\$ 84</b>	<b>\$ 92</b>
<b>Funded status at December 31</b>	<b>\$ (871)</b>	<b>\$ 2,920</b>	<b>\$(10,291)</b>	<b>\$ (9,157)</b>	<b>\$(5,037)</b>	<b>\$(4,456)</b>	<b>\$(733)</b>	<b>\$ (740)</b>
Accumulated benefit obligation**	\$56,643	\$51,034	\$ 47,516	\$47,806	N/A	N/A	N/A	N/A

\* Includes the reinstatement of certain plan assets in Brazil due to government rulings in 2011 and 2013 allowing certain previously restricted plan assets to be returned to IBM. The assets will be returned to IBM monthly over a three-year period, starting June 2011 and September 2013 respectively, with approximately \$122 million returned during 2014. The remaining surplus in Brazil at December 31, 2014 remains excluded from total plan assets due to continued restrictions imposed by the government on the use of those plan assets.

\*\* Represents the benefit obligation assuming no future participant compensation increases.

N/A—Not applicable

The following table presents the net funded status recognized in the Consolidated Statement of Financial Position.

(\$ in millions)

	Defined Benefit Pension Plans				Nonpension Postretirement Benefit Plans			
	U.S. Plans		Non-U.S. Plans		U.S. Plan		Non-U.S. Plans	
	2014	2013	2014	2013	2014	2013	2014	2013
<b>At December 31:</b>								
Prepaid pension assets	\$ 1,065	\$ 4,639	\$ 1,095	\$ 912	\$ 0	\$ 0	\$ 0	\$ 1
Current liabilities—compensation and benefits	(111)	(107)	(326)	(364)	(381)	(256)	(13)	(16)
Noncurrent liabilities—retirement and nonpension postretirement benefit obligations	(1,825)	(1,612)	(11,060)	(9,705)	(4,656)	(4,200)	(720)	(725)
<b>Funded status—net</b>	<b>\$ (871)</b>	<b>\$ 2,920</b>	<b>\$(10,291)</b>	<b>\$(9,157)</b>	<b>\$(5,037)</b>	<b>\$(4,456)</b>	<b>\$(733)</b>	<b>\$(740)</b>

The following table presents the pre-tax net loss and prior service costs/(credits) and transition (assets)/liabilities recognized in OCI and the changes in the pre-tax net loss, prior service costs/(credits) and transition (assets)/liabilities recognized in AOCI for the retirement-related benefit plans.

(\$ in millions)

	Defined Benefit Pension Plans				Nonpension Postretirement Benefit Plans			
	U.S. Plans		Non-U.S. Plans		U.S. Plan		Non-U.S. Plans	
	2014	2013	2014	2013	2014	2013	2014	2013
Net loss at January 1	\$13,709	\$19,488	\$19,777	\$22,188	\$304	\$806	\$161	\$269
Current period loss/(gain)	5,789	(3,989)	3,324	(814)	548	(480)	38	(85)
Curtailments and settlements	—	—	(25)	3	—	—	1	0
Amortization of net loss included in net periodic (income)/cost	(1,056)	(1,790)	(1,400)	(1,600)	0	(21)	(11)	(23)
<b>Net loss at December 31</b>	<b>\$18,442</b>	<b>\$13,709</b>	<b>\$21,676</b>	<b>\$19,777</b>	<b>\$852</b>	<b>\$304</b>	<b>\$189</b>	<b>\$161</b>
Prior service costs/(credits) at January 1	\$ 120	\$ 130	\$ (496)	\$ (614)	\$ 15	\$ —	\$ (32)	\$ (6)
Current period prior service costs/(credits)	—	—	(1)	0	—	15	0	(31)
Amortization of prior service (costs)/credits included in net periodic (income)/cost	(10)	(10)	111	119	7	—	5	5
<b>Prior service costs/(credits) at December 31</b>	<b>\$ 110</b>	<b>\$ 120</b>	<b>\$ (386)</b>	<b>\$ (496)</b>	<b>\$ 23</b>	<b>\$ 15</b>	<b>\$ (26)</b>	<b>\$ (32)</b>
Transition (assets)/liabilities at January 1	\$ —	\$ —	\$ 0	\$ 0	\$ —	\$ —	\$ 0	\$ 0
Amortization of transition assets/(liabilities) included in net periodic (income)/cost	—	—	0	0	—	—	0	0
<b>Transition (assets)/liabilities at December 31</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 0</b>	<b>\$ 0</b>
<b>Total loss recognized in accumulated other comprehensive income/(loss)*</b>	<b>\$18,552</b>	<b>\$13,829</b>	<b>\$21,290</b>	<b>\$19,281</b>	<b>\$875</b>	<b>\$319</b>	<b>\$163</b>	<b>\$129</b>

\* See note L, "Equity Activity," on pages 118 through 121 for the total change in AOCI, and the Consolidated Statement of Comprehensive Income for the components of net periodic (income)/cost, including the related tax effects, recognized in OCI for the retirement-related benefit plans.

The following table presents the pre-tax estimated net loss, estimated prior service costs/(credits) and estimated transition (assets)/liabilities of the retirement-related benefit plans that will be amortized from AOCI into net periodic (income)/cost in 2015.

(\$ in millions)

	Defined Benefit Pension Plans		Nonpension Postretirement Benefit Plans	
	U.S. Plans	Non-U.S. Plans	U.S. Plan	Non-U.S. Plans
Net loss	\$1,659	\$1,693	\$43	\$11
Prior service costs/(credits)	10	(98)	(7)	(5)
Transition (assets)/liabilities	—	—	—	—

During the year ended December 31, 2013, the company amended the U.S. nonpension postretirement benefit plan. A plan amendment effective January 1, 2014, which established an HRA for Medicare eligible participants increased the benefit obligation \$91 million. A plan amendment which ended life insurance eligibility for employees who retire on or after January 1, 2015 reduced the benefit obligation \$76 million.

On March 24, 2014, the Supreme Court of Spain issued a ruling against IBM Spain in litigation involving its defined benefit and defined contribution plans. As a result of the ruling, the company recorded a pre-tax retirement-related obligation of \$148 million in 2014 in selling, general and administrative expense in the

Consolidated Statement of Earnings. This obligation is reflected in "Non-U.S. Plans—Multi-employer plans/other costs" in the table on page 134. To date, the rulings in this case are declaratory only.

In 2012, the High Court in London issued a ruling against IBM United Kingdom Limited and IBM United Kingdom Holdings Limited, both wholly owned subsidiaries of the company, in litigation involving one of IBM UK's defined benefit plans. As a result of the ruling, the company recorded an additional pre-tax retirement-related obligation of \$162 million in 2012 in selling, general and administrative expense in the Consolidated Statement of Earnings. See note M, "Contingencies and Commitments," on page 123 for additional information regarding pension plan litigation matters.

**Assumptions Used to Determine Plan Financial Information**

Underlying both the measurement of benefit obligations and net periodic (income)/cost are actuarial valuations. These valuations use participant-specific information such as salary, age and years of service, as well as certain assumptions, the most significant of which include estimates of discount rates, expected return on plan assets, rate of compensation increases, interest crediting rates and

mortality rates. The company evaluates these assumptions, at a minimum, annually, and makes changes as necessary.

The table below presents the assumptions used to measure the net periodic (income)/cost and the year-end benefit obligations for retirement-related benefit plans.

	Defined Benefit Pension Plans					
	U.S. Plans			Non-U.S. Plans		
	2014	2013	2012	2014	2013	2012
<b>Weighted-average assumptions used to measure net periodic (income)/cost for the year ended December 31</b>						
Discount rate	4.50%	3.60%	4.20%	3.32%	3.23%	4.28%
Expected long-term returns on plan assets	8.00%	8.00%	8.00%	6.08%	6.21%	6.26%
Rate of compensation increase	N/A	N/A	N/A	2.52%	2.51%	2.43%
<b>Weighted-average assumptions used to measure benefit obligations at December 31</b>						
Discount rate	3.70%	4.50%	3.60%	2.34%	3.32%	3.23%
Rate of compensation increase	N/A	N/A	N/A	2.49%	2.52%	2.51%

N/A—Not applicable

	Nonpension Postretirement Benefit Plans					
	U.S. Plan			Non-U.S. Plans		
	2014	2013	2012	2014	2013	2012
<b>Weighted-average assumptions used to measure net periodic cost for the year ended December 31</b>						
Discount rate	4.10%	3.30%	3.90%	7.78%	6.43%	7.37%
Expected long-term returns on plan assets	N/A	0.35%	N/A	10.22%	9.01%	9.01%
<b>Weighted-average assumptions used to measure benefit obligations at December 31</b>						
Discount rate	3.40%	4.10%	3.30%	7.51%	7.78%	6.43%

N/A—Not applicable

**Discount Rate**

The discount rate assumptions used for retirement-related benefit plans accounting reflect the yields available on high-quality, fixed-income debt instruments at the measurement date. For the U.S. and certain non-U.S. countries, a portfolio of high-quality corporate bonds is used to construct a yield curve. The cash flows from the company's expected benefit obligation payments are then matched to the yield curve to derive the discount rates. In other non-U.S. countries, where the markets for high-quality long-term bonds are not generally as well developed, a portfolio of long-term government bonds is used as a base, to which a credit spread is added to simulate corporate bond yields at these maturities in the jurisdiction of each plan, as the benchmark for developing the respective discount rates.

For the U.S. defined benefit pension plans, the changes in the discount rate assumptions impacted the net periodic (income)/cost and the PBO. The changes in the discount rate assumptions resulted in an increase in 2014 net periodic income of \$275

million, a decrease in 2013 net periodic income of \$162 million and a decrease in 2012 net periodic income of \$258 million. The changes in the discount rate assumptions resulted in an increase in the PBO of \$4,437 million and a decrease of \$4,785 million at December 31, 2014 and 2013, respectively.

For the U.S. nonpension postretirement benefit plans, the changes in the discount rate assumptions had no material impact on net periodic cost for the years ended December 31, 2014, 2013 and 2012 and resulted in an increase in the APBO of \$256 million and a decrease of \$298 million at December 31, 2014 and 2013, respectively.

For all of the company's retirement-related benefit plans, the changes in the discount rate assumptions resulted in an increase in the benefit obligations of approximately \$11.0 billion at December 31, 2014.

### Expected Long-Term Returns on Plan Assets

Expected returns on plan assets, a component of net periodic (income)/cost, represent the expected long-term returns on plan assets based on the calculated market-related value of plan assets. Expected long-term returns on plan assets take into account long-term expectations for future returns and the investment policies and strategies as described on page 139. These rates of return are developed by the company and are tested for reasonableness against historical returns. The use of expected long-term returns on plan assets may result in recognized pension income that is greater or less than the actual returns of those plan assets in any given year. Over time, however, the expected long-term returns are designed to approximate the actual long-term returns, and therefore result in a pattern of income and cost recognition that more closely matches the pattern of the services provided by the employees. Differences between actual and expected returns are recognized as a component of net loss or gain in AOCI, which is amortized as a component of net periodic (income)/cost over the service lives or life expectancy of the plan participants, depending on the plan, provided such amounts exceed certain thresholds provided by accounting standards. The market-related value of plan assets recognizes changes in the fair value of plan assets systematically over a five-year period in the expected return on plan assets line in net periodic (income)/cost.

For the U.S. defined benefit pension plan, the Qualified PPP, the expected long-term rate of return on plan assets of 8.00 percent remained constant for the years ended December 31, 2014, 2013 and 2012 and, consequently, had no incremental impact on net periodic (income)/cost. For 2015, the projected long-term rate of return on plan assets is approximately 7.5 percent.

For the nonpension postretirement benefit plans, the company maintains a highly liquid trust fund balance to ensure timely payments are made. As a result, for the years ended December 31, 2014, 2013 and 2012, the expected long-term return on plan assets and the actual return on those assets were not material.

### Rate of Compensation Increases and Mortality Rate

The rate of compensation increases is determined by the company, based upon its long-term plans for such increases. The rate of compensation increase is not applicable to the U.S. defined benefit pension plans as benefit accruals ceased December 31, 2007 for all participants. Mortality rate assumptions are based on life expectancy and death rates for different types of participants. Mortality rates are periodically updated based on actual experience. In the U.S., the Society of Actuaries released new mortality tables in 2014 which the company utilized in its plan remeasurements at December 31, 2014. For the U.S. retirement-related benefit plans, the change in mortality assumptions resulted in an increase to the benefit obligations of approximately \$2.6 billion.

### Interest Crediting Rate

Benefits for certain participants in the PPP are calculated using a cash balance formula. An assumption underlying this formula is an interest crediting rate, which impacts both net periodic (income)/cost and the PBO. This assumption provides a basis for projecting the expected interest rate that participants will earn on the benefits that they are expected to receive in the following year and is based on the average from August to October of the one-year U.S. Treasury Constant Maturity yield plus one percent.

For the PPP, the change in the interest crediting rate to 1.1 percent for the year ended December 31, 2014, from 1.2 percent for the year ended December 31, 2013, resulted in an increase in 2014 net periodic income of \$8 million. The change in the interest crediting rate to 1.2 percent for the year ended December 31, 2013, from 1.1 percent for the year ended December 31, 2012, resulted in a decrease in 2013 net periodic income of \$6 million. The change in the interest crediting rate to 1.1 percent for the year ended December 31, 2012, from 1.3 percent for the year ended December 31, 2011, resulted in an increase in 2012 net periodic income of \$10 million.

### Healthcare Cost Trend Rate

For nonpension postretirement benefit plan accounting, the company reviews external data and its own historical trends for healthcare costs to determine the healthcare cost trend rates. However, the healthcare cost trend rate has an insignificant effect on plan costs and obligations as a result of the terms of the plan which limit the company's obligation to the participants. The company assumes that the healthcare cost trend rate for 2015 will be 7 percent. In addition, the company assumes that the same trend rate will decrease to 5 percent over the next four years. A one percentage point increase or decrease in the assumed healthcare cost trend rate would not have had a material effect on 2014, 2013 and 2012 net periodic cost or the benefit obligations as of December 31, 2014 and 2013.

### Plan Assets

Retirement-related benefit plan assets are recognized and measured at fair value. Because of the inherent uncertainty of valuations, these fair value measurements may not necessarily reflect the amounts the company could realize in current market transactions.

### Investment Policies and Strategies

The investment objectives of the Qualified PPP portfolio are designed to generate returns that will enable the plan to meet its future obligations. The precise amount for which these obligations will be settled depends on future events, including the retirement dates and life expectancy of the plans' participants. The obligations are estimated using actuarial assumptions, based on the current economic environment and other pertinent factors described on pages 137 through 138. The Qualified PPP portfolio's investment strategy balances the requirement to generate returns, using potentially higher yielding assets such as equity securities, with the need to control risk in the portfolio with less volatile assets, such as fixed-income securities. Risks include, among others, inflation, volatility in equity values and changes in interest rates that could cause the plan to become underfunded, thereby increasing its dependence on contributions from the company. To mitigate any potential concentration risk, careful consideration is given to balancing the portfolio among industry sectors, companies and geographies, taking into account interest rate sensitivity, dependence on economic growth, currency and other factors that affect investment returns. In 2014, the company changed its investment strategy, modifying the target asset allocation, primarily by reducing equity securities and increasing debt securities. This change was designed to reduce the potential negative impact that equity markets might have on the funded status of the plan. As a result, the Qualified PPP portfolio's target allocation is 33 percent equity securities, 57 percent fixed-income securities, 5 percent real estate and 5 percent other investments.

The assets are managed by professional investment firms and investment professionals who are employees of the company. They are bound by investment mandates determined by the company's management and are measured against specific benchmarks. Among these managers, consideration is given, but not limited to, balancing security concentration, issuer concentration, investment style and reliance on particular active and passive investment strategies.

Market liquidity risks are tightly controlled, with \$6,229 million of the Qualified PPP portfolio invested in private market assets consisting of private equities and private real estate investments, which are less liquid than publicly traded securities. As of December 31, 2014, the Qualified PPP portfolio had \$2,629 million in commitments for future investments in private markets to be made over a number of years. These commitments are expected to be funded from plan assets.

Derivatives are used as an effective means to achieve investment objectives and/or as a component of the plan's risk management strategy. The primary reasons for the use of derivatives are fixed income management, including duration, interest rate management and credit exposure, cash equitization and to manage currency and commodity strategies.

Outside the U.S., the investment objectives are similar to those described above, subject to local regulations. The weighted-average target allocation for the non-U.S. plans is 32 percent equity securities, 56 percent fixed-income securities, 2 percent real estate and 10 percent other investments, which is consistent with the allocation decisions made by the company's management. The table on page 140 details the actual equity, fixed income, real estate and other types of investments for non-U.S. plans. In some countries, a higher percentage allocation to fixed income is required to manage solvency and funding risks. In others, the responsibility for managing the investments typically lies with a board that may include up to 50 percent of members elected by employees and retirees. This can result in slight differences compared with the strategies previously described. Generally, these non-U.S. plans do not invest in illiquid assets and their use of derivatives is consistent with the U.S. plan and mainly for currency hedging, interest rate risk management, credit exposure and alternative investment strategies.

The company's nonpension postretirement benefit plans are underfunded or unfunded. For some plans, the company maintains a nominal, highly liquid trust fund balance to ensure timely benefit payments.

### Defined Benefit Pension Plan Assets

The following table presents the company's defined benefit pension plans' asset classes and their associated fair value at December 31, 2014. The U.S. Plan consists of the Qualified PPP and the Non-U.S. Plans consist of all plans sponsored by the company's subsidiaries.

(\$ in millions)

	U.S. Plan				Non-U.S. Plans			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Equity</b>								
Equity securities <sup>(a)</sup>	\$11,527	\$ 1	\$ —	\$11,528	\$5,652	\$ —	\$ —	\$ 5,652
Equity commingled/mutual funds <sup>(b)(c)</sup>	85	2,277	—	2,362	126	7,415	—	7,540
<b>Fixed income</b>								
Government and related <sup>(d)</sup>	—	7,883	—	7,883	—	8,159	32	8,191
Corporate bonds <sup>(e)</sup>	—	18,828	4	18,832	—	2,063	1	2,063
Mortgage and asset-backed securities	—	567	20	587	—	238	—	238
Fixed income commingled/mutual funds <sup>(b)(f)</sup>	312	3,118	295	3,725	87	9,715	—	9,802
Insurance contracts	—	—	—	—	—	1,053	—	1,053
Cash and short-term investments <sup>(g)</sup>	345	2,304	—	2,650	158	393	—	551
Hedge funds	—	1,474	889	2,362	—	745	—	745
Private equity <sup>(h)</sup>	—	—	3,287	3,287	—	—	513	513
Private real estate <sup>(h)</sup>	—	—	2,942	2,942	—	—	664	664
Derivatives <sup>(i)</sup>	(55)	3	—	(53)	2	846	—	848
Other commingled/mutual funds <sup>(b)(j)</sup>	—	—	—	—	33	1,513	220	1,766
Subtotal	12,214	36,455	7,437	56,106	6,056	32,139	1,429	39,625
Other <sup>(k)</sup>	—	—	—	(333)	—	—	—	(82)
<b>Fair value of plan assets</b>	<b>\$12,214</b>	<b>\$36,455</b>	<b>\$7,437</b>	<b>\$55,772</b>	<b>\$6,056</b>	<b>\$32,139</b>	<b>\$1,429</b>	<b>\$39,543</b>

<sup>(a)</sup> Represents U.S. and international securities. The U.S. Plan includes IBM common stock of \$55 million, representing 0.1 percent of the U.S. Plan assets. Non-U.S. Plans include IBM common stock of \$21 million, representing 0.1 percent of the non-U.S. Plans assets.

<sup>(b)</sup> Commingled funds represent pooled institutional investments.

<sup>(c)</sup> Invests in predominantly equity securities.

<sup>(d)</sup> Includes debt issued by national, state and local governments and agencies.

<sup>(e)</sup> The U.S. Plan includes IBM corporate bonds of \$10 million, representing 0.02 percent of the U.S. Plan assets. Non-U.S. plans include IBM corporate bonds of \$4 million representing 0.01 percent of the non-U.S. Plan assets.

<sup>(f)</sup> Invests in predominantly fixed-income securities.

<sup>(g)</sup> Includes cash and cash equivalents and short-term marketable securities.

<sup>(h)</sup> Primarily includes limited partnerships.

<sup>(i)</sup> Includes interest rate derivatives, forwards, exchange traded and other over-the-counter derivatives.

<sup>(j)</sup> Invests in both equity and fixed-income securities.

<sup>(k)</sup> Represents net unsettled transactions, relating primarily to purchases and sales of plan assets.

The U.S. nonpension postretirement benefit plan assets of \$16 million were invested in cash, categorized as Level 1 in the fair value hierarchy. The Non-U.S. nonpension postretirement benefit plan assets of \$84 million, primarily in Brazil, and, to a lesser extent, in Mexico and South Africa, were invested primarily in government and related fixed-income securities and corporate bonds, categorized as Level 2 in the fair value hierarchy.

The following table presents the company's defined benefit pension plans' asset classes and their associated fair value at December 31, 2013. The U.S. Plan consists of the Qualified PPP and the Non-U.S. Plans consist of all plans sponsored by the company's subsidiaries.

(\$ in millions)

	U.S. Plan				Non-U.S. Plans			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>Equity</b>								
Equity securities <sup>(a)</sup>	\$15,929	\$ —	\$ —	\$15,929	\$6,489	\$ —	\$ —	\$ 6,489
Equity commingled/mutual funds <sup>(b)(c)</sup>	216	2,593	—	2,809	132	8,325	—	8,457
<b>Fixed income</b>								
Government and related <sup>(d)</sup>	—	7,093	1	7,094	—	8,682	42	8,724
Corporate bonds <sup>(e)</sup>	—	14,639	5	14,644	—	1,881	4	1,885
Mortgage and asset-backed securities	—	691	19	709	—	8	—	8
Fixed income commingled/mutual funds <sup>(b)(f)</sup>	221	716	274	1,211	75	8,596	—	8,670
Insurance contracts	—	—	—	—	—	1,196	—	1,196
Cash and short-term investments <sup>(g)</sup>	427	1,915	—	2,343	154	451	—	605
Hedge funds	—	1,368	860	2,228	—	740	—	740
Private equity <sup>(h)</sup>	—	—	3,771	3,771	—	—	410	410
Private real estate <sup>(h)</sup>	—	—	3,038	3,038	—	—	655	655
Derivatives <sup>(i)</sup>	1	6	—	7	1	150	—	151
Other commingled/mutual funds <sup>(b)(j)</sup>	—	—	—	—	36	1,518	—	1,554
Subtotal	16,795	29,021	7,968	53,784	6,886	31,547	1,110	39,544
Other <sup>(k)</sup>	—	—	—	170	—	—	—	(80)
<b>Fair value of plan assets</b>	<b>\$16,795</b>	<b>\$29,021</b>	<b>\$7,968</b>	<b>\$53,954</b>	<b>\$6,886</b>	<b>\$31,547</b>	<b>\$1,110</b>	<b>\$39,464</b>

<sup>(a)</sup> Represents U.S. and international securities. The U.S. Plan includes IBM common stock of \$83 million, representing 0.2 percent of the U.S. Plan assets. Non-U.S. Plans include IBM common stock of \$31 million, representing 0.1 percent of the non-U.S. Plans assets.

<sup>(b)</sup> Commingled funds represent pooled institutional investments.

<sup>(c)</sup> Invests in predominantly equity securities.

<sup>(d)</sup> Includes debt issued by national, state and local governments and agencies.

<sup>(e)</sup> The U.S. Plan includes IBM corporate bonds of \$9 million, representing 0.02 percent of the U.S. Plan assets. Non-U.S. plans include IBM corporate bonds of \$1 million representing 0.001 percent of the non-U.S. Plan assets.

<sup>(f)</sup> Invests in predominantly fixed-income securities.

<sup>(g)</sup> Includes cash and cash equivalents and short-term marketable securities.

<sup>(h)</sup> Includes limited partnerships and venture capital partnerships.

<sup>(i)</sup> Primarily includes interest rate derivatives and, to a lesser extent, forwards, exchange traded and other over-the-counter derivatives.

<sup>(j)</sup> Invests in both equity and fixed-income securities.

<sup>(k)</sup> Represents net unsettled transactions, relating primarily to purchases and sales of plan assets.

The U.S. nonpension postretirement benefit plan assets of \$177 million were invested in cash, categorized as Level 1 in the fair value hierarchy. The Non-U.S. nonpension postretirement benefit plan assets of \$92 million, primarily in Brazil, and, to a lesser extent, in Mexico and South Africa, were invested primarily in government and related fixed-income securities and corporate bonds, categorized as Level 2 in the fair value hierarchy.

## Notes to Consolidated Financial Statements

International Business Machines Corporation and Subsidiary Companies

The following tables present the reconciliation of the beginning and ending balances of Level 3 assets for the years ended December 31, 2014 and 2013 for the U.S. Plan.

(\$ in millions)

	Government and Related	Corporate Bonds	Mortgage and Asset- Backed Securities	Fixed Income Commingled/ Mutual Funds	Hedge Funds	Private Equity	Private Real Estate	Total
Balance at January 1, 2014	\$ 1	\$ 5	\$ 19	\$ 274	\$ 860	\$ 3,771	\$ 3,038	\$ 7,968
Return on assets held at end of year	—	0	0	21	28	(10)	197	238
Return on assets sold during the year	—	0	0	—	—	332	199	531
Purchases, sales and settlements, net	—	0	(3)	—	—	(807)	(492)	(1,302)
Transfers, net	(1)	(1)	4	—	—	—	—	2
<b>Balance at December 31, 2014</b>	<b>\$ —</b>	<b>\$ 4</b>	<b>\$ 20</b>	<b>\$ 295</b>	<b>\$ 889</b>	<b>\$ 3,287</b>	<b>\$ 2,942</b>	<b>\$ 7,437</b>

(\$ in millions)

	Government and Related	Corporate Bonds	Mortgage and Asset- Backed Securities	Fixed Income Commingled/ Mutual Funds	Hedge Funds	Private Equity	Private Real Estate	Total
Balance at January 1, 2013	\$ 6	\$ 11	\$ 45	\$ 267	\$ 756	\$ 4,085	\$ 2,861	\$ 8,032
Return on assets held at end of year	0	0	(1)	7	104	1,104	889	2,103
Return on assets sold during the year	0	0	0	—	0	(528)	(412)	(939)
Purchases, sales and settlements, net	(5)	3	0	—	0	(891)	(301)	(1,194)
Transfers, net	0	(8)	(26)	—	—	—	—	(33)
<b>Balance at December 31, 2013</b>	<b>\$ 1</b>	<b>\$ 5</b>	<b>\$ 19</b>	<b>\$ 274</b>	<b>\$ 860</b>	<b>\$ 3,771</b>	<b>\$ 3,038</b>	<b>\$ 7,968</b>

The following tables present the reconciliation of the beginning and ending balances of Level 3 assets for the years ended December 31, 2014 and 2013 for the non-U.S. Plans.

(\$ in millions)

	Government and Related	Corporate Bonds	Private Equity	Private Real Estate	Other Commingled/ Mutual Funds	Total
Balance at January 1, 2014	\$ 42	\$ 4	\$ 410	\$ 655	\$ —	\$ 1,110
Return on assets held at end of year	3	0	26	83	26	138
Return on assets sold during the year	0	0	46	(12)	—	34
Purchases, sales and settlements, net	(8)	(3)	75	(13)	104	155
Transfers, net	—	—	0	—	102	102
Foreign exchange impact	(5)	0	(45)	(49)	(12)	(110)
<b>Balance at December 31, 2014</b>	<b>\$ 32</b>	<b>\$ 1</b>	<b>\$ 513</b>	<b>\$ 664</b>	<b>\$ 220</b>	<b>\$ 1,429</b>

(\$ in millions)

	Government and Related	Corporate Bonds	Private Equity	Private Real Estate	Total
Balance at January 1, 2013	\$ 76	\$ 5	\$ 353	\$ 609	\$ 1,042
Return on assets held at end of year	(12)	0	1	33	22
Return on assets sold during the year	1	0	18	(3)	16
Purchases, sales and settlements, net	(24)	(1)	26	1	1
Foreign exchange impact	2	0	12	15	29
<b>Balance at December 31, 2013</b>	<b>\$ 42</b>	<b>\$ 4</b>	<b>\$ 410</b>	<b>\$ 655</b>	<b>\$ 1,110</b>

### Valuation Techniques

The following is a description of the valuation techniques used to measure plan assets at fair value. There were no changes in valuation techniques during 2014 and 2013.

Equity securities are valued at the closing price reported on the stock exchange on which the individual securities are traded. IBM common stock is valued at the closing price reported on the New York Stock Exchange. Equity commingled/mutual funds are typically valued using the net asset value (NAV) provided by the administrator of the fund and reviewed by the company. The NAV is based on the value of the underlying assets owned by the fund, minus liabilities and divided by the number of shares or units outstanding. These assets are classified as Level 1, Level 2 or Level 3 depending on availability of quoted market prices.

The fair value of fixed-income securities is typically estimated using pricing models, quoted prices of securities with similar characteristics or discounted cash flows and are generally classified as Level 2. If available, they are valued using the closing price reported on the major market on which the individual securities are traded.

Cash includes money market accounts that are valued at their cost plus interest on a daily basis, which approximates fair value. Short-term investments represent securities with original maturities of one year or less. These assets are classified as Level 1 or Level 2.

Private equity and private real estate partnership valuations require significant judgment due to the absence of quoted market prices, the inherent lack of liquidity and the long-term nature of such assets. These assets are initially valued at cost and are reviewed periodically utilizing available and relevant market data to determine if the carrying value of these assets should be adjusted. These investments are classified as Level 3. The valuation methodology is applied consistently from period to period.

Exchange traded derivatives are valued at the closing price reported on the exchange on which the individual securities are traded, while forward contracts are valued using a mid-close price. Over-the-counter derivatives are typically valued using pricing models. The models require a variety of inputs, including, for example, yield curves, credit curves, measures of volatility and foreign exchange rates. These assets are classified as Level 1 or Level 2 depending on availability of quoted market prices.

### Expected Contributions

#### Defined Benefit Pension Plans

It is the company's general practice to fund amounts for pensions sufficient to meet the minimum requirements set forth in applicable employee benefits laws and local tax laws. From time to time, the company contributes additional amounts as it deems appropriate.

The company contributed \$465 million and \$449 million in cash to non-U.S. defined benefit pension plans and \$54 million and \$57 million in cash to non-U.S. multi-employer plans during the years ended December 31, 2014 and 2013, respectively. The cash contributions to multi-employer plans represent the annual cost included in net periodic (income)/cost recognized in the Consolidated Statement of Earnings. The company has no liability for participants in multi-employer plans other than its own employees. As a result, the company's participation in multi-employer plans has no material impact on the company's financial statements.

In 2015, the company is not legally required to make any contributions to the U.S. defined benefit pension plans. However, depending on market conditions, or other factors, the company may elect to make discretionary contributions to the Qualified PPP during the year.

The Pension Protection Act of 2006 (the Act), enacted into law in 2006, is a comprehensive reform package that, among other provisions, increases pension funding requirements for certain U.S. defined benefit plans, provides guidelines for measuring pension plan assets and pension obligations for funding purposes and raises tax deduction limits for contributions to retirement-related benefit plans. The additional funding requirements by the Act apply to plan years beginning after December 31, 2007. The Act was updated by the Worker, Retiree and Employer Recovery Act of 2008, which revised the funding requirements in the Act by clarifying that pension plans may smooth the value of pension plans over 24 months. At December 31, 2014, no mandatory contribution was required for 2015.

In 2015, the company estimates contributions to its non-U.S. defined benefit and multi-employer plans to be approximately \$600 million, the largest of which will be contributed to defined benefit pension plans in the UK, Japan and the Netherlands. This amount represents the legally mandated minimum contributions. Financial market performance in 2015 could increase the legally mandated minimum contribution in certain countries which require monthly or daily remeasurement of the funded status. The company could also elect to contribute more than the legally mandated amount based on market conditions or other factors.

**Defined Contribution Plans**

The company contributed \$1,239 million and \$1,361 million in cash to the defined contribution plans during the years ended December 31, 2014 and 2013, respectively. In 2015, the company estimates cash contributions to the defined contribution plans to be approximately \$1.2 billion.

**Nonpension Postretirement Benefit Plans**

The company contributed \$144 million and \$80 million to the nonpension postretirement benefit plans during the years ended December 31, 2014 and 2013, respectively. These contribution

amounts exclude the Medicare-related subsidy discussed on page 145.

**Expected Benefit Payments****Defined Benefit Pension Plan Expected Payments**

The following table presents the total expected benefit payments to defined benefit pension plan participants. These payments have been estimated based on the same assumptions used to measure the plans' PBO at December 31, 2014 and include benefits attributable to estimated future compensation increases, where applicable.

(\$ in millions)

	Qualified U.S. Plan Payments	Nonqualified U.S. Plans Payments	Qualified Non-U.S. Plans Payments	Nonqualified Non-U.S. Plans Payments	Total Expected Benefit Payments
2015	\$ 3,449	\$113	\$ 1,849	\$ 348	\$ 5,758
2016	3,476	115	1,854	344	5,790
2017	3,492	117	1,880	348	5,837
2018	3,501	118	1,911	357	5,887
2019	3,458	120	1,949	374	5,901
2020–2024	17,566	607	10,290	2,060	30,523

The 2015 expected benefit payments to defined benefit pension plan participants not covered by the respective plan assets (underfunded plans) represent a component of compensation and benefits, within current liabilities, in the Consolidated Statement of Financial Position.

**Nonpension Postretirement Benefit Plan Expected Payments**

The following table reflects the total expected benefit payments to nonpension postretirement benefit plan participants. These payments have been estimated based on the same assumptions used to measure the plans' APBO at December 31, 2014.

(\$ in millions)

	U.S. Plan Payments	Qualified Non-U.S. Plans Payments	Nonqualified Non-U.S. Plans Payments	Total Expected Benefit Payments
2015	\$ 426	\$ 8	\$ 31	\$ 465
2016	405	8	35	448
2017	410	9	38	457
2018	412	9	41	463
2019	412	10	44	466
2020–2024	1,871	59	257	2,187

The 2015 expected benefit payments to nonpension postretirement benefit plan participants not covered by the respective plan assets represent a component of compensation and benefits, within current liabilities, in the Consolidated Statement of Financial Position.

## Medicare Prescription Drug Act

In connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003, the company qualified to receive a federal subsidy through 2013. Due to benefit plan changes effective January 1, 2014, the company did not qualify for the subsidy as of that date. The company received total subsidies of \$23 million and \$30 million for prescription drug-related coverage during the years ended December 31, 2014 and 2013, respectively, which were utilized to reduce the company contributions to the U.S. nonpension postretirement benefit plan. The company is also

expected to receive additional subsidies after 2014 to true up the final subsidy amount due to IBM under the Act.

## Other Plan Information

The following table presents information for defined benefit pension plans with accumulated benefit obligations (ABO) in excess of plan assets. For a more detailed presentation of the funded status of the company's defined benefit pension plans, see the table on page 135.

(\$ in millions)

	2014		2013	
	Benefit Obligation	Plan Assets	Benefit Obligation	Plan Assets
<b>At December 31:</b>				
Plans with PBO in excess of plan assets	\$34,976	\$21,655	\$41,003	\$29,223
Plans with ABO in excess of plan assets	33,148	20,680	40,315	29,213
Plans with assets in excess of PBO	71,501	73,660	58,651	64,194

## NOTE T. SEGMENT INFORMATION

The company's major operations consist of five business segments: Global Technology Services, Global Business Services, Software, Systems and Technology and Global Financing. The segments represent components of the company for which separate financial information is available that is utilized on a regular basis by the chief executive officer in determining how to allocate resources and evaluate performance. The segments are determined based on several factors, including client base, homogeneity of products, technology, delivery channels and similar economic characteristics.

Information about each segment's business and the products and services that generate each segment's revenue is located in the "Description of Business" section on pages 29 to 31, and in "Segment Details," on pages 33 to 38 in the Management Discussion.

Segment revenue and pre-tax income include transactions between the segments that are intended to reflect an arm's-length, market-based transfer price. Systems and software that are used by Global Technology Services in outsourcing engagements are primarily sourced internally from Systems and Technology and Software. For providing IT services that are used internally, Global Technology Services and Global Business Services recover

cost, as well as a reasonable fee, that is intended to reflect the arm's-length value of providing the services. The Global Services segments enter into arm's-length loans at prices equivalent to market rates with Global Financing to facilitate the acquisition of equipment used in services engagements. All internal transaction prices are reviewed annually, and reset if appropriate.

The company utilizes globally integrated support organizations to realize economies of scale and efficient use of resources. As a result, a considerable amount of expense is shared by all of the segments. This shared expense includes sales coverage, certain marketing functions and support functions such as Accounting, Treasury, Procurement, Legal, Human Resources and Billing and Collections. Where practical, shared expenses are allocated based on measurable drivers of expense, e.g., head count. When a clear and measurable driver cannot be identified, shared expenses are allocated on a financial basis that is consistent with the company's management system, e.g., advertising expense is allocated based on the gross profits of the segments. A portion of the shared expenses, which are recorded in net income, are not allocated to the segments. These expenses are associated with the elimination of internal transactions and other miscellaneous items.

The following tables reflect the results of continuing operations of the company's segments consistent with the management and measurement system utilized within the company. Performance measurement is based on pre-tax income from continuing operations. These results are used, in part, by senior management, both in evaluating the performance of, and in allocating resources to, each of the segments.

## Management System Segment View

(\$ in millions)

For the year ended December 31:	Global Services Segments		Software	Systems and Technology*	Global Financing	Total Segments*
	Global Technology Services	Global Business Services				
<b>2014</b>						
External revenue	\$37,130	\$17,825	\$25,434	\$ 9,996	\$2,034	\$ 92,418
Internal revenue	934	543	3,496	647	2,488	8,108
<b>Total revenue</b>	<b>\$38,063</b>	<b>\$18,367</b>	<b>\$28,931</b>	<b>\$10,643</b>	<b>\$4,522</b>	<b>\$100,527</b>
<b>Pre-tax income from continuing operations</b>	<b>\$ 6,340</b>	<b>\$ 2,999</b>	<b>\$10,699</b>	<b>\$ 34</b>	<b>\$2,189</b>	<b>\$ 22,262</b>
Revenue year-to-year change	(3.9)%	(3.9)%	(0.7)%	(21.6)%	5.1%	(4.9)%
Pre-tax income year-to-year change	(9.2)%	(6.7)%	(3.7)%	(84.1)%	0.8%	(6.0)%
Pre-tax income margin	16.7%	16.3%	37.0%	0.3%	48.4%	22.1%
<b>2013*</b>						
External revenue	\$38,551	\$18,396	\$25,932	\$12,988	\$2,022	\$ 97,889
Internal revenue	1,063	714	3,191	593	2,282	7,843
<b>Total revenue</b>	<b>\$39,615</b>	<b>\$19,109</b>	<b>\$29,123</b>	<b>\$13,581</b>	<b>\$4,304</b>	<b>\$105,732</b>
<b>Pre-tax income from continuing operations</b>	<b>\$ 6,983</b>	<b>\$ 3,214</b>	<b>\$11,106</b>	<b>\$ 213</b>	<b>\$2,171</b>	<b>\$ 23,687</b>
Revenue year-to-year change	(4.3)%	(0.9)%	1.4%	(18.7)%	5.7%	(4.0)%
Pre-tax income year-to-year change	0.3%	7.7%	2.7%	(88.6)%	6.8%	(3.9)%
Pre-tax income margin	17.6%	16.8%	38.1%	1.6%	50.4%	22.4%
<b>2012*</b>						
External revenue	\$40,236	\$18,566	\$25,448	\$16,034	\$2,013	\$102,297
Internal revenue	1,166	719	3,274	676	2,060	7,896
<b>Total revenue</b>	<b>\$41,402</b>	<b>\$19,286</b>	<b>\$28,722</b>	<b>\$16,710</b>	<b>\$4,073</b>	<b>\$110,193</b>
<b>Pre-tax income from continuing operations</b>	<b>\$ 6,961</b>	<b>\$ 2,983</b>	<b>\$10,810</b>	<b>\$ 1,866</b>	<b>\$2,034</b>	<b>\$ 24,653</b>
Revenue year-to-year change	(1.7)%	(4.0)%	1.8%	(7.0)%	(2.9)%	(2.1)%
Pre-tax income year-to-year change	10.8%	(0.8)%	8.4%	(11.6)%	1.1%	5.4%
Pre-tax income margin	16.8%	15.5%	37.6%	11.2%	49.9%	22.4%

\*Reclassified to reflect discontinued operations presentation.

**Reconciliations of IBM as Reported**

(\$ in millions)

For the year ended December 31:	2014	2013*	2012*
<b>Revenue</b>			
Total reportable segments	\$100,527	\$105,732	\$110,193
Other revenue and adjustments	374	478	577
Elimination of internal transactions	(8,108)	(7,843)	(7,896)
<b>Total IBM consolidated revenue</b>	<b>\$ 92,793</b>	<b>\$ 98,367</b>	<b>\$102,874</b>

(\$ in millions)

For the year ended December 31:	2014	2013*	2012*
<b>Pre-tax income from continuing operations:</b>			
Total reportable segments	\$22,262	\$23,687	\$24,653
Amortization of acquired intangible assets	(791)	(758)	(703)
Acquisition-related charges	(12)	(46)	(36)
Non-operating retirement-related (costs)/income	(353)	(1,062)	(538)
Elimination of internal transactions	(1,914)	(1,480)	(1,197)
Unallocated corporate amounts**	795	(98)	361
<b>Total income from continuing operations, before tax</b>	<b>\$19,986</b>	<b>\$20,244</b>	<b>\$22,540</b>

\* Reclassified to reflect discontinued operations presentation.

\*\* The 2014, 2013 and 2012 amounts include the gain related to the Retail Store Solutions divestiture. The 2014 amount also includes the net gain related to the industry standard server divestiture.

**Immaterial Items****Investment in Equity Alliances and Equity Alliances Gains/(Losses)**

The investments in equity alliances and the resulting gains and (losses) from these investments that are attributable to the segments did not have a material effect on the financial position or the financial results of the segments.

**Segment Assets and Other Items**

Global Technology Services assets are primarily plant, property and equipment, including the assets associated with the outsourcing business, goodwill, accounts receivable, deferred services arrangement transition costs, maintenance parts inventory and acquired intangible assets. Global Business Services assets are primarily goodwill and accounts receivable. Software assets are mainly goodwill, acquired intangible assets and accounts receivable. Systems and Technology assets are primarily plant, property and equipment, goodwill, manufacturing inventory and accounts receivable. Global Financing assets are primarily financing receivables and fixed assets under operating leases.

To ensure the efficient use of the company's space and equipment, several segments may share plant, property and equipment assets. Where assets are shared, landlord ownership of the assets is assigned to one segment and is not allocated to each user segment. This is consistent with the company's management system and is reflected accordingly in the table on page 148. In those cases, there will not be a precise correlation between segment pre-tax income and segment assets.

Similarly, the depreciation amounts reported by each segment are based on the assigned landlord ownership and may not be consistent with the amounts that are included in the segments' pre-tax income. The amounts that are included in pre-tax income reflect occupancy charges from the landlord segment and are not specifically identified by the management reporting system. Capital expenditures that are reported by each segment also are consistent with the landlord ownership basis of asset assignment.

Global Financing amounts for interest income and interest expense reflect the interest income and interest expense associated with the Global Financing business, including the intercompany financing activities discussed on page 31, as well as the income from investment in cash and marketable securities. The explanation of the difference between cost of financing and interest expense for segment presentation versus presentation in the Consolidated Statement of Earnings is included on page 76 of the Management Discussion.

## Management System Segment View

(\$ in millions)

For the year ended December 31:	Global Services Segments			Software	Systems and Technology**	Global Financing	Total Segments**
	Global Technology Services	Global Business Services					
<b>2014</b>							
Assets	\$17,245	\$7,795	\$25,813	\$4,235	\$38,845	\$93,933	
Depreciation/amortization of intangibles*	1,873	58	1,210	712	455	4,308	
Capital expenditures/investments in intangibles	2,272	33	534	600	482	3,921	
Interest income	—	—	—	—	1,951	1,951	
Interest expense	—	—	—	—	518	518	
<b>2013**</b>							
Assets	\$18,048	\$8,311	\$27,101	\$4,901	\$40,138	\$98,499	
Depreciation/amortization of intangibles*	1,670	72	1,211	435	574	3,963	
Capital expenditures/investments in intangibles	1,938	69	540	395	467	3,410	
Interest income	—	—	—	—	1,904	1,904	
Interest expense	—	—	—	—	405	405	
<b>2012**</b>							
Assets	\$15,884	\$8,022	\$26,291	\$5,092	\$38,882	\$94,170	
Depreciation/amortization of intangibles*	1,597	75	1,157	404	853	4,088	
Capital expenditures/investments in intangibles	1,760	42	618	517	708	3,644	
Interest income	—	—	—	—	1,972	1,972	
Interest expense	—	—	—	—	410	410	

\* Segment pre-tax income from continuing operations does not include the amortization of intangible assets.

\*\* Reclassified to reflect discontinued operations presentation.

### Reconciliations of IBM as Reported

(\$ in millions)

At December 31:	2014	2013*	2012*
<b>Assets</b>			
Total reportable segments	\$ 93,933	\$ 98,499	\$ 94,170
Elimination of internal transactions	(5,193)	(4,740)	(4,943)
Unallocated amounts			
Cash and marketable securities	7,182	9,697	9,779
Notes and accounts receivable	4,253	2,907	3,987
Deferred tax assets	6,643	4,532	5,194
Plant, other property and equipment	2,169	4,827	4,900
Pension assets	2,160	5,551	945
Other	6,386	4,949	5,181
<b>Total IBM consolidated assets</b>	<b>\$117,532</b>	<b>\$126,223</b>	<b>\$119,213</b>

\* Reclassified to reflect discontinued operations presentation.

### Major Clients

No single client represented 10 percent or more of the company's total revenue in 2014, 2013 or 2012.

### Geographic Information

The following provides information for those countries that are 10 percent or more of the specific category.

#### Revenue\*

(\$ in millions)

For the year ended December 31:	2014	2013**	2012**
United States	\$32,021	\$33,427	\$ 34,653
Japan	8,382	9,070	10,696
Other countries	52,390	55,871	57,525
<b>Total IBM consolidated revenue</b>	<b>\$92,793</b>	<b>\$98,367</b>	<b>\$102,874</b>

\* Revenues are attributed to countries based on the location of the client.

\*\* Reclassified to reflect discontinued operations presentation.

#### Plant and Other Property—Net

(\$ in millions)

At December 31:	2014	2013	2012
United States	\$ 4,388	\$ 6,723	\$ 6,555
Other countries	5,690	6,257	6,299
<b>Total</b>	<b>\$10,078</b>	<b>\$12,979</b>	<b>\$12,854</b>

### Revenue by Classes of Similar Products or Services

The following table presents external revenue for similar classes of products or services within the company's reportable segments. Within Global Technology Services and Global Business Services, client solutions often include IBM software and systems and other suppliers' products if the client solution requires it. Within Software, product license charges and ongoing subscription and support are reported as Software, and software as a service, consulting, education, training and other product-related services are reported as Services.

(\$ in millions)

For the year ended December 31:	2014	2013*	2012*
Global Technology Services			
Services	\$28,817	\$29,953	\$31,161
Maintenance	6,853	7,111	7,343
Systems	1,294	1,322	1,574
Software	165	164	159
Global Business Services			
Services	\$17,515	\$18,065	\$18,216
Software	185	221	208
Systems	124	109	142
Software			
Software	\$22,722	\$23,420	\$23,144
Services	2,712	2,512	2,304
Systems and Technology*			
Servers	\$ 7,320	\$ 9,946	\$12,623
Storage	2,676	3,041	3,411
Global Financing			
Financing	\$ 1,543	\$ 1,493	\$ 1,471
Used equipment sales	491	529	542

\*Reclassified to reflect discontinued operations presentation.

### NOTE U. SUBSEQUENT EVENTS

On January 27, 2015, the company announced that the Board of Directors approved a quarterly dividend of \$1.10 per common share. The dividend is payable March 10, 2015 to shareholders of record on February 10, 2015.

On February 4, 2015, the company issued \$2.0 billion in bonds as follows: \$1.5 billion of 3-year fixed-rate bonds with a 1.125 percent coupon and \$0.5 billion of 3-year floating-rate bonds priced at LIBOR plus 19 basis points.

(\$ in millions except per share amounts)

<b>For the year ended December 31:</b>	<b>2014</b>	2013	2012	2011	2010
Revenue	<b>\$ 92,793</b>	\$ 98,367	\$102,874	\$105,056	\$ 98,018
Income from continuing operations	<b>\$ 15,751</b>	\$ 16,881	\$ 16,999	\$ 16,108	\$ 15,082
Loss from discontinued operations, net of tax	<b>\$ (3,729)</b>	\$ (398)	\$ (395)	\$ (253)	\$ (249)
Net income	<b>\$ 12,022</b>	\$ 16,483	\$ 16,604	\$ 15,855	\$ 14,833
Operating (non-GAAP) earnings	<b>\$ 16,702</b>	\$ 18,356	\$ 18,022	\$ 16,571	\$ 15,272
Earnings/(loss) per share of common stock:					
Assuming dilution:					
Continuing operations	<b>\$ 15.59</b>	\$ 15.30	\$ 14.71	\$ 13.27	\$ 11.71
Discontinued operations	<b>\$ (3.69)</b>	\$ (0.36)	\$ (0.34)	\$ (0.21)	\$ (0.19)
Total	<b>\$ 11.90</b>	\$ 14.94	\$ 14.37	\$ 13.06	\$ 11.52
Basic:					
Continuing operations	<b>\$ 15.68</b>	\$ 15.42	\$ 14.88	\$ 13.46	\$ 11.89
Discontinued operations	<b>\$ (3.71)</b>	\$ (0.36)	\$ (0.35)	\$ (0.21)	\$ (0.20)
Total	<b>\$ 11.97</b>	\$ 15.06	\$ 14.53	\$ 13.25	\$ 11.69
Diluted operating (non-GAAP)	<b>\$ 16.53</b>	\$ 16.64	\$ 15.60	\$ 13.65	\$ 11.86
Cash dividends paid on common stock	<b>\$ 4,265</b>	\$ 4,058	\$ 3,773	\$ 3,473	\$ 3,177
Per share of common stock	<b>4.25</b>	3.70	3.30	2.90	2.50
Investment in property, plant and equipment	<b>\$ 3,740</b>	\$ 3,623	\$ 4,082	\$ 4,108	\$ 4,185
Return on IBM stockholders' equity	<b>72.5%</b>	83.8%	81.6%	71.2%	66.8%

<b>At December 31:</b>	<b>2014</b>	2013	2012	2011	2010
Total assets	<b>\$117,532</b>	\$126,223	\$119,213	\$116,433	\$113,452
Net investment in property, plant and equipment	<b>\$ 10,771</b>	\$ 13,821	\$ 13,996	\$ 13,883	\$ 14,096
Working capital	<b>\$ 9,822</b>	\$ 11,196	\$ 5,807	\$ 8,805	\$ 7,554
Total debt	<b>\$ 40,804</b>	\$ 39,718	\$ 33,269	\$ 31,320	\$ 28,624
Total equity	<b>\$ 12,014</b>	\$ 22,929	\$ 18,984	\$ 20,236	\$ 23,172

## GAAP Reconciliation

Refer to the "GAAP Reconciliation," on pages 45 and 63 for the reconciliation of non-GAAP financial information for 2014, 2013 and 2012. See the adjacent table for the reconciliation of non-GAAP financial information for 2011 and 2010. The reconciling items, as described in the "Operating (non-GAAP) Earnings," section on page 22, have not changed from previously reported amounts.

(\$ in millions except per share amounts)

<b>For the year ended December 31:</b>	2011	2010
As reported:		
Revenue	\$106,916	\$99,870
Net income	15,855	14,833
Operating (non-GAAP) earnings	16,318	15,023
Diluted earnings per share	13.06	11.52
Diluted operating (non-GAAP) earnings per share	13.44	11.67
Continuing operations:		
Revenue	\$105,056	\$98,018
Income from continuing operations	16,108	15,082
Diluted earnings per share	13.27	11.71
Discontinued operations:		
Revenue	\$ 1,859	\$ 1,853
Loss from discontinued operations, net of tax	(253)	(249)
Diluted earnings per share	(0.21)	(0.19)
Operating (non-GAAP):		
Operating (non-GAAP) earnings	\$ 16,571	\$15,272
Diluted operating (non-GAAP) earnings per share	13.65	11.86

## Selected Quarterly Data

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts and stock prices)

<b>2014</b>	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Revenue	\$22,236	\$24,047	\$22,397	\$24,113	\$92,793
Gross profit	\$10,627	\$12,044	\$10,874	\$12,862	\$46,407
Income from continuing operations	\$ 2,530	\$ 4,251	\$ 3,455	\$ 5,515	\$15,751
Loss from discontinued operations, net of tax	\$ (146)	\$ (115)	\$ (3,437)	\$ (31)	\$ (3,729)
Net income	\$ 2,384	\$ 4,137	\$ 18	\$ 5,484	\$12,022
Operating (non-GAAP) earnings***	\$ 2,790	\$ 4,456	\$ 3,671	\$ 5,785	\$16,702
Earnings per share of common stock*					
Assuming dilution:					
Continuing operations	\$ 2.43	\$ 4.23	\$ 3.46	\$ 5.54	\$ 15.59
Discontinued operations	\$ (0.14)	\$ (0.11)	\$ (3.44)	\$ (0.03)	\$ (3.69)
Total	\$ 2.29	\$ 4.12	\$ 0.02	\$ 5.51	\$ 11.90
Basic:					
Continuing operations	\$ 2.44	\$ 4.25	\$ 3.48	\$ 5.57	\$ 15.68
Discontinued operations	\$ (0.14)	\$ (0.11)	\$ (3.46)	\$ (0.03)	\$ (3.71)
Total	\$ 2.30	\$ 4.14	\$ 0.02	\$ 5.54	\$ 11.97
Diluted operating (non-GAAP)***	\$ 2.68	\$ 4.43	\$ 3.68	\$ 5.81	\$ 16.53
Dividends per share of common stock	\$ 0.95	\$ 1.10	\$ 1.10	\$ 1.10	\$ 4.25
Stock prices**					
High	\$195.63	\$199.21	\$196.40	\$190.89	
Low	\$172.19	\$179.27	\$181.70	\$150.50	

(\$ in millions except per share amounts and stock prices)

<b>2013</b>	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Revenue	\$23,101	\$24,544	\$23,338	\$27,385	\$98,367
Gross profit	\$10,734	\$12,184	\$11,429	\$14,337	\$48,684
Income from continuing operations	\$ 3,161	\$ 3,365	\$ 4,139	\$ 6,216	\$16,881
Loss from discontinued operations, net of tax	\$ (129)	\$ (138)	\$ (98)	\$ (32)	\$ (398)
Net income	\$ 3,032	\$ 3,226	\$ 4,041	\$ 6,185	\$16,483
Operating (non-GAAP) earnings***	\$ 3,505	\$ 3,718	\$ 4,485	\$ 6,649	\$18,356
Earnings per share of common stock*					
Assuming dilution:					
Continuing operations	\$ 2.81	\$ 3.03	\$ 3.77	\$ 5.76	\$ 15.30
Discontinued operations	\$ (0.11)	\$ (0.12)	\$ (0.09)	\$ (0.03)	\$ (0.36)
Total	\$ 2.70	\$ 2.91	\$ 3.68	\$ 5.73	\$ 14.94
Basic:					
Continuing operations	\$ 2.84	\$ 3.06	\$ 3.79	\$ 5.80	\$ 15.42
Discontinued operations	\$ (0.12)	\$ (0.13)	\$ (0.09)	\$ (0.03)	\$ (0.36)
Total	\$ 2.72	\$ 2.93	\$ 3.70	\$ 5.77	\$ 15.06
Diluted operating (non-GAAP)***	\$ 3.12	\$ 3.35	\$ 4.08	\$ 6.16	\$ 16.64
Dividends per share of common stock	\$ 0.85	\$ 0.95	\$ 0.95	\$ 0.95	\$ 3.70
Stock prices**					
High	\$215.90	\$214.89	\$200.94	\$187.79	
Low	\$190.39	\$187.68	\$181.10	\$172.57	

\* Earnings Per Share (EPS) in each quarter is computed using the weighted-average number of shares outstanding during that quarter while EPS for the full year is computed using the weighted-average number of shares outstanding during the year. Thus, the sum of the four quarters' EPS does not equal the full-year EPS.

\*\* The stock prices reflect the high and low prices for IBM's common stock on the New York Stock Exchange composite tape for the periods presented.

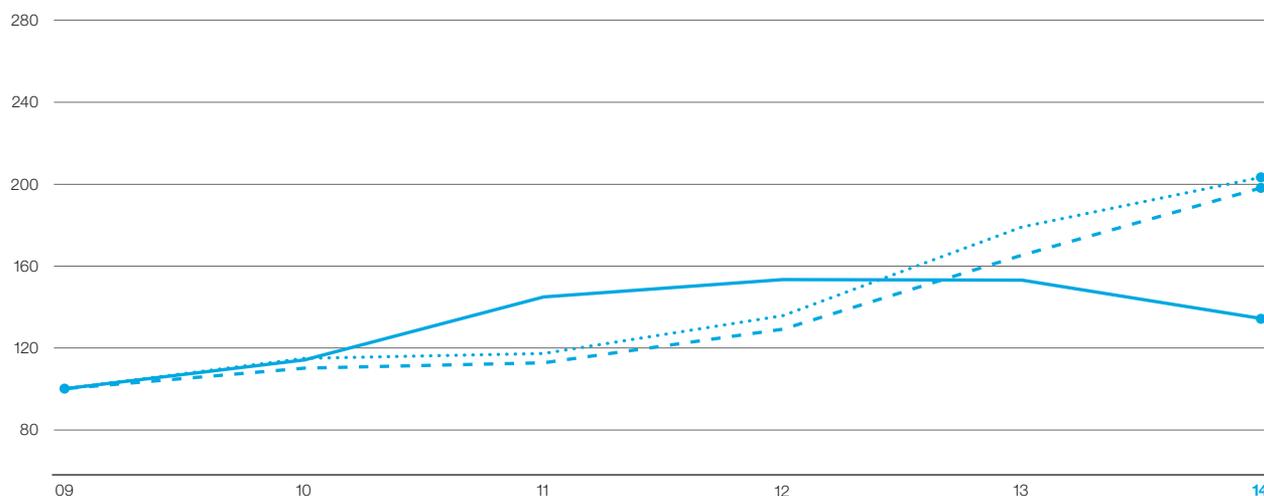
\*\*\* Refer to pages 44 and 45 in Attachment II of the company's Form 8-K filed on January 20, 2015 and Attachment A of the company's Form 8-K (Item 8.01) filed on October 20, 2014 for the reconciliation of non-GAAP financial information for the first and second quarters of 2014 and 2013, respectively. Refer to page 86 of the company's third-quarter 2014 Form 10-Q filed on October 28, 2014 for the reconciliation of non-GAAP financial information for the third quarter of 2014 and 2013. See also the "GAAP Reconciliation," sections on pages 45, 46 and 52 for the reconciliation of non-GAAP financial information for the full year and fourth quarter of 2014 and 2013, respectively. The reconciling items described in the "Operating (non-GAAP) Earnings," section on page 22 have not changed from previously reported amounts.

### COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN FOR IBM, S&P 500 STOCK INDEX AND S&P INFORMATION TECHNOLOGY INDEX

The following graph compares the five-year cumulative total returns for IBM common stock with the comparable cumulative return of certain Standard & Poor's (S&P) indices. Due to the fact that IBM is a company included in the S&P 500 Stock Index, the SEC's rules require the use of that index. Under those rules, the second index used for comparison may be a published industry

or line-of-business index. The S&P Information Technology Index is such an index. IBM is also included in this index.

The graph assumes \$100 invested on December 31 (of the initial year shown in the graph) in IBM common stock and \$100 invested on the same date in each of the S&P indices. The comparisons assume that all dividends are reinvested.



(U.S. Dollar)	2009	2010	2011	2012	2013	2014
— IBM Common Stock	\$100.00	\$114.28	\$145.62	\$154.26	\$153.98	<b>\$134.89</b>
.... S&P 500 Index	100.00	115.06	117.49	136.30	180.44	<b>205.14</b>
- - S&P Information Technology Index	100.00	110.19	112.84	129.57	166.41	<b>199.89</b>

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Stockholders with questions about their accounts should contact:

Computershare Trust Company, N.A.  
P.O. Box 43078  
Providence, Rhode Island 02940-3078  
(888) IBM-6700

Investors residing outside the United States, Canada and Puerto Rico should call (781) 575-2727.

Stockholders can also reach Computershare Trust Company, N.A. via e-mail at: [ibm@computershare.com](mailto:ibm@computershare.com)

Hearing-impaired stockholders with access to a telecommunications device (TDD) can communicate directly with Computershare Trust Company, N.A., by calling (800) 490-1493. Stockholders residing outside the United States, Canada and Puerto Rico should call (781) 575-2694.

**IBM on the Internet**

Topics featured in this Annual Report can be found on the IBM home page on the Internet ([www.ibm.com](http://www.ibm.com)). Financial results, news on IBM products, services and other activities can also be found at that address.

IBM files reports with the Securities and Exchange Commission (SEC), including the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any other filings required by the SEC.

IBM's website ([www.ibm.com](http://www.ibm.com)) contains a significant amount of information about IBM, including the company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC ([www.ibm.com/investor](http://www.ibm.com/investor)). These materials are available free of charge on or through our website.

The public may read and copy any materials the company files with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at (800) SEC-0330. The SEC maintains an Internet site ([www.sec.gov](http://www.sec.gov)) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

**IBM Investor Services Program**

The Investor Services Program brochure outlines a number of services provided for IBM stockholders and potential IBM investors, including the reinvestment of dividends, direct purchase and the deposit of IBM stock certificates for safekeeping. Call (888) IBM-6700 for a copy of the brochure. Investors residing outside the United States, Canada and Puerto Rico should call (781) 575-2727.

Investors with other requests may write to: IBM Stockholder Relations, New Orchard Road, Armonk, New York 10504

**IBM Stock**

IBM common stock is listed on the New York Stock Exchange, the Chicago Stock Exchange, and outside the United States.

**Stockholder Communications**

Stockholders can get quarterly financial results, a summary of the Annual Meeting remarks, and voting results from the meeting by calling (914) 499-7777, by sending an e-mail to [infoibm@us.ibm.com](mailto:infoibm@us.ibm.com), or by writing to International Business Machines Corporation, 1 New Orchard Road, M/D 325, Armonk, New York 10504.

**Annual Meeting**

The IBM Annual Meeting of Stockholders will be held on Tuesday, April 28, 2015, at 10 a.m. in the Statehouse Convention Center, Little Rock, Arkansas.

**Literature for IBM Stockholders**

The literature mentioned below on IBM is available without charge from:

Computershare Trust Company, N.A.  
P.O. Box 43078  
Providence, Rhode Island 02940-3078  
(888) IBM-6700

Investors residing outside the United States, Canada and Puerto Rico should call (781) 575-2727.

The company's annual report on Form 10-K and the quarterly reports on Form 10-Q provide additional information on IBM's business. The 10-K report is released by the end of February; 10-Q reports are released by early May, August and November.

An audio recording of the 2014 Annual Report will be available for sight-impaired stockholders in June 2015.

The IBM Corporate Responsibility Report highlights IBM's values and its integrated approach to corporate responsibility, including its innovative strategies to transforming communities through global citizenship. The Report Summary is available in printed form and downloadable at [www.ibm.com/responsibility](http://www.ibm.com/responsibility). The full Corporate Responsibility Report is online with downloadable sections at [www.ibm.com/responsibility](http://www.ibm.com/responsibility).

**General Information**

Stockholders of record can receive online account information and answers to frequently asked questions regarding stockholder accounts on the Internet ([www.ibm.com/investor](http://www.ibm.com/investor)). Stockholders of record can also consent to receive future IBM Annual Reports and Proxy Statements online through this site.

For answers to general questions about IBM from within the continental United States, call (800) IBM-4YOU. From outside the United States, Canada and Puerto Rico, call (914) 499-1900.



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