INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
July 26, 2016
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 JUNE 30, 2016

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

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

914-499-1900

(Registrant s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section l3 or l5(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

Large accelerated filer x	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 x

The registrant had 955,844,217 shares of common stock outstanding at June 30, 2016.

Table of Contents

Index

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 except per share amounts)	Three Months Ended June 30, 2016	2015	Six Months Ended June 30, 2016	2015
Revenue:				
Services	$ 13,018	$ 12,597	$ 25,409	$ 24,963
Sales	6,792	7,733	12,671	14,489
Financing	429	484	843	950
Total revenue	20,238	20,813	38,923	40,403
Cost:				
Services	8,691	8,431	17,074	16,709
Sales	1,582	1,726	2,960	3,351
Financing	263	266	501	501
Total cost	10,536	10,423	20,535	20,561
Gross profit	9,702	10,390	18,388	19,842
Expense and other (income):				
Selling, general and administrative	5,349	5,179	11,361	10,541
Research, development and engineering	1,465	1,300	2,923	2,598
Intellectual property and custom development income	(365)	(128)	(582)	(301)
Other (income) and expense	37	(301)	289	(444)
Interest expense	167	115	315	223
Total expense and other (income)	6,653	6,165	14,306	12,617
Income from continuing operations before income taxes	3,049	4,224	4,082	7,225
Provision for/(benefit from) income taxes	544	698	(439)	1,283
Income from continuing operations	$ 2,505	$ 3,526	$ 4,521	$ 5,942
Loss from discontinued operations, net of tax	0	(77)	(3)	(165)
Net income	$ 2,504	$ 3,449	$ 4,518	$ 5,777
Earnings/(loss) per share of common stock:				
Assuming dilution:				
Continuing operations	$ 2.61	$ 3.58	$ 4.69	$ 6.01
Discontinued operations	0.00	(0.08)	0.00	(0.17)
Total	$ 2.61	$ 3.50	$ 4.69	$ 5.84
Basic:				
Continuing operations	$ 2.62	$ 3.59	$ 4.71	$ 6.03
Discontinued operations	0.00	(0.08)	0.00	(0.17)
Total	$ 2.62	$ 3.51	$ 4.71	$ 5.86
Weighted-average number of common shares outstanding: (millions)				
Assuming dilution	960.5	986.7	962.4	989.5

Basic	957.4	982.3	959.5	985.2
Cash dividend per common share	$ 1.40	$ 1.30	$ 2.70	$ 2.40

(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 COMPREHENSIVE INCOME

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in millions)	**2016**	**2015**	**2016**	**2015**
Net income	$ 2,504	$ 3,449	$ 4,518	$ 5,777
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	(248)	102	(10)	(350)
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	1	(15)	(35)	17
Reclassification of (gains)/losses to net income	0	0	37	0
Total net changes related to available-for-sale securities	1	(15)	2	16
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	9	(187)	(256)	432
Reclassification of (gains)/losses to net income	102	(321)	11	(570)
Total unrealized gains/(losses) on cash flow hedges	111	(508)	(245)	(138)
Retirement-related benefit plans:				
Prior service costs/(credits)		1		6
Net (losses)/gains arising during the period	78	93	(68)	16
Curtailments and settlements	10	3	14	7
Amortization of prior service (credits)/costs	(27)	(25)	(53)	(51)
Amortization of net (gains)/losses	693	821	1,383	1,656
Total retirement-related benefit plans	754	894	1,277	1,635
Other comprehensive income/(loss), before tax	617	472	1,023	1,163
Income tax (expense)/benefit related to items of other comprehensive income	(223)	(62)	(21)	(719)
Other comprehensive income/(loss)	394	411	1,002	444
Total comprehensive income/(loss)	$ 2,899	$ 3,860	$ 5,520	$ 6,221

(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 June 30, 2016	At December 31, 2015
Assets:		
Current assets:		
Cash and cash equivalents	$ 10,017	$ 7,686
Marketable securities	600	508
Notes and accounts receivable - trade (net of allowances of $352 in 2016 and $367 in 2015)	8,782	8,333
Short-term financing receivables (net of allowances of $526 in 2016 and $490 in 2015)	16,635	19,020
Other accounts receivable (net of allowances of $58 in 2016 and $51 in 2015)	1,130	1,201
Inventories, at lower of average cost or market:		
Finished goods	414	352
Work in process and raw materials	1,271	1,199
Total inventories	1,685	1,551
Prepaid expenses and other current assets	4,676	4,205
Total current assets	43,524	42,504
Property, plant and equipment	30,136	29,342
Less: Accumulated depreciation	19,044	18,615
Property, plant and equipment net	11,092	10,727
Long-term financing receivables (net of allowances of $142 in 2016 and $118 in 2015)	9,267	10,013
Prepaid pension assets	2,957	1,734
Deferred taxes	4,387	4,822
Goodwill	36,422	32,021
Intangible assets net	5,148	3,487
Investments and sundry assets	5,259	5,187
Total assets	$ 118,056	$ 110,495

(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 (CONTINUED)

(UNAUDITED)

LIABILITIES AND EQUITY

(Dollars in millions)	At June 30, 2016	At December 31, 2015
Liabilities:		
Current liabilities:		
Taxes	$ 2,275	$ 2,847
Short-term debt	4,887	6,461
Accounts payable	5,484	6,028
Compensation and benefits	3,950	3,560
Deferred income	11,508	11,021
Other accrued expenses and liabilities	5,480	4,353
Total current liabilities	33,585	34,269
Long-term debt	39,638	33,428
Retirement and nonpension postretirement benefit obligations	16,723	16,504
Deferred income	3,837	3,771
Other liabilities	8,385	8,099
Total liabilities	102,167	96,071
Equity:		
IBM stockholders equity:		
Common stock, par value $0.20 per share, and additional paid-in capital	53,565	53,262
Shares authorized: 4,687,500,000		
Shares issued:2016 - 2,224,090,577		
2015 - 2,221,223,449		
Retained earnings	148,071	146,124
Treasury stock - at cost	(157,298)	(155,518)
Shares:2016 - 1,268,246,360		
2015 - 1,255,494,724		
Accumulated other comprehensive income/(loss)	(28,604)	(29,607)
Total IBM stockholders equity	15,733	14,262
Noncontrolling interests	156	162
Total equity	15,889	14,424
Total liabilities and equity	$ 118,056	$ 110,495

(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

(UNAUDITED)

(Dollars in millions)	Six Months Ended June 30, 2016	2015
Cash flows from operating activities:		
Net income	$ 4,518	$ 5,777
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	1,382	1,335
Amortization of intangibles	745	594
Stock-based compensation	261	257
Net (gain)/loss on asset sales and other	167	152
Loss on Microelectronics business disposal		37
Changes in operating assets and liabilities, net of acquisitions/divestitures	2,015	(659)
Net cash provided by operating activities	9,088	7,494
Cash flows from investing activities:		
Payments for property, plant and equipment	(1,826)	(1,722)
Proceeds from disposition of property, plant and equipment	172	182
Investment in software	(295)	(290)
Acquisition of businesses, net of cash acquired	(5,405)	(708)
Divestitures of businesses, net of cash transferred	35	81
Non-operating finance receivables net	1,127	1,338
Purchases of marketable securities and other investments	(2,386)	(1,716)
Proceeds from disposition of marketable securities and other investments	2,028	1,464
Net cash used in investing activities	(6,550)	(1,371)
Cash flows from financing activities:		
Proceeds from new debt	8,263	2,765
Payments to settle debt	(3,425)	(4,463)
Short-term borrowings/(repayments) less than 90 days net	(909)	177
Common stock repurchases	(1,775)	(2,303)
Common stock transactions other	115	221
Cash dividends paid	(2,590)	(2,366)
Net cash used in financing activities	(322)	(5,970)
Effect of exchange rate changes on cash and cash equivalents	114	(236)
Net change in cash and cash equivalents	2,330	(83)
Cash and cash equivalents at January 1	7,686	8,476
Cash and cash equivalents at June 30	$ 10,017	$ 8,393

(Amounts may not add due to rounding.)

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

7

Table of Contents

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(UNAUDITED)

(Dollars in millions)	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Non-Controlling Interests	Total Equity
Equity - January 1, 2016	$ 53,262	$ 146,124	$ (155,518)	$ (29,607)	$ 14,262	$ 162	$ 14,424
Net income plus other comprehensive income/(loss)							
Net income		4,518			4,518		4,518
Other comprehensive income/(loss)				1,002	1,002		1,002
Total comprehensive income/(loss)					$ 5,520		$ 5,520
Cash dividends paid common stock		(2,590)			(2,590)		(2,590)
Common stock issued under employee plans (2,867,128 shares)	321				321		321
Purchases (769,837 shares) and sales (323,578 shares) of treasury stock under employee plans net		16	(71)		(56)		(56)
Other treasury shares purchased, not retired (12,305,377 shares)			(1,709)		(1,709)		(1,709)
Changes in other equity	(18)	2			(16)		(16)
Changes in noncontrolling interests						(6)	(6)
Equity - June 30, 2016	$ 53,565	$ 148,071	$ (157,298)	$ (28,604)	$ 15,733	$ 156	$ 15,889

(Dollars in millions)	Common Stock and Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income/(Loss)	Total IBM Stockholders Equity	Non-Controlling Interests	Total Equity
Equity - January 1, 2015	$ 52,666	$ 137,793	$ (150,715)	$ (27,875)	$ 11,868	$ 146	$ 12,014
Net income plus other comprehensive income/(loss)							
Net income		5,777			5,777		5,777
Other comprehensive income/(loss)				444	444		444
Total comprehensive income/(loss)					$ 6,221		$ 6,221
Cash dividends paid common stock		(2,366)			(2,366)		(2,366)
Common stock issued under employee plans (3,929,697 shares)	395				395		395

Purchases (931,120 shares) and sales (475,037 shares) of treasury stock under employee plans net		14	(91)		(77)		(77)
Other treasury shares purchased, not retired (14,467,545 shares)			(2,356)		(2,356)		(2,356)
Changes in other equity	(2)				(2)		(2)
Changes in noncontrolling interests						8	8
Equity - June 30, 2015	$ 53,059	$ 141,218	$ (153,162)	$ (27,432)	$ 13,684	$ 153	$ 13,837

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

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amount of assets, liabilities, revenue, costs, expenses and other comprehensive income/(loss) that are reported in the Consolidated Financial Statements and accompanying disclosures. These estimates are based on management s best knowledge of current events, historical experience, actions that the company may undertake in the future and on various other assumptions that are believed to be reasonable under the circumstances. As a result, actual results may be different from these estimates. Refer to the company s recast 2015 Annual Report on Form 8-K, dated June 13, 2016, pages 48 to 51, for a discussion of the company s critical accounting estimates.

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

In January 2016, the company made a number of changes to its organizational structure and management system. These changes impacted the company s reportable segments, but did not impact the Consolidated Financial Statements. Refer to note 6, Segments, on pages 27 to 29 for additional information on the changes in reportable segments. The periods presented in this Form 10-Q are reported on a comparable basis. The company filed a recast 2015 Annual Report in a Form 8-K on June 13, 2016 to recast its historical segment information to reflect these changes.

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

In the first quarter of 2016, the company reported a benefit from income taxes of $983 million, and its effective tax rate was (95.1) percent, primarily driven by the resolution of a long-standing non-U.S. tax matter in February 2016. For the six months ended June 30, 2016, the company s benefit from income taxes is $439 million and its effective tax rate is (10.8) percent. See Taxes on page 71 for additional information.

Noncontrolling interest amounts of $3.0 million and $2.4 million, net of tax, for the three months ended June 30, 2016 and 2015, respectively, and $4.4 million and $3.5 million, net of tax, for the six months ended June 30, 2016 and 2015, respectively, are included in the Consolidated Statement of Earnings within the other (income) and expense line item.

Interim results are not necessarily indicative of financial results for a full year. The information included in this Form 10-Q should be read in conjunction with the company s 2015 Annual Report and Form 8-K dated June 13, 2016.

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

2. Accounting Changes:

New Standards to be Implemented

In June 2016, the Financial Accounting Standards Board (FASB) issued guidance for credit impairment based on an expected loss rather than incurred loss model. The guidance requires the consideration of all available relevant information when estimating expected credit losses, including past events, current conditions and forecasts and their implications for expected credit losses. The guidance is effective January 1, 2020 with a one year early adoption permitted. The company is evaluating the impact of the new guidance and the effective date.

Table of Contents

Notes to Consolidated Financial Statements (continued)

In March 2016, the FASB issued guidance which changes the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification in the Consolidated Statement of Cash Flows. The guidance is effective January 1, 2017 and early adoption is permitted. The impact of the guidance could result in increased volatility of the company s provision for income taxes and earnings per share in the Consolidated Statement of Earnings, depending on the company s share price at exercise or vesting of share-based awards compared to grant date. The standard is not expected to have a material impact upon adoption.

In February 2016, the FASB issued guidance which changes the accounting for leases. The guidance requires lessees to recognize right-of-use assets and lease liabilities for most leases in the Consolidated Statement of Financial Position. The guidance makes some changes to lessor accounting, including the elimination of the use of residual value guarantee insurance in the capital lease test, and overall aligns with the new revenue recognition guidance. The guidance also requires qualitative and quantitative disclosures to assess the amount, timing and uncertainty of cash flows arising from leases. The guidance is effective January 1, 2019 and early adoption is permitted. The company is currently evaluating the impact of the new guidance and the effective date. The company s operating lease commitments were $6.4 billion at December 31, 2015, and in 2015, the use of residual value guarantee insurance resulted in the company recognizing $608 million of sales-type lease revenue that would otherwise have been recognized as operating lease revenue over the lease term.

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

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

Standards Implemented

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

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

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

In April 2015, the FASB issued guidance which requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The guidance was effective January 1, 2016 with early adoption permitted. The company adopted the guidance in the fourth quarter of 2015 on a retrospective basis. The company had debt issuance costs of $90 million and $74 million at June 30, 2016 and December 31, 2015, respectively. Debt issuance costs were previously included in investments and sundry assets in the Consolidated Statement of Financial Position.

3. Financial Instruments:

Fair Value Measurements

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

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

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

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

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

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

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

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

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

Certain financial assets are measured at fair value on a nonrecurring basis. These assets include equity method investments that are recognized at fair value at the measurement date to the extent that they are deemed to be other-than-temporarily impaired. Certain assets that are measured at fair value on a recurring basis can be subject to nonrecurring fair value measurements. These assets include available-for-sale equity investments that are deemed to be other-than-temporarily

Table of Contents

Notes to Consolidated Financial Statements (continued)

impaired. In the event of an other-than-temporary impairment of a financial investment, fair value is measured using a model described above.

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. During the six months ended June 30, 2016, the company recorded an impairment on certain assets that are classified as held for sale. See note 1, Basis of Presentation, for additional information. There were no material impairments of non-financial assets for the six months ended June 30, 2015.

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

The following tables present the company s financial assets and financial liabilities that are measured at fair value on a recurring basis at June 30, 2016 and December 31, 2015.

(Dollars in millions) **At June 30, 2016**	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	$	$ 3,198	$	$ 3,198
Commercial paper				
Money market funds	2,141			2,141
U.S. government securities		1,500		1,500
Canadian government securities		462		462
Total	2,141	5,160		7,301(6)
Debt securities - current (2)		599		599(6)
Debt securities - noncurrent (3)	1	7		9
Available-for-sale equity investments (3)	11			11
Derivative assets (4)				
Interest rate contracts		1,015		1,015
Foreign exchange contracts		258		258
Equity contracts		11		11
Total		1,284		1,284(7)
Total assets	$ 2,153	$ 7,051	$	$ 9,204(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	$	$ 406	$	$ 406
Equity contracts		8		8
Total liabilities	$	$ 414	$	$ 414(7)

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

(2) U.S. government securities, time deposits and certificates of deposit reported as marketable securities in the Consolidated Statement of Financial Position.

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

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at June 30, 2016 were $262 million and $1,022 million, respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at June 30, 2016 were $374 million and $40 million, respectively.

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

(7) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions each would have been reduced by $280 million.

Table of Contents

Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At December 31, 2015	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	$	$ 2,856	$	$ 2,856
Money market funds	2,069			2,069
Other securities		18		18
Total	2,069	2,874		4,943(6)
Debt securities - current (2)		506		506(6)
Debt securities - noncurrent (3)	1	6		8
Trading security investments (3)	28			28
Available-for-sale equity investments (3)	192			192
Derivative assets (4)				
Interest rate contracts		656		656
Foreign exchange contracts		332		332
Equity contracts		6		6
Total		994		994(7)
Total assets	$ 2,290	$ 4,381	$	$ 6,671(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	$	$ 164	$	$ 164
Equity contracts		19		19
Interest rate contracts		3		3
Total liabilities	$	$ 186	$	$ 186(7)

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

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

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

(4) The gross balances of derivative assets contained within prepaid expenses and other current assets, and investments and sundry assets in the Consolidated Statement of Financial Position at December 31, 2015 were $292 million and $702 million, respectively.

(5) The gross balances of derivative liabilities contained within other accrued expenses and liabilities, and other liabilities in the Consolidated Statement of Financial Position at December 31, 2015 were $164 million and $22 million, respectively.

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

(7) If derivative exposures covered by a qualifying master netting agreement had been netted in the Consolidated Statement of Financial Position, the total derivative asset and liability positions each would have been reduced by $139 million.

There were no transfers between Levels 1 and 2 for the six months ended June 30, 2016 and the year ended December 31, 2015.

Financial Assets and Liabilities Not Measured at Fair Value

Short-Term Receivables and Payables

Notes and other accounts receivable and other investments are financial assets with carrying values that approximate fair value. Accounts payable, other accrued expenses and short-term debt (excluding the current portion of long-term debt) are financial liabilities with carrying values that approximate fair value. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Loans and Long-term Receivables

Fair values are based on discounted future cash flows using current interest rates offered for similar loans to clients with similar credit ratings for the same remaining maturities. At June 30, 2016 and December 31, 2015, the difference between the carrying amount and estimated fair value for loans and long-term receivables was immaterial. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy.

Table of Contents

Notes to Consolidated Financial Statements (continued)

Long-Term Debt

Fair value of publicly-traded long-term debt is based on quoted market prices for the identical liability when traded as an asset in an active market. For other long-term debt for which a quoted market price is not available, an expected present value technique that uses rates currently available to the company for debt with similar terms and remaining maturities is used to estimate fair value. The carrying amount of long-term debt was $39,638 million and $33,428 million, and the estimated fair value was $42,506 million and $35,220 million at June 30, 2016 and December 31, 2015, respectively. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

Debt and Marketable Equity Securities

The company s cash equivalents and current debt securities are considered available-for-sale and recorded at fair value, which is not materially different from carrying value, in the Consolidated Statement of Financial Position.

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

(Dollars in millions) At June 30, 2016:		**Adjusted Cost**		**Gross Unrealized Gains**		**Gross Unrealized Losses**		**Fair Value**
Debt securities noncurrent(1)	$	6	$	3	$		$	9
Available-for-sale equity investments(1)	$	2	$	9	$	0	$	11

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

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

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

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

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

(Dollars in millions) **For the three months ended June 30:**	**2016**	**2015**
Proceeds	$ 1	$ 1
Gross realized gains (before taxes)	0	0
Gross realized losses (before taxes)	0	0

(Dollars in millions) **For the six months ended June 30:**	**2016**	**2015**
Proceeds	$ 149	$ 6
Gross realized gains (before taxes)	0	1
Gross realized losses (before taxes)	37	0

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

(Dollars in millions) For the three months ended June 30:	2016	2015
Net unrealized gains/(losses) arising during the period	$ 1	$ (10)
Net unrealized (gains)/losses reclassified to net income*	0	0

*There were no writedowns for the three months ended June 30, 2016 and 2015, respectively.

(Dollars in millions) For the six months ended June 30:	2016	2015
Net unrealized gains/(losses) arising during the period	$ (22)	$ 10
Net unrealized (gains)/losses reclassified to net income*	23	0

* There were no writedowns for the six months ended June 30, 2016 and 2015, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at June 30, 2016.

Derivative Financial Instruments

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

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

The company is also a party to collateral security arrangements with most of its major derivative counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds. Posting thresholds can be fixed or can vary based on credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at June 30, 2016 and December 31, 2015 was $99 million and $28 million, respectively, for which no collateral was posted at June 30, 2016 and December 31, 2015. Full collateralization of these agreements would be required in the event that the company s credit rating falls below investment grade or if its credit default swap spread exceeds 250 basis points, as applicable, pursuant to the terms of the collateral security arrangements. The aggregate fair value of derivative instruments in asset positions as of June 30, 2016 and December 31, 2015 was $1,284 million and $994 million, respectively. This amount represents the maximum exposure to loss at the reporting date if the counterparties failed to perform as contracted. This exposure was reduced by $280 million and $139 million at June 30, 2016 and December 31, 2015, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at June 30, 2016 and December 31, 2015, this exposure was reduced by $230 million and $90 million of cash collateral, and $96 million and $40 million of non-cash collateral in U.S. Treasury securities, respectively, received by the company. At June 30, 2016 and December 31, 2015, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was $678 million and $726 million, respectively. At June 30, 2016 and December 31, 2015, the net exposure related to derivative liabilities recorded in the Consolidated Statement of Financial Position was $134 million and $47 million, respectively.

In the Consolidated Statement of Financial Position, the company does not offset derivative assets against liabilities in master netting arrangements nor does it offset receivables or payables recognized upon payment or receipt of cash collateral against the fair values of the related derivative instruments. No amount was recognized in other receivables at June 30, 2016 or December 31, 2015 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation

Table of Contents

Notes to Consolidated Financial Statements (continued)

to return cash collateral was $230 million and $90 million at June 30, 2016 and December 31, 2015, respectively. The company restricts the use of cash collateral received to rehypothecation, and therefore reports it in prepaid expenses and other current assets in the Consolidated Statement of Financial Position. No amount was rehypothecated at June 30, 2016 and December 31, 2015.

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

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

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

Interest Rate Risk

Fixed and Variable Rate Borrowings

The company issues debt in the global capital markets to fund its operations and financing business. Access to cost-effective financing can result in interest rate mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company uses interest-rate swaps to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt issuances into fixed-rate debt (i.e., cash flow hedges). At June 30, 2016 and December 31, 2015, the total notional amount of the company s interest rate swaps was $7.3 billion at both periods. The weighted-average remaining maturity of these instruments at June 30, 2016 and December 31, 2015 was approximately 6.7 years and 7.2 years, respectively.

Forecasted Debt Issuance

The company is exposed to interest rate volatility on future debt issuances. To manage this risk, the company may use forward starting interest-rate swaps to lock in the rate on the interest payments related to the forecasted debt issuance. These swaps are accounted for as cash flow hedges. The company did not have any derivative instruments relating to this program outstanding at June 30, 2016 and December 31, 2015.

At June 30, 2016 and December 31, 2015, net gains of less than $1 million (before taxes), respectively, were recorded in accumulated other comprehensive income/(loss) in connection with cash flow hedges of the company s borrowings. Within these amounts, less than $1 million of gains, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying transactions.

Foreign Exchange Risk

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A large portion of the company s foreign currency denominated debt portfolio is designated as a hedge of net investment in foreign subsidiaries to reduce the volatility in stockholders equity caused by changes in foreign currency exchange rates in the functional currency of major foreign subsidiaries with respect to the U.S. dollar. The company also uses cross-currency swaps and foreign exchange forward contracts for this risk management purpose. At June 30, 2016 and December 31, 2015, the total notional amount of derivative instruments designated as net investment hedges was $8.3 billion and $5.5 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2016 and December 31, 2015 was approximately 0.1 years and 0.2 years, respectively.

Anticipated Royalties and Cost Transactions

The company s operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company s non-U.S. subsidiaries and with the parent company. In

Table of Contents

Notes to Consolidated Financial Statements (continued)

anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is four years. At June 30, 2016 and December 31, 2015, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was $8.1 billion and $8.2 billion, respectively. The weighted-average remaining maturity of these instruments at June 30, 2016 and December 31, 2015 was 0.6 years and 0.7 years, respectively.

At June 30, 2016 and December 31, 2015, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of $76 million and net gains of $147 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $118 million of losses and $121 million of gains, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

Foreign Currency Denominated Borrowings

The company is exposed to exchange rate volatility on foreign currency denominated debt. To manage this risk, the company employs cross-currency swaps to convert fixed-rate foreign currency denominated debt to fixed-rate debt denominated in the functional currency of the borrowing entity. These swaps are accounted for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is approximately nine years. At June 30, 2016 the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was $1.4 billion. At December 31, 2015, no amounts were outstanding under this program.

At June 30, 2016 and December 31, 2015, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of $24 million and net losses of $2 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $22 million of gains and less than $1 million of losses, respectively, are expected to be reclassified to net income within the next 12 months, providing an offsetting economic impact against the underlying exposure.

Subsidiary Cash and Foreign Currency Asset/Liability Management

The company uses its Global Treasury Centers to manage the cash of its subsidiaries. These centers principally use currency swaps to convert cash flows in a cost-effective manner. In addition, the company uses foreign exchange forward contracts to economically hedge, on a net basis, the foreign currency exposure of a portion of the company s nonfunctional currency assets and liabilities. The terms of these forward and swap contracts are generally less than one year. The changes in the fair values of these contracts and of the underlying hedged exposures are generally offsetting and are recorded in other (income) and expense in the Consolidated Statement of Earnings. At June 30, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was $11.1 billion and $11.7 billion, respectively.

Equity Risk Management

The company is exposed to market price changes in certain broad market indices and in the company s own stock primarily related to certain obligations to employees. Changes in the overall value of these employee compensation obligations are recorded in selling, general and administrative (SG&A) expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes derivatives, including equity swaps and futures, to economically hedge the exposures related to its employee compensation obligations. The derivatives are linked to the total return on certain broad market indices or the total return on the company s common stock, and are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings. At June 30, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of these compensation obligations was $1.1 billion and $1.2 billion, respectively.

Other Risks

The company may hold warrants to purchase shares of common stock in connection with various investments that are deemed derivatives because they contain net share or net cash settlement provisions. The company records the changes in the fair value of these warrants in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any warrants qualifying as derivatives outstanding at June 30, 2016 and December 31, 2015.

Table of Contents

Notes to Consolidated Financial Statements (continued)

The company is exposed to a potential loss if a client fails to pay amounts due under contractual terms. The company may utilize credit default swaps to economically hedge its credit exposures. The swaps are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. The company did not have any derivative instruments relating to this program outstanding at June 30, 2016 and December 31, 2015.

The company is exposed to market volatility on certain investment securities. The company may utilize options or forwards to economically hedge its market exposure. The derivatives are recorded at fair value with gains and losses reported in other (income) and expense in the Consolidated Statement of Earnings. At June 30, 2016 the company did not have any derivative instruments relating to this program outstanding. At December 31, 2015 the total notional amount of derivative instruments in economic hedges of investment securities was less than $0.1 billion.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of June 30, 2016 and December 31, 2015, as well as for the three and six months ended June 30, 2016 and 2015, respectively.

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

As of June 30, 2016 and December 31, 2015

	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
(Dollars in millions)	**Balance Sheet Classification**	**6/30/2016**	**12/31/2015**	**Balance Sheet Classification**	**6/30/2016**	**12/31/2015**
Designated as hedging instruments:						
Interest rate contracts:	Prepaid expenses and other current assets	$	$	Other accrued expenses and liabilities	$	$
	Investments and sundry assets	1,015	656	Other liabilities		3
Foreign exchange contracts:	Prepaid expenses and other current assets	163	197	Other accrued expenses and liabilities	311	70
	Investments and sundry assets	7	5	Other liabilities	25	19
Fair value of derivative assets		$ 1,185	$ 858	**Fair value of derivative liabilities**	$ 335	$ 92
Not designated as hedging instruments:						
Foreign exchange contracts:	Prepaid expenses and other current assets	$ 88	$ 90	Other accrued expenses and liabilities	$ 55	$ 75
	Investments and sundry assets	0	40	Other liabilities	15	
Equity contracts:	Prepaid expenses and other current assets	11	6	Other accrued expenses and liabilities	8	19
	Investments and sundry assets			Other liabilities		
Fair value of derivative assets		$ 99	$ 136	**Fair value of derivative liabilities**	$ 79	$ 94
Total debt designated as hedging instruments:						
Short-term debt		N/A	N/A		$ 827	$
Long-term debt		N/A	N/A		$ 8,359	$ 7,945
Total		$ 1,284	$ 994		$ 9,600	$ 8,131

N/A-not applicable

Table of Contents

Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings

For the three months ended June 30, 2016 and 2015

(Dollars in millions) For the three months ended June 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings Recognized on Derivatives(1) 2016	2015	Attributable to Risk Being Hedged(2) 2016	2015
Derivative instruments in fair value hedges(5):					
Interest rate contracts	Cost of financing	$ 77	$ (78)	$ (55)	$ 102
	Interest expense	88	(65)	(63)	86
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	184	(91)	N/A	N/A
Interest rate contracts	Other (income) and expense	0	(1)	N/A	N/A
Equity contracts	SG&A expense	21	(6)	N/A	N/A
	Other (income) and expense	0	2	N/A	N/A
Total		$ 370	$ (238)	$ (118)	$ 189

(Dollars in millions) For the three months ended June 30:	Gain (Loss) Recognized in Earnings and Other Comprehensive Income — Effective Portion Recognized in OCI 2016	2015	Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI 2016	2015	(Ineffectiveness) and Amounts Excluded from Effectiveness Testing(3) 2016	2015
Derivative instruments in cash flow hedges:							
Interest rate contracts	$	$	Interest expense	$ (7)	$ 0	$	$
Foreign exchange contracts	9	(187)	Other (income) and expense	(75)	221	(1)	3
			Cost of sales	(13)	58		
			SG&A expense	(7)	42		
Instruments in net investment hedges(4):							
Foreign exchange contracts	(247)	(175)	Interest expense			16	2
Total	$ (238)	$ (362)		$ (102)	$ 321	$ 15	$ 5

N/A-not applicable

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

(1) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these derivative contracts.

(2) The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging relationships during the period.

(3) The amount of gain/(loss) recognized in income represents ineffectiveness on hedge relationships.

(4) Instruments in net investment hedges include derivative and non-derivative instruments.

(5) For the three month periods ended June 30, 2016 and June 30, 2015, fair value hedges resulted in a gains of $1 million and a loss of $5 million in ineffectiveness, respectively.

Table of Contents

Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings

For the six months ended June 30, 2016 and 2015

(Dollars in millions) For the six months ended June 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings Recognized on Derivatives(1) 2016	2015	Attributable to Risk Being Hedged(2) 2016	2015
Derivative instruments in fair value hedges(4):					
Interest rate contracts	Cost of financing	$ 213	$ 15	$ (166)	$ 39
	Interest expense	236	13	(184)	32
Derivative instruments not designated as hedging instruments(1):					
Foreign exchange contracts	Other (income) and expense	305	(74)	N/A	N/A
Interest rate contracts	Other (income) and expense	0	(1)	N/A	N/A
Equity contracts	SG&A expense	43	18	N/A	N/A
	Other (income) and expense	(1)	3	N/A	N/A
Total		$ 796	$ (26)	$ (350)	$ 71

For the six months ended June 30:	Effective Portion Recognized in OCI 2016	2015	Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI 2016	2015	(Ineffectiveness) and Amounts Excluded from Effectiveness Testing 2016	2015
	Gain (Loss) Recognized in Earnings and Other Comprehensive Income						
Derivative instruments in cash flow hedges:							
Interest rate contracts	$	$	Interest expense	$ (9)	$ 0	$	$
Foreign exchange contracts	(256)	432	Other (income) and expense	12	380	0	3
			Cost of sales	(10)	108		
			SG&A expense	(3)	82		
Instruments in net investment hedges(3):							
Foreign exchange contracts	(940)	519	Interest expense			26	3
Total	$ (1,197)	$ 951		$ (11)	$ 570	$ 26	$ 6

N/A-not applicable

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

(1) The amount includes changes in clean fair values of the derivative instruments in fair value hedging relationships and the periodic accrual for coupon payments required under these derivative contracts.

(2) The amount includes basis adjustments to the carrying value of the hedged item recorded during the period and amortization of basis adjustments recorded on de-designated hedging relationships during the period.

(3) Instruments in net investment hedges include derivative and non-derivative instruments.

(4) For the six month periods ended June 30, 2016 and June 30, 2015, fair value hedges resulted in a gain of $3 million and a loss of $3 million in ineffectiveness, respectively.

For the three and six months ending June 30, 2016 and 2015, there were no significant gains or losses excluded from the assessment of hedge effectiveness (for fair value hedges), or associated with an underlying exposure that did not or was not expected to occur (for cash flow hedges); nor are there any anticipated in the normal course of business.

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

(Dollars in millions)	At June 30, 2016	At December 31, 2015
Current:		
Net investment in sales-type and direct financing leases	$ 3,089	$ 3,057
Commercial financing receivables	7,146	8,948
Client loan and installment payment receivables (loans)	6,400	7,015
Total	$ 16,635	$ 19,020
Noncurrent:		
Net investment in sales-type and direct financing leases	$ 4,200	$ 4,501
Client loan and installment payment receivables (loans)	5,067	5,512
Total	$ 9,267	$ 10,013

Net investment in sales-type and direct financing leases relates principally to the company s systems products and are for terms ranging generally from two to six years. Net investment in sales-type and direct financing leases includes unguaranteed residual values of $595 million and $645 million at June 30, 2016 and December 31, 2015, respectively, and is reflected net of unearned income of $546 million and $536 million, and net of allowance for credit losses of $222 million and $213 million at those dates, respectively.

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

Client loan and installment payment receivables (loans), net of allowance for credit losses of $428 million and $377 million at June 30, 2016 and December 31, 2015, respectively, are loans that are provided primarily to clients to finance the purchase of hardware, software and services. Payment terms on these financing arrangements are generally for terms up to seven years.

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

The company utilizes certain of its financing receivables as collateral for nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were $563 million and $545 million at June 30, 2016 and December 31, 2015, respectively.

The company did not have any financing receivables held for sale as of June 30, 2016 and December 31, 2015.

Financing Receivables by Portfolio Segment

The following tables present financing receivables on a gross basis, excluding the allowance for credit losses and residual value, by portfolio segment and by class, excluding commercial financing receivables and other miscellaneous financing receivables at June 30, 2016 and December 31, 2015. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio into two classes: major markets and growth markets.

Table of Contents

Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At June 30, 2016	Major Markets	Growth Markets	Total
Financing receivables:			
Lease receivables	$ 5,355	$ 1,478	$ 6,833
Loan receivables	9,077	2,817	11,894
Ending balance	$ 14,433	$ 4,294	$ 18,727
Collectively evaluated for impairment	$ 14,334	$ 3,829	$ 18,163
Individually evaluated for impairment	$ 99	$ 465	$ 564
Allowance for credit losses:			
Beginning balance at January 1, 2016			
Lease receivables	$ 25	$ 188	$ 213
Loan receivables	83	293	377
Total	$ 109	$ 481	$ 590
Write-offs	(3)	(25)	(27)
Provision	12	64	76
Other	3	8	11
Ending balance at June 30, 2016	$ 121	$ 528	$ 649
Lease receivables	$ 36	$ 186	$ 222
Loan receivables	$ 85	$ 343	$ 428
Collectively evaluated for impairment	$ 36	$ 82	$ 119
Individually evaluated for impairment	$ 85	$ 446	$ 531

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

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

Financing Receivables on Non-Accrual Status

The following table presents the recorded investment in financing receivables which were on non-accrual status at June 30, 2016 and December 31, 2015.

Table of Contents

Notes to Consolidated Financial Statements (continued)

(Dollars in millions)		At June 30, 2016		At December 31, 2015
Major markets	$	1	$	2
Growth markets		44		63
Total lease receivables	$	45	$	65
Major markets	$	18	$	13
Growth markets		121		91
Total loan receivables	$	139	$	104
Total receivables	$	184	$	168

Impaired Loans

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

The following tables present impaired client loan receivables.

	At June 30, 2016				At December 31, 2015			
(Dollars in millions)		Recorded Investment		Related Allowance		Recorded Investment		Related Allowance
Major markets	$	74	$	70	$	50	$	47
Growth markets		319		302		297		284
Total	$	393	$	372	$	347	$	331

(Dollars in millions) For the three months ended June 30, 2016:		Average Recorded Investment		Interest Income Recognized		Interest Income Recognized on Cash Basis
Major markets	$	70	$	0	$	
Growth markets		307		0		
Total	$	377	$	0	$	

(Dollars in millions) For the three months ended June 30, 2015:		Average Recorded Investment		Interest Income Recognized		Interest Income Recognized on Cash Basis
Major markets	$	51	$		$	
Growth markets		341		0		
Total	$	392	$	0	$	

24

Table of Contents

Notes to Consolidated Financial Statements (continued)

(Dollars in millions) For the six months ended June 30, 2016:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 64	$ 0	$
Growth markets	304	0	
Total	$ 367	$ 0	$

(Dollars in millions) For the six months ended June 30, 2015:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Major markets	$ 52	$	$
Growth markets	327	0	
Total	$ 379	$ 0	$

Credit Quality Indicators

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

The following tables present the gross recorded investment for each class of receivables, by credit quality indicator, at June 30, 2016 and December 31, 2015. Receivables with a credit quality indicator ranging from Aaa to Baa3 are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company takes to transfer credit risk to third parties.

(Dollars in millions) At June 30, 2016:	Lease Receivables Major Markets	Lease Receivables Growth Markets	Loan Receivables Major Markets	Loan Receivables Growth Markets
Credit Rating:				
Aaa Aa3	$ 490	$ 41	$ 831	$ 78
A1 A3	1,235	136	2,093	260
Baa1 Baa3	1,498	192	2,539	366
Ba1 Ba2	1,213	359	2,055	684
Ba3 B1	513	427	870	814
B2 B3	372	213	631	407
Caa D	35	109	59	209
Total	$ 5,355	$ 1,478	$ 9,077	$ 2,817

At June 30, 2016, the industries which made up Global Financing s receivables portfolio consisted of: Financial (36 percent), Government (14 percent), Manufacturing (14 percent), Services (10 percent), Retail (8 percent), Communications (7 percent), Healthcare (6 percent) and Other (6 percent).

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

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

Past Due Financing Receivables

(Dollars in millions) At June 30, 2016:	Total Past Due > 90 days (1)	Fully Reserved Financing Receivables	<90 Days or Unbilled Financing Receivables	Total Financing Receivables	Recorded Investment > 90 Days and Accruing (2)
Major markets	$ 7	$ 35	$ 5,314	$ 5,355	$ 106
Growth markets	24	144	1,310	1,478	73
Total lease receivables	$ 30	$ 179	$ 6,624	$ 6,833	$ 179
Major markets	$ 9	$ 39	$ 9,030	$ 9,077	$ 130
Growth markets	15	296	2,506	2,817	55
Total loan receivables	$ 24	$ 335	$ 11,536	$ 11,894	$ 185
Total	$ 54	$ 513	$ 18,160	$ 18,727	$ 364

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

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

(Dollars in millions) At December 31, 2015*:	Total Past Due > 90 days (1)	Fully Reserved Financing Receivables	<90 Days or Unbilled Financing Receivables	Total Financing Receivables	Recorded Investment > 90 Days and Accruing (2)
Major markets	$ 5	$ 33	$ 5,479	$ 5,517	$ 108
Growth markets	30	140	1,355	1,524	60

Total lease receivables	$	35	$	173	$	6,834	$	7,041	$	168
Major markets	$	7	$	35	$	9,696	$	9,739	$	134
Growth markets		31		309		2,825		3,165		86
Total loan receivables	$	38	$	344	$	12,521	$	12,904	$	220
Total	$	73	$	517	$	19,355	$	19,945	$	388

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

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

* Reclassified to conform with 2016 presentation.

Table of Contents

Notes to Consolidated Financial Statements (continued)

Troubled Debt Restructurings

The company did not have any troubled debt restructurings during the six months ended June 30, 2016 and for the year ended December 31, 2015.

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

(Dollars in millions)	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Cost	$ 23	$ 27	$ 44	$ 54
Selling, general and administrative	91	92	190	178
Research, development and engineering	14	12	27	26
Other (income) and expense*		0		(1)
Pre-tax stock-based compensation cost	128	131	261	257
Income tax benefits	(42)	(45)	(84)	(87)
Total net stock-based compensation cost	$ 86	$ 86	$ 176	$ 171

* Reflects the one-time effects related to divestitures.

Pre-tax stock-based compensation cost for the three months ended June 30, 2016 decreased $3 million compared to the corresponding period in the prior year. This was due to decreases related to restricted stock units ($9 million) and performance share units ($4 million); partially offset by increases related to the conversion of stock-based awards previously issued by acquired entities ($8 million) and stock option awards ($1 million).

Pre-tax stock-based compensation cost for the six months ended June 30, 2016 increased $3 million compared to the corresponding period in the prior year. This was due to increases related to the conversion of stock-based awards previously issued by acquired entities ($11 million), performance share units ($9 million) and stock option awards ($2 million); partially offset by a decrease related to restricted stock units ($20 million).

The amount of stock-based compensation cost included in discontinued operations, net of tax, was immaterial in all periods presented.

As of June 30, 2016, the total unrecognized compensation cost of $1,154 million related to non-vested awards was expected to be recognized over a weighted-average period of approximately 2.7 years.

There was no significant capitalized stock-based compensation cost at June 30, 2016 and 2015.

6. Segments: The tables on pages 28 and 29 reflect the results of continuing operations of the company s segments consistent with the management and measurement system utilized within the company. Performance measurement is based on operating pre-tax income from continuing operations. These results are used, in part, by the chief operating decision maker, both in evaluating the performance of, and in allocating resources to, each of the segments.

In January 2016, the company made a number of changes to its organizational structure and management system consistent with its ongoing transformation to a cognitive solutions and cloud platform business. With these changes, the company updated its reportable segments. The company continues to have five reportable segments as follows:

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

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

SEGMENT INFORMATION

	Cognitive Solutions& Industry Services					
(Dollars in millions)	Cognitive Solutions	Global Business Services	Technology Services & Cloud Platforms	Systems	Global Financing	Total Segments
For the three months ended June 30, 2016:						
External revenue	$ 4,675	$ 4,255	$ 8,857	$ 1,950	$ 424	$ 20,162
Internal revenue	594	103	156	206	502	1,561
Total revenue	$ 5,269	$ 4,359	$ 9,013	$ 2,156	$ 926	$ 21,723
Pre-tax income/(loss) from continuing operations	$ 1,451	$ 476	$ 1,279	$ 229	$ 467	$ 3,901
Revenue year-to-year change	4.4%	(2.6)%	(0.6)%	(21.0)%	(21.7)%	(3.5)%
Pre-tax income year-to-year change	(20.5)%	(26.1)%	(9.5)%	(57.5)%	(23.8)%	(22.5)%
Pre-tax income margin	27.5%	10.9%	14.2%	10.6%	50.5%	18.0%
For the three months ended June 30, 2015*:						
External revenue	$ 4,516	$ 4,345	$ 8,898	$ 2,541	$ 478	$ 20,778
Internal revenue	532	130	173	189	704	1,728
Total revenue	$ 5,049	$ 4,475	$ 9,071	$ 2,730	$ 1,182	$ 22,506
Pre-tax income from continuing operations	$ 1,825	$ 643	$ 1,414	$ 538	$ 613	$ 5,033
Pre-tax income margin	36.1%	14.4%	15.6%	19.7%	51.9%	22.4%

* Recast to conform with 2016 presentation.

Reconciliations to IBM as Reported:

(Dollars in millions) For the three months ended June 30:	2016	2015*
Revenue:		
Total reportable segments	$ 21,723	$ 22,506
Eliminations of internal transactions	(1,561)	(1,728)
Other revenue	76	35
Total consolidated revenue	$ 20,238	$ 20,813
Pre-tax income from continuing operations:		
Total reportable segments	$ 3,901	$ 5,033
Amortization of acquired intangible assets	(265)	(160)

Acquisition-related (charges)/income		(23)		(7)
Non-operating retirement-related (costs)/income		(163)		(186)
Eliminations of internal transactions		(334)		(473)
Unallocated corporate amounts		(67)		18
Total pre-tax income from continuing operations	$	3,049	$	4,224

* Recast to conform with 2016 presentation.

Table of Contents

Notes to Consolidated Financial Statements (continued)

SEGMENT INFORMATION

	Cognitive Solutions & Industry Services					
(Dollars in millions)	**Cognitive Solutions**	**Global Business Services**	**Technology Services & Cloud Platforms**	**Systems**	**Global Financing**	**Total Segments**
For the six months ended June 30, 2016:						
External revenue	$ 8,654	$ 8,387	$ 17,280	$ 3,626	$ 834	$ 38,781
Internal revenue	1,262	216	321	418	988	3,206
Total revenue	$ 9,916	$ 8,603	$ 17,602	$ 4,044	$ 1,822	$ 41,987
Pre-tax income/(loss) from continuing operations	$ 2,465	$ 665	$ 1,537	$ 218	$ 853	$ 5,739
Revenue year-to-year change	1.9%	(3.6)%	(1.1)%	(19.8)%	(18.3)%	(4.0)%
Pre-tax income year-to-year change	(26.5)%	(46.0)%	(39.6)%	(72.7)%	(24.4)%	(36.6)%
Pre-tax income margin	24.9%	7.7%	8.7%	5.4%	46.8%	13.7%
For the six months ended June 30, 2015*:						
External revenue	$ 8,564	$ 8,663	$ 17,452	$ 4,683	$ 939	$ 40,301
Internal revenue	1,167	261	339	362	1,290	3,419
Total revenue	$ 9,731	$ 8,923	$ 17,791	$ 5,044	$ 2,229	$ 43,719
Pre-tax income from continuing operations	$ 3,353	$ 1,231	$ 2,544	$ 800	$ 1,128	$ 9,056
Pre-tax income margin	34.5%	13.8%	14.3%	15.9%	50.6%	20.7%

* Recast to conform with 2016 presentation.

Reconciliations to IBM as Reported:

(Dollars in millions) **For the six months ended June 30:**	**2016**	**2015***
Revenue:		
Total reportable segments	$ 41,987	$ 43,719
Eliminations of internal transactions	(3,206)	(3,419)
Other revenue	142	102
Total consolidated revenue	$ 38,923	$ 40,403
Pre-tax income from continuing operations:		
Total reportable segments	$ 5,739	$ 9,056
Amortization of acquired intangible assets	(477)	(330)
Acquisition-related charges	3	(8)
Non-operating retirement-related (costs)/income	(306)	(627)
Eliminations of internal transactions	(689)	(813)
Unallocated corporate amounts	(189)	(53)

Total pre-tax income from continuing operations	$ 4,082	$ 7,225

* Recast to conform with 2016 presentation.

Table of Contents

Notes to Consolidated Financial Statements (continued)

7. Equity Activity:

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) **For the three months ended June 30, 2016:**	**Before Tax Amount**	**Tax (Expense)/ Benefit**	**Net of Tax Amount**
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ (248)	$ 95	$ (154)
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ 1	$ 0	$ 1
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Total net changes related to available-for-sale securities	$ 1	$ 0	$ 1
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ 9	$ 5	$ 13
Reclassification of (gains)/losses to:			
Cost of sales	13	(5)	8
SG&A expense	7	(3)	4
Other (income) and expense	75	(29)	46
Interest expense	7	(3)	5
Total unrealized gains/(losses) on cash flow hedges	$ 111	$ (34)	$ 76
Retirement-related benefit plans(1):			
Net (losses)/gains arising during the period	$ 78	$ (27)	$ 51
Curtailments and settlements	10	(4)	6
Amortization of prior service (credits)/costs	(27)	10	(17)
Amortization of net (gains)/losses	693	(263)	431
Total retirement-related benefit plans	$ 754	$ (283)	$ 471
Other comprehensive income/(loss)	$ 617	$ (223)	$ 394

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) For the three months ended June 30, 2015:	Before Tax Amount	Tax (Expense)/ Benefit	Net of Tax Amount
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ 102	$ 67	$ 169
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ (15)	$ 6	$ (10)
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Total net changes related to available-for-sale securities	$ (15)	$ 6	$ (10)
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ (187)	$ 60	$ (127)
Reclassification of (gains)/losses to:			
Cost of sales	(58)	17	(41)
SG&A expense	(42)	12	(30)
Other (income) and expense	(221)	85	(136)
Interest expense	0	0	0
Total unrealized gains/(losses) on cash flow hedges	$ (508)	$ 175	$ (333)
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 1	$ 0	$ 1
Net (losses)/gains arising during the period	93	(31)	62
Curtailments and settlements	3	(1)	2
Amortization of prior service (credits)/costs	(25)	9	(16)
Amortization of net (gains)/losses	821	(285)	536
Total retirement-related benefit plans	$ 894	$ (310)	$ 585
Other comprehensive income/(loss)	$ 472	$ (62)	$ 411

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) **For the six months ended June 30, 2016:**	**Before Tax Amount**	**Tax (Expense)/ Benefit**	**Net of Tax Amount**
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ (10)	$ 361	$ 351
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ (35)	$ 14	$ (22)
Reclassification of (gains)/losses to other (income) and expense	37	(14)	23
Total net changes related to available-for-sale securities	$ 2	$ (1)	$ 1
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ (256)	$ 96	$ (160)
Reclassification of (gains)/losses to:			
Cost of sales	10	(5)	5
SG&A expense	3	(2)	1
Other (income) and expense	(12)	5	(7)
Interest expense	9	(4)	6
Total unrealized gains/(losses) on cash flow hedges	$ (245)	$ 90	$ (156)
Retirement-related benefit plans(1):			
Net (losses)/gains arising during the period	$ (68)	$ 25	$ (43)
Curtailments and settlements	14	(5)	9
Amortization of prior service (credits)/costs	(53)	19	(33)
Amortization of net (gains)/losses	1,383	(510)	873
Total retirement-related benefit plans	$ 1,277	$ (471)	$ 806
Other comprehensive income/(loss)	$ 1,023	$ (21)	$ 1,002

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

Reclassifications and Taxes Related to Items of Other Comprehensive Income

(Dollars in millions) **For the six months ended June 30, 2015:**	**Before Tax Amount**	**Tax (Expense)/ Benefit**	**Net of Tax Amount**
Other comprehensive income/(loss):			
Foreign currency translation adjustments	$ (350)	$ (199)	$ (549)
Net changes related to available-for-sale securities:			
Unrealized gains/(losses) arising during the period	$ 17	$ (6)	$ 10
Reclassification of (gains)/losses to other (income) and expense	0	0	0
Total net changes related to available-for-sale securities	$ 16	$ (6)	$ 10
Unrealized gains/(losses) on cash flow hedges:			
Unrealized gains/(losses) arising during the period	$ 432	$ (158)	$ 274
Reclassification of (gains)/losses to:			
Cost of sales	(108)	32	(76)
SG&A expense	(82)	24	(58)
Other (income) and expense	(380)	146	(234)
Interest expense	0	0	0
Total unrealized gains/(losses) on cash flow hedges	$ (138)	$ 44	$ (94)
Retirement-related benefit plans(1):			
Prior service costs/(credits)	$ 6	$ (2)	$ 4
Net (losses)/gains arising during the period	16	(5)	10
Curtailments and settlements	7	(2)	5
Amortization of prior service (credits)/costs	(51)	17	(33)
Amortization of net (gains)/losses	1,656	(565)	1,091
Total retirement-related benefit plans	$ 1,635	$ (558)	$ 1,077
Other comprehensive income/(loss)	$ 1,163	$ (719)	$ 444

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

(Dollars in Millions)	Net Unrealized Gains/(Losses) on Cash Flow Hedges	Foreign Currency Translation Adjustments*	Net Change Retirement-Related Benefit Plans	Net Unrealized Gains/(Losses) on Available-For-Sale Securities	Accumulated Other Comprehensive Income/(Loss)
January 1, 2016	$ 100	$ (3,463)	$ (26,248)	$ 5	$ (29,607)
Other comprehensive income before reclassifications	(160)	351	(34)	(22)	135
Amount reclassified from accumulated other comprehensive income	4	0	840	23	867
Total change for the period	(156)	351	806	1	1,002
June 30, 2016	$ (56)	$ (3,112)	$ (25,442)	$ 6	$ (28,604)

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

(Dollars in Millions)	Net Unrealized Gains/(Losses) on Cash Flow Hedges	Foreign Currency Translation Adjustments*	Net Change Retirement-Related Benefit Plans	Net Unrealized Gains/(Losses) on Available-For-Sale Securities	Accumulated Other Comprehensive Income/(Loss)
January 1, 2015	$ 392	$ (1,742)	$ (26,509)	$ (15)	$ (27,875)
Other comprehensive income before reclassifications	274	(549)	19	10	(246)
Amount reclassified from accumulated other comprehensive income	(368)	0	1,058	0	690
Total change for the period	(94)	(549)	1,077	10	444
June 30, 2015	$ 298	$ (2,292)	$ (25,433)	$ (5)	$ (27,432)

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

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

(Dollars in millions) For the three months ended June 30:	2016	2015	Yr. to Yr. Percent Change
Retirement-related plans cost			

Defined benefit and contribution pension plans cost	$	455	$ 493	(7.7)%
Nonpension postretirement plans cost		61	67	(9.8)
Total	$	516	$ 560	(7.9)%

(Dollars in millions) For the six months ended June 30:		2016	2015	Yr. to Yr. Percent Change
Retirement-related plans cost				
Defined benefit and contribution pension plans cost	$	894	$ 1,242	(28.0)%
Nonpension postretirement plans cost		121	139	(13.0)
Total	$	1,014	$ 1,380	(26.5)%

Table of Contents

Notes to Consolidated Financial Statements (continued)

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

Cost/(Income) of Pension Plans

(Dollars in millions)	**U.S. Plans**		**Non-U.S. Plans**	
For the three months ended June 30:	**2016**	**2015**	**2016**	**2015**
Service cost	$	$	$ 106	$ 116
Interest cost	511	507	267	270
Expected return on plan assets	(922)	(988)	(481)	(482)
Amortization of prior service costs/(credits)	3	2	(27)	(24)
Recognized actuarial losses	324	412	359	393
Curtailments and settlements			10	3
Multi-employer plans/other costs			37	8
Total net periodic pension (income)/cost of defined benefit plans	(85)	(67)	271	283
Cost of defined contribution plans	161	166	108	111
Total defined benefit and contribution plans cost recognized in the Consolidated Statement of Earnings	$ 76	$ 99	$ 379	$ 394

(Dollars in millions)	**U.S. Plans**		**Non-U.S. Plans**	
For the six months ended June 30:	**2016**	**2015**	**2016**	**2015**
Service cost	$	$	$ 210	$ 224
Interest cost	1,024	1,014	529	541
Expected return on plan assets	(1,845)	(1,977)	(951)	(965)
Amortization of prior service costs/(credits)	5	5	(52)	(49)
Recognized actuarial losses	657	827	706	