

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

October 28, 2008

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 - Q

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

FOR THE QUARTER ENDED SEPTEMBER 30, 2008

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State of incorporation)

13-0871985

(IRS employer identification number)

Armonk, New York

(Address of principal executive offices)

10504

(Zip Code)

914-499-1900

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(Registrant's telephone number)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

The registrant has 1,343,457,986 shares of common stock outstanding at September 30, 2008.

Table of Contents

Index

| | Page |
|---|-------------|
| <u>Part I - Financial Information:</u> | |
| <u>Item 1. Consolidated Financial Statements:</u> | |
| <u>Consolidated Statement of Earnings for the three and nine months ended September 30, 2008 and 2007</u> | 3 |
| <u>Consolidated Statement of Financial Position at September 30, 2008 and December 31, 2007</u> | 5 |
| <u>Consolidated Statement of Cash Flows for the nine months ended September 30, 2008 and 2007</u> | 7 |
| <u>Notes to Consolidated Financial Statements</u> | 8 |
| <u>Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition</u> | 24 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 57 |
| <u>Item 4. Controls and Procedures</u> | 58 |
| <u>Part II - Other Information:</u> | 58 |
| <u>Item 1. Legal Proceedings</u> | 58 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds and Issuer Repurchases of Equity Securities</u> | 58 |
| <u>Item 5. Other Information</u> | 58 |
| <u>Item 6. (a) Exhibits</u> | 59 |

Table of Contents**Part I - Financial Information****Item 1. Consolidated Financial Statements:**

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF EARNINGS
(UNAUDITED)**

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|---------------|---------------------------------|---------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenue: | | | | |
| Services | \$ 14,773 | \$ 13,657 | \$ 44,550 | \$ 39,152 |
| Sales | 9,892 | 9,833 | 30,156 | 28,916 |
| Financing | 636 | 629 | 1,918 | 1,852 |
| Total revenue | 25,302 | 24,119 | 76,623 | 69,920 |
| Cost: | | | | |
| Services | 10,230 | 9,855 | 31,287 | 28,356 |
| Sales | 3,789 | 3,960 | 11,687 | 11,827 |
| Financing | 324 | 348 | 924 | 977 |
| Total cost | 14,342 | 14,163 | 43,898 | 41,160 |
| Gross profit | 10,959 | 9,956 | 32,725 | 28,760 |
| Expense and other income: | | | | |
| Selling, general and administrative | 5,644 | 5,324 | 17,553 | 16,044 |
| Research, development and engineering | 1,579 | 1,524 | 4,809 | 4,568 |
| Intellectual property and custom development income | (267) | (270) | (825) | (721) |
| Other (income) and expense | (51) | (95) | (201) | (528) |
| Interest expense | 159 | 193 | 482 | 396 |
| Total expense and other income | 7,064 | 6,676 | 21,818 | 19,759 |
| Income from continuing operations before income taxes | 3,895 | 3,280 | 10,907 | 9,001 |
| Provision for income taxes | 1,071 | 918 | 2,999 | 2,534 |
| Income from continuing operations | 2,824 | 2,362 | 7,907 | 6,467 |

(Amounts may not add due to rounding.)

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

Table of Contents

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF EARNINGS (continued)
(UNAUDITED)**

| (Dollars in millions except per share amounts) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|----------|---------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Discontinued operations | | | | |
| Loss from discontinued operations, net of tax | | (1) | | (1) |
| Net income | \$ 2,824 | \$ 2,361 | \$ 7,907 | \$ 6,466 |
| Earnings/(loss) per share of common stock: | | | | |
| Assuming dilution: | | | | |
| Continuing operations | \$ 2.05 | \$ 1.68 | \$ 5.68 | \$ 4.42 |
| Discontinued operations | | (0.00) | | (0.00) |
| Total | \$ 2.05 | \$ 1.68 | \$ 5.68 | \$ 4.42 |
| Basic: | | | | |
| Continuing operations | \$ 2.09 | \$ 1.72 | \$ 5.79 | \$ 4.50 |
| Discontinued operations | | (0.00) | | (0.00) |
| Total | \$ 2.09 | \$ 1.72 | \$ 5.79 | \$ 4.50 |
| Weighted-average number of common shares outstanding: (millions) | | | | |
| Assuming dilution | 1,379.1 | 1,405.8 | 1,393.1 | 1,463.1 |
| Basic | 1,350.7 | 1,371.4 | 1,366.7 | 1,436.0 |
| Cash dividends per common share | \$ 0.50 | \$ 0.40 | \$ 1.40 | \$ 1.10 |

(Amounts may not add due to rounding.)

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

Table of Contents

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(UNAUDITED)
ASSETS**

| (Dollars in millions) | At September 30, 2008 | At December 31, 2007 |
|--|--------------------------|-------------------------|
| Assets: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 9,755 | \$ 14,991 |
| Marketable securities | 1 | 1,155 |
| Notes and accounts receivable trade (net of allowances of \$225 in 2008 and \$241 in 2007) | 9,964 | 11,428 |
| Short-term financing receivables (net of allowances of \$305 in 2008 and \$296 in 2007) | 13,912 | 16,289 |
| Other accounts receivable (net of allowances of \$52 in 2008 and \$13 in 2007) | 1,063 | 1,072 |
| Inventories, at lower of average cost or market: | | |
| Finished goods | 677 | 668 |
| Work in process and raw materials | 2,323 | 1,996 |
| Total inventories | 3,000 | 2,664 |
| Deferred taxes | 1,778 | 1,687 |
| Prepaid expenses and other current assets | 4,714 | 3,891 |
| Total current assets | 44,187 | 53,177 |
| Plant, rental machines and other property | 39,012 | 38,584 |
| Less: Accumulated depreciation | 24,353 | 23,503 |
| Plant, rental machines and other property net | 14,659 | 15,081 |
| Long-term financing receivables (net of allowances of \$136 in 2008 and \$58 in 2007) | 10,855 | 11,603 |
| Prepaid pension assets | 18,773 | 17,417 |
| Intangible assets net | 3,048 | 2,107 |
| Goodwill | 18,861 | 14,285 |
| Investments and sundry assets | 5,526 | 6,761 |
| Total assets | \$ 115,910 | \$ 120,431 |

(Amounts may not add due to rounding.)

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

Table of Contents

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(UNAUDITED)
LIABILITIES AND STOCKHOLDERS EQUITY**

| (Dollars in millions except per share amounts) | At September 30, 2008 | At December 31, 2007 |
|--|--------------------------|-------------------------|
| Liabilities and Stockholders Equity: | | |
| Current liabilities: | | |
| Taxes | \$ 2,497 | \$ 3,673 |
| Short-term debt | 16,181 | 12,235 |
| Accounts payable | 6,770 | 8,054 |
| Compensation and benefits | 4,426 | 4,645 |
| Deferred income | 9,555 | 9,802 |
| Other accrued expenses and liabilities | 5,324 | 5,901 |
| Total current liabilities | 44,752 | 44,310 |
| Long-term debt | 18,232 | 23,039 |
| Retirement and nonpension postretirement benefit obligations | 13,582 | 13,582 |
| Deferred income | 2,881 | 3,060 |
| Other liabilities | 8,944 | 7,970 |
| Total liabilities | 88,391 | 91,962 |
| Stockholders equity: | | |
| Common stock - par value \$0.20 per share and additional paid-in capital | 38,874 | 35,188 |
| Shares authorized: 4,687,500,000 | | |
| Shares issued: 2008 2,095,054,797 | | |
| 2007 2,057,607,421 | | |
| Retained earnings | 66,600 | 60,640 |
| Treasury stock - at cost | (73,571) | (63,945) |
| Shares: 2008 751,596,811 | | |
| 2007 672,373,283 | | |
| Accumulated gains and (losses) not affecting retained earnings | (4,384) | (3,414) |
| Total stockholders equity | 27,519 | 28,470 |
| Total liabilities and stockholders equity | \$ 115,910 | \$ 120,431 |

(Amounts may not add due to rounding.)

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

Table of Contents

**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30,
(UNAUDITED)**

| (Dollars in millions) | 2008 | 2007 |
|--|-----------------|-----------------|
| Cash flow from operating activities from continuing operations: | | |
| Net Income | \$ 7,907 | \$ 6,467 |
| Loss from discontinued operations | | (1) |
| Adjustments to reconcile income from continuing operations to cash provided from operating activities: | | |
| Depreciation | 3,144 | 2,989 |
| Amortization of intangibles | 985 | 875 |
| Stock-based compensation | 501 | 539 |
| Net gain on asset sales and other | (353) | (302) |
| Changes in operating assets and liabilities, net of acquisitions/divestitures | 7 | 376 |
| Net cash provided by operating activities from continuing operations | 12,191 | 10,943 |
| Cash flow from investing activities from continuing operations: | | |
| Payments for plant, rental machines and other property, net of proceeds from dispositions | (2,951) | (2,870) |
| Investment in software | (555) | (669) |
| Acquisition of businesses, net of cash acquired | (6,017) | (718) |
| Divestiture of businesses, net of cash transferred | 71 | 310 |
| Non-operating finance receivables net (1) | 203 | 298 |
| Purchases of marketable securities and other investments (1) | (4,260) | (19,795) |
| Proceeds from sale of marketable securities and other investments (1) | 5,103 | 17,672 |
| Net cash used in investing activities from continuing operations | (8,405) | (5,773) |
| Cash flow from financing activities from continuing operations: | | |
| Proceeds from new debt (2) | 8,251 | 19,813 |
| Payments to settle debt (2) | (7,597) | (7,786) |
| Short-term (repayments)/borrowings less than 90 days net | (1,523) | 371 |
| Common stock repurchases | (9,838) | (18,357) |
| Common stock transactions other | 3,658 | 3,433 |
| Cash dividends paid | (1,916) | (1,593) |
| Net cash used in financing activities from continuing operations | (8,964) | (4,119) |
| Effect of exchange rate changes on cash and cash equivalents | (58) | 230 |
| Net cash used in discontinued operations - operating activities | | (9) |
| Net change in cash and cash equivalents | (5,236) | 1,273 |
| Cash and cash equivalents at January 1 | 14,991 | 8,022 |
| Cash and cash equivalents at September 30 | \$ 9,755 | \$ 9,295 |

(1) Non-operating finance receivables net represents net cash flows from short-term commercial financing arrangements (terms generally 30 to 90 days) with dealers and remarketers of predominantly non-IBM products. Amounts previously presented gross within Purchases/Proceeds of marketable securities and other investments.

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(2) Reclassified from September 30, 2007 presentation. See Consolidated Statement of Cash Flows on page 64 of the 2007 IBM Annual Report for additional information.

(Amounts may not add due to rounding.)

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

Table of Contents

Notes to Consolidated Financial Statements:

1. Basis of Presentation: The accompanying consolidated financial statements and footnotes thereto are unaudited. In the opinion of the management of the International Business Machines Corporation (the company), these statements include all adjustments, which are of a normal recurring nature, necessary to present a fair statement of the company's results of operations, financial position and cash flows.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts of assets, liabilities, revenue, costs, expenses and gains and losses not affecting retained earnings that are reported in the Consolidated Financial Statements and accompanying disclosures. Actual results may be different. See the company's 2007 Annual Report for a discussion of the company's critical accounting estimates.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the company's 2007 Annual Report.

Within the financial tables in this Form 10-Q, 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.

2. Accounting Changes: In June 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*, which will become effective in 2009 via retrospective application. Under the FSP, unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and, therefore, are included in computing earnings per share (EPS) pursuant to the two-class method. The two-class method determines earnings per share for each class of common stock and participating securities according to dividends or dividend equivalents and their respective participation rights in undistributed earnings. Restricted Stock Units (RSUs) granted to employees prior to December 31, 2007 are considered participating securities as they receive non-forfeitable dividend equivalents at the same rate as common stock. RSUs granted after December 31, 2007 do not receive dividend equivalents and are not considered participating securities. The company will adopt the FSP in fiscal year 2009. Upon implementation, the company does not expect a material impact on diluted and basic EPS. The implementation of the FSP is expected to decrease diluted EPS by \$0.01 for the third-quarter 2008 and by \$0.03 for the nine months ended September 30, 2008. Basic EPS is expected to decrease by \$0.01 for the third-quarter 2008 and by \$0.04 for the nine months ended September 30, 2008.

In March 2008, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities*-an amendment of FASB Statement No. 133. SFAS No. 161 expands the current disclosure requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, such that entities must now provide enhanced disclosures on a quarterly basis regarding how and why the entity uses derivatives; how derivatives and related hedged items are accounted for under SFAS No. 133 and how derivatives and related hedged items affect the entity's financial position, financial results and cash flow. Pursuant to the transition provisions of

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the Statement, the company will adopt SFAS No. 161 in fiscal year 2009 and will present the required disclosures in the prescribed format on a prospective basis. This Statement will not impact the consolidated financial results as it is disclosure-only in nature.

In February 2008, the FASB issued FSP Financial Accounting Standard (FAS) 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, and FSP FAS 157-2, Effective Date of FASB Statement No. 157. FSP FAS 157-1 removes leasing from the scope of SFAS No. 157, Fair Value Measurements. FSP FAS 157-2 delays the effective date of SFAS No. 157 from 2008 to 2009 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). In October 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active. FSP FAS 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 became effective immediately upon issuance, and its adoption did not have an effect on the Consolidated Financial Statements. See Note 6 on pages 13 and 14 for additional information regarding SFAS No. 157.

Table of Contents

Notes to Consolidated Financial Statements (continued)

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, which will become effective in 2009 via prospective application to business combinations. This Statement requires that the acquisition method of accounting be applied to a broader set of business combinations, amends the definition of a business combination, provides a definition of a business, requires an acquirer to recognize an acquired business at its fair value at the acquisition date and requires the assets and liabilities assumed in a business combination to be measured and recognized at their fair values as of the acquisition date (with limited exceptions). The company will adopt this Statement in fiscal year 2009 and its effects on future periods will depend on the nature and significance of business combinations subject to this statement.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. This Statement requires that the noncontrolling interest in the equity of a subsidiary be accounted for and reported as equity, provides revised guidance on the treatment of net income and losses attributable to the noncontrolling interest and changes in ownership interests in a subsidiary and requires additional disclosures that identify and distinguish between the interests of the controlling and noncontrolling owners. Pursuant to the transition provisions of SFAS No. 160, the company will adopt the Statement in fiscal year 2009 via retrospective application of the presentation and disclosure requirements. The company does not expect the adoption of this Statement to have a material effect on the Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*, which became effective January 1, 2008. SFAS No. 159 permits entities to measure 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 generally accepted accounting principles. The fair value measurement election is irrevocable and subsequent changes in fair value must be recorded in earnings. The company adopted this Statement as of January 1, 2008 but has not applied the fair value option to any eligible assets or liabilities. Thus, the adoption of this Statement did not affect the Consolidated Financial Statements.

In September 2006, the FASB finalized SFAS No. 157 which became effective January 1, 2008 except as amended by FSP FAS 157-1, FSP FAS 157-2 and FSP FAS 157-3 as previously described. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements; however, it does not require any new fair value measurements. The provisions of SFAS No. 157 were applied prospectively to fair value measurements and disclosures for financial assets and financial liabilities and nonfinancial assets and nonfinancial liabilities recognized or disclosed at fair value in the financial statements on at least an annual basis beginning in the first quarter of 2008. The adoption of this Statement did not have a material effect on the Consolidated Financial Statements for fair value measurements made during the nine months ended September 30, 2008. While the adoption of this Statement did not have a material impact on its Consolidated Financial Statements, the company continues to monitor any additional implementation guidance that is issued that addresses the fair value measurements for certain financial assets, such as private market pension plan assets, and nonfinancial assets and nonfinancial liabilities not disclosed at fair value in the financial statements on at least an annual basis. See Note 6 on pages 13 and 14 for additional information regarding the adoption of this Statement.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

3. Stockholders' Equity: The following table summarizes Net income plus gains and (losses) not affecting retained earnings (net of tax), a component of Stockholders' equity in the Consolidated Statement of Financial Position:

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|----------|---------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Net income | \$ 2,824 | \$ 2,361 | \$ 7,907 | \$ 6,466 |
| Gains and (losses) not affecting retained earnings (net of tax): | | | | |
| Foreign currency translation adjustments | (2,000) | 325 | (1,543) | 675 |
| Prior service costs, net gains/(losses) and transition assets/(obligations) | 128 | 252 | 404 | 722 |
| Net unrealized (losses)/gains on marketable securities (1) | (102) | 84 | (278) | 131 |
| Net unrealized gains/(losses) on cash flow hedge derivatives | 596 | (178) | 447 | (140) |
| Total net (losses) and gains not affecting retained earnings | (1,378) | 484 | (970) | 1,388 |
| Net income plus gains and (losses) not affecting retained earnings | \$ 1,446 | \$ 2,845 | \$ 6,938 | \$ 7,853 |

(1) Sale of Lenovo stock and mark-to-market adjustments of remaining Lenovo stock accounted for a loss of \$98 million and a \$87 million gain for third quarter of 2008 and 2007, and a loss of \$267 million and a gain of \$139 million in the first nine months of 2008 and 2007, respectively.

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

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|----------------------------------|--------|---------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Cost | \$ 29 | \$ 41 | \$ 88 | \$ 131 |
| Selling, general and administrative | 116 | 122 | 368 | 357 |
| Research, development and engineering | 15 | 15 | 44 | 52 |
| Other (income) and expense | | | | (1) |
| Pre-tax stock-based compensation cost | 160 | 177 | 501 | 539 |
| Income tax benefits | (58) | (45) | (168) | (188) |
| Total stock-based compensation cost | \$ 103 | \$ 132 | \$ 333 | \$ 351 |

The reduction in pre-tax stock-based compensation cost for the three months ended September 30, 2008, as compared to the corresponding period in the prior year, was principally the result of a reduction in the level of stock option grants (\$41 million), partially offset by an increase related to restricted and performance-based stock units (\$21 million). The reduction in pre-tax stock-based compensation cost for the nine months ended September 30, 2008, as compared to the corresponding period in the prior year, was principally the result of a reduction in the

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level of stock option grants (\$160 million), partially offset by an increase related to restricted and performance-based stock units (\$114 million). The effects on pre-tax stock-based compensation cost related to the formation of a joint venture based on the company's Printing Systems Division are included in Other (income) and expense above and in the Consolidated Statement of Earnings for the nine-months period ended September 30, 2007.

As of September 30, 2008, the total unrecognized compensation cost of \$1,159 million related to non-vested awards is expected to be recognized over a weighted-average period of approximately three years.

There were no significant capitalized stock-based compensation costs at September 30, 2008 and 2007.

For Restricted Stock Units (RSUs) awarded after December 31, 2007, dividend equivalents will not be 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.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

5. Retirement-Related Benefits: The company offers defined benefit pension plans, defined contribution pension plans, as well as nonpension postretirement plans primarily consisting of retiree medical benefits. The following tables provide the total retirement-related benefit plans' impact on income from continuing operations before income taxes.

| For the three months ended September 30: (Dollars in millions) | 2008 | | 2007 | | Yr. to Yr. Percent Change |
|---|-------------|------------|-------------|------------|--|
| Retirement-related plans cost: | | | | | |
| Defined benefit and contribution pension plans cost | \$ | 288 | \$ | 557 | (48.3)% |
| Nonpension postretirement plans cost | | 93 | | 97 | (4.0) |
| Total | \$ | 381 | \$ | 654 | (41.7)% |

| For the nine months ended September 30: (Dollars in millions) | 2008 | | 2007 | | Yr. to Yr. Percent Change |
|--|-------------|--------------|-------------|--------------|--|
| Retirement-related plans cost: | | | | | |
| Defined benefit and contribution pension plans cost | \$ | 939 | \$ | 1,631 | (42.4)% |
| Nonpension postretirement plans cost | | 278 | | 294 | (5.4) |
| Total | \$ | 1,217 | \$ | 1,925 | (36.8)% |

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

Cost/(Income) of Pension Plans

| For the three months ended September 30: (Dollars in millions) | U.S. Plans | | Non-U.S. Plans | |
|---|-------------------|-------------|-----------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ | 186 | \$ | 149 |
| Interest cost | 669 | 646 | 500 | 441 |
| Expected return on plan assets | (994) | (926) | (676) | (627) |
| Amortization of transition assets | | | | (1) |
| Amortization of prior service cost | | 15 | (32) | (30) |
| Recognized actuarial losses | 66 | 170 | 150 | 229 |
| Net periodic pension (income)/cost U.S. Plan and material non-U.S. Plans | (259)* | 91* | 78** | 161** |
| Cost of other defined benefit plans | 25 | 34 | 54 | 46 |
| Total net periodic pension (income)/cost for all defined benefit plans | (234) | 125 | 132 | 207 |
| Cost of defined contribution plans | 254 | 102 | 136 | 123 |
| | \$ | 20 | \$ | 330 |

Total retirement plan cost recognized in the
Consolidated Statement of Earnings

* Represents the qualified portion of the IBM Personal Pension Plan.

** Represents the qualified and non-qualified portion of material non-U.S. Plans.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

| For the nine months ended September 30: (Dollars in millions) | U.S. Plans | | Non-U.S. Plans | |
|---|------------|---------|----------------|---------|
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ | \$ 559 | \$ 413 | \$ 414 |
| Interest cost | 2,006 | 1,939 | 1,524 | 1,248 |
| Expected return on plan assets | (2,983) | (2,778) | (2,071) | (1,844) |
| Amortization of transition assets | | | | (2) |
| Amortization of prior service cost | | 45 | (100) | (92) |
| Recognized actuarial losses | 199 | 510 | 460 | 660 |
| Net periodic pension (income)/cost U.S. Plan and material non-U.S. Plans | (778)* | 275* | 225** | 384** |
| Cost of other defined benefit plans | 75 | 96 | 170 | 212 |
| Total net periodic pension (income)/cost for all defined benefit plans | (703) | 371 | 395 | 596 |
| Cost of defined contribution plans | 828 | 315 | 420 | 349 |
| Total retirement plan cost recognized in the Consolidated Statement of Earnings | \$ 125 | \$ 686 | \$ 814 | \$ 945 |

* Represents the qualified portion of the IBM Personal Pension Plan.

** Represents the qualified and non-qualified portion of material non-U.S. Plans.

In 2008, the company expects to contribute to its non-U.S. defined benefit plans approximately \$660 million, which is the legally mandated minimum contribution for its non-U.S. plans. Total contributions to the non-U.S. plans in the first nine months of 2008 were \$425 million.

On April 29, 2008, the IBM Board of Directors approved a pension adjustment for certain U.S. retirees and beneficiaries. Effective September 1, 2008, this adjustment provided a pension increase to approximately 42,000 retirees who retired before January 1, 1997. The impact of this adjustment will be included in the IBM Personal Pension Plan remeasurement at December 31, 2008, therefore, there will be no impact to 2008 net periodic pension cost.

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

Cost of Nonpension Postretirement Plans

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------|----------------------------------|-------|---------------------------------|-------|
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ 14 | \$ 16 | \$ 41 | \$ 50 |
| Interest cost | 78 | 78 | 234 | 233 |

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| | | | | |
|--|-------|-------|--------|--------|
| Amortization of prior service cost | (15) | (15) | (46) | (45) |
| Expected return on plan assets | (2) | | (6) | |
| Recognized actuarial losses | 2 | 4 | 7 | 16 |
| Net periodic post retirement plan cost U.S. Plan | 77 | 83 | 230 | 254 |
| Cost of non-U.S. Plans | 16 | 14 | 48 | 40 |
| Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings | \$ 93 | \$ 97 | \$ 278 | \$ 294 |

Table of Contents

Notes to Consolidated Financial Statements (continued)

The company received a \$13.7 million subsidy in the third quarter and \$33.9 million for the first nine months of 2008 in connection with the Medicare Prescription Drug Improvement and Modernization Act of 2003. A portion of this amount is used by the company to reduce its obligation and expense related to the plan, and the remainder is contributed to the plan to reduce contributions required by the participants. For further information related to the Medicare Prescription Drug Act, see page 115 in the company's 2007 Annual Report.

6. Fair Value: As highlighted in Note 2 on page 8, the company adopted the provisions of SFAS No. 157 as amended by FSP FAS 157-1 and FSP FAS 157-2 on January 1, 2008, and FSP FAS 157-3 on October 10, 2008. Pursuant to the provisions of FSP FAS 157-2, the company will not apply the provisions of SFAS No. 157 until January 1, 2009 for the following major categories of nonfinancial assets and liabilities from the Consolidated Statement of Financial Position: Plant, rental machines and other property-net; Goodwill; Intangible assets-net; and, the Asset retirement obligation liabilities within Other accrued expenses and liabilities and Other liabilities. The company recorded no change to its opening balance of Retained earnings as of January 1, 2008 as it did not have any financial instruments requiring retrospective application per the provisions of SFAS No. 157.

Fair Value Hierarchy

SFAS No. 157 specifies a hierarchy of valuation techniques based upon whether the inputs to those valuation techniques reflect assumptions other market participants would use based upon market data obtained from independent sources (observable inputs) or reflect the company's own assumptions of market participant valuation (unobservable inputs). In accordance with SFAS No. 157, these two types of inputs have created the following fair value hierarchy:

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

SFAS No. 157 requires the use of observable market data if such data is available without undue cost and effort.

Measurement of Fair Value

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The company measures fair value as an exit price using the procedures described below for all assets and liabilities measured at fair value. When available, the company uses unadjusted quoted market prices to measure 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, where possible, 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. Thus, an item may be classified in Level 3 even though there may be inputs that are readily observable. If quoted market prices are not available, the valuation model used generally depends on the specific asset or liability being valued. The determination of fair value considers various factors including interest rate yield curves and time value underlying the financial instruments. For derivatives and marketable debt securities, the company uses a discounted cash flow analysis using discount rates commensurate with the duration of the instrument. In the event of an other-than-temporary impairment of a nonpublic equity method investment, the company uses the net asset value of its investment in the investee adjusted using discounted cash flows for the company's estimate of the price that it would receive to sell the investment to a market participant that would consider all factors that would impact the investment's fair value. In determining the fair value of financial instruments, the company considers 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, where the base valuation uses market parameters based on an AA (or equivalent) credit rating. Due to the fact that not all counterparties have a AA (or equivalent) credit rating, it is necessary to take into account the actual credit rating of a counterparty to determine the true fair value of such an instrument.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

- 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.

Items Measured at Fair Value on a Recurring Basis

The following table presents the company's assets and liabilities that are measured at fair value on a recurring basis at September 30, 2008 consistent with the fair value hierarchy provisions of SFAS No. 157.

| (Dollars in millions) | Level 1 | Level 2 | Level 3 | Netting (1) | Total |
|-------------------------------|---------------|-----------------|-----------|-----------------|-----------------|
| Assets: | | | | | |
| Cash and cash equivalents | \$ 60 | \$ 6,555 | \$ | \$ | \$ 6,615 |
| Derivative assets (2) | 37 | 1,400 | | (452) | 985 |
| Investments and sundry assets | 250 | 1 | | | 251 |
| Total Assets | \$ 347 | \$ 7,956 | \$ | \$ (452) | \$ 7,851 |
| Liabilities: | | | | | |
| Derivative liabilities (3) | \$ | \$ 1,044 | \$ | \$ (452) | \$ 592 |
| Total Liabilities | \$ | \$ 1,044 | \$ | \$ (452) | \$ 592 |

- (1) Represents netting of derivative exposures covered by a qualifying master netting agreement in accordance with FASB Interpretation No. 39, "Offsetting of Amounts Relating to Certain Contracts," and credit risk adjustments, if material.
- (2) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at September 30, 2008 are \$941 million and \$496 million, respectively.
- (3) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at September 30, 2008 are \$734 million and \$309 million, respectively.

At September 30, 2008, the company did not have any assets or liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

Items Measured at Fair Value on a Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis and therefore are not included in the table above. These assets include equity method investments that are recognized at fair value at the end of the period to the extent that they are deemed to be other-than-temporarily impaired. Certain assets that are measured at fair value on a recurring basis and are included in the table above can also be subject to

nonrecurring fair value measurements. These assets include public cost method investments that are deemed to be other-than-temporarily impaired. The company did not record any other-than-temporary impairment charges for these assets during the first nine months of 2008.

7. Accelerated Share Repurchase: In May 2007, IBM International Group (IIG), a wholly-owned foreign subsidiary of the company repurchased 118.8 million shares of common stock for \$12.5 billion under accelerated share repurchase (ASR) agreements with three banks.

Pursuant to the ASR agreements, executed on May 25, 2007, IIG paid an initial purchase price of \$105.18 per share for the repurchase. The initial purchase price was subject to adjustment based on the volume weighted average price of IBM common stock over a settlement period of three months for each of the banks. The adjustment also reflected certain other amounts including the banks' carrying costs, compensation for ordinary dividends declared by the company during the settlement period and interest benefits for receiving the \$12.5 billion payment in advance of the anticipated purchases by each bank of shares in the open market during its settlement period. The adjustment amount could be settled in cash, registered shares or unregistered shares at IIG's option. Under the ASR, IIG had a separate settlement with each of the three banks. The first settlement occurred on September 6, 2007, resulting in a settlement payment to the bank of \$151.8 million. The second settlement occurred on December 5, 2007, resulting in a settlement payment to the bank of \$253.1 million. The third settlement occurred on March 4, 2008, resulting in a settlement payment to the company of \$54.2 million. The settlement amounts were paid in cash at the election of IIG in accordance with the provisions of the ASR and were recorded as adjustments to Stockholders equity in the Consolidated Statement of Financial Position on the settlement dates. The adjusted average price paid per share during the ASR period was \$108.13, resulting in a total purchase price of \$12,851 million versus the original \$12,500 million. The \$351 million difference was settled in cash.

Table of Contents

Notes to Consolidated Financial Statements (continued)

8. Acquisitions: During the nine months ended September 30, 2008, the company completed 13 acquisitions at an aggregate cost of \$6,451 million. The Cognos, Inc. and Telelogic, AB acquisitions are shown separately given their significant purchase prices.

Cognos, Inc. (Cognos) On January 31, 2008, the company acquired 100 percent of the outstanding common shares of Cognos for consideration of \$5,021 million consisting of \$4,998 million of cash and \$24 million of equity instruments. Through this acquisition, IBM and Cognos will become a leading provider of technology and services for business intelligence and performance management, delivering the industry's most complete, open standards-based platform with the broadest range of expertise to help companies expand the value of their information, optimize their business processes and maximize performance across their enterprises. The company acquired Cognos to accelerate its Information on Demand strategy, a cross-company initiative that combines the company's strength in information integration, content and data management and business consulting services to unlock the business value of information. Cognos was integrated into the Software segment upon acquisition, and goodwill, as reflected in the table on page 16 has been entirely assigned to the Software segment. It is expected that 20-30 percent of the goodwill will be deductible for tax purposes. The overall weighted average useful life of the intangible assets acquired, excluding goodwill, is 6.5 years.

Telelogic, AB (Telelogic) On April 3, 2008, IBM acquired 100 percent of the outstanding common shares of Telelogic for cash consideration of \$885 million. Telelogic is a leading global provider of solutions for automating and supporting best practices across the enterprise from powerful modeling of business processes and enterprise architectures to requirements-driven development of advanced systems and software. Telelogic's solutions enable organizations to align product, systems and software development lifecycles with business objectives and customer needs to dramatically improve quality and predictability, while significantly reducing time-to-market and overall costs. Clients will benefit from the combined technologies and services of both companies, providing them a wider range of software and system development capabilities used to build complex systems. Telelogic was integrated into the Software segment upon acquisition, and goodwill, as reflected in the table on page 16 has been entirely assigned to the Software segment. None of the goodwill will be deductible for tax purposes. The overall weighted average useful life of the intangible assets acquired, excluding goodwill, is 7.0 years.

Other Acquisitions The company acquired 11 additional companies at an aggregate cost of \$544 million that are presented in the table on page 16 as Other Acquisitions.

The Software segment completed seven other acquisitions, all privately held companies: in the first quarter; AptSoft Corporation, Solid Information Technology, Net Integration Technologies Inc., and Encentuate, Inc; in the second quarter; Infodyne, Beijing Super Info and FilesX.

Global Technology Services (GTS) completed one acquisition in the first quarter: Arsenal Digital Solutions, a privately held company. Arsenal provides global clients with security rich information protection services designed to handle increasing data retention requirements.

Global Business Services (GBS) completed one acquisition in the first quarter: u9consult, a privately held company. u9consult complements the company's existing capabilities in value chain consulting.

Systems and Technology completed two acquisitions in the second quarter: Diligent Technologies Corporation and Platform Solutions, Inc (PSI), both privately held companies. Diligent will be an important component of IBM's New Enterprise Data Center model, which helps clients improve IT efficiency and facilitates the rapid deployment of new IT services for future business growth. PSI's technologies and skills, along with its intellectual capital, will be integrated into the company's mainframe product engineering cycles and future product plans. In the second quarter, \$24 million of the purchase price of PSI was attributed to the fair value of a dismissed claim from a preexisting lawsuit between IBM and PSI and recorded in SG&A expense. See note 14 on page 20 for additional information regarding this litigation. Also, the company recorded a \$24 million In-Process Research and Development (IPR&D) charge related to this acquisition in the second quarter.

Purchase price consideration for the Other Acquisitions was paid all in cash. All acquisitions are reported in the Consolidated Statement of Cash Flows net of acquired cash and cash equivalents.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

The table below reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of September 30, 2008.

| (Dollars in millions) | Amortization Life (yrs.) | Cognos* | Telelogic* | Other Acquisitions* |
|--------------------------------------|-----------------------------|----------|------------|------------------------|
| Current assets | | \$ 506 | \$ 238 | \$ 35 |
| Fixed assets/noncurrent | | 125 | 11 | 16 |
| Intangible assets: | | | | |
| Goodwill | N/A | 4,189 | 663 | 444 |
| Completed technology | 3 7 | 534 | 108 | 47 |
| Client relationships | 3 7 | 512 | 127 | 11 |
| IPR&D | N/A | | | 24 |
| Other | 3 7 | 78 | 15 | 20 |
| Total assets acquired | | 5,944 | 1,162 | 597 |
| Current liabilities | | (797) | (222) | (65) |
| Noncurrent liabilities | | (126) | (54) | (13) |
| Total liabilities assumed | | (923) | (277) | (77) |
| Settlement of preexisting litigation | | | | 24 |
| Total purchase price | | \$ 5,021 | \$ 885 | \$ 544 |

* Purchase price allocation at September 30, 2008 reflects immaterial adjustments from the June 30, 2008 balances.

The acquisitions were accounted for as purchase transactions, and accordingly, the assets and liabilities of the acquired entities were recorded at their estimated fair values at the date of acquisition. The primary items that generated the goodwill are the value of the synergies between the acquired companies and IBM and the acquired assembled workforce, neither of which qualify as an amortizable intangible asset. For the Other Acquisitions, the overall weighted-average life of the identified amortizable intangible assets acquired is 5.0 years. With the exception of goodwill, these identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$444 million has been assigned to the Software (\$122 million), Global Technology Services (\$84 million) and Systems and Technology (\$239 million) segments. Substantially, all of the goodwill related to Other Acquisitions is not deductible for tax purposes.

On July 28, 2008, the company announced it signed a memorandum of understanding to launch a tender offer to acquire ILOG, a publicly held company. ILOG will add business rules management, optimization and visualization technology to the software portfolio. The estimated purchase price is approximately \$333 million. This offer is subject to approval from ILOG shareholders and all necessary regulatory clearances.

9. Printing Systems Divestiture: In January 2007, the company announced an agreement with Ricoh Company Limited (Rico), a publicly traded company, to form a joint venture company based on IBM's Printing System Division (a division of the Systems and Technology segment). The company initially created a wholly-owned subsidiary, InfoPrint Solutions Company, LLC (InfoPrint), by contributing specific assets and liabilities from its printer business. The Printing System Division generated approximately \$1 billion of revenue in 2006. The InfoPrint portfolio includes solutions for production printing for enterprises and commercial printers as well as solutions for office workgroup environments and industrial segments. On June 1, 2007 (closing date), the company divested 51 percent of its interest

in InfoPrint to Ricoh. The company will divest its remaining ownership to Ricoh quarterly over a three year period from the closing date. At September 30, 2008, the company's ownership in InfoPrint was 28.5 percent. See IBM's 2007 Annual Report, Note C, Acquisitions/Divestitures, for additional information.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

10. Intangible Assets Including Goodwill: The following schedule details the company's intangible asset balances by major asset class:

| (Dollars in millions) Intangible asset class | At September 30, 2008 | | |
|---|-----------------------|--------------------------|---------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Capitalized software | \$ 1,905 | \$ (850) | \$ 1,055 |
| Client-related | 1,597 | (621) | 976 |
| Completed technology | 1,133 | (281) | 851 |
| Patents/Trademarks | 193 | (65) | 128 |
| Other(1) | 167 | (128) | 39 |
| Total | \$ 4,995 | \$ (1,946) | \$ 3,048 |

| (Dollars in millions) Intangible asset class | At December 31, 2007 | | |
|---|-----------------------|--------------------------|---------------------|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Capitalized software | \$ 1,926 | \$ (826) | \$ 1,100 |
| Client-related | 1,054 | (495) | 559 |
| Completed technology | 536 | (194) | 342 |
| Strategic alliances | 103 | (103) | |
| Patents/Trademarks | 128 | (61) | 67 |
| Other(1) | 154 | (115) | 39 |
| Total | \$ 3,901 | \$ (1,794) | \$ 2,107 |

(1) Other intangibles are primarily acquired proprietary and non-proprietary business processes, methodologies and systems and impacts from currency translation.

The net carrying amount of intangible assets increased \$941 million during the first nine months of 2008, primarily due to acquired intangible assets and capitalized software additions, partially offset by amortization. The aggregate intangible asset amortization expense was \$331 million and \$985 million for the third quarter and first nine months of 2008, respectively, versus \$295 million and \$875 million for the third quarter and first nine months ended September 30, 2007, respectively. In addition, in the first nine months of 2008, the company retired \$818 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 September 30, 2008:

| (Dollars in millions) | Capitalized Software | Acquired Intangibles | Total |
|-----------------------|----------------------|----------------------|--------|
| 2008 (for Q4) | \$ 194 | \$ 134 | \$ 328 |
| 2009 | 568 | 490 | 1,058 |
| 2010 | 248 | 402 | 650 |

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| | | | |
|------|----|-----|-----|
| 2011 | 45 | 349 | 394 |
| 2012 | | 283 | 283 |

Table of Contents**Notes to Consolidated Financial Statements (continued)**

The changes in the goodwill balances by reportable segment, for the nine months ended September 30, 2008, are as follows:

| (Dollars in millions) Segment | Balance 12/31/07 | Goodwill Additions | Purchase Price Adjustments | Divestitures | Foreign Currency Translation And Other Adjustments | Balance 9/30/08 |
|----------------------------------|---------------------|-----------------------|----------------------------------|--------------|--|--------------------|
| Global Business Services | \$ 4,041 | \$ | \$ (1) | \$ (16) | \$ (106) | \$ 3,920 |
| Global Technology Services | 2,914 | 84 | (3) | | (146) | 2,846 |
| Systems and Technology | 484 | 239 | 9 | | (1) | 731 |
| Software | 6,846 | 4,973 | (71) | | (384) | 11,363 |
| Global Financing | | | | | | |
| Total | \$ 14,285 | \$ 5,295 | \$ (67) | \$ (16) | \$ (636) | \$ 18,861 |

There were no goodwill impairment losses recorded during the first nine months of 2008.

11. Financing Receivables: The following table presents financing receivables, net of allowances for doubtful accounts, including residual values.

| (Dollars in millions) | At September 30, 2008 | At December 31, 2007 |
|-------------------------------------|--------------------------|-------------------------|
| Current: | | |
| Net investment in sales-type leases | \$ 4,354 | \$ 4,746 |
| Commercial financing receivables | 4,507 | 6,263 |
| Client loans receivables | 4,518 | 4,652 |
| Installment payment receivables | 534 | 629 |
| Total | \$ 13,912 | \$ 16,289 |
| Noncurrent: | | |
| Net investment in sales-type leases | \$ 5,860 | \$ 6,085 |
| Commercial financing receivables | 98 | 113 |
| Client loans receivables | 4,483 | 4,931 |
| Installment payment receivables | 415 | 474 |
| Total | \$ 10,855 | \$ 11,603 |

Net investment in sales-type leases is for leases that relate principally to the company's equipment and are for terms ranging from two to seven years. Net investment in sales-type leases includes unguaranteed residual values of \$916 million and \$915 million at September 30, 2008 and December 31, 2007, respectively, and is reflected net of unearned income of \$1,040 million and \$1,016 million and of allowance for uncollectible accounts of \$161 million and \$127 million at those dates, respectively.

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

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

The company utilizes certain of its financing receivables as collateral for non-recourse borrowings. Financing receivables pledged as collateral for borrowings were \$358 million and \$258 million at September 30, 2008 and December 31, 2007, respectively.

The company did not have any financing receivables held for sale as of September 30, 2008 and December 31, 2007.

Table of Contents**Notes to Consolidated Financial Statements (continued)**

12. Segments: The tables on pages 65 and 66 of this Form 10-Q reflect the results of the company's reportable segments consistent with the management system used by the company's chief operating decision maker. These results are not necessarily a depiction that is in conformity with GAAP. For example, employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments based on headcount. Different results could occur if actuarial assumptions that are unique to each segment were used. Segment performance measurement is based on income before income taxes (pre-tax income). These results are used, in part, by management, both in evaluating the performance of, and in allocating resources to, each of the segments.

13. Restructuring-Related Liabilities: The following table provides a rollforward of the current and noncurrent liability balances for actions taken in the following periods: (1) the second-quarter of 2005; (2) the fourth-quarter 2002 actions associated with the acquisition of the PricewaterhouseCoopers consulting business; (3) the second-quarter 2002 actions associated with the Microelectronics Division and the rebalancing of both the company's workforce and leased space resources; (4) the 2002 actions associated with the hard disk drive (HDD) business for reductions in workforce, manufacturing capacity and space; (5) actions taken in 1999; and (6) actions that took place prior to 1994. See the company's 2007 Annual Report, Note Q on pages 99 and 100 for additional information on the actions taken in 2005.

| (Dollars in millions) | Liability as of 12/31/2007 | Payments | Other adjustments* | Liability as of 9/30/2008 |
|-------------------------|----------------------------------|-----------------|-----------------------|---------------------------------|
| Current: | | | | |
| Workforce | \$ 130 | \$ (100) | \$ 45 | \$ 75 |
| Space | 30 | (39) | 39 | 30 |
| Other | 7 | | | 7 |
| Total Current | \$ 167 | \$ (139) | \$ 84 | \$ 112 |
| Noncurrent: | | | | |
| Workforce | \$ 557 | \$ | (47) | \$ 510 |
| Space | 74 | | (39) | 35 |
| Total Noncurrent | \$ 631 | \$ | (87) | \$ 544 |

* The other adjustments column in the table above principally includes the reclassification of noncurrent to current, foreign currency translation adjustments and interest accretion.

14. Contingencies: The company is involved in a variety of claims, demands, suits, investigations and proceedings that arise from time to time in the ordinary course of its business, including actions with respect to contracts, intellectual property (IP), product liability, employment, benefits, securities, foreign operations and environmental matters. These actions may be commenced by a number of different parties, including competitors, partners, clients, current or former employees, government and regulatory agencies, stockholders and representatives of the locations in which the company does business.

The following is a summary of some 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. The company has asserted counterclaims, including breach of contract, violation of the Lanham Act, unfair competition, intentional torts, unfair and deceptive trade practices, breach of the General Public License that governs open source distributions, promissory estoppel and copyright infringement. In October 2005, the company withdrew its patent counterclaims in an effort to simplify and focus the issues in the case and to expedite their resolution. Motions for summary judgment were heard in March 2007, and the court has not yet issued its decision. On August 10, 2007, the court in another suit, The SCO Group, Inc. v. Novell, Inc., issued a decision and order determining, among other things, that Novell is the owner of UNIX and UnixWare copyrights, and obligating SCO to recognize Novell's waiver of SCO's claims against IBM and Sequent for breach of UNIX license agreements. At the request of the court in SCO v. IBM, on August 31, 2007, each of the parties filed a status report with the court concerning the effect of the August 10th Novell ruling on the SCO v. IBM case, including the pending motions. On September 14, 2007, plaintiff filed for bankruptcy protection, and all proceedings in this case were stayed.

Table of Contents

Notes to Consolidated Financial Statements (continued)

On November 29, 2006, the company filed a lawsuit against Platform Solutions, Inc. (PSI) in the United States District Court for the Southern District of New York. IBM filed its amended complaint on August 17, 2007 and asserted claims for patent infringement, trade secret misappropriation, copyright infringement, tortious interference and breach of contract in connection with PSI's development and marketing of a computer system that PSI says is compatible with IBM's S/390 and System z architectures. IBM also sought a declaratory judgment that its refusal to license its patents to PSI and certain of its software for use on PSI systems does not violate the antitrust laws. IBM seeks damages and injunctive relief. On September 21, 2007, PSI answered the amended complaint and asserted counterclaims against IBM for alleged monopolization and attempted monopolization, tying, violations of New York and California statutes proscribing unfair competition, tortious interference with the acquisition of PSI by a third party and promissory estoppel. PSI also sought declaratory judgments of noninfringement of IBM's patents and patent invalidity. In October 2007, PSI filed a complaint with the European Commission claiming that the company's alleged refusal to do business with PSI violated European competition law. The company responded to this complaint in December. On January 11, 2008, the court in the New York lawsuit permitted T3 Technologies, a reseller of PSI computer systems, to intervene as a counterclaim-plaintiff, and the court also permitted the company to file a second amended complaint adding patent infringement claims against T3. On June 30, 2008, IBM acquired PSI. As a result of this transaction, IBM and PSI dismissed all claims against each other. Litigation between the company and T3 continues.

In October 2003, a purported collective action lawsuit was filed against IBM in the United States District Court for the Northern District of California by 10 former IBM employees alleging, on behalf of themselves and allegedly similarly situated former employees, that the company engaged in a pattern and practice of discriminating against employees on the basis of age when it terminated employees, both in connection with reductions in force and individualized determinations (*Syverson v. IBM*). Initially, the District Court dismissed the lawsuit on the basis of release agreements signed by all the plaintiffs. On appeal, the Ninth Circuit reversed the trial court's finding that the release barred these claims, and in January 2007, after denial of IBM's petition for rehearing, the matter was returned to the trial court for further proceedings. On October 3, 2007, the court dismissed with prejudice plaintiffs' claim for relief under the Older Workers Benefit Protection Act, and dismissed with leave to amend plaintiffs' claim asserting disparate impact age discrimination with respect to individualized terminations. On November 6, 2007, plaintiffs filed a Third Amended Complaint, amending the disparate impact claim. IBM filed its answer on November 26, 2007, and discovery is proceeding.

In July 2005, two lawsuits were filed in the United States District Court for the Southern District of New York related to the company's disclosures concerning first-quarter 2005 earnings and the expensing of equity compensation. Pursuant to an Order from the Court dated March 28, 2006, the two lawsuits were consolidated into a single action captioned *In re International Business Machines Corp. Securities Litigation*. Plaintiffs filed a corrected consolidated amended complaint dated May 19, 2006, in which they named the company and IBM's Senior Vice President and Chief Financial Officer as defendants and alleged that defendants made certain misrepresentations and omissions in violation of Section 10(b), and Rule 10b-5 thereunder, and Section 20(a) of the Securities Exchange Act of 1934. On September 20, 2006, the Court denied a Motion to Dismiss that was filed by IBM. On March 12, 2007, the plaintiffs' class was certified; class notifications were mailed on or about May 30, 2007. On May 30, 2008, the Court granted preliminary approval of a settlement of this action. On September 9, 2008, the court granted final approval of the settlement. Class members did not file an appeal of the court's judgment prior to the deadline. Therefore, the judgment is final.

In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid-rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG Electronics, which has since been dissolved, effective January, 2005) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Debarment orders were imposed at different times, covering a period of no more than a year from the date of issuance, which barred IBM Korea from doing business directly with certain government-controlled entities in Korea. All debarment orders have since expired and when they were in force did not prohibit IBM Korea from selling products and services to business partners who sold to

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government-controlled entities in Korea. In addition, the U.S. Department of Justice and the SEC have both contacted the company in connection with this matter. In March 2008, the company received a request from the SEC for additional information.

Table of Contents

Notes to Consolidated Financial Statements (continued)

On March 27, 2008, the company was temporarily suspended from participating in new business with U.S. Federal government agencies. The notice of temporary suspension was issued by the Environmental Protection Agency (EPA) and related to an investigation by the EPA of possible violations of the Procurement Integrity provisions of the Office of Federal Procurement Policy Act regarding a specific bid for business with the EPA originally submitted in March 2006. In addition, the U.S. Attorney's Office for the Eastern District of Virginia served the company and certain employees with grand jury subpoenas related to the bid, requesting testimony and documents regarding interactions between employees of the EPA and certain company employees. On April 4, 2008, the company announced an agreement with the EPA that terminated the temporary suspension order. The company is cooperating with the EPA and with the U.S. Attorney's Office for the Eastern District of Virginia.

The company is a defendant in a civil lawsuit brought in Tokyo District Court by Tokyo Leasing Co., Ltd., which seeks to recover losses that it allegedly suffered after IXI Co., Ltd. initiated civil rehabilitation (bankruptcy) proceedings in Japan and apparently failed to pay Tokyo Leasing amounts for which Tokyo Leasing now seeks to hold IBM and others liable. The claims in this suit include tort and breach of contract.

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 authorities regarding non-income tax assessments and non-income tax litigation matters. These matters principally relate to claims for taxes on the importation of computer software. The total amounts related to these matters are approximately \$2.3 billion, including amounts currently in litigation and other amounts. In addition, the company has received an income tax assessment from Mexican authorities relating to the deductibility of certain warranty payments. In response, the company has filed an appeal in the Mexican Federal Fiscal court. The total potential amount related to this matter for all applicable years is approximately \$550 million. The company believes it will prevail on these matters and that these amounts are not meaningful indicators of liability.

In accordance with SFAS No. 5, Accounting for Contingencies, (SFAS No. 5), the company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and proceedings are reviewed at least quarterly and provisions are taken or adjusted to reflect the impact and status of settlements, rulings,

advice of counsel and other information pertinent to a particular matter. Any recorded liabilities including any changes to such liabilities for the quarter ended September 30, 2008, were not material to the Consolidated Financial Statements. Based on its experience, the company believes that the damage amounts claimed in the matters previously referred to are not a meaningful indicator of the potential liability. Claims, suits, investigations and proceedings are inherently uncertain and it is not possible to predict the ultimate outcome of the matters previously discussed. While the company will continue to defend itself vigorously in all such matters, 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.

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

15. Commitments: The company's extended lines of credit to third-party entities include unused amounts of \$4,643 million and \$3,702 million at September 30, 2008 and December 31, 2007, 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 \$4,187 million and \$3,654 million at September 30, 2008 and December 31, 2007, respectively.

The company has applied the disclosure provisions of FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, to its agreements that contain guarantee or indemnification clauses. These disclosure provisions expand those required by SFAS No. 5, by requiring a guarantor to disclose certain types of guarantees, even if the likelihood of requiring the guarantor's performance is remote. The following is a description of arrangements in which the company is the guarantor.

The company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts entered into by the company, under which the company customarily agrees to hold the party harmless against losses arising from a breach of representations and covenants related to such matters as title to the assets sold, certain intellectual property (IP) rights, specified environmental matters, third-party performance of non-financial contractual obligations and certain income taxes. In each of these circumstances, payment by the company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party's claims. Further, the company's obligations under these agreements may be limited in terms of time and/or amount, 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 \$23 million at September 30, 2008 and December 31, 2007, respectively. The fair value of the guarantees recognized in the Consolidated Statement of Financial Position is not material.

The company offers warranties for its hardware products that 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. Revenue

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

Standard Warranty Liability

| (Dollars in millions) | 2008 | | 2007 | |
|--|------|-------|------|-------|
| Balance at January 1 | \$ | 412 | \$ | 582 |
| Current period accruals | | 294 | | 331 |
| Accrual adjustments to reflect actual experience | | 37 | | (23) |
| Charges incurred | | (373) | | (478) |
| Balance at September 30 | \$ | 370 | \$ | 412 |

The decrease in the balance was primarily driven by a reduction in estimated future cost as a result of the divestiture of the Personal Computing business to Lenovo Group Limited (Lenovo) in April 2005.

Table of Contents**Notes to Consolidated Financial Statements (continued)****Extended Warranty Liability**

| (Dollars in millions) | 2008 | 2007 |
|--|--------|--------|
| Aggregate deferred revenue at January 1 | \$ 409 | \$ 131 |
| Revenue deferred for new extended warranty contracts | 230 | 206 |
| Amortization of deferred revenue | (87) | (51) |
| Other (a) | (15) | 5 |
| Aggregate deferred revenue at September 30 | \$ 536 | \$ 291 |
| Current | \$ 249 | \$ 116 |
| Noncurrent | 287 | 175 |
| Aggregate deferred revenue at September 30 | \$ 536 | \$ 291 |

(a) Other primarily consists of foreign currency translation adjustments.

16. Subsequent Events: On October 28, 2008, the company announced that the Board of Directors approved a quarterly dividend of \$0.50 per common share. The dividend is payable December 10, 2008 to stockholders of record on November 10, 2008.

On October 15, 2008, the company issued \$4.0 billion of 5, 10 and 30 year bonds. See Debt on page 48 for additional information.

Table of Contents

Item 2.

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008***

Snapshot

(Dollars in millions except per share amounts)

| Three months ended September 30: | 2008 | 2007 | Yr. To Yr. Percent/ Margin Change |
|---|-----------|-----------|--|
| Revenue | \$ 25,302 | \$ 24,119 | 4.9%** |
| Gross profit margin | 43.3% | 41.3% | 2.0pts. |
| Total expense and other income | \$ 7,064 | \$ 6,676 | 5.8% |
| Total expense and other income to revenue ratio | 27.9% | 27.7% | 0.2pts. |
| Provision for income taxes | \$ 1,071 | \$ 918 | 16.6% |
| Income from continuing operations | \$ 2,824 | \$ 2,362 | 19.6% |
| Net income | \$ 2,824 | \$ 2,361 | 19.6% |
| Net income margin | 11.2% | 9.8% | 1.4pts. |
| Earnings per share from continuing operations: | | | |
| Assuming dilution | \$ 2.05 | \$ 1.68 | 22.0% |
| Basic | \$ 2.09 | \$ 1.72 | 21.5% |
| Weighted average shares outstanding: | | | |
| Assuming dilution | 1,379.1 | 1,405.8 | (1.9)% |
| Basic | 1,350.7 | 1,371.4 | (1.5)% |

* The following Results of Continuing Operations discussion does not include the hard disk drive (HDD) business that the company sold to Hitachi, Ltd. on December 31, 2002. The HDD business was accounted for as a discontinued operation under generally accepted accounting principles. There were no losses from Discontinued Operations in the third quarter and first nine months of 2008 and a \$1 million loss in the third quarter and the first nine months of 2007.

** 1.7 percent adjusted for currency

Within the Management Discussion, selected references to adjusted for currency or at constant currency are made so that the financial results can be viewed without the impact of fluctuations in foreign currency exchange rates, thereby facilitating period-to-period comparisons of the company's business performance.

In the third quarter, in a challenging economic environment, the company delivered solid financial results. Total revenue increased 4.9 percent as reported, 1.7 percent adjusted for currency, versus the third quarter of 2007. Pre-tax income from continuing operations was \$3,895 million, up

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18.7 percent compared to the prior year. Diluted earnings per share from continuing operations was \$2.05, an increase of 22.0 percent year to year.

The company has been executing a strategy that has two major elements. In the emerging markets, the company continues to invest to capture opportunities created from the build out of the public and private infrastructures in these economies. In the more established markets, the company has been focused on driving productivity and improving efficiency while delivering transformational solutions that provide high value to its clients.

The company's focus on productivity has yielded a more efficient cost and expense structure. The company benefited from these structural changes in the third quarter delivering improved margins while revenue growth slowed in major markets.

In addition, the company's solid base of annuity businesses provide a good revenue foundation and a steady source of profit and cash. The company has built these businesses over many years and they provide the company with advantages in the current economic environment.

The company's balance sheet and liquidity positions remain strong. At September 30, 2008, cash on hand was approximately \$10 billion; in addition, the company issued \$4 billion in long-term debt on October 15, 2008 and continues to have access to a \$10 billion global credit facility.

Table of Contents

The company's third quarter financial results demonstrate that the combination of a solid annuity base, investments for growth in emerging markets, a continued focus on productivity, a range of products and services that deliver value to clients and a strong balance sheet and liquidity position enable the company to be well positioned in the current environment.

Total geographic revenue increased 6.0 percent (3 percent adjusted for currency) compared to the third quarter of 2007. Americas revenue increased 2.9 percent (2 percent adjusted for currency), Europe increased 10.1 percent (4 percent adjusted for currency) and Asia Pacific increased 5.8 percent (1 percent adjusted for currency). In the more established countries, which the company manages through its major markets organization, U.S. revenue growth was 1 percent and Canada increased 6 percent, adjusted for currency. In Europe, revenue adjusted for currency, increased 8 percent in Spain, 3 percent in the U.K. and 2 percent in Germany, France and Italy, respectively. Japan revenue, adjusted for currency, decreased 5 percent.

The company focuses on the emerging markets through its new growth markets organization. These countries represented 19 percent of the company's geographic revenue in the quarter and grew 12.7 percent (10 percent adjusted for currency). A subset of these countries, Brazil, Russia, India and China, together grew 18.7 percent (12 percent adjusted for currency). The increase was driven by double-digit growth in India of 23.7 percent (33 percent adjusted for currency), Brazil 27.9 percent (13 percent adjusted for currency) and Russia 51.4 percent (51 percent adjusted for currency).

On a segment basis, Software had the best revenue growth (11.8 percent), leveraging a strong annuity base and acquisitions. Global Technology Services revenue increased 8.5 percent, while Global Business Services revenue improved by 6.8 percent versus the third quarter of 2007, both driven by good short-term signings performance. Systems and Technology revenue decreased 9.5 percent, as this segment was most impacted by a slowdown in transactions at the end of the quarter. Total Systems revenue declined 6.5 percent in the third quarter, with growth in System z and converged System p partially offset by declines in System x and legacy System i. Global Financing revenue increased 1.7 percent reflecting an improvement in financing revenue of 6.1 percent, offset by a decline in used equipment sales.

The gross profit margin was 43.3 percent, an increase of 2.0 points, primarily due to improved margins in Global Business Services (0.9 points of the increase), Global Technology Services (0.8 points of the increase) and improved segment revenue mix (0.4 points of the increase) driven by Software. These improvements were partially offset by a lower margin in Systems and Technology which impacted the overall margin by 0.4 points.

Total expense and other income increased 5.8 percent (2 percent adjusted for currency) for the third quarter of 2008 versus the third quarter of 2007. Overall, the increase was driven by approximately 4 points due to the effects of currency and 5 points due to acquisitions, with operational expense improving year to year.

The company's effective tax rate for the third quarter of 2008 was 27.5 percent versus 28.0 percent in the third quarter of 2007.

The company generated \$3,738 million in cash flow provided by operating activities, a decrease of \$746 million, compared to the third quarter of 2007, primarily driven by changes in operating assets and liabilities (\$996 million), partially offset by increased net income (\$462 million). Net cash used in investing activities of \$1,496 million was \$1,708 million lower than the third quarter of 2007, primarily due to net impact of purchases and sales of marketable securities and other investments (\$1,002 million) and acquisitions (\$351 million). Net cash used in financing

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activities of \$1,881 million was \$2,770 million higher, primarily due to increased common stock repurchases (\$2,522 million) in the third quarter of 2008 versus the third quarter of 2007.

In the third-quarter 2008, total Global Services signings decreased 4 percent year to year to \$12,675 million (\$11,124 million adjusted for currency, down 5 percent). Short-term signings were \$6,097 million, an increase of 13 percent year to year (8 percent adjusted for currency). Long-term signings were \$6,578 million, a decrease of 16 percent (15 percent adjusted for currency). The estimated Global Services backlog, at constant currency, was \$114 billion at September 30, 2008, down \$2 billion versus the June 30, 2008 balance and down \$2 billion versus the September 30, 2007 balance.

Table of Contents

(Dollars in millions except per share amounts)

| Nine months ended September 30: | 2008 | | 2007 | | Yr. To Yr. Percent/ Margin Change |
|---|------|---------|------|----------|--|
| Revenue | \$ | 76,623 | \$ | 69,920 | 9.6%** |
| Gross profit margin | | 42.7% | | 41.1% | 1.6pts. |
| Total expense and other income | \$ | 21,818 | \$ | 19,759 | 10.4% |
| Total expense and other income to revenue ratio | | 28.5% | | 28.3% | 0.2pts. |
| Provision for income taxes | \$ | 2,999 | \$ | 2,534 | 18.4% |
| Income from continuing operations | \$ | 7,907 | \$ | 6,467 | 22.3% |
| Net income | \$ | 7,907 | \$ | 6,466 | 22.3% |
| Net income margin | | 10.3% | | 9.2% | 1.1pts. |
| Earnings per share from continuing operations: | | | | | |
| Assuming dilution | \$ | 5.68 | \$ | 4.42 | 28.5% |
| Basic | \$ | 5.79 | \$ | 4.50 | 28.7% |
| Weighted average shares outstanding: | | | | | |
| Assuming dilution | | 1,393.1 | | 1,463.1 | (4.8)% |
| Basic | | 1,366.7 | | 1,436.0 | (4.8)% |
| | | | | | |
| | | 9/30/08 | | 12/31/07 | |
| Assets | \$ | 115,910 | \$ | 120,431 | (3.8)% |
| Liabilities | \$ | 88,391 | \$ | 91,962 | (3.9)% |
| Equity | \$ | 27,519 | \$ | 28,470 | (3.3)% |

** 3.7 percent adjusted for currency

For the first nine months of 2008, total revenue increased 9.6 percent as reported, 3.7 percent adjusted for currency, versus the prior year. Pre-tax income from continuing operations was \$10,907 million, a 21.2 percent increase compared to the first nine months of 2007. Diluted earnings per share from continuing operations was \$5.68, reflecting a 28.5 percent improvement year to year.

Americas revenue increased 6.5 percent (5 percent adjusted for currency), Europe increased 15.2 percent (5 percent adjusted for currency) and Asia Pacific increased 11.8 percent (3 percent adjusted for currency) in the first nine months of 2008. In the established countries, U.S. revenue growth was 4 percent and Canada increased 6 percent, adjusted for currency. In Europe, revenue adjusted for currency, increased 9 percent in Spain, 4 percent in the U.K., 3 percent in Italy, 2 percent in France and 2 percent in Germany. Japan revenue decreased 3 percent adjusted for currency year to year.

Across the geographies, aggregate revenue from the growth market countries increased 17.2 percent (12 percent adjusted for currency) in the first nine months of 2008 and represented approximately 18 percent of the company's geographic revenue. Revenue in the key growth countries of Brazil, Russia, India and China together grew 25.0 percent (15 percent adjusted for currency) in the first nine months of 2008 versus the first nine months of 2007.

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The increase in year-to-date revenue was driven by double digit growth in the Global Services segments. Global Technology Services revenue increased 13.5 percent, while Global Business Services revenue improved by 13.8 percent. Software revenue increased 14.2 percent, led by branded middleware and contributions from acquisitions. Systems and Technology revenue decreased 4.5 percent primarily driven by weaker performance in Microelectronics OEM, legacy System i, System x and the impact of the prior year printer divestiture, partially offset by increased revenue for the new z10 mainframe and growth in converged System p servers and Storage. Total Systems revenue growth was 1.9 percent in the first nine months. Global Financing revenue increased 3.6 percent reflecting an improvement in financing revenue, offset by a decline in used equipment sales.

The gross profit margin was 42.7 percent, an increase of 1.6 points, primarily due to improved margins in Global Technology Services (0.8 points of the increase), improved segment revenue mix driven by Software (0.2 points of the increase), improved margins in Global Business Services (0.5 points of the increase) and improved margins in Systems and Technology (0.1 points of the increase).

Table of Contents

Total expense and other income increased 10.4 percent (4 percent adjusted for currency) for the first nine months of 2008 versus the first nine months of 2007. Overall, the increase was driven by approximately 6 points due to the effects of currency and 5 points due to acquisitions, with operational expenses lower year-to-year.

The effective tax rate for the first nine months of 2008 was 27.5 percent versus 28.2 percent for the comparable period in 2007.

The company generated \$12,191 million in cash flow provided by operating activities, an increase of \$1,247 million, compared to the first nine months of 2007, primarily driven by increased net income (\$1,440 million), partially offset by decreases in changes in operating assets and liabilities (\$370 million). Net cash used in investing activities of \$8,405 million was \$2,632 million higher than the first nine months of 2007, primarily due to the Cognos and Telelogic acquisitions (\$5,299) million, partially offset by the net impact of purchases and sales of marketable securities and other investments (\$2,966 million). Net cash used in financing activities of \$8,964 million was \$4,845 million higher year to year, primarily due to net payments associated with debt (\$13,267 million), partially offset by lower payments to repurchase common stock (\$8,519 million).

Total assets decreased \$4,521 million (decreased \$1,723 million adjusted for currency) from December 31, 2007, primarily driven by lower cash and marketable securities (\$6,391 million), lower financing receivables (\$3,124 million), lower accounts receivable (\$1,472 million) and lower investments and sundry assets (\$1,235 million). These decreases were partially offset by increases in goodwill (\$4,576 million) and intangible assets (\$941 million) primarily due to the Cognos and Telelogic acquisitions, prepaid pension assets (\$1,356 million) and prepaid expenses and other current assets (\$823 million). The company had \$9,755 million in cash and marketable securities at September 30, 2008.

Total liabilities decreased \$3,570 million (decreased \$2,509 million adjusted for currency) from December 31, 2007, primarily due to accounts payable (\$1,285 million), taxes (\$1,176 million), debt (\$861 million), other accrued expenses and liabilities (\$577 million) and deferred income (\$427 million). These decreases were partially offset by an increase in other liabilities (\$974 million).

Stockholders' equity of \$27,519 million decreased \$951 million from December 31, 2007, primarily due to increased treasury stock (\$9,626 million) as a result of common stock repurchases, partially offset by higher retained earnings (\$5,959 million) due to net income and common stock (\$3,686 million) driven by stock option activity.

Table of Contents**Third Quarter and First Nine Months in Review***Results of Continuing Operations*Segment Details

The following is an analysis of the third quarter and first nine months of 2008 versus the third quarter and first nine months of 2007 reportable segment external revenue and gross margin results.

(Dollars in millions)

| For the three months ended | | | Yr. to Yr. Percent/Margin Change | Yr. to Yr. Percent Change Adjusting for Currency |
|-----------------------------------|-------------|-------------|---|---|
| September 30: | 2008 | 2007 | | |
| Revenue: | | | | |
| Global Technology Services | \$ 9,864 | \$ 9,093 | 8.5% | 5.0% |
| Gross margin | 32.7% | 30.6% | 2.1pts. | |
| Global Business Services | 4,900 | 4,586 | 6.8% | 3.5% |
| Gross margin | 27.4% | 22.9% | 4.5pts. | |
| Systems and Technology | 4,431 | 4,898 | (9.5)% | (11.2)% |
| Gross margin | 36.2% | 38.5% | (2.4)pts. | |
| Software | 5,249 | 4,694 | 11.8% | 7.7% |
| Gross margin | 84.7% | 84.2% | 0.5pts. | |
| Global Financing | 633 | 623 | 1.7% | (1.2)% |
| Gross margin | 49.1% | 44.6% | 4.5pts. | |
| Other | 224 | 225 | (0.4)% | (3.3)% |
| Gross margin | 15.7% | 2.7% | 13.0pts. | |
| Total revenue | \$ 25,302 | \$ 24,119 | 4.9% | 1.7% |
| Gross profit | \$ 10,959 | \$ 9,956 | 10.1% | |
| Gross margin | 43.3% | 41.3% | 2.0pts. | |

(Dollars in millions)

| For the nine months ended | | | Yr. to Yr. Percent/Margin Change | Yr. to Yr. Percent Change Adjusting for Currency |
|----------------------------------|-------------|-------------|---|---|
| September 30: | 2008 | 2007 | | |
| Revenue: | | | | |
| Global Technology Services | \$ 29,640 | \$ 26,106 | 13.5% | 7.1% |
| Gross margin | 31.9% | 29.9% | 2.0pts. | |

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| | | | | |
|--------------------------|-----------|-----------|------------|--------|
| Global Business Services | 14,918 | 13,108 | 13.8% | 7.1% |
| Gross margin | 26.1% | 23.7% | 2.4pts. | |
| Systems and Technology | 13,862 | 14,520 | (4.5)% | (8.3)% |
| Gross margin | 37.3% | 36.9% | 0.4pts. | |
| Software | 15,670 | 13,723 | 14.2% | 7.9% |
| Gross margin | 84.4% | 84.3% | 0.2pts. | |
| Global Financing | 1,900 | 1,834 | 3.6% | (1.6)% |
| Gross margin | 51.8% | 47.2% | 4.6pts. | |
| Other | 633 | 630 | 0.6% | (4.1)% |
| Gross margin | 0.6% | 11.2% | (10.6)pts. | |
| Total revenue | \$ 76,623 | \$ 69,920 | 9.6% | 3.7% |
| Gross profit | \$ 32,725 | \$ 28,760 | 13.8% | |
| Gross margin | 42.7% | 41.1% | 1.6pts. | |

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Table of Contents

The following table presents each reportable segment's external revenue as a percentage of total external segment revenue.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------|------------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Global Technology Services | 39.3% | 38.1% | 39.0% | 37.7% |
| Global Business Services | 19.5 | 19.2 | 19.6 | 18.9 |
| Total Global Services | 58.9 | 57.2 | 58.6 | 56.6 |
| Systems and Technology | 17.7 | 20.5 | 18.2 | 21.0 |
| Global Financing | 2.5 | 2.6 | 2.5 | 2.6 |
| Total Systems and Technology/Global Financing | 20.2 | 23.1 | 20.7 | 23.6 |
| Software | 20.9 | 19.6 | 20.6 | 19.8 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

Global Services

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|-----------|-----------|---------------------------------|
| For the three months ended September 30: | | | |
| Global Services Revenue: | \$ 14,764 | \$ 13,679 | 7.9% |
| Global Technology Services | \$ 9,864 | \$ 9,093 | 8.5% |
| Strategic Outsourcing | 5,084 | 4,729 | 7.5 |
| Integrated Technology Services | 2,329 | 2,096 | 11.1 |
| Maintenance | 1,815 | 1,712 | 6.0 |
| Business Transformation Outsourcing | 636 | 556 | 14.5 |
| Global Business Services | \$ 4,900 | \$ 4,586 | 6.8% |

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|-----------|-----------|---------------------------------|
| For the nine months ended September 30: | | | |
| Global Services Revenue: | \$ 44,559 | \$ 39,214 | 13.6% |
| Global Technology Services | \$ 29,640 | \$ 26,106 | 13.5% |
| Strategic Outsourcing | 15,278 | 13,632 | 12.1 |
| Integrated Technology Services | 6,894 | 6,054 | 13.9 |
| Maintenance | 5,515 | 4,859 | 13.5 |
| Business Transformation Outsourcing | 1,956 | 1,561 | 25.3 |
| Global Business Services | \$ 14,918 | \$ 13,108 | 13.8% |

The company's Global Services segments, Global Technology Services and Global Business Services, had combined revenue of \$14,764 million, an increase of 7.9 percent (4 percent adjusted for currency) in the third quarter and \$44,559 million, an increase of 13.6 percent (7 percent adjusted for currency) in the first nine months of 2008, respectively, when compared to same periods of 2007. Revenue growth in the quarter continued to be driven primarily by short-term signings performance, but as expected, the rate of growth slowed compared to strong revenue growth in both segments in third-quarter 2007. In third-quarter 2008, total Global Services signings decreased 4 percent year to year to \$12,675 million (\$11,124 million adjusted for currency, down 5 percent). Short-term signings were \$6,097 million, an increase of 13 percent year to year

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(8 percent adjusted for currency). Short-term signings increased in both the growth markets and the major markets with cost savings continuing to be the primary motivator. Long-term signings were \$6,578 million, a decrease of 16 percent (15 percent adjusted for currency) compared to strong signings in the third quarter of 2007. Long-term signings declined in the major markets in the quarter, while long-term signings in the growth markets increased approximately 60 percent. The Global Services segments leveraged very strong margin performance and delivered combined pre-tax profit of \$1,913 million in the third quarter and \$5,111 million in the first nine months of 2008, an improvement of 23.5 percent and 28.6 percent, respectively, versus the same periods of 2007. The strong profit performance is a function of the quality of the segments' contracts portfolio and ongoing programs to drive operational efficiencies and structural changes to the services cost base.

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Table of Contents

Global Technology Services (GTS) revenue increased 8.5 percent (5 percent adjusted for currency) and 13.5 percent (7 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the third quarter and first nine months of 2007. Total signings in GTS decreased 8 percent (7 percent adjusted for currency) in the third quarter of 2008, with long-term signings decreasing 17 percent (14 percent adjusted for currency) and short-term signings increasing 19 percent (14 percent adjusted for currency).

Strategic Outsourcing (SO) revenue was up 7.5 percent (4 percent adjusted for currency) in the third quarter and 12.1 percent (5 percent adjusted for currency) in the first nine months of 2008, respectively, versus the same periods in 2007. Revenue increased 21 percent in the third quarter in the growth markets; however growth in the major markets moderated in the quarter due to a number of large contracts reaching a comparable year-over-year revenue basis and the impact of the lower level of long-term signings over the last few quarters. SO signings in the third quarter of 2008 decreased 19 percent (16 percent adjusted for currency) when compared to the third quarter of 2007.

Integrated Technology Services (ITS) revenue increased 11.1 percent (8 percent adjusted for currency) in the third quarter and 13.9 percent (8 percent adjusted for currency) in the first nine months of 2008 when compared to the same periods in 2007. Revenue growth continues to be driven by the key infrastructure offerings. ITS signings in the third quarter increased 19 percent (14 percent adjusted for currency) year to year. Signings were strong in the key infrastructure offerings and grew in all geographies and all sectors.

Maintenance revenue increased 6.0 percent (2 percent adjusted for currency) and 13.5 percent (7 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively versus the same periods in the prior year. As expected, revenue growth moderated in the quarter due to the transfer of the Ricoh Infoprint maintenance contract.

Business Transformation Outsourcing (BTO) revenue increased 14.5 percent (15 percent adjusted for currency) in the third quarter and was up 25.3 percent (23 percent adjusted for currency) for the first nine months of 2008. BTO signings, which can vary significantly period-to-period, increased 14 percent (15 percent adjusted for currency) in the third quarter.

Global Business Services (GBS) revenue increased 6.8 percent (3 percent adjusted for currency) and 13.8 percent (7 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the prior year periods. Revenue growth in the quarter was impacted by declines in two countries, Japan and Australia. When combined, these two countries were down 13 percent adjusted for currency while the remainder of GBS was up 8 percent adjusted for currency. Total signings in GBS increased 1 percent (decreased 3 percent adjusted for currency) in the third quarter of 2008. Short-term signings increased 10 percent (5 percent adjusted for currency) with increases in Europe and Asia Pacific partially offset by decreases in the Americas. Long-term signings decreased 16 percent (18 percent adjusted for currency) compared to a strong third quarter of 2007, which increased more than 85 percent versus the prior year.

(Dollars in millions)

| | 2008 | 2007 | Yr. To Yr. Percent/ Margin Change |
|---|------|------|--|
| For the three months ended September 30: | | | |
| Global Services gross profit: | | | |
| Global Technology Services: | | | |

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| | | | | | |
|---------------------------|----|-------|----|-------|---------|
| Gross profit | \$ | 3,222 | \$ | 2,781 | 15.9% |
| Gross profit margin | | 32.7% | | 30.6% | 2.1pts. |
| Global Business Services: | | | | | |
| Gross profit | | 1,342 | | 1,051 | 27.7% |
| Gross profit margin | | 27.4% | | 22.9% | 4.5pts. |

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Table of Contents

(Dollars in millions)

| | 2008 | | 2007 | | Yr. To Yr. Percent/ Margin Change |
|--|------|-------|------|-------|--|
| For the nine months ended September 30: | | | | | |
| Global Services gross profit: | | | | | |
| Global Technology Services | | | | | |
| Gross profit | \$ | 9,443 | \$ | 7,795 | 21.1% |
| Gross profit margin | | 31.9% | | 29.9% | 2.0pts. |
| Global Business Services | | | | | |
| Gross profit | | 3,888 | | 3,102 | 25.4% |
| Gross profit margin | | 26.1% | | 23.7% | 2.4pts. |

GTS gross profit increased 15.9 percent in the third quarter and 21.1 percent in the first nine months of 2008 compared to the same periods of 2007, with gross profit margins improving 2.1 points and 2.0 points, respectively, year to year. Segment pre-tax profit increased 15.6 percent to \$1,189 million, with a pre-tax margin of 11.6 percent in the third quarter of 2008, up 0.8 points versus third-quarter 2007. Pre-tax profit in the first nine months of 2008 increased 27.0 percent to \$3,171 million, with a pre-tax margin of 10.3 percent, an improvement of 1.2 points year to year. The margin expansion was driven primarily by an improved cost structure, a mix to higher value offerings in ITS and year-to-year savings in retirement-related costs.

GBS gross profit increased 27.7 percent in the third quarter and 25.4 percent for the first nine months of 2008 compared to the same periods in 2007, with gross profit margins improving 4.5 points and 2.4 points, respectively, year to year. Segment pre-tax profit increased 38.9 percent to \$724 million, with a pre-tax margin of 14.0 percent in the third quarter of 2008, an expansion of 3.3 points year to year. Approximately 2 points of the margin improvement was driven by better resource utilization, pricing and cost and expense management with the remainder attributable to lower retirement-related costs. Pre-tax profit in the first nine months of 2008 increased 31.4 percent to \$1,940 million, with a pre-tax margin of 12.4 percent, an increase of 1.8 points versus the first nine months of 2007.

Global Services Signings

The tables below present Global Services signings at actual currency and constant currency rates. Signings at actual currency rates provide investors a better view of how these signings will convert to services revenue and provides better comparability to other companies in the industry who report signings using actual rates.

(At Actual Currency Rates)

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------|-------------------------------------|-------|------------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| GTS Signings: | | | | |
| Long term | \$ | 5,147 | \$ | 6,174 |
| | | | \$ | 16,226 |
| | | | \$ | 16,642 |

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| | | | | | | | | |
|---------------|----|-------|----|-------|----|--------|----|--------|
| Short term | | 2,403 | | 2,017 | | 7,423 | | 6,442 |
| Total | \$ | 7,551 | \$ | 8,191 | \$ | 23,648 | \$ | 23,084 |
| GBS Signings: | | | | | | | | |
| Long term | \$ | 1,430 | \$ | 1,695 | \$ | 4,226 | \$ | 4,601 |
| Short term | | 3,694 | | 3,360 | | 12,101 | | 10,573 |
| Total | \$ | 5,124 | \$ | 5,055 | \$ | 16,327 | \$ | 15,174 |

Table of Contents

(At Constant Currency Rates)

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------|-------------------------------------|----------|------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| GTS Signings: | | | | |
| Long term | \$ 4,563 | \$ 5,306 | \$ 13,760 | \$ 14,682 |
| Short term | 2,075 | 1,826 | 6,347 | 5,828 |
| Total | \$ 6,638 | \$ 7,132 | \$ 20,107 | \$ 20,511 |
| GBS Signings: | | | | |
| Long term | \$ 1,336 | \$ 1,624 | \$ 3,751 | \$ 4,439 |
| Short term | 3,150 | 3,009 | 10,249 | 9,556 |
| Total | \$ 4,486 | \$ 4,633 | \$ 14,000 | \$ 13,996 |

Global Services signings are management's initial estimate of the value of a client's commitment under a Global Services contract. Signings are used by management to assess period performance of Global Services management. There are no third-party standards or requirements governing the calculation of signings. The calculation used by management includes an approximation of currency and 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. For example, for long-term contracts that require significant up-front investment by the company, the portions of these contracts that are a signing are those periods in which there is a significant economic impact on the client if the commitment is not achieved, usually through a termination charge or the client incurring significant wind-down costs as a result of the termination. For short-term contracts that do not require significant upfront investments, a signing is usually equal to the full contract value. Long-term contracts represent SO and BTO contracts as well as GBS contracts with the U.S. Federal government and its agencies and Application Management Services (AMS) for custom and legacy applications. Short-term contracts represent the remaining GBS offerings of Consulting and Systems Integration, AMS for packaged applications and ITS contracts.

Signings include SO, BTO, ITS and GBS 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.

Backlog includes SO, BTO, ITS, GBS and Maintenance. Backlog is intended to be a statement of overall work under contract and therefore does not 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 currency assumptions used to approximate constant currency.

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.

Systems and Technology

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(Dollars in millions)

| For the three months ended September 30: | 2008 | | 2007 | | Yr. to Yr. Percent Change |
|---|-------------|-------|-------------|-------|--|
| Systems and Technology Revenue: | \$ | 4,431 | \$ | 4,898 | (9.5)% |
| System z | | | | | 25.1 |
| System p | | | | | 7.4 |
| System i | | | | | (81.9) |
| System x | | | | | (20.4) |
| Storage | | | | | (3.4) |
| Retail Store Solutions | | | | | (24.4) |
| Total Systems | | | | | (6.5) |
| Microelectronics OEM | | | | | (26.8) |

Table of Contents

(Dollars in millions)

| For the nine months ended September 30: | | | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| | 2008 | 2007 | |
| Systems and Technology Revenue: | \$ 13,862 | \$ 14,520 | (4.5)% |
| System z | | | 23.4 |
| System p | | | 12.8 |
| System i | | | (51.2) |
| System x | | | (10.3) |
| Storage | | | 5.8 |
| Retail Store Solutions | | | (9.7) |
| Total Systems | | | 1.9 |
| Microelectronics OEM | | | (22.0) |
| Printing Systems | | | nm |

 nm - not meaningful

Systems and Technology revenue decreased 9.5 percent (down 11 percent adjusted for currency) and declined 4.5 percent (8 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the same periods in 2007. On June 1, 2007, the company completed the divestiture of its printing business. Systems and Technology revenue, excluding the divested printing business, decreased 1.9 percent (6 percent adjusted for currency) for the first nine months of 2008 versus the comparable period in 2007. See Note 9 on page 16 for additional information regarding this divestiture. Total Systems revenue decreased 6.5 percent (8 percent adjusted for currency) and increased 1.9 percent (down 3 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, compared to the prior year periods.

System z revenue increased 25.1 percent and 23.4 percent (22 percent and 17 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the third quarter and first nine months of 2007, respectively. In the third quarter, System z had double digit revenue growth across all geographies, with clients in emerging markets also leveraging this platform's stability and efficiency. MIPS (millions of instructions per second) shipments increased 49 percent and 33 percent in the third quarter and first nine months of 2008 versus the third quarter and first nine months of 2007, respectively, reflecting strength in both traditional and specialty workloads. Specialty MIPS increased over 120 percent in the third quarter as clients exploit the capabilities of System z to bring new Linux and Java applications to this highly efficient and cost effective platform. System z continues to perform well, even in a tough environment, due to its ability to consolidate the workloads done by many different servers onto a single, virtualized platform.

Converged System p revenue increased 7.4 percent and 12.8 percent (6 percent and 9 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the third quarter and first nine months of 2007, respectively, reflecting solid demand for the company's virtualization and energy-saving capabilities. The revenue growth was primarily driven by midrange servers which increased 21 percent and 47 percent in the third quarter and first nine months of 2008 versus the same periods in 2007 and high-end servers which increased 19 percent in the third quarter and were essentially flat in the first nine months of 2008 versus the third quarter and first nine months of 2007, respectively.

Legacy System i revenue decreased 81.9 percent and 51.2 percent (82 percent and 54 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the same periods in 2007, respectively, as the company transitions the System i customer base to the converged

POWER platform within System p.

System x revenue decreased 20.4 percent and 10.3 percent (22 percent and 15 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the third quarter and first nine months of 2007. System x server revenue declined 18 percent and 8 percent in the third quarter and first nine months of 2008 versus the comparable periods of 2007, respectively. Blades revenue decreased 8 percent and increased 8 percent in the third quarter and first nine months of 2008 versus the third quarter and first nine months of 2007, respectively. The third quarter declines were primarily driven by sales execution issues, a competitive pricing environment and a continuation of the slowdown in the x86 market.

Storage revenue decreased 3.4 percent and increased 5.8 percent (down 5 percent and up 1 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the comparable periods in 2007. Total disk revenue increased 1 percent and 9 percent in the third quarter of 2008 and the first nine months of 2008 versus the third quarter and first nine

Table of Contents

months of 2007, respectively. These increases were driven by growth in Enterprise Disk (1 percent and 11 percent for the periods) on continued strong demand for the DS8000 product, driven by the strong System z performance. Tape revenue declined 11 percent in the third quarter of 2008 and was essentially flat for the first nine months of 2008 versus the comparable periods of 2007, respectively. The decline in the third quarter was due primarily to clients deciding to purchase additional media to expand the utilization of their existing devices rather than commit to new capital purchases.

Microelectronics OEM revenue decreased 26.8 percent and 22.0 percent (27 percent and 22 percent adjusted for currency), for the third quarter and first nine months of 2008, respectively, versus the comparable periods of 2007. The primary mission of this business is to provide leadership technology for the systems business, as demonstrated during the first nine months of 2008 in the new z10 mainframe and POWER6 systems.

Retail Stores Solutions revenue decreased 24.4 percent and 9.7 percent (26 percent and 13 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the same periods in 2007, respectively. The decline in the third quarter was primarily driven by a very strong compare to the third quarter of 2007 and the weakening economic conditions in the retail market.

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent/ Margin Change |
|---|----------|----------|--|
| For the three months ended September 30: | | | |
| Systems and Technology: | | | |
| Gross profit | \$ 1,602 | \$ 1,886 | (15.1)% |
| Gross profit margin | 36.2% | 38.5% | (2.4)pts. |

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent/ Margin Change |
|--|----------|----------|--|
| For the nine months ended September 30: | | | |
| Systems and Technology: | | | |
| Gross profit | \$ 5,177 | \$ 5,363 | (3.5)% |
| Gross profit margin | 37.3% | 36.9% | 0.4pts. |

The decreases in gross profit for the third quarter and first nine months of 2008 versus the same periods of 2007 were primarily due to the decreases in revenue in System x, legacy System i and Microelectronics OEM.

Overall, gross margin in the third quarter decreased by 2.4 points versus the prior year. This decrease was driven by margin declines in System x, System z and Microelectronics which impacted the overall margin by 3.0 points, 1.7 points and 1.6 points, respectively. Offsetting these margin declines was a revenue mix benefit of 2.9 points due to a shift in revenue towards System z and margin improvement in converged

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System p which impacted the overall margin by 0.6 points. For the first nine months of 2008, gross margin increased 0.4 points compared to the first nine months of 2007. This increase was driven by a revenue mix benefit of 3.0 points towards System z and margin improvement in converged System p and Storage which impacted overall margins by 0.8 points and 0.2 points. Offsetting this were margin declines in System z, Microelectronics and System x which impacted overall margins by 1.7 points, 1.2 points and 1.0 points, respectively.

Systems and Technology's pre-tax income decreased 21.7 percent in the third quarter, and increased 5.0 percent for the first nine months when compared to the prior year. Pre-tax margin decreased 1.0 points in the third quarter and increased 0.5 points for the first nine months, respectively, versus the prior year periods.

Table of ContentsSoftware**(Dollars in millions)**

| For the three months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| Software Revenue: | \$ 5,249 | \$ 4,694 | 11.8% |
| Middleware: | \$ 4,065 | \$ 3,627 | 12.1% |
| Key Branded Middleware: | 2,849 | 2,477 | 15.0 |
| WebSphere Family | | | 4.0 |
| Information Management | | | 26.1 |
| Lotus | | | 9.6 |
| Tivoli | | | 1.5 |
| Rational | | | 23.1 |
| Other middleware | 1,216 | 1,150 | 5.7 |
| Operating systems | 594 | 564 | 5.2 |
| Product Lifecycle Management | 221 | 233 | (5.2) |
| Other | 369 | 270 | 36.8 |

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| Software Revenue: | \$ 15,670 | \$ 13,723 | 14.2% |
| Middleware: | \$ 12,127 | \$ 10,547 | 15.0% |
| Key Branded Middleware: | 8,497 | 7,167 | 18.5 |
| WebSphere Family | | | 10.1 |
| Information Management | | | 27.6 |
| Lotus | | | 15.7 |
| Tivoli | | | 6.6 |
| Rational | | | 21.7 |
| Other middleware | 3,630 | 3,380 | 7.4 |
| Operating systems | 1,715 | 1,654 | 3.7 |
| Product Lifecycle Management | 736 | 743 | (0.9) |
| Other | 1,092 | 779 | 40.2 |

Software segment revenue increased 11.8 percent (8 percent adjusted for currency) to \$5,249 million and 14.2 percent (8 percent adjusted for currency) to \$15,670 million in the third quarter and first nine months of 2008, respectively, versus the same periods in 2007, reflecting contributions from a strong annuity base as well as acquisitions.

Revenue from Key Branded Middleware increased 15.0 percent (11 percent adjusted for currency) in the third quarter of 2008 and 18.5 percent (12 percent adjusted for currency) in the first nine months of 2008, compared to the same periods in 2007 and represented 54 percent of total software segment revenue. Customer demand continues to be focused on software products that generate short-term returns and improve

operational efficiency.

Revenue from the WebSphere Family of products increased 4.0 percent (flat adjusted for currency) and 10.1 percent (4 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the same periods in 2007. Revenue growth in the quarter was impacted by the slowing growth in the U.S. and Europe, although revenue growth increased in Asia Pacific. Revenue performance in the nine month period continues to be driven by double-digit growth in WebSphere Application Servers and WebSphere Integration software.

Information Management revenue increased 26.1 percent and 27.6 percent (22 percent and 21 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, reflecting strong demand for the company's relational database products. Revenue from the Cognos acquisition was also a key driver of the growth in both the quarter and the nine month period.

Lotus revenue increased 9.6 percent (6 percent adjusted for currency) and 15.7 percent (9 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, versus the same periods in 2007 as customers continue to invest to improve their workforce efficiency and drive effective global teaming. Lotus Notes revenue continued to increase and advanced collaboration technologies had strong growth in the quarter. This was the 16th consecutive quarter of revenue growth from Lotus software.

Table of Contents

Tivoli revenue increased 1.5 percent (decreased 1 percent adjusted for currency) and 6.6 percent (1 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, compared to the same periods of 2007. Revenue growth in the quarter was impacted by the slowing growth in the U.S. and Europe, however revenue growth increased in Asia Pacific. Double digit growth in Tivoli Security and Storage Management products continue to drive the year-to-date revenue performance in the brand.

Rational revenue increased 23.1 percent and 21.7 percent (20 percent and 15 percent adjusted for currency) in the third quarter and first nine months of 2008 versus the comparable prior year periods driven by the Telelogic acquisition. With the addition of Telelogic, Rational now provides a common framework for software and systems delivery across a client's business.

Operating systems product revenue increased 5.2 percent (1 percent adjusted for currency) and 3.7 percent (decreased 2 percent adjusted for currency) in the third quarter and first nine months of 2008, respectively, compared to the same periods of 2007. Revenue growth was led by System z and converged System p operating systems software.

Other software segment revenue increased 36.8 percent (32 percent adjusted for currency) in the third quarter and 40.2 percent (33 percent adjusted for currency) in the first nine months of 2008 when compared to the same periods of 2007, reflecting continued growth in software-related services.

(Dollars in millions)

| | 2008 | | 2007 | | Yr. to Yr. Percent/ Margin Change |
|---|------|-------|------|-------|--|
| For the three months ended September 30: | | | | | |
| Software: | | | | | |
| Gross profit | \$ | 4,447 | \$ | 3,954 | 12.5% |
| Gross profit margin | | 84.7% | | 84.2% | 0.5pts. |

(Dollars in millions)

| | 2008 | | 2007 | | Yr. to Yr. Percent/ Margin Change |
|--|------|--------|------|--------|--|
| For the nine months ended September 30: | | | | | |
| Software: | | | | | |
| Gross profit | \$ | 13,230 | \$ | 11,564 | 14.4% |
| Gross profit margin | | 84.4% | | 84.3% | 0.2pts. |

The annuity nature of the Software business provides a predictable and growing stream of profit and cash for the company. Software segment gross profit increased 12.5 percent to \$4,447 million for the third quarter and 14.4 percent to \$13,230 million for the first nine months of 2008, driven primarily by revenue growth. Gross profit margin was 84.7 percent in the third quarter, an increase of 0.5 points year to year and

was 84.4 percent in the first nine months, up 0.2 points year to year.

The Software segment contributed \$1,527 million of pre-tax profit in the third quarter of 2008, an increase of 19.0 percent, and \$4,286 million in the first nine months, an increase of 20.1 percent, when compared to the same periods of 2007. The segment pre-tax profit margin was 25.9 percent and 24.2 percent in the third quarter and first nine months of 2008, up 1.5 points and 1.1 points, respectively, versus the prior year periods. Revenue growth and productivity, partially offset by acquisition-related items, drove the pre-tax income and margin improvements.

Global Financing

See page 52 for a discussion of Global Financing's revenue and gross profit.

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, which is presented separately.

Table of Contents**(Dollars in millions)**

| For the three months ended September 30: | 2008 | | 2007 | | Yr. to Yr. Percent Change |
|---|-------------|--------|-------------|--------|--|
| Total Revenue | \$ | 25,302 | \$ | 24,119 | 4.9% |
| Geographies: | \$ | 24,628 | \$ | 23,229 | 6.0% |
| Americas | | 10,503 | | 10,205 | 2.9 |
| Europe/Middle East/Africa | | 8,933 | | 8,117 | 10.1 |
| Asia Pacific | | 5,192 | | 4,907 | 5.8 |
| OEM | \$ | 673 | \$ | 890 | (24.4)% |

(Dollars in millions)

| For the nine months ended September 30: | 2008 | | 2007 | | Yr. to Yr. Percent Change |
|--|-------------|--------|-------------|--------|--|
| Total Revenue | \$ | 76,623 | \$ | 69,920 | 9.6% |
| Geographies: | \$ | 74,547 | \$ | 67,350 | 10.7% |
| Americas | | 31,353 | | 29,447 | 6.5 |
| Europe/Middle East/Africa | | 27,552 | | 23,908 | 15.2 |
| Asia Pacific | | 15,642 | | 13,994 | 11.8 |
| OEM | \$ | 2,076 | \$ | 2,570 | (19.3)% |

Geographic revenue increased 6.0 percent (3 percent adjusted for currency) to \$24,628 million in the third quarter of 2008 when compared to the third quarter of 2007. Adjusted for currency, growth was led by Europe which increased 4 percent, while Americas was up 2 percent and Asia Pacific was up 1 percent. Revenue from the company's growth markets organization increased 12.7 percent (10 percent adjusted for currency) while growth in the more established major markets slowed to 5 percent (1 percent adjusted for currency).

Americas revenue increased 2.9 percent (2 percent adjusted for currency) in the third quarter. Canada increased 5.8 percent (6 percent adjusted for currency), Latin America increased 20.7 percent (12 percent adjusted for currency) while U.S. growth slowed to 1.1 percent.

Europe/Middle East/Africa (EMEA) revenue increased 10.1 percent (4 percent adjusted for currency) in the third quarter of 2008 when compared to the third quarter of 2007. In the major countries, Germany revenue increased 11.8 percent (2 percent adjusted for currency), France increased 10.7 percent (2 percent adjusted for currency), Italy increased 11.6 percent (2 percent adjusted for currency), Spain increased 18.1 percent (8 percent adjusted for currency) while the U.K. decreased 3.6 percent as reported (increased 3 percent adjusted for currency).

Asia Pacific revenue increased 5.8 percent (1 percent adjusted for currency) in the third quarter of 2008 versus the prior year third quarter. Adjusted for currency, growth was led by the India, Australia/New Zealand, South Korea and ASEAN regions. Japan increased 3.6 percent as reported, but decreased 5 percent adjusted for currency.

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Across the geographies, aggregate revenue from the countries comprising the company's growth markets organization increased 12.7 percent (10 percent adjusted for currency) in the third quarter of 2008 and represented approximately 19 percent of the company's geographic revenue. The company has been investing heavily in these emerging markets to capture the opportunities to build out public and private infrastructures. The BRIC countries, a subset of the growth markets, together grew 18.7 percent (12 percent adjusted for currency), led by double-digit growth in India of 23.7 percent (33 percent adjusted for currency), Brazil 27.9 percent (13 percent adjusted for currency) and Russia 51.4 percent (51 percent adjusted for currency). China revenue increased 2.9 percent as reported but decreased 4 percent adjusted for currency due primarily to greater than anticipated delays in IT spending, attributed to the country's focus on the Summer Olympics. The company believes the fundamental growth opportunity in China continues to be compelling and continues to invest in capabilities to capture the growth.

In the third quarter, within total geographic revenue, there were several industry sectors which significantly impacted the company's overall revenue results. Public sector revenue increased 8.6 percent (6 percent adjusted for currency) driven primarily by government and healthcare industries. Within the government business, the U.S. increased 7.5 percent, and in the growth markets, revenue grew 39.0 percent (33 percent adjusted for currency) as governments in these markets are utilizing technology as a key enabler for national development. The Industrial sector lagged overall performance, increasing 1.7 percent (down 2 percent adjusted for currency) as concerns with the credit markets and margin pressures impacted short-term spending decisions.

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Table of Contents

Worldwide Financial Services sector revenue increased 7.0 percent (2 percent adjusted for currency). U.S. revenue decreased 1.0 percent, slightly better than the second quarter decline of 2.2 percent. Outside of the U.S., where the company generates over 75 percent of this sector's revenue, third quarter revenue increased 9.8 percent (4 percent adjusted for currency). Overall, approximately 60 percent of the Financial Services sector revenue is in annuity businesses.

Geographic revenue for the first nine months of 2008 increased 10.7 percent (5 percent adjusted for currency) to \$74,547 million versus the same period of 2007. Adjusted for currency, revenue growth was led by Europe and the Americas. Revenue from the company's growth markets organization increased 17.2 percent (12 percent adjusted for currency) and revenue from the more established major markets grew 9.4 percent (3 percent adjusted for currency).

Americas revenue for the first nine months of 2008 was \$31,353 million, an increase of 6.5 percent (5 percent adjusted for currency) when compared to the same period of 2007. The U.S. increased 4.1 percent, Canada increased 13.8 percent (6 percent adjusted for currency) and Latin America increased 23.2 percent (11 percent adjusted for currency).

EMEA revenue was \$27,552 million, up 15.2 percent (5 percent adjusted for currency) in the first nine months of 2008 versus the same period in 2007. Revenue increased in all major countries with Spain up 23.1 percent (9 percent adjusted for currency), Italy 16.3 percent (3 percent adjusted for currency), France 16.0 percent (2 percent adjusted for currency), Germany 16.2 percent (2 percent adjusted for currency) and the U.K. 1.4 percent (4 percent adjusted for currency).

Asia Pacific revenue increased 11.8 percent (3 percent adjusted for currency) to \$15,642 million in the first nine months of 2008 when compared to the first nine months of 2007. Revenue increased in all geographic regions and was led by the performance in the emerging markets of India (increased 33.3 percent as reported, 34 percent adjusted for currency), China (increased 15.2 percent as reported, 8 percent adjusted for currency), South Korea (increased 5.7 percent as reported, 15 percent adjusted for currency) and Australia (increased 16.3 percent as reported, 5 percent adjusted for currency). Japan increased 9.1 percent as reported, but decreased 3 percent adjusted for currency.

Across the geographies, aggregate revenue from the emerging markets increased 17.2 percent (12 percent adjusted for currency) in the first nine months of 2008 and represented approximately 18 percent of the company's geographic revenue. Revenue in the BRIC countries of Brazil, Russia, India and China together grew 25.0 percent (15 percent adjusted for currency) in the first nine months of 2008 versus the first nine months of 2007.

OEM revenue decreased 19.3 percent (20 percent adjusted for currency) in the first nine months of 2008 driven by reduced demand in the Microelectronics OEM business.

Expense

The company continued to execute its investment strategy in the third quarter of 2008, aligning investments to growth opportunities on a global basis. The company also continues to focus on productivity improvements in its more established markets. The total expense and other

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income to revenue ratio was 27.9 percent and 28.5 percent for the third quarter and first nine months of 2008 versus 27.7 percent and 28.3 percent for the third quarter and first nine months of 2007, respectively. Total expense and other income increased 5.8 percent and 10.4 percent in the third quarter and first nine months of 2008, respectively. Overall, these increases were primarily driven by approximately 4 points and 6 points due to the effects of currency and approximately 5 points due to acquisitions for the third quarter and first nine months of 2008 versus the comparable periods in 2007, respectively. Operational expense for the third quarter of 2008 improved by 4 points versus the third quarter of 2007, and by 1 point for the first nine months of 2008, when compared to the first nine months of 2007.

For additional information regarding Total expense and other income, see the following analyses by category.

Table of ContentsSelling, general and administrative expense

(Dollars in millions)

| | 2008 | 2007* | Yr. To Yr. Percent Change |
|---|-----------------|-----------------|---------------------------------|
| For the three months ended September 30: | | | |
| Selling, general and administrative expense: | | | |
| Selling, general and administrative base | \$ 4,843 | \$ 4,637 | 4.4% |
| Advertising and promotional expense | 313 | 295 | 6.2 |
| Workforce reductions ongoing | 80 | 60 | 34.2 |
| Amortization expense acquired intangibles | 79 | 60 | 32.1 |
| Retirement-related expense | 86 | 147 | (41.7) |
| Stock-based compensation | 116 | 122 | (4.9) |
| Bad debt expense | 128 | 4 | nm |
| Total | \$ 5,644 | \$ 5,324 | 6.0% |

* Reclassified to conform with 2008 presentation.

nm - not meaningful

(Dollars in millions)

| | 2008 | 2007* | Yr. To Yr. Percent Change |
|--|------------------|------------------|---------------------------------|
| For the nine months ended September 30: | | | |
| Selling, general and administrative expense: | | | |
| Selling, general and administrative base | \$ 15,284 | \$ 13,895 | 10.0% |
| Advertising and promotional expense | 948 | 910 | 4.2 |
| Workforce reductions ongoing | 265 | 261 | 1.3 |
| Amortization expense acquired intangibles | 230 | 181 | 27.4 |
| Retirement-related expense | 275 | 445 | (38.1) |
| Stock-based compensation | 368 | 357 | 3.2 |
| Bad debt expense | 183 | (5) | nm |
| Total | \$ 17,553 | \$ 16,044 | 9.4% |

* Reclassified to conform with 2008 presentation.

nm - not meaningful

Total Selling, general and administrative (SG&A) expense increased 6.0 percent (3 percent adjusted for currency) and 9.4 percent (4 percent adjusted for currency), respectively, in the third quarter and first nine months of 2008 versus the same periods in 2007. The increases in SG&A

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were primarily due to the effects of currency (3 points in the third quarter and 5 points in the first nine months of 2008) and acquisition related spending, predominantly for Cognos and Telelogic, which accounted for approximately 5 points of the increase for the third quarter and first nine months of 2008, respectively. In addition, bad debt expense increased in both the third quarter and first nine months of 2008 driven by additional specific accounts receivable reserves reflecting the current economic environment in many industries. This increased the company's accounts receivable provision coverage to 2.0 percent, an increase of 50 basis points from the third quarter of 2007 and 30 basis points from June 30, 2008. These increases were partially offset by lower retirement-related expense in the third quarter (\$61 million) and first nine months of 2008 (\$170 million). See Note 5 on pages 11 to 13 and the caption Retirement-Related Benefits on page 42 for additional information.

Table of ContentsOther (income) and expense

(Dollars in millions)

| For the three months ended September 30: | 2008 | 2007* | Yr. to Yr. Percent Change |
|--|-------------|--------------|--|
| Other (income) and expense: | | | |
| Foreign currency transaction losses | \$ 15 | \$ 38 | (60.3)% |
| Losses on derivative instruments | 131 | 20 | nm |
| Interest income | (74) | (123) | (39.7) |
| Net gains from securities and investment assets | (42) | (3) | nm |
| Net realized gains from certain real estate activities | | (1) | (108.3) |
| Other | (82) | (27) | 204.4 |
| Total | \$ (51) | \$ (95) | (46.0)% |

* Reclassified to conform with 2008 presentation.

nm - not meaningful

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007* | Yr. to Yr. Percent Change |
|--|-------------|--------------|--|
| Other (income) and expense: | | | |
| Foreign currency transaction losses/(gains) | \$ 125 | \$ (8) | nm% |
| Losses on derivative instruments | 280 | 143 | 95.5 |
| Interest income | (286) | (389) | (26.5) |
| Net gains from securities and investment assets | (149) | (80) | 85.6 |
| Net realized gains from certain real estate activities | (23) | (15) | 51.1 |
| Other | (147) | (178) | (17.2) |
| Total | \$ (201) | \$ (528) | (61.9)% |

* Reclassified to conform with 2008 presentation.

nm not meaningful

Other (income) and expense was income of \$51 million and \$95 million in the third quarter of 2008 and 2007, and income of \$201 million and \$528 million for the first nine months of 2008 and 2007, respectively. The decrease in income in the third quarter was primarily driven by increased losses (\$112 million) on derivative instruments which hedge other foreign currency risks associated with recorded financial assets and liabilities. The company also hedges its major cross-border cash flows to mitigate the effect of currency volatility in its global cash planning,

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which also reduces volatility in the year-over-year results. The impact of these hedging programs is primarily reflected in Other (income) and expense, as well as cost of goods sold. The impact of losses from these cash flow hedges reflected in Other (income) and expense was \$46 million, a decrease of \$1 million year to year in the third quarter of 2008. The decrease in interest income in the third quarter was primarily driven by declining interest rates.

The decrease in income for the first nine months of 2008 was primarily driven by foreign currency transaction losses of \$133 million, lower interest income of \$103 million primarily driven by lower interest rates and increased losses on derivative instruments of \$137 million. The impact of losses from the major cross-border cash flow hedges reflected in Other (income) and expense was \$277 million, an increase of \$168 million year to year in the first nine months of 2008.

In addition, net gains from securities and investments primarily reflect sales of Lenovo stock in the third quarter of 2008, and the first nine months of 2008 and 2007. As a result of the sales of shares, the company's ownership in Lenovo declined to voting ownership of 4.7 percent at September 30, 2008.

Table of ContentsResearch, Development and Engineering

(Dollars in millions)

| For the three months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| Research, development and engineering | \$ 1,579 | \$ 1,524 | 3.6% |

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| Research, development and engineering | \$ 4,809 | \$ 4,568 | 5.3% |

The increase for the third quarter of 2008 was due to increased spending in Software (\$87 million) primarily due to acquisitions. This increase was partially offset by lower spending in Systems and Technology (\$6 million) and other unit spending (\$25 million). The increase for the first nine months of 2008 was due to increased spending in Software (\$245 million) primarily due to acquisitions and other unit spending (\$38 million). This increase was partially offset by lower spending in Systems and Technology (\$42 million).

Intellectual Property and Custom Development Income

(Dollars in millions)

| For the three months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| Intellectual Property and Custom Development Income: | | | |
| Sales and other transfers of intellectual property | \$ 26 | \$ 55 | (52.3)% |
| Licensing/royalty-based fees | 119 | 100 | 19.0 |
| Custom development income | 122 | 116 | 5.2 |
| Total | \$ 267 | \$ 270 | (1.3)% |

(Dollars in millions)

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| For the nine months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|---------------|---------------|--|
| Intellectual Property and Custom Development Income: | | | |
| Sales and other transfers of intellectual property | \$ 63 | \$ 116 | (45.9)% |
| Licensing/royalty-based fees | 387 | 269 | 43.7 |
| Custom development income | 376 | 336 | 11.7 |
| Total | \$ 825 | \$ 721 | 14.4% |

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 IP transactions in the third quarter or first nine months of 2008 and 2007.

Interest Expense

(Dollars in millions)

| For the three months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|-------------|-------------|--|
| Interest expense | \$ 159 | \$ 193 | (17.7)% |

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|-------------|-------------|--|
| Interest expense | \$ 482 | \$ 396 | 21.6% |

The decrease in interest expense in the third quarter of 2008 versus the third quarter of 2007 was primarily due to lower interest rates.

The increase in interest expense for the first nine months of 2008 versus the same period of 2007 was primarily due to the increase in debt associated with the financing of the ASR agreements in 2007, partially offset by lower interest rates. See Note 7 on page 14 for additional information. Interest expense is presented in Cost of Financing in the Consolidated

Table of Contents

Statement of Earnings only if the related external borrowings are to support the Global Financing external business. See page 56 for additional information regarding Global Financing debt and interest expense. Overall interest expense for the third quarter and first nine months of 2008 was \$354 million and \$1,067 million, a decrease of \$39 million and an increase of \$78 million, respectively, versus the prior year periods.

Retirement-Related Benefits

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

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|--------|--------|---------------------------------|
| For the three months ended September 30: | | | |
| Retirement-related plans cost: | | | |
| Defined benefit and contribution pension plans cost | \$ 288 | \$ 557 | (48.3)% |
| Nonpension postretirement plans cost | 93 | 97 | (4.0) |
| Total | \$ 381 | \$ 654 | (41.7)% |

(Dollars in millions)

| | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|----------|----------|---------------------------------|
| For the nine months ended September 30: | | | |
| Retirement-related plans cost: | | | |
| Defined benefit and contribution pension plans cost | \$ 939 | \$ 1,631 | (42.4)% |
| Nonpension postretirement plans cost | 278 | 294 | (5.4) |
| Total | \$ 1,217 | \$ 1,925 | (36.8)% |

The company had income of \$103 million and incurred costs of \$332 million associated with its defined benefit pension plans for the third quarter of 2008 and 2007, respectively. The comparable amounts for the first nine months of 2008 and 2007 was income of \$308 million and costs of \$967 million, respectively. The decrease in cost was primarily driven by benefit accruals no longer being recorded for the IBM Personal Pension Plan, effective January 1, 2008, as well as by lower cost due to amortization of prior years' actual return on assets exceeding expected return on assets and lower cost due to recognized actuarial losses. These decreases were partially offset by an increase in the cost of defined contribution plans of \$166 million and \$583 million in the third quarter and first nine months of 2008 versus the same periods of 2007. These increases in cost were primarily driven by pension redesign efforts, primarily in the IBM 401(k) Plus Plan in the U.S., effective January 1, 2008. See Note U, Retirement-Related Benefits, in the company's 2007 Annual Report for additional information on these plan changes. The third quarter 2008 year-to-year decrease in total retirement-related cost impacted gross profit, SG&A expense, RD&E expense and Other (income) and expense by approximately \$182 million, \$61 million, \$25 million and \$4 million, respectively. The first nine months decrease in total

retirement-related cost impacted gross profit, SG&A expense, RD&E expense and Other (income) and expense by approximately \$464 million, \$170 million, \$70 million and \$4 million, respectively.

Acquired Intangible Asset Amortization

The company has been investing in targeted acquisitions to increase its capabilities in higher value market segments. The following table presents the total acquired intangible asset amortization by reportable segment included in the referenced category in the Consolidated Statement of Earnings.

(Dollars in millions)

| For the three months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|--|--------|-------|---------------------------------|
| Cost: | | | |
| Software (Sales) | \$ 45 | \$ 22 | 101.8% |
| Global Technology Services (Services) | 8 | 12 | (30.6) |
| Systems and Technology (Sales) | 2 | | nm |
| Selling, general and administrative | 79 | 60 | 32.1 |
| Total | \$ 134 | \$ 95 | 43.0% |

nm not meaningful

Table of Contents

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007 | Yr. to Yr. Percent Change |
|---|--------|--------|---------------------------------|
| Cost: | | | |
| Software (Sales) | \$ 129 | \$ 69 | 87.1% |
| Global Technology Services (Services) | 25 | 30 | (18.5) |
| Global Business Services (Services) | | 1 | nm |
| Systems and Technology (Sales) | 6 | | nm |
| Selling, general and administrative | 230 | 181 | 27.4 |
| Total | \$ 390 | \$ 281 | 38.9% |

 nm not meaningful
Taxes

The effective tax rate for the third quarter of 2008 was 27.5 percent compared with an effective tax rate of 28.0 percent for the third quarter of 2007. The corresponding effective tax rate for the first nine months of 2008 was 27.5 percent versus 28.2 percent for the first nine months of 2007. The decline in the respective tax rates was due to a more favorable mix of income in lower tax jurisdictions, increased tax incentives and foreign tax credits associated with the foreign dividend repatriation, offset by a reduction in the U.S. research tax credit which expired in December 2007 and the absence of the gain associated with the sale of the printing business in 2007.

During the second quarter of 2008, the company reached an agreement with the Internal Revenue Service (IRS) regarding claims for certain tax incentives. The resolution of this matter resulted in a net reduction of the second quarter provision for income taxes of \$281 million. Also during the second quarter, the company completed its analysis with respect to certain issues associated with recently issued U.S. tax regulations. The review resulted in a reduction of the second quarter provision for income taxes of \$200 million. The above benefits were predominately offset by a one-time tax cost associated with the intercompany transfer of certain intellectual property.

The amount of unrecognized tax benefits at December 31, 2007 determined in accordance with FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109, increased by \$299 million in the first nine months to \$3,393 million. The amount of unrecognized tax benefits increased by \$84 million during the third quarter of 2008. The total amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate is \$2,675 million at September 30, 2008.

With limited exception, the company is no longer subject to U.S. federal, state and local or non-U.S. income tax audits by taxing authorities for years through 2001. The years subsequent to 2001 contain matters that could be subject to differing interpretations of applicable tax laws and regulations as it relates to the amount and/or timing of income, deductions and tax credits. Although the outcome of tax audits is always uncertain, the company believes that adequate amounts of tax and interest have been provided for any adjustments that are expected to result for these years.

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The IRS commenced the audit of the company's U.S. tax returns for 2004 and 2005 in the first quarter of 2007. The company anticipates that the IRS will complete its field examination of the company's 2004-2005 income tax returns during the fourth quarter of 2008. As part of this examination, the IRS is reviewing the valuation placed on the transfer of certain intellectual property rights to a non-U.S. subsidiary. There may be a wide difference of views between the company and the IRS with respect to this and other similar transfers. At this time, the company believes that adequate amounts of tax and interest have been provided for any potential adjustments relating to these transfers. However, the ultimate liability for these transfers may vary from the amounts provided and is dependent on the outcome of the review by the IRS, negotiations and administrative proceedings.

The company has certain foreign tax loss carryforwards that have not been reflected in the gross deferred tax asset balance. These losses, the potential tax benefit of which is approximately \$1.1 billion, have not been recorded in the Consolidated Statement of Financial Position as the company has not determined if it will claim these losses. The company is currently evaluating whether to claim these losses and expects to make a decision within the next nine months.

See the 2007 IBM Annual Report, Note O, Taxes, for additional information.

Table of ContentsEarnings 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 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.

| | 2008 | 2007 | Yr. To Yr. Percent Change |
|--|---------|---------|---------------------------------|
| For the three months ended September 30: | | | |
| Earnings per share from continuing operations: | | | |
| Assuming dilution | \$ 2.05 | \$ 1.68 | 22.0% |
| Basic | \$ 2.09 | \$ 1.72 | 21.5% |
| Weighted-average shares outstanding: (in millions) | | | |
| Assuming dilution | 1,379.1 | 1,405.8 | (1.9)% |
| Basic | 1,350.7 | 1,371.4 | (1.5)% |
| For the nine months ended September 30: | | | |
| Earnings per share from continuing operations: | | | |
| Assuming dilution | \$ 5.68 | \$ 4.42 | 28.5% |
| Basic | \$ 5.79 | \$ 4.50 | 28.7% |
| Weighted-average shares outstanding: (in millions) | | | |
| Assuming dilution | 1,393.1 | 1,463.1 | (4.8)% |
| Basic | 1,366.7 | 1,436.0 | (4.8)% |

Actual shares outstanding at September 30, 2008 was 1,343.5 million. The weighted-average number of common shares outstanding assuming dilution during the third quarter and first nine months of 2008 was 26.7 million and 70.0 million lower than the same periods in 2007 primarily as a result of the company's common share repurchase program.

Results of Discontinued Operations

There was no loss from Discontinued Operations in the third quarter and first nine months of 2008 versus a \$1 million loss in the third quarter and first nine months of 2007.

Financial Position

Dynamics

At September 30, 2008, the company's balance sheet and liquidity positions remain strong. Cash on hand was approximately \$10 billion. At the close of the third quarter, the company had \$4.5 billion of commercial paper outstanding, down \$1.3 billion from December 31, 2007. The company continues to access the short-term commercial paper market at sub-LIBOR pricing in its normal tenors. On October 15, 2008, the company demonstrated substantial access to the term debt market by raising \$4 billion in cash across five, ten and thirty year maturities. In addition, the company continues to have available a \$10 billion global credit facility as back-up liquidity.

The assets and debt associated with the Global Financing business are a significant part of IBM's financial position. The financial position amounts appearing on pages 5 and 6 are the consolidated amounts including Global Financing. The amounts appearing in the separate Global Financing section, beginning on page 52, are supplementary data presented to facilitate an understanding of the Global Financing business.

Table of ContentsWorking Capital

| (Dollars in millions) | At September 30, 2008 | At December 31, 2007 |
|-----------------------|--------------------------|-------------------------|
| Current assets | \$ 44,187 | \$ 53,177 |
| Current liabilities | 44,752 | 44,310 |
| Working capital | \$ (565) | \$ 8,867 |
| Current ratio | 0.99:1 | 1.20:1 |

Working capital decreased \$9,432 million compared to the year-end 2007 position primarily as a result of a decrease in current assets. The key drivers are described below:

Current assets decreased \$8,990 million, including a negative currency effect of \$968 million, due to:

- A decrease of \$6,391 million in cash and cash equivalents and marketable securities (see Cash Flow analysis on pages 46 and 47); and
- A decline of \$3,849 million in short-term receivables driven by:
 - a decrease of \$3,136 million due to collections of higher year-end balances; and
 - approximately \$714 million negative currency effect.
- An increase of \$823 million in prepaid expenses and other current assets primarily resulting from:
 - an increase of \$348 million in derivative assets primarily due to changes in foreign currency rates;
 - an increase of \$339 million primarily related to the pending ILOG acquisition;

- an increase of \$147 million in prepaid software for services contracts; partially offset by
- approximately \$127 million negative currency effect.
- Growth of \$337 million in inventory primarily driven by hardware sales performance at the end of the third quarter for Systems and Technology products.
- An increase of \$90 million in deferred taxes primarily due to an increase in tax deductions expected to be realized within the next 12 months.

Current liabilities increased \$441 million, including a \$656 million negative effect from currency, as a result of:

- An increase in short-term debt of \$3,946 million primarily driven by;
- Reclasses of \$8,405 million from long-term to short-term debt to reflect maturity dates; and
- \$999 million in new debt issuances; partially offset by
- \$3,941 million in payments and a \$1,289 million reduction in commercial paper.
- A decrease in accounts payable of \$1,285 million (including a negative currency effect of \$150 million) and a decrease of \$219 million (including a negative currency effect of \$99 million) in compensation and benefits reflecting declines from typically higher year-end balances;

Table of Contents

- A decrease of \$1,176 million in taxes payable primarily due to income tax payments in the first nine months of 2008;
- A decrease of \$577 million (including \$103 million of negative currency effect) in other accrued expenses and liabilities primarily driven by;
- \$190 million decrease in derivative liabilities primarily due to changes in foreign currency rates;
- \$125 million decrease in taxes withheld from employees;
- \$99 million decrease in infrastructure cost accruals; and
- \$95 million decrease in accrued cost for services contracts.
- A decrease in deferred income of \$247 million, which was primarily driven by negative effects of currency.

Cash Flow

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

| (Dollars in millions) | Nine Months Ended September 30, | |
|--|------------------------------------|-----------|
| | 2008 | 2007 |
| Net cash provided by/(used in) continuing operations: | | |
| Operating activities | \$ 12,191 | \$ 10,943 |
| Investing activities | (8,405) | (5,773) |
| Financing activities | (8,964) | (4,119) |
| Effect of exchange rate changes on cash and cash equivalents | (58) | 230 |
| Net cash used in discontinued operations | | (9) |
| Net change in cash and cash equivalents | \$ (5,236) | \$ 1,273 |

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Net cash from operating activities increased \$1,247 million as compared to the first nine months of 2007 driven by the following key factors:

- Increase in net income of \$1,440 million;
- Lower retirement-related plan funding of \$458 million (\$425 million in 2008 for non-U.S. plans versus \$883 million in 2007: \$500 million in the U.S. for retiree medical and \$383 million funding for non-U.S. plans);
- An increase in cash provided by accounts receivable of \$460 million driven by improved collections;
- A decrease in cash from deferred income of \$592 million primarily driven by a prior year prepayment of future services related to the divestiture of the printing business; and
- A decrease in cash of \$350 million driven by growth in inventory.

Net cash used in investing activities increased \$2,632 million driven by:

- An increase of \$5,299 million utilized in acquisitions primarily driven by Cognos and Telelogic;
- A decrease of \$239 million from divestitures; partially offset by
- The net impact of the purchases and sales of marketable securities and other investments which resulted in an increased source of cash of \$2,966 million.

Table of Contents

Net cash used in financing activities increased \$4,845 million as a result of:

- Increase of \$13,267 million due to reduced debt issuances in 2008; and
- Increase of \$323 million in cash dividends paid; partially offset by
- Lower common stock repurchases of \$8,519 million driven by the prior year accelerated share repurchase; and
- Higher common stock transactions of \$225 million driven by stock options.

Noncurrent Assets and Liabilities

| (Dollars in millions) | At September 30, 2008 | At December 31, 2007 |
|---|--------------------------|-------------------------|
| Noncurrent assets | \$ 71,723 | \$ 67,254 |
| Long-term debt | 18,232 | 23,039 |
| Noncurrent liabilities (excluding debt) | 25,407 | 24,612 |

The increase in noncurrent assets of \$4,469 million (including \$1,831 million negative currency effect) was driven by:

- An increase of \$4,576 million in goodwill (including \$636 million negative currency effect) and an increase of \$941 million (including \$78 million negative currency effect) in intangible assets - net was primarily driven by the Cognos and Telelogic acquisitions; and
- An increase of \$1,356 million (including \$370 million negative currency effect) in prepaid pension assets; partially offset by
- A decrease of \$747 million (including \$271 million negative currency effect) in financing receivables primarily due to the collections of higher year-end balances in commercial financing;

- A decrease of \$552 million in alliance investments primarily driven by the sale of Lenovo stock; and
- A decrease of \$525 million in long-term marketable securities due to the liquidation of these investments.

Long-term debt decreased \$4,807 million primarily due to reclasses to short-term debt of \$8,405 million, as certain instruments approach maturity, and payments of \$3,679 million; offset by debt issuances of \$7,320 million.

Other noncurrent liabilities, excluding debt, increased \$795 million primarily driven by:

- An increase in noncurrent deferred tax liabilities of \$889 million;
- An increase of \$553 million in income tax reserves reflecting current year additions related to unrecognized tax benefits; partially offset by
- A decrease of \$228 million in noncurrent derivative liabilities; and
- A decrease of \$180 million in noncurrent deferred income driven primarily by the negative effect of currency.

Table of ContentsDebt

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

| (Dollars in millions) | At September 30, 2008 | | At December 31, 2007 | |
|-------------------------------------|--------------------------|--------|-------------------------|--------|
| Total company debt | \$ | 34,413 | \$ | 35,274 |
| Total Global Financing segment debt | \$ | 24,522 | \$ | 24,532 |
| Debt to support external clients | | 20,991 | | 21,072 |
| Debt to support internal clients | | 3,531 | | 3,460 |

Global Financing provides funding 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 nature, 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 page 56.

Non-global financing debt decreased \$851 million and the debt-to-capitalization ratio decreased to 29.1 percent from 30.0 percent at December 31, 2007. The company's long-term debt-to-capitalization ratio objective is 20 to 30 percent. This ratio can vary from period to period as the company manages its global cash and debt positions.

As previously discussed, on October 15, 2008, the company issued \$4.0 billion of bonds with \$1.4 billion with five-year maturities, \$1.6 billion with 10 year maturities and \$1.0 billion with 30 year maturities. The proceeds will be used for general corporate purposes.

Equity

Stockholders' equity decreased \$951 million primarily as a result of a decrease related to net stock transactions of \$5,940 million, driven by the company's common stock repurchases which resulted in an increase in treasury stock at September 30, 2008, and a \$970 million decrease in accumulated gains and losses not affecting retained earnings primarily driven by a decrease in foreign currency translation adjustments. These decreases were partially offset by a \$5,959 million increase in retained earnings driven by net income (\$7,907 million), partially offset by dividend payments (\$1,916 million).

Looking Forward

The following key drivers impacting IBM's business are described in more detail in the 2007 IBM Annual Report

on page 22.

- Economic environment and corporate spending budgets
- Internal business transformation and global integration initiatives
- Innovation initiatives
- Open standards
- Investing in growth opportunities

The company has a significant global presence, operating in 170 countries, with approximately 63 percent of its 2007 revenue and 65 percent of its revenue for the first nine months of 2008 generated outside the U.S. In addition, approximately 70 percent of the company's employees are located outside the United States, including about 37 percent in Asia Pacific. This global reach gives the company access to markets, with well-established organizations and management systems who understand the clients and their challenges and who can respond to these opportunities with value-add solutions. The company's transformation to a globally integrated enterprise provides the capabilities to service clients globally and deliver the best skills and cost from anywhere in the world.

Table of Contents

In May 2007, the company met with investors and analysts and discussed a road map to deliver earnings per share in 2010 in the range of \$10 to \$11 per share, or 14 to 16 percent compound growth rate from 2006. The company's 2010 roadmap is to generate earnings per share growth in the range of \$9 to \$10 per share, or 10 to 14 percent compound growth from 2006 through a combination of revenue growth, margin improvement, growth initiatives, acquisitions and effective capital deployment to fund growth and provide returns to stockholders through dividends and common stock repurchases. In addition to these elements, the company's roadmap to the \$10 to \$11 per share range includes the projected benefit of retirement-related costs based on December 31, 2006 assumptions. Actual retirement-related costs will depend on several factors including financial market performance, the interest rate environment and actuarial assumptions. In March 2008, the company met again with investors and analysts and discussed the progress the company is making on its 2010 roadmap.

The company's performance in the first nine months of 2008 highlighted the benefits of its global reach and the strength of its business model. The financial results reflected solid progress on major elements of the long-term goals; however, the company measures the success of its business model over the long term, not any individual quarter or year. Earnings per share growth is dependent on a number of factors and may not be consistent throughout the periods. The company's strategies, investments and actions are all taken with an objective of optimizing long-term performance.

In the emerging growth markets, the company will continue to invest for revenue growth and leadership. The company is focused on identifying growth opportunities and following a disciplined investment policy to capitalize on these opportunities. Through its investments, the company has developed extensive capabilities in emerging countries to capture these growth opportunities. In 2008, the company implemented a new organization and management structure that has increased its focus on these growth markets. The company expects these rapidly growing markets to drive revenue and profit growth in future periods. In the more established markets, the company will continue to drive productivity. The company will also continue its focus on internal business transformation and global integration activities. The company has made significant progress in its initiatives, but, there is additional opportunity going-forward to improve the company's balance point. On-going initiatives in these areas have contributed to both gross margin improvement and operational expense improvement and are expected to provide additional productivity improvements going-forward. Key focus areas include Global Technology Services service delivery, Integrated Supply Chain and integrated Global Support functions.

The company is a proven infrastructure provider of IT technology. The company's broad product and services portfolio delivers value to clients through a combination of services, hardware and software. The portfolio is focused on high-value solutions that can deliver measurable benefit to clients with offerings that can address a wide scope of client issues including: energy savings, security and resiliency, risk management and cost reduction among many others.

The company remains committed to technology leadership and will continue to focus internal investments, complemented with strategic acquisitions, on high-value, high-growth opportunities. In July, the company announced that it plans to invest \$1.5 billion to promote nanotechnology research and advanced semiconductor technology. In October, the company announced that it will open a new research facility in Shanghai, China that will focus on next-generation Internet applications and solutions for small and medium businesses.

The continued investments in the Software segment have led to this business emergence as a strong source of revenue growth and the largest contributor to the company's profit in 2007 and the first nine months of 2008. The Software business is differentiated in the industry by both the strength of its individual products and the breadth of the software offerings. The key to continued Software growth stems from the ability to maintain and grow this industry-leading software business, and by continuing to capitalize on industry trends such as SOA and Information on Demand. The company expects to accomplish this through a combination of internal development and strategic acquisitions. In July, the company announced an agreement to acquire ILOG, which will increase the company's software capabilities. These products will be rapidly developed and integrated to bring continued value to clients.

Within the Global Services business, revenue, profit growth and margin has improved and the company continues to see significant results from the targeted actions and investments it has made the last few years. The Global Services business enters the fourth quarter with strong executional momentum and with a signings backlog of \$114 billion. The portfolio is strong with a complement of offerings and capabilities that deliver both high value and productivity to clients. The overall Global Services business is well positioned going forward to take advantage of profitable opportunities in the marketplace.

In the Systems and Technology business, the company will focus its investments on differentiating technologies with high-growth potential including POWER6, BladeCenter-S, high-performance computing, virtualization and energy efficiency. The transition to POWER6 technology was completed in the first half of 2008. The April product announcements in converged System p have provided momentum for this brand going-forward. Within Storage, the company has started to

Table of Contents

integrate the recently acquired (December 2007) XIV technologies into its portfolio. In October, the company announced a new entry-level System z10 business class mainframe targeted at midsize companies and clients in emerging markets focused on application development, server consolidation and a platform which can serve as the foundation of new enterprise data centers. The company also announced new Storage disk and tape products to work with the new mainframe.

The company expects 2008 pre-tax retirement-related plan cost to be approximately \$1.5 billion, a decrease of approximately \$1.1 billion compared to 2007. This estimate reflects current pension plan assumptions, the impacts of pension plan redesign efforts and the fourth quarter termination of the Japan Career Choice Retirement Plan that will result in a one-time benefit of approximately \$100 million. Through September 30, 2008, the year-to-date actual return on assets for the IBM Personal Pension Plan was (10.1) percent and for the company's material non-U.S. defined benefit plans, the return on assets ranged from (12.0) to (19.0) percent. Consistent with accounting requirements, the company will remeasure its defined benefit pension plans at December 31, 2008. If pension plan returns on assets continue at the September 30, 2008 level, the company would experience a non-cash impact to its Consolidated Statement of Financial Position and Stockholders' Equity. See the company's 2007 Annual Report Note U, Retirement-Related Benefits, on page 105 for additional information.

The company expects that its effective tax rate in 2008 will be approximately 27.5 percent. This rate is lower than the 2007 tax rate of 28.1 percent due to an expectation of a more favorable mix of income in lower tax jurisdictions, increased tax incentives and foreign tax credits associated with foreign dividend repatriation, offset by a reduction in tax credits. The rate may change period to period based on non-recurring events, such as the settlement of income tax audits, 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.

In 2007 and 2006, the company's cash tax rate was approximately 18 percent and 16 percent, respectively.

The company's cash tax rate represents the amount of income taxes paid during the year over Income from continuing operations before income taxes. The cash tax rate differs from the company's effective tax rate due to a number of variables including, but not limited to, certain items of income and expense that are recognized in different years for financial reporting purposes than for income tax purposes, differences in currency rates used in the translation of the non-U.S. income tax provision and income tax payments and current year cash tax payments or refunds that are related to prior years. The company anticipates that its cash tax rate may decrease for the current year as a result of additional tax credits.

Currency Rate Fluctuations

Changes in the relative values of non-U.S. currencies to the U.S. dollar affect the company's results. At September 30, 2008, currency changes resulted in assets and liabilities denominated in local currencies being translated into fewer U.S. dollars than at year-end 2007. The company uses a variety of 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 the 2007 IBM Annual Report in Note K, Derivatives and Hedging Transactions, on pages 88 to 91.

In the first nine months of 2008, the company's revenue increased 9.6 percent as reported and 3.7 percent adjusted for currency. In the third quarter, revenue increased 4.9 percent as reported and 1.7 percent adjusted for currency. This currency benefit, which narrowed in the quarter,

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was driven from the company's operations in currencies other than the U.S. dollar. The company's expectation is that currency changes may have a negative impact on year-to-year revenue growth in the fourth quarter of 2008. The company maintains currency hedging programs for cash planning purposes which mitigate, but do not eliminate, the volatility of currency impacts on the company's financial results. In addition to the translation of earnings, the impact of currency changes also may affect the company's pricing and sourcing actions. For example, the company may procure components and supplies in multiple functional currencies and sell products and services in other currencies. Since the company operates in a very competitive environment, it believes that some of this currency-based cost advantage is passed on to the client in reduced price. Therefore, it is impractical to precisely quantify the impact of currency on these transactions and on consolidated net income. However, the company estimates that the maximum effect of currency, before taking pricing or sourcing actions into account, and net of hedging activity, contributed approximately no more than 20 percent of total earnings per share growth in the third-quarter 2008. This hypothetical upper limit assumes that no currency benefit was passed through to clients in pricing actions or mitigated through sourcing actions.

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, as required by SFAS No. 52, Foreign Currency Translation. Generally, the company manages currency risk in these entities by linking prices and contracts to U.S. dollars and, as needed, by entering into foreign currency hedge contracts.

Table of ContentsLiquidity and Capital Resources

In the company's 2007 IBM Annual Report, on pages 44 to 46, there is a discussion of the company's liquidity including two tables that present five years of data. The table presented on page 44 includes net cash from operating activities, cash and marketable securities and the size of the company's global credit facilities for each of the past five years. For the nine months ended or as of, as applicable, September 30, 2008, those amounts are \$12.2 billion for net cash from operating activities, \$9.8 billion of cash and marketable securities and \$10 billion in global credit facilities, respectively.

The major rating agencies' ratings on the company's debt securities at September 30, 2008 appear in the table below and remain unchanged from December 31, 2007. The company has no 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 AND POOR'S | MOODY'S INVESTORS SERVICE | FITCH RATINGS |
|-----------------------|---------------------------|---------------------------------|------------------|
| Senior long-term debt | A+ | A1 | A+ |
| Commercial paper | A-1 | Prime-1 | F1 |

The table appearing on page 45 of the 2007 IBM Annual Report presents the format in which management reviews cash flows for each of the past five years and is accompanied by a description of the way cash flow is managed, measured and reviewed. While the company prepares its Consolidated Statement of Cash Flows in accordance with SFAS No. 95, Statement of Cash Flows, on page 7 of this Form 10-Q and discusses causes and events underlying sources and uses of cash in that format on pages 46 and 47, the following is the management view of cash flows for the first nine months of 2008 and 2007 prepared in a manner consistent with the table on page 45 of the 2007 IBM Annual Report:

(Dollars in millions)

| For the nine months ended September 30: | 2008 | 2007 |
|--|------------|-----------|
| Net cash from operating activities (Continuing Operations): | \$ 12,191 | \$ 10,943 |
| Less: Global Financing accounts receivable | 2,252 | 2,246 |
| Net cash from operating activities (Continuing Operations), excluding Global Financing accounts receivable | 9,938 | 8,697 |
| Capital expenditures, net | (3,505) | (3,539) |
| Free cash flow (excluding Global Financing accounts receivable) | 6,433 | 5,159 |
| Acquisitions | (6,017) | (718) |
| Divestitures | 71 | 310 |
| Share repurchase | (9,838) | (18,357) |
| Dividends | (1,916) | (1,593) |
| Non-Global Financing debt | (1,384) | 11,732 |
| Other (includes Global Financing accounts receivable and Global Financing debt) | 6,260 | 6,633 |
| Change in cash, cash equivalents and short-term marketable securities | \$ (6,391) | \$ 3,166 |

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Free cash flow for the first nine months of 2008 increased \$1,274 million versus the first nine months of 2007. The improvement year to year was driven by the increase in net income and lower retirement-related plan funding, partially offset by an increase in inventory. There were several significant uses of cash in the first nine months of 2008 including the Cognos and Telelogic acquisitions and capital investments. Also, in the first nine months of 2008, \$11.8 billion was returned to stockholders through dividends and share repurchases.

In February, the company's Board of Directors authorized \$15 billion in additional funds for use in the company's common stock repurchase program. At September 30, 2008, the company had approximately \$6.3 billion of share repurchase authorization remaining.

At December 31, 2007, the company had liabilities of \$937 million, representing the fair value of derivative investments in qualifying net investment hedge relationships. During the first nine months of 2008, the company took actions to reduce hedge levels in some currencies. See the 2007 Annual Report, Note K, Derivatives and Hedging Transactions, for additional information. In the first nine months of 2008, the company had a use of cash in investing activities of \$338 million related to these instruments. The company will reflect a use of cash in investing activities of \$546 million for 2008 and

Table of Contents

estimates a use of cash of \$481 million in 2009, related to these liabilities.

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 or periods of severe and prolonged downturn in the capital markets. Whether any litigation has such an adverse impact will depend on a number of variables, which are more completely described in Note 14 on pages 19 to 22 of this Form 10-Q. With respect to pension funding, the company is not quantifying any future impact from pension funding because it is not possible to predict future movements in the capital markets.

Global Financing

Global Financing is a reportable segment within IBM that is measured as if it were a standalone entity. Accordingly, the information presented in this section is consistent with this separate company view. The mission of Global Financing is to generate a strong return on equity and to facilitate client s acquisition of IBM hardware, software and services.

Results of Operations

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------|-------------------------------------|--------|------------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| External revenue | \$ 633 | \$ 623 | \$ 1,900 | \$ 1,834 |
| Internal revenue | 456 | 348 | 1,367 | 1,037 |
| Total revenue | 1,090 | 970 | 3,267 | 2,871 |
| Total cost | 478 | 461 | 1,417 | 1,312 |
| Gross profit | \$ 611 | \$ 509 | \$ 1,850 | \$ 1,559 |
| Gross profit margin | 56.1% | 52.5% | 56.6% | 54.3% |
| Pre-tax income | \$ 349 | \$ 339 | \$ 1,165 | \$ 1,045 |
| After-tax income | \$ 230 | \$ 217 | \$ 761 | \$ 663 |
| Return on equity* | 25.7% | 25.6% | 28.2% | 26.1% |

* See page 56 for the details of the After-tax income and the Return on equity calculation.

The increase in revenue, in the third quarter of 2008, as compared to the same period in 2007, was primarily due to:

- An increase in external revenue of 1.7 percent (1 percent decline adjusted for currency), due to growth in financing revenue (up 6.1 percent to \$484 million), partially offset by a decrease in used equipment sales (down 10.4 percent to \$149 million); and

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- Growth in internal revenue of 31.3 percent driven by an increase in used equipment sales to the System and Technology segment to support their external sales (up 58.3 percent to \$273 million) and an increase in internal financing (up 4.6 percent to \$183 million).

The increase in external and internal financing revenue was primarily due to higher average asset balances.

The increase in revenue, in the first nine months of 2008, as compared to the same period in 2007, was primarily due to:

- An increase in external revenue of 3.6 percent (2 percent decline adjusted for currency) due to growth in financing revenue (up 9.6 percent to \$1,473 million), offset by a decrease in used equipment sales (down 12.8 percent to \$427 million); and
- Growth in internal revenue of 31.8 percent driven by an increase in used equipment sales to the System and Technology segment to support their external sales (up 51.6 percent to \$799 million) and an increase in internal financing (up 11.4 percent to \$568 million).

The increase in external and internal financing revenue was primarily due to higher average asset balances.

Global Financing gross profit increased 20.0 percent in the third quarter of 2008 compared to the same period in 2007, with gross margin increasing 3.6 points. Gross profit increased 18.6 percent in the first nine months of 2008 compared to the prior year, with gross margin increasing 2.3 points. The improvement in both periods was primarily due to an improvement in equipment sales margins.

Table of Contents

Global Financing pre-tax income increased 3.2 percent in the third quarter of 2008 versus the third quarter of 2007, primarily driven by the increase in gross profit of \$102 million, offset partially by an increase in accounts receivable provisions of \$86 million and an increase in selling, general and administrative expense of \$10 million. Pre-tax income increased 11.6 percent in the first nine months of 2008 compared to the prior year, primarily driven by the increase in gross profit of \$290 million, partially offset by an increase in accounts receivable provisions of \$126 million and an increase in selling, general and administrative expense of \$40 million.

The increase in return on equity from third quarter 2008 to the same period in 2007 and for the first nine months of 2008 compared to the first nine months of 2007 was primarily due to higher after-tax income.

Financial Condition

Balance Sheet

| (Dollars in millions) | At September 30, | | At December 31, | |
|--|-------------------------|--------|------------------------|--------|
| | 2008 | | 2007 | |
| Cash and cash equivalents | \$ | 1,017 | \$ | 755 |
| Net investment in sales-type and direct financing leases | | 10,250 | | 10,876 |
| Equipment under operating leases: | | | | |
| External clients (a) | | 2,249 | | 2,401 |
| Internal clients (b) (c) | | 1,711 | | 1,872 |
| Client loans | | 9,943 | | 10,667 |
| Total client financing assets | | 24,153 | | 25,816 |
| Commercial financing receivables | | 4,604 | | 6,375 |
| Intercompany financing receivables(b) (c) | | 2,670 | | 2,984 |
| Other receivables | | 393 | | 368 |
| Other assets | | 952 | | 1,288 |
| Total financing assets | \$ | 33,788 | \$ | 37,586 |
| Intercompany payables(b) | \$ | 3,285 | \$ | 6,934 |
| Debt(d) | | 24,522 | | 24,532 |
| Other liabilities | | 2,534 | | 2,672 |
| Total financing liabilities | | 30,341 | | 34,138 |
| Total financing equity | | 3,447 | | 3,448 |
| Total financing liabilities and equity | \$ | 33,788 | \$ | 37,586 |

(a) Includes intercompany mark-up, priced on an arms-length basis, on products purchased from the company's product divisions, which is eliminated in IBM's consolidated results.

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

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

(d) Global Financing debt is comprised of intercompany loans and external debt. A portion of Global Financing debt is in support of the company's internal business, or related to intercompany mark-up embedded in the Global Financing assets. See table on page 56.

Sources and Uses of Funds

The primary use of funds in Global Financing is to originate client and commercial financing assets. Client financing assets for end users consist primarily of IBM hardware, software and services, but also include non-IBM equipment, software and services to meet IBM clients' total solutions requirements. Client financing assets are primarily sales-type, direct financing and operating leases for equipment as well as loans for hardware, software and services with terms generally for two to seven years. Global Financing's client loans are primarily for software and services and are unsecured. These loans are subjected to additional credit analysis in order to mitigate the associated risk. Loan agreements include credit protective language and dollar limits on how much can be financed in order to minimize credit risk. Client financing also includes internal activity as described on page 51 of the 2007 IBM Annual Report.

Commercial financing receivables arise primarily from inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory financing and accounts receivable financing

Table of Contents

Management Discussion (continued)

generally range from 30 to 90 days. These short-term receivables are primarily unsecured and are also subject to additional credit actions in order to mitigate the associated risk.

Within Global Financing's total financing assets, excluding internal assets, approximately 97 percent of the portfolio is in the segment's core competency of technology financing. At September 30, 2008, approximately 60 percent of the external portfolio is with investment grade clients, with no exposure to consumers or mortgage-lending institutions.

Originations

The following are total external and internal financing originations:

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------|-------------------------------------|------------------|------------------------------------|------------------|
| | 2008 | 2007 | 2008 | 2007 |
| Client financing: | | | | |
| External | \$ 3,670 | \$ 2,852 | \$ 10,401 | \$ 8,824 |
| Internal | 268 | 245 | 757 | 758 |
| Commercial financing | 7,952 | 7,151 | 23,539 | 20,584 |
| Total | \$ 11,890 | \$ 10,248 | \$ 34,697 | \$ 30,166 |

Cash collections of both client and commercial financing assets exceeded new financing originations in the third quarter, as well as the first nine months of 2008, which resulted in a net decline in financing assets from June 30, 2008 and December 31, 2007, respectively. The increase in originations in both periods was due to improving volumes in both client and commercial financing.

Cash generated by Global Financing was primarily deployed to pay the intercompany payables and dividends to IBM.

Global Financing Receivables and Allowances

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

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| (Dollars in millions) | At September 30, 2008 | | At December 31, 2007 | |
|---|--------------------------|--------|-------------------------|--------|
| Gross financing receivables | \$ | 24,615 | \$ | 27,642 |
| Specific allowance for doubtful accounts | | 314 | | 230 |
| Unallocated allowance for doubtful accounts | | 127 | | 138 |
| Total allowance for doubtful accounts | | 441 | | 368 |
| Net financing receivables | \$ | 24,174 | \$ | 27,274 |
| Allowance for doubtful account coverage | | 1.8% | | 1.3% |

Roll-Forward of Global Financing Receivables Allowance for Doubtful Accounts

(Dollars in millions)

| December 31, 2007 | Allowance Used * | Additions/ (Reductions) Bad Debt Expense | Other** | September 30, 2008 |
|-------------------|---------------------|---|---------|-----------------------|
| \$ 368 | \$ (40) | \$ 119 | \$ (6) | \$ 441 |

* Represents reserved receivables, net of recoveries, which were disposed of during the period.

** Primarily represents translation adjustments.

The percentage of financing receivables reserved increased from 1.3 percent at December 31, 2007 to 1.8 percent at September 30, 2008 due to the increase in the specific allowance for doubtful accounts. Specific reserves increased 36.5 percent from December 31, 2007 to September 30, 2008 due to current economic conditions. Unallocated reserves decreased \$11 million in the same period due to the decline in gross financing receivables.

Table of Contents

Global Financing's bad debt expense was \$119 million for the nine months ended September 30, 2008, compared with a reduction of \$8 million for the nine months ended September 30, 2007. The increase was primarily attributed to the increase in specific reserves.

In the third quarter of 2008, compared to the third quarter of 2007, bad debt expense increased \$86 million.

Residual Value

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

Global Financing optimizes the recovery of residual values by selling assets sourced from end of lease, leasing used equipment to new clients, or extending lease arrangements with current clients. Sales of equipment, which are primarily sourced from equipment returned at the end of a lease, represented 38.8 percent and 37.5 percent of Global Financing's revenue in the third quarter and first nine months, respectively, of 2008 and 34.9 percent and 35.4 percent in the third quarter and first nine months, respectively, of 2007. The increase in the third quarter of 2008 and the first nine months of 2008 was driven primarily by the increase in internal used sales to the Systems and Technology segment. The gross margins on these sales were 48.1 percent and 39.4 percent in the third quarter of 2008 and 2007, respectively. The increase is driven by a shift in mix towards internal sales of higher margin products as well as higher margins on overall used equipment sales. The gross margins were 47.9 percent and 42.0 percent for the first nine months of 2008 and 2007, respectively. This increase is primarily driven by a shift in mix towards the higher margin internal sales and higher margins on internal used equipment sales.

The following table presents the recorded amount of unguaranteed residual value for sales-type and direct financing leases and operating leases at December 31, 2007 and September 30, 2008. 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 September 30, 2008 is expected to be returned to the company. In addition to the unguaranteed residual value below, on a limited basis, Global Financing will obtain guarantees of the future value of the equipment to be returned at end of lease. 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 or operating lease. The aggregate asset values associated with the guarantees were \$279 million and \$156 million for the financing transactions originated during the quarters ended September 30, 2008 and September 30, 2007, respectively, and \$757 million and \$473 million for the nine months ended September 30, 2008 and September 30, 2007, respectively. The associated aggregate guaranteed future values at the scheduled end of lease were \$9 million and \$8 million for the financing transactions originated during the quarters ended September 30, 2008 and September 30, 2007, respectively, and \$39 million and \$22 million for the financing transactions originated during the nine months ended September 30, 2008 and September 30, 2007, respectively. The cost of guarantees was \$0.9 million for the quarter ended September 30, 2008 and \$0.9 million for the quarter ended September 30, 2007, and \$4.9 million and \$2.9 million for each of the nine months ended September 30, 2008 and September 30, 2007, respectively.

Unguaranteed Residual Value

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| (Dollars in millions) | December 31, 2007 | | September 30, 2008 | | 2008 | | Amortization of September 30, 2008 balance | | 2011 and Beyond | | | |
|--|-------------------|--------|--------------------|--------|------|------|--|-----|-----------------|-----|----|-----|
| | | | | | 2009 | 2010 | | | | | | |
| Sales-type and direct financing leases | \$ | 915 | \$ | 916 | \$ | 61 | \$ | 225 | \$ | 266 | \$ | 364 |
| Operating leases | | 421 | | 391 | | 60 | | 115 | | 119 | | 97 |
| Total unguaranteed residual value | \$ | 1,336 | \$ | 1,307 | \$ | 121 | \$ | 340 | \$ | 385 | \$ | 461 |
| Related original amount financed | \$ | 24,517 | \$ | 23,162 | | | | | | | | |
| Percentage | | 5.4% | | 5.6% | | | | | | | | |

Table of Contents

Debt

| | At September 30, 2008 | At December 31, 2007 |
|----------------------|--------------------------|-------------------------|
| Debt-to-equity ratio | 7.1x | 7.1x |

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. Both assets and debt are presented in the Global Financing balance sheet on page 53.

The Global Financing business provides funding predominantly for the company's external clients but also provides intercompany financing for the company. As previously stated, the company measures Global Financing as if it were a standalone 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 52 and in Segment Information on pages 65 and 66.

In the company's Consolidated Statement of Earnings on pages 3 and 4, however, the 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 debt. In this table, Intercompany activity is comprised of 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 levered in line with the overall Global Financing business model.

| (Dollars in millions) | September 30, 2008 | | December 31, 2007 | |
|----------------------------------|--------------------|---------|-------------------|---------|
| Global Financing Segment | \$ | 24,522 | \$ | 24,532 |
| Debt to support external clients | \$ | 20,991 | \$ | 21,072 |
| Debt to support internal clients | | 3,531 | | 3,460 |
| Non-Global Financing Segments | | 9,892 | | 10,743 |
| Debt supporting operations | | 13,422 | | 14,203 |
| Intercompany activity | | (3,531) | | (3,460) |
| Total company debt | \$ | 34,413 | \$ | 35,274 |

Liquidity and Capital Resources

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

Return on Equity

| (Dollars in millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Numerator : | | | | |
| Global Financing after tax income* | \$ 230 | \$ 217 | \$ 761 | \$ 663 |
| Annualized after tax income (A) | \$ 920 | \$ 868 | \$ 1,015 | \$ 884 |
| Denominator : | | | | |
| Average Global Financing equity (B)** | \$ 3,567 | \$ 3,385 | \$ 3,593 | \$ 3,388 |
| Global Financing Return on Equity(A)/(B) | 25.7% | 25.6% | 28.2% | 26.1% |

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

** Average of the ending equity for Global Financing for the last 2 quarters and 3 quarters, for the three months ended September 30, and for the nine months ended September 30, respectively.

Table of Contents

Looking Forward

Global Financing's financial position provides flexibility and funding capacity which enable the company to be well positioned in the current environment. Global Financing's assets and new financing volumes are primarily IBM 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.

The company's System z and high-end converged System p servers announced this year are a significant financing opportunity. 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.

Although funding costs have risen, IBM has continued 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 funding 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 bad debts. Global Financing will continue to apply rigorous credit policies in both the origination of new business and the evaluation of the existing portfolio.

As discussed on page 55, 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 economy.

Forward Looking and Cautionary Statements

Except for the historical information and discussions contained herein, statements contained in this release may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, including the company's failure to continue to develop and

market new and innovative products and services and to keep pace with technological change; competitive pressures; failure to obtain or protect intellectual property rights; breaches of the company's data security measures; changes in the economic environment and corporate IT spending budgets; fluctuations in revenues and purchases, and volatility of stock prices; the company's ability to attract and retain key personnel and its reliance on critical skills; adverse affects from tax matters; environmental matters; currency fluctuations and customer financing risks; customer credit risk on receivables; risks from investing in growth opportunities; the company's failure to maintain the adequacy of its internal controls; the company's use of certain estimates and assumptions; dependence on certain suppliers; changes in the financial or business condition of the company's distributors or resellers; the company's ability to successfully manage acquisitions and alliances; failure to have sufficient insurance; legal, political, health and economic conditions; risk factors related to IBM securities; and other risks, uncertainties and factors discussed in the company's Form 10-Q, Form 10-K and in the company's other filings with the U.S. Securities and Exchange Commission (SEC) or in materials incorporated therein by reference. The company assumes no obligation to update or revise any forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk affecting IBM, see "Quantitative and Qualitative Disclosures About Market Risk" in Item 7A. of Part II, of the company's Annual Report on Form 10-K for the year ended December 31, 2007, which is incorporated by reference. The company's exposure to market risk has not changed materially since December 31, 2007.

Table of Contents**Item 4. Controls and Procedures**

The company's management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the company's disclosure controls and procedures were effective as of the end of the period covered by this report. There has been no change in the company's internal control over financial reporting that occurred during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Part II - Other Information**Item 1. Legal Proceedings**

Refer to Note 14 on pages 19 to 22 of this Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds and Issuer Repurchases of Equity Securities

The following table provides information relating to the company's repurchase of common stock for the third quarter of 2008.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program(1) |
|--|----------------------------------|------------------------------|--|---|
| July 1, 2008 - July 31, 2008 | 7,752,795 | \$ 124.57 | 7,752,795 | \$ 7,889,107,267 |
| August 1, 2008 - August 31, 2008 | 6,037,600 | \$ 125.39 | 6,037,600 | \$ 7,132,081,975 |
| September 1, 2008 - September 30, 2008 | 7,555,300 | \$ 116.62 | 7,555,300 | \$ 6,251,018,469 |
| Total | 21,345,695 | \$ 121.99 | 21,345,695 | |

- (1) On February 26, 2008, the Board of Directors authorized \$15.0 billion in funds for use in the company's common stock repurchase program; the company stated that it would repurchase shares on the open market or in private transactions depending on market conditions, and that it expects to use cash from operations for the repurchases. The common stock repurchase program does not have an expiration date. This table does not include shares tendered to satisfy the exercise price in connection with cashless exercises of employee stock

options or shares tendered to satisfy tax withholding obligations in connection with employee equity awards.

Item 5. Other Information

Lucio A. Noto retired from the IBM Board of Directors, effective October 28, 2008. Mr. Noto served on IBM's Board of Directors since 1995, and the company is very grateful for his valuable contributions. The company is including this disclosure in this Form 10-Q rather than filing a Form 8-K under Item 5.02(b) at a later date. In connection with Mr. Noto's retirement, Article III, Section 2 of IBM's By-laws was amended to decrease the number of directors to twelve, effective October 28, 2008. The full text of IBM's By-laws, as amended, is included as Exhibit 3 to this report.

Table of Contents

Item 6 (a). Exhibits

Exhibit Number

- 3 The By-laws of IBM as amended through October 28, 2008.
- 11 Statement re: computation of per share earnings.
- 12 Statement re: computation of ratios.
- 31.1 Certification by CEO pursuant to Rule 13A-14(a) or 15D-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by CFO pursuant to Rule 13A-14(a) or 15D-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification by CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

International Business Machines Corporation
(Registrant)

Date: October 28, 2008

By: /s/ James J. Kavanaugh
James J. Kavanaugh
Vice President and Controller

Table of Contents

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