

INTERNATIONAL BUSINESS MACHINES CORP

Form 10-Q

October 25, 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 SEPTEMBER 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

10504

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

(Address of principal executive offices)

(Zip Code)

914-499-1900

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 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 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 ☒ 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 ☒

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 had 950,854,551 shares of common stock outstanding at September 30, 2016.

Table of Contents

Index

	Page
<u>Part I - Financial Information:</u>	
<u>Item 1. Consolidated Financial Statements (Unaudited):</u>	
<u>Consolidated Statement of Earnings for the three and nine months ended September 30, 2016 and 2015</u>	3
<u>Consolidated Statement of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015</u>	4
<u>Consolidated Statement of Financial Position at September 30, 2016 and December 31, 2015</u>	5
<u>Consolidated Statement of Cash Flows for the nine months ended September 30, 2016 and 2015</u>	7
<u>Consolidated Statement of Changes in Equity for the nine months ended September 30, 2016 and 2015</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
<u>Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	47
<u>Item 4. Controls and Procedures</u>	89
<u>Part II - Other Information:</u>	
<u>Item 1. Legal Proceedings</u>	89
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds and Issuer Repurchases of Equity Securities</u>	89
<u>Item 6. Exhibits</u>	90

[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 September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue:				
Services	\$ 12,938	\$ 12,327	\$ 38,347	\$ 37,290
Sales	5,872	6,501	18,542	20,990
Financing	417	452	1,260	1,403
Total revenue	19,226	19,280	58,149	59,682
Cost:				
Services	8,418	8,067	25,492	24,776
Sales	1,536	1,544	4,496	4,895
Financing	259	233	760	733
Total cost	10,213	9,844	30,748	30,405
Gross profit	9,013	9,436	27,401	29,278
Expense and other (income):				
Selling, general and administrative	4,732	4,731	16,093	15,273
Research, development and engineering	1,397	1,287	4,320	3,885
Intellectual property and custom development income	(528)	(188)	(1,110)	(489)
Other (income) and expense	(8)	(133)	281	(578)
Interest expense	158	117	473	340
Total expense and other (income)	5,751	5,815	20,056	18,431
Income from continuing operations before income taxes	3,263	3,621	7,345	10,846
Provision for/(benefit from) income taxes	409	659	(31)	1,943
Income from continuing operations	\$ 2,854	\$ 2,962	\$ 7,375	\$ 8,904
Loss from discontinued operations, net of tax	(1)	(12)	(4)	(176)
Net income	\$ 2,853	\$ 2,950	\$ 7,371	\$ 8,727
Earnings/(loss) per share of common stock:				
Assuming dilution:				
Continuing operations	\$ 2.98	\$ 3.02	\$ 7.67	\$ 9.03
Discontinued operations	0.00	(0.01)	0.00	(0.18)
Total	\$ 2.98	\$ 3.01	\$ 7.67	\$ 8.85
Basic:				
Continuing operations	\$ 2.99	\$ 3.04	\$ 7.70	\$ 9.07
Discontinued operations	0.00	(0.01)	0.00	(0.18)
Total	\$ 2.99	\$ 3.03	\$ 7.70	\$ 8.89

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Weighted-average number of common shares outstanding: (millions)					
Assuming dilution	957.3	979.0	960.7	986.0	
Basic	954.0	975.1	957.7	981.8	
Cash dividend per common share	\$ 1.40	\$ 1.30	\$ 4.10	\$ 3.70	

(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)

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$ 2,853	\$ 2,950	\$ 7,371	\$ 8,727
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	(99)	(1,015)	(109)	(1,365)
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	(1)	(102)	(36)	(85)
Reclassification of (gains)/losses to net income	(1)	0	36	0
Total net changes related to available-for-sale securities	(2)	(101)	0	(85)
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	35	36	(221)	467
Reclassification of (gains)/losses to net income	15	(273)	26	(843)
Total unrealized gains/(losses) on cash flow hedges	50	(237)	(195)	(376)
Retirement-related benefit plans:				
Prior service costs/(credits)		0		6
Net (losses)/gains arising during the period	11	(2)	(57)	14
Curtailments and settlements	4	11	19	19
Amortization of prior service (credits)/costs	(28)	(25)	(81)	(76)
Amortization of net (gains)/losses	696	823	2,079	2,479
Total retirement-related benefit plans	683	807	1,960	2,441
Other comprehensive income/(loss), before tax	632	(547)	1,656	616
Income tax (expense)/benefit related to items of other comprehensive income	(192)	(176)	(213)	(895)
Other comprehensive income/(loss)	440	(724)	1,442	(280)
Total comprehensive income/(loss)	\$ 3,293	\$ 2,227	\$ 8,813	\$ 8,448

(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, 2016	At December 31, 2015
Assets:		
Current assets:		
Cash and cash equivalents	\$ 9,039	\$ 7,686
Marketable securities	929	508
Notes and accounts receivable - trade (net of allowances of \$325 in 2016 and \$367 in 2015)	8,291	8,333
Short-term financing receivables (net of allowances of \$532 in 2016 and \$490 in 2015)	16,032	19,020
Other accounts receivable (net of allowances of \$48 in 2016 and \$51 in 2015)	873	1,201
Inventories, at lower of average cost or market:		
Finished goods	433	352
Work in process and raw materials	1,297	1,199
Total inventories	1,729	1,551
Prepaid expenses and other current assets	4,539	4,205
Total current assets	41,433	42,504
Property, plant and equipment	30,842	29,342
Less: Accumulated depreciation	19,738	18,615
Property, plant and equipment net	11,104	10,727
Long-term financing receivables (net of allowances of \$116 in 2016 and \$118 in 2015)	8,936	10,013
Prepaid pension assets	3,487	1,734
Deferred taxes	4,289	4,822
Goodwill	36,401	32,021
Intangible assets net	4,881	3,487
Investments and sundry assets	5,075	5,187
Total assets	\$ 115,606	\$ 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 September 30, 2016	At December 31, 2015
Liabilities:		
Current liabilities:		
Taxes	\$ 2,137	\$ 2,847
Short-term debt	6,920	6,461
Accounts payable	5,271	6,028
Compensation and benefits	3,958	3,560
Deferred income	10,815	11,021
Other accrued expenses and liabilities	5,346	4,353
Total current liabilities	34,447	34,269
Long-term debt	35,563	33,428
Retirement and nonpension postretirement benefit obligations	16,688	16,504
Deferred income	3,611	3,771
Other liabilities	8,138	8,099
Total liabilities	98,447	96,071
Equity:		
IBM stockholders' equity:		
Common stock, par value \$0.20 per share, and additional paid-in capital	53,759	53,262
Shares authorized: 4,687,500,000		
Shares issued: 2016 - 2,224,594,441		
2015 - 2,221,223,449		
Retained earnings	149,585	146,124
Treasury stock - at cost	(158,170)	(155,518)
Shares: 2016 - 1,273,739,890		
2015 - 1,255,494,724		
Accumulated other comprehensive income/(loss)	(28,164)	(29,607)
Total IBM stockholders' equity	17,010	14,262
Noncontrolling interests	149	162
Total equity	17,159	14,424
Total liabilities and equity	\$ 115,606	\$ 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)	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 7,371	\$ 8,727
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	2,106	1,981
Amortization of intangibles	1,148	884
Stock-based compensation	403	369
Net (gain)/loss on asset sales and other	100	584
Loss on Microelectronics business disposal		48
Changes in operating assets and liabilities, net of acquisitions/divestitures	2,174	(864)
Net cash provided by operating activities	13,301	11,729
Cash flows from investing activities:		
Payments for property, plant and equipment	(2,594)	(2,670)
Proceeds from disposition of property, plant and equipment	234	314
Investment in software	(441)	(407)
Acquisition of businesses, net of cash acquired	(5,445)	(821)
Divestitures of businesses, net of cash transferred	35	(488)
Non-operating finance receivables net	1,130	1,334
Purchases of marketable securities and other investments	(4,021)	(2,101)
Proceeds from disposition of marketable securities and other investments	3,501	2,125
Net cash used in investing activities	(7,600)	(2,714)
Cash flows from financing activities:		
Proceeds from new debt	8,368	3,701
Payments to settle debt	(5,616)	(5,389)
Short-term borrowings/(repayments) less than 90 days net	(864)	1,080
Common stock repurchases	(2,632)	(3,846)
Common stock transactions other	166	271
Cash dividends paid	(3,927)	(3,636)
Net cash used in financing activities	(4,504)	(7,818)
Effect of exchange rate changes on cash and cash equivalents	155	(194)
Net change in cash and cash equivalents	1,352	1,004
Cash and cash equivalents at January 1	7,686	8,476
Cash and cash equivalents at September 30	\$ 9,039	\$ 9,480

(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 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		7,371			7,371		7,371
Other comprehensive income/(loss)				1,442	1,442		1,442
Total comprehensive income/(loss)					\$ 8,813		\$ 8,813
Cash dividends paid common stock		(3,927)			(3,927)		(3,927)
Common stock issued under employee plans (3,370,992 shares)	513				513		513
Purchases (787,805 shares) and sales (336,480 shares) of treasury stock under employee plans net		16	(72)		(56)		(56)
Other treasury shares purchased, not retired (17,793,841 shares)			(2,579)		(2,579)		(2,579)
Changes in other equity	(16)	0			(17)		(17)
Changes in noncontrolling interests						(12)	(12)
Equity - September 30, 2016	\$ 53,759	\$ 149,585	\$ (158,170)	\$ (28,164)	\$ 17,010	\$ 149	\$ 17,159

(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		8,727			8,727		8,727
Other comprehensive income/(loss)				(280)	(280)		(280)
Total comprehensive income/(loss)					\$ 8,448		\$ 8,448
Cash dividends paid common stock		(3,636)			(3,636)		(3,636)
Common stock issued under employee plans (4,349,552 shares)	556				556		556
Purchases (954,158 shares) and sales (484,817 shares) of treasury stock under employee plans net		14	(93)		(79)		(79)
			(3,861)		(3,861)		(3,861)

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Other treasury shares purchased, not retired (24,293,844 shares)											
Changes in other equity		(2)				(2)				(2)	
Changes in noncontrolling interests										11	
Equity - September 30, 2015										11	
\$	53,220	\$	142,898	\$	(154,669)	\$	(28,155)	\$	13,294	\$	157
										\$	13,450

(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 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 nine months ended September 30, 2016, the company's benefit from income taxes is \$31 million and its effective tax rate is (0.4) percent. See Taxes on pages 71 and 72 for additional information.

Noncontrolling interest amounts of \$3.1 million and \$2.4 million, net of tax, for the three months ended September 30, 2016 and 2015, respectively, and \$7.5 million and \$5.9 million, net of tax, for the nine months ended September 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 model rather than an 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.

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.

Table of Contents

Notes to Consolidated Financial Statements (continued)

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. 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.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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.

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

Table of Contents

Notes to Consolidated Financial Statements (continued)

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 \$86 million and \$74 million at September 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.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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

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

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

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

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

Non-financial assets such as property, plant and equipment, land, goodwill and intangible assets are also subject to nonrecurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset. During the nine months ended September 30, 2016, a pre-tax impairment charge related to

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

certain property, plant and equipment of \$218 million was recorded. There were no material impairments of non-financial assets for the nine months ended September 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 September 30, 2016 and December 31, 2015.

(Dollars in millions)				
At September 30, 2016	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	\$	\$ 1,948	\$	\$ 1,948
Money market funds	2,237			2,237
U.S. government securities		1,299		1,299
Canadian government securities		456		456
Other securities		34		34
Total	2,237	3,737		5,974(6)
Debt securities - current (2)		929		929(6)
Debt securities - noncurrent (3)	1	7		9
Available-for-sale equity investments (3)	12			12
Derivative assets (4)				
Interest rate contracts		919		919
Foreign exchange contracts		245		245
Equity contracts		2		2
Total		1,166		1,166(7)
Total assets	\$ 2,250	\$ 5,840	\$	\$ 8,090(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	\$	\$ 277	\$	\$ 277
Equity contracts		9		9
Total liabilities	\$	\$ 286	\$	\$ 286(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 September 30, 2016 were \$198 million and \$967 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 September 30, 2016 were \$282 million and \$3 million, respectively.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

- (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 \$185 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 nine months ended September 30, 2016 and the year ended December 31, 2015.

Financial Assets and Liabilities Not Measured at Fair Value**Short-Term Receivables and Payables**

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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 September 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 \$35,563 million and \$33,428 million, and the estimated fair value was \$38,455 million and \$35,220 million at September 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)	Adjusted		Gross		Gross		Fair	
At September 30, 2016:	Cost		Unrealized		Unrealized		Value	
			Gains		Losses			
Debt securities noncurrent(1)	\$	6	\$	3	\$	0	\$	9
Available-for-sale equity investments(1)	\$	3	\$	9	\$	0	\$	12

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

(Dollars in millions)	Adjusted		Gross		Gross		Fair	
At December 31, 2015:	Cost		Unrealized		Unrealized		Value	
			Gains		Losses			
Debt securities noncurrent(1)	\$	5	\$	3	\$	0	\$	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.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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 September 30:

	2016		2015
Proceeds	\$ 1	\$	1
Gross realized gains (before taxes)	1		0
Gross realized losses (before taxes)			0

(Dollars in millions)

For the nine months ended September 30:

	2016		2015
Proceeds	\$ 150	\$	7
Gross realized gains (before taxes)	1		1
Gross realized losses (before taxes)	37		1

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 September 30:**

	2016		2015
Net unrealized gains/(losses) arising during the period	\$ (1)	\$	(63)
Net unrealized (gains)/losses reclassified to net income*	(1)		0

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

(Dollars in millions)**For the nine months ended September 30:**

	2016		2015
Net unrealized gains/(losses) arising during the period	\$ (22)	\$	(52)
Net unrealized (gains)/losses reclassified to net income*	22		0

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

The contractual maturities of substantially all available-for-sale debt securities are less than one year at September 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.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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 September 30, 2016 and December 31, 2015 was \$64 million and \$28 million, respectively, for which no collateral was posted at September 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 September 30, 2016 and December 31, 2015 was \$1,166 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 \$185 million and \$139 million at September 30, 2016 and December 31, 2015, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at September 30, 2016 and December 31, 2015, this exposure was reduced by \$224 million and \$90 million of cash collateral, and \$100 million and \$40 million of non-cash collateral in U.S. Treasury securities, respectively, received by the company. At September 30, 2016 and December 31, 2015, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was \$656 million and \$726 million, respectively. At September 30, 2016 and December 31, 2015, the net exposure related to derivative liabilities recorded in the Consolidated Statement of Financial Position was \$100 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 September 30,

Table of Contents

Notes to Consolidated Financial Statements (continued)

2016 or December 31, 2015 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral was \$224 million and \$90 million at September 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 September 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 September 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 September 30, 2016 and December 31, 2015 was approximately 6.5 years and 7.2 years, respectively.

Forecasted Debt Issuance

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

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 September 30, 2016 and December 31, 2015.

At September 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 September 30, 2016 and December 31, 2015, the total notional amount of derivative instruments designated as net investment hedges was \$9.1 billion and \$5.5 billion, respectively. At September 30, 2016 and December 31, 2015, the weighted-average remaining maturity of these instruments was approximately 0.2 years at both dates.

Table of Contents

Notes to Consolidated Financial Statements (continued)

Anticipated Royalties and Cost Transactions

The company's operations generate significant nonfunctional currency, third-party vendor payments and intercompany payments for royalties and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward contracts to manage its currency risk. These forward contracts are accounted for as cash flow hedges. The maximum length of time over which the company has hedged its exposure to the variability in future cash flows is four years. At September 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 \$7.8 billion and \$8.2 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2016 and December 31, 2015 was 0.6 years and 0.7 years, respectively.

At September 30, 2016 and December 31, 2015, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of \$45 million and net gains of \$147 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$108 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 September 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 September 30, 2016 and December 31, 2015, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net losses of \$4 million and net losses of \$2 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, \$25 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 September 30, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was \$13.7 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 September 30, 2016 and December 31, 2015, the total notional amount of derivative instruments in economic hedges of these compensation obligations was \$1.2 billion for both periods.

Table of Contents

Notes to Consolidated Financial Statements (continued)

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 September 30, 2016 and December 31, 2015.

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 September 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 September 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 econom"left" STYLE="color:#ffffff">

Total

10,750

Convertible debt

June 15, 2013

1,250 0.000% 1.849%

Total unamortized discount

(85)

Total

\$ 11,915

Table of Contents

PART I

Item 1

Notes

As of March 31, 2011, we had issued and outstanding \$10.8 billion of debt securities as illustrated in the table above (collectively the Notes), including \$4.75 billion issued in September 2010 and \$2.25 billion issued in February 2011. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued \$1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were \$1.24 billion, net of fees and expenses, which were capitalized. Each \$1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of \$33.40 per share.

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft s common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock, or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of \$1.24 billion were allocated between debt for \$1.18 billion and stockholders equity for \$58 million with the portion in stockholders equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to \$37.16. The purchased capped calls were valued at \$40 million and recorded to stockholders equity.

NOTE 11 INCOME TAXES

Our effective tax rates were approximately 13% and 25% for the three months ended March 31, 2011 and 2010, respectively, and 21% and 25% for the nine months ended March 31, 2011 and 2010, respectively. Our rates decreased and were lower than the U.S. federal statutory rate primarily due to the settlement of a portion of a U.S. Internal Revenue Service (I.R.S.) audit of tax years 2004 to 2006, which reduced our income tax expense for the third quarter by \$461 million, and a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from continued emphasis on producing and distributing our products and services through our foreign regional operational centers in Ireland, Singapore and Puerto Rico, which are subject to lower income tax rates.

Tax contingencies and other tax liabilities were \$7.2 billion and \$6.9 billion as of March 31, 2011 and June 30, 2010, respectively, and were included in other long-term liabilities. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006, we remain under audit for these years. Subsequent to quarter end, the I.R.S. issued proposed adjustments for tax years 2004 to 2006 that we have not agreed to and intend to contest through the administrative process. The impact of these proposed adjustments on years currently open to examination could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the audit will be concluded within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2010.

Table of Contents**PART I**

Item 1

NOTE 12 UNEARNED REVENUE

The components of unearned revenue were as follows:

(In millions)

	March 31, 2011	June 30, 2010
Volume licensing programs	\$ 10,634	\$ 12,180
Undelivered elements	165	624
Other	2,220	2,026
Total	<u>\$ 13,019</u>	<u>\$ 14,830</u>

Unearned revenue by segment was as follows:

(In millions)

	March 31, 2011	June 30, 2010
Windows & Windows Live Division	\$ 1,370	\$ 1,701
Server and Tools	4,883	5,282
Microsoft Business Division	5,836	7,004
Other segments	930	843
Total	<u>\$ 13,019</u>	<u>\$ 14,830</u>

NOTE 13 COMMITMENTS AND GUARANTEES**Yahoo! Commercial Agreement**

On December 4, 2009, we entered into a definitive agreement with Yahoo! whereby Microsoft will provide the exclusive algorithmic and paid search platform for Yahoo! Web sites. The term of the agreement is 10 years subject to termination provisions after five years based on performance.

Microsoft provided Yahoo! with revenue per search guarantees for a period of 18 months after implementation of the Microsoft search ads platform in each country. These guarantees are calculated, paid and true-up periodically based on the cumulative reduction in revenue per search, if any, during the 18-month period from pre-implementation levels, except in the case of the U.S. and Canada where performance during each of the first two calendar quarters after implementation is independent and not cumulative. This is a rate guarantee and not a guarantee of search volume. We estimate the total cost of the revenue per search guarantees during the guarantee period could range up to \$150 million.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Microsoft also agreed to reimburse Yahoo! for certain transition expenses incurred both before and after the effective date of the agreement.

Finally, Microsoft also agreed to reimburse Yahoo! for certain costs of running algorithmic and paid search services prior to migration to Microsoft's platform.

Table of Contents**PART I**

Item 1

Product Warranty

Our aggregate product warranty liabilities, which are included in other current liabilities and other long-term liabilities, changed during the three months and nine months ended March 31, 2011 as follows:

(In millions)	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2011	2010	2011	2010
Balance, beginning of period	\$ 202	\$ 308	\$ 240	\$ 342
Accrual for warranties issued	14	27	46	121
Adjustments to pre-existing warranties	0	0	0	(2)
Settlements of warranty claims	(31)	(77)	(101)	(203)
Balance, end of period	\$ 185	\$ 258	\$ 185	\$ 258

NOTE 14 CONTINGENCIES**Government Competition Law Matters**

We are subject to a Consent Decree and Final Judgment (Final Judgments) that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Final Judgments imposed various constraints on our Windows operating system businesses. The Final Judgments are scheduled to expire in May 2011.

In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

Antitrust, Unfair Competition, and Overcharge Class Actions

A large number of antitrust and unfair competition class action lawsuits were filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims that have been made to date in 19 states and the District of Columbia.

The settlements in all states have received final court approval. Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately \$2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers. We estimate the total cost to resolve all of the state overcharge class action cases will range between \$1.9 billion and \$2.0 billion. At March 31, 2011, we have recorded a liability related to these claims of approximately \$585 million, which reflects our estimated exposure of \$1.9 billion less payments made to date of approximately \$1.3 billion mostly for vouchers, legal fees, and administrative expenses.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

The three cases pending in British Columbia, Ontario, and Quebec, Canada have not been settled. In March 2010, the court in the British Columbia case certified it as a class action. On April 15, 2011, the British Columbia Court of Appeal reversed the class certification ruling and dismissed the case, holding that indirect purchasers do not have a claim. We expect the plaintiffs will seek review by the Canadian Supreme Court. The other two actions have been stayed.

Other Antitrust Litigation and Claims

In November 2004, Novell, Inc. filed a complaint in U.S. District Court for the District of Utah (later transferred to federal court in Maryland), asserting antitrust and unfair competition claims against us related to Novell's ownership

Table of Contents

PART I

Item 1

of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. In March 2010 the trial court granted summary judgment in favor of Microsoft as to all remaining claims. Novell has appealed that ruling. The appeal was argued in March 2011 and we are awaiting a ruling.

Patent and Intellectual Property Claims

In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents (although this action began before the merger of Alcatel and Lucent in 2006, for simplicity we refer to the post-merger entity of Alcatel-Lucent). In April 2008, a jury returned a verdict in Alcatel-Lucent's favor in a trial on a consolidated group of one video and three user interface patents. The jury concluded that we had infringed two user interface patents and awarded \$367 million in damages. In June 2008, the trial judge increased the amount of damages to \$512 million to include \$145 million of interest. We appealed that award. In December 2008, we entered into a settlement agreement resolving all other litigation pending between Microsoft and Alcatel-Lucent, leaving approximately \$500 million remaining in dispute. In September 2009, the court of appeals affirmed the liability award but vacated the verdict and remanded the case to the trial court for a re-trial of the damages ruling, indicating the damages previously awarded were too high. Trial on the remanded damages claim is set to begin in July 2011.

In October 2003, Uniloc USA Inc., a subsidiary of a Singapore-based company, filed a patent infringement suit in U.S. District Court in Rhode Island, claiming that product activation technology supporting Windows XP and certain other Microsoft programs violated a Uniloc patent. After we obtained a favorable summary judgment that we did not infringe any of the claims of this patent, the court of appeals vacated the trial court decision and remanded the case for trial. In April 2009, the jury returned a \$388 million verdict against us, including a finding of willful infringement. In September 2009, the district court judge overturned the jury verdict, ruling that the evidence did not support the jury's findings either that Microsoft infringed the patent or was willful. Uniloc appealed, and in January 2011 the court of appeals reversed the district court's finding of non-infringement (thus reinstating the jury verdict of infringement) but affirmed the district court's ruling that Microsoft was not willful and affirmed the district court's grant of a new trial on damages. Uniloc has filed a petition seeking a rehearing of the appellate court's decision as to damages.

In March 2007, i4i Limited Partnership sued Microsoft in U.S. District Court in Texas claiming that certain custom XML technology in Word 2003 and 2007 infringed i4i's patent. In May 2009, a jury returned a verdict against us, finding damages of \$200 million and that we willfully infringed the patent. In August 2009, the court denied our post-trial motions and awarded enhanced damages of \$40 million and prejudgment interest of \$37 million. The court also issued a permanent injunction prohibiting additional distribution of the allegedly infringing technology. We appealed and the appellate court stayed the injunction pending our appeal. In December 2009, the court of appeals rejected our appeal and affirmed the trial court's judgment and injunction, except that the court of appeals modified the effective date of the injunction to January 11, 2010. In November 2010, the U.S. Supreme Court granted our petition seeking review of the case. Oral argument was heard April 18, 2011. We expect a decision by the end of June 2011.

In October 2010, we filed suit against Motorola with the International Trade Commission and in U.S. District Court in Washington for infringement of nine Microsoft patents by Motorola's Android-based smartphones. In addition, in November 2010, we filed suit against Motorola in U.S. District Court in Washington for breach of Motorola's contractual commitments to the Institute of Electrical and Electronics Engineers (IEEE) and International Telecommunications Union (ITU) to license identified patents related to wireless and video coding technologies under reasonable and non-discriminatory terms and conditions. In November 2010, Motorola filed two patent infringement actions against us in U.S. District Court in Wisconsin and one in U.S. District Court in Florida on a total of sixteen patents asserted variously against Windows, Windows Phone 7, Windows Mobile 6.5, Xbox, Bing Maps, Hotmail, Messenger, and Exchange Server.

In addition to these cases, there are approximately 50 other patent infringement cases pending against Microsoft.

Other

We also are subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial statements, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

Table of Contents**PART I**

Item 1

As of March 31, 2011, we had accrued aggregate liabilities of \$1.0 billion in other current liabilities and \$301 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could reach approximately \$720 million in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.

NOTE 15 STOCKHOLDERS' EQUITY**Share Repurchases**

We repurchased the following shares of common stock during the periods presented:

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
Shares of common stock repurchased	30	67	381	250
Value of common stock repurchased	\$ 827	\$ 2,000	\$ 9,827	\$ 7,028

We repurchased all shares with cash resources. As of March 31, 2011, approximately \$13.9 billion remained of our \$40.0 billion repurchase program that we announced on September 22, 2008. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
(in millions)				
Fiscal Year 2011				
September 21, 2010	\$ 0.16	November 18, 2010	\$ 1,363	December 9, 2010
December 15, 2010	\$ 0.16	February 17, 2011	\$ 1,349	March 10, 2011
March 14, 2011	\$ 0.16	May 19, 2011	\$ 1,349	June 9, 2011
Fiscal Year 2010				
September 18, 2009	\$ 0.13	November 19, 2009	\$ 1,152	December 10, 2009
December 9, 2009	\$ 0.13	February 18, 2010	\$ 1,139	March 11, 2010
March 8, 2010	\$ 0.13	May 20, 2010	\$ 1,130	June 10, 2010

The estimate of the amount to be paid as a result of the March 14, 2011 declaration was included in other current liabilities as of March 31, 2011.

NOTE 16 SEGMENT INFORMATION

In its operation of the business, management, including our chief operating decision maker, the Company's Chief Executive Officer, reviews certain financial information, including segmented internal profit and loss statements prepared on a basis not consistent with U.S. GAAP. The segment information within this note is reported on that basis. Our five segments are Windows & Windows Live Division; Server and Tools; Online Services Division; Microsoft Business Division; and Entertainment and Devices Division.

Due to the integrated structure of our business, certain revenue earned and costs incurred by one segment may benefit other segments. Revenue on certain contracts may be allocated among the segments based on the relative value of the underlying products and services. Costs that are identifiable are allocated to the segments that benefit to incent cross-collaboration among our segments so that one segment is not solely burdened by the cost of a mutually beneficial activity. Allocated costs may include those relating to development and marketing of products and services

Table of Contents**PART I**

Item 1

from which multiple segments benefit, or those costs relating to services performed by one segment on behalf of other segments. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated.

In addition, certain costs incurred at a corporate level that are identifiable and that benefit our segments are allocated to them. These allocated costs include costs of: field selling; employee benefits; shared facilities services; and customer service and support. Each allocation is measured differently based on the specific facts and circumstances of the costs being allocated. Certain other corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; legal settlements and contingencies; and employee severance.

We have recast certain prior period amounts within this note to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Microsoft's PC hardware business from Entertainment and Devices Division to Windows & Windows Live Division, Windows Embedded from Entertainment and Devices Division to Server and Tools, and Office for Mac from Entertainment and Devices Division to Microsoft Business Division, as well as implementing intersegment cost allocations between all segments related to the collaborative investment in mobile platform development.

Segment revenue and operating income (loss) were as follows during the periods presented:

(In millions)	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
Revenue				
Windows & Windows Live Division	\$ 4,393	\$ 4,508	\$ 14,083	\$ 14,098
Server and Tools	4,107	3,709	12,461	11,237
Online Services Division	648	566	1,866	1,631
Microsoft Business Division	5,266	4,649	16,174	14,016
Entertainment and Devices Division	1,898	1,215	7,320	5,065
Unallocated and other	116	(144)	672	398
Consolidated	<u>\$ 16,428</u>	<u>\$ 14,503</u>	<u>\$ 52,576</u>	<u>\$ 46,445</u>
Operating income (loss)				
Windows & Windows Live Division	\$ 2,708	\$ 2,919	\$ 9,102	\$ 9,312
Server and Tools	1,385	1,227	4,737	3,837
Online Services Division	(743)	(729)	(1,883)	(1,698)
Microsoft Business Division	3,164	2,826	10,203	8,511
Entertainment and Devices Division	187	135	1,188	755
Reconciling amounts	(992)	(1,205)	(2,357)	(2,549)
Consolidated	<u>\$ 5,709</u>	<u>\$ 5,173</u>	<u>\$ 20,990</u>	<u>\$ 18,168</u>

Reconciling amounts in the tables above and below include adjustments to conform our internal accounting policies to U.S. GAAP and corporate-level activity not specifically attributed to a segment. Significant internal accounting policies that differ from U.S. GAAP relate to revenue recognition, income statement classification, depreciation, and amortization of stock-based awards.

Table of Contents**PART I**

Item 1

Significant reconciling items were as follows:

(In millions)	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2011	2010	2011	2010
Corporate-level activity ^(a)	\$ (1,138)	\$ (1,153)	\$ (3,151)	\$ (3,205)
Stock-based compensation	129	121	373	389
Revenue reconciling amounts	72	(174)	536	253
Other	(55)	1	(115)	14
Total	\$ (992)	\$ (1,205)	\$ (2,357)	\$ (2,549)

(a) *Corporate-level activity excludes stock-based compensation and revenue reconciling amounts presented separately in those line items.*
 Assets are not allocated to segments for internal reporting presentations. A portion of amortization and depreciation is included with various other costs in an overhead allocation to each segment and it is impracticable for us to separately identify the amount of amortization and depreciation by segment that is included in the measure of segment profit or loss.

Table of Contents

PART I

Item 1

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Microsoft Corporation

Redmond, Washington

We have reviewed the accompanying consolidated balance sheet of Microsoft Corporation and subsidiaries (the Corporation) as of March 31, 2011, and the related consolidated statements of income, cash flows, and stockholders' equity for the three-month and nine-month periods ended March 31, 2011 and 2010. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Microsoft Corporation and subsidiaries as of June 30, 2010, and the related consolidated statements of income, cash flows, and stockholders' equity for the year then ended (not presented herein); and in our report dated July 30, 2010 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of June 30, 2010 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP

Seattle, Washington

April 28, 2011

Table of Contents

PART I

Item 2

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including without limitation, the following sections: Management's Discussion and Analysis, and Risk Factors. These forward-looking statements generally are identified by the words believe, project, expect, anticipate, estimate, intend, strategy, future, opportunity, plan, may, should, will, would, likely result, and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section titled Risk Factors (refer to Part II, Item 1A of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

OVERVIEW

Management's discussion and analysis is intended to help the reader understand the results of operations and financial condition of Microsoft Corporation. The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2010 and the Consolidated Financial Statements and accompanying notes (Notes) included in this Form 10-Q.

We generate revenue by developing, manufacturing, licensing, and supporting a wide range of software products and services for many different types of computing devices. Our software products and services include operating systems for personal computers, servers, and intelligent devices; server applications for distributed computing environments; information worker productivity applications; business solutions applications; high-performance computing applications; software development tools; and video games. We provide consulting and product and solution support services, and we train and certify computer system integrators and developers. We also design and sell hardware, including the Xbox 360 console, the Kinect for Xbox 360, and accessories, and Microsoft PC hardware products. Online offerings and information are delivered to consumers through Bing, Windows Live, Xbox LIVE, Microsoft Office Web Apps, our MSN portals and channels, and to businesses through Microsoft Online Services offerings, such as Microsoft Dynamics CRM Online, Exchange Online, and SharePoint Online, and through Windows Azure and SQL Azure. We enable the delivery of online advertising across our broad range of digital media properties and on Bing through our proprietary adCenter platform.

Our revenue historically has fluctuated quarterly and has generally been the highest in the second quarter of our fiscal year due to corporate calendar year-end spending trends in our major markets and holiday season spending by consumers. Our Entertainment and Devices Division is particularly seasonal as its products are aimed at the consumer market and are in highest demand during the holiday shopping season. Typically, the Entertainment and Devices Division has generated approximately 40% of its yearly segment revenues in our second fiscal quarter. In addition, quarterly revenues may be impacted by the deferral of revenue. See the discussions below regarding sales of earlier versions of the Microsoft Office system with a guarantee to be upgraded to the newest version of the Microsoft Office system at minimal or no cost (the Office Deferral).

Global macroeconomic factors have a strong correlation to demand for our software, services, hardware, and online offerings. The current macroeconomic factors remain dynamic and uncertain. Irrespective of global economic conditions, we are positive about our relative market position, our current product portfolio, and future product pipeline. Because we offer a wide range of products and services that enable companies to improve productivity and reduce costs, including cloud-based services, we believe that Microsoft is well-positioned to create new opportunities to increase revenue as the global economy improves. We remain focused on executing in the areas we can control by continuing to provide high value products at the lowest total cost of ownership while managing our expenses.

Table of Contents**PART I**

Item 2

All growth and percentage comparisons refer to the three months and nine months ended March 31, 2011, as compared with the three months and nine months ended March 31, 2010, unless otherwise noted.

RESULTS OF OPERATIONS**Summary**

	Three Months Ended		Percentage	Nine Months Ended		Percentage
(In millions, except per share amounts and percentages)	March 31,		Change	March 31,		Change
	2011	2010		2011	2010	
Revenue	\$ 16,428	\$ 14,503	13%	\$ 52,576	\$ 46,445	13%
Operating income	\$ 5,709	\$ 5,173	10%	\$ 20,990	\$ 18,168	16%
Diluted earnings per share	\$ 0.61	\$ 0.45	36%	\$ 2.01	\$ 1.59	26%

Three months ended March 31, 2011 compared with three months ended March 31, 2010

Revenue increased primarily due to strong sales of the Xbox 360 console, Kinect for Xbox 360, the 2010 Microsoft Office system, and Server and Tools products, offset in part by lower sales of Windows 7. Revenue also increased due to the \$305 million Office Deferral during the three months ended March 31, 2010. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income increased reflecting an increase in revenue, offset in part by higher operating expenses. Key changes in operating expenses were:

Cost of revenue increased \$1.1 billion or 41%, due to increased volumes of Xbox 360 consoles and Kinect sensors sold and higher costs associated with our online offerings, including traffic acquisition costs and royalty costs relating to Xbox LIVE digital content sold, as well as due to higher expenses from providing Enterprise Services.

Sales and marketing expenses increased \$190 million or 6%, primarily reflecting increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, and higher headcount-related expenses.

Research and development expenses increased \$49 million or 2%, due mainly to higher headcount-related expenses.

Diluted earnings per share increased reflecting higher revenue, repurchases of common stock, and a partial settlement with the U.S. Internal Revenue Service (I.R.S.), which added \$0.05 to our diluted earnings per share, offset in part by higher operating expenses.

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

Revenue increased primarily due to strong sales of the Xbox 360 console, Kinect for Xbox 360, and video games, the 2010 Microsoft Office system, and Server and Tools products, offset in part by lower sales of Windows 7. Revenue also increased due to the \$305 million Office Deferral during the nine months ended March 31, 2010 and the recognition of \$254 million of revenue associated with the Office Deferral

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

during the nine months ended March 31, 2011. Changes in foreign currency exchange rates had an insignificant impact on revenue.

Operating income increased reflecting the change in revenue, offset in part by higher operating expenses. Key changes in operating expenses were:

Cost of revenue increased \$2.6 billion or 29%, due to increased volumes of Xbox 360 consoles and Kinect sensors sold and higher costs associated with our online offerings, including traffic acquisition costs and royalty costs relating to Xbox LIVE digital content sold, as well as due to higher expenses from providing Enterprise Services.

Sales and marketing expenses increased \$412 million or 4%, primarily reflecting increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, and higher headcount-related expenses.

Research and development expenses increased \$286 million or 4%, due mainly to higher headcount-related expenses and third-party development and programming costs.

Diluted earnings per share increased reflecting higher revenue, repurchases of common stock, and a partial settlement with the I.R.S., which added \$0.05 to our diluted earnings per share, offset in part by higher operating expenses.

Table of Contents**PART I**

Item 2

SEGMENT PRODUCT REVENUE AND OPERATING INCOME (LOSS)

The revenue and operating income (loss) amounts in this section are presented on a basis consistent with accounting principles generally accepted in the U.S. (U.S. GAAP) and include certain reconciling items attributable to each of the segments. Segment information appearing in Note 16 Segment Information of the Notes to Financial Statements (Part I, Item I of this Form 10-Q) is presented on a basis consistent with our current internal management reporting. Certain corporate-level activity has been excluded from segment operating results and is analyzed separately.

We have recast certain prior period amounts within this MD&A to conform to the way we internally managed and monitored segment performance during the current fiscal year, including moving Microsoft's PC hardware business from Entertainment and Devices Division to Windows & Windows Live Division, Windows Embedded from Entertainment and Devices Division to Server and Tools, and Office for Mac from Entertainment and Devices Division to Microsoft Business Division, as well as implementing intersegment cost allocations between all segments related to the collaborative investment in mobile platform development.

Windows & Windows Live Division

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
Revenue	\$ 4,445	\$ 4,650	(4)%	\$ 14,284	\$ 14,713	(3)%
Operating income	\$ 2,764	\$ 3,073	(10)%	\$ 9,338	\$ 9,968	(6)%

Windows & Windows Live Division (Windows Division) develops and markets PC operating systems and related software and online services. The Windows Division offerings consist of multiple editions of the Windows operating system, software and services through Windows Live, and Microsoft PC hardware products.

Windows Division revenue growth is largely correlated to the growth of the PC market worldwide as approximately 75% of total Windows Division revenue comes from pre-installed versions of the Windows operating system purchased by original equipment manufacturers (OEMs). The remaining approximately 25% of Windows Division revenue (other revenue) is generated by commercial and retail sales of Windows and PC hardware products and online advertising from Windows Live.

Three months ended March 31, 2011 compared with three months ended March 31, 2010

Windows Division revenue was driven primarily by growth in PC market segments. We estimate that sales of PCs to businesses grew approximately 9% this quarter and that sales of PCs to consumers declined approximately 8%. The decline in consumer PC sales included an approximately 40% decline in the sales of Netbooks. Taken together the total PC market declined an estimated 1% to 3%. Considering the impact of the Windows 7 launch in the prior year, we estimate Windows Division revenue and OEM licenses were in line with the PC market. Revenue was also driven by growth in sales of multi-year licensing agreements to businesses and somewhat higher inventory and attach rates offset by higher relative growth in emerging markets.

Windows Division operating income decreased as a result of decreased revenue and higher sales and marketing expenses. Sales and marketing expenses increased \$127 million or 21% reflecting increased corporate marketing activities and increased advertising of Windows and Windows Live.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

Windows Division revenue was driven primarily by growth in PC market segments. We estimate that sales of PCs to businesses grew approximately 12% fiscal year to date and that sales of PCs to consumers declined approximately 1%. The decline in consumer PC sales included an approximately 30% decline in the sales of Netbooks. Taken together the total PC market increased an estimated 3% to 5%. Considering the impact of the Windows 7 launch in the prior year, we estimate Windows Division revenue was in line with the PC market. Revenue was also driven by growth in sales of multi-year licensing agreements to businesses offset by higher relative growth in emerging markets.

Table of Contents**PART I**

Item 2

Windows Division operating income decreased as a result of decreased revenue and higher sales and marketing expenses. Sales and marketing expenses increased \$172 million or 9% reflecting increased advertising of Windows and Windows Live. Cost of revenue increased \$17 million or 1%, primarily driven by higher traffic acquisition costs, partially offset by decreased product and services costs.

Server and Tools

(In millions, except percentages)	Three Months Ended		Percentage Change	Nine Months Ended		Percentage Change
	March 31,			March 31,		
	2011	2010		2011	2010	
Revenue	\$ 4,104	\$ 3,706	11%	\$ 12,453	\$ 11,229	11%
Operating income	\$ 1,419	\$ 1,270	12%	\$ 4,834	\$ 3,979	21%

Server and Tools develops and markets technology and related services that enable information technology professionals and their systems to be more productive and efficient. Server and Tools product and service offerings include Windows Server, Microsoft SQL Server, Windows Azure, Windows Embedded device platforms and Enterprise Services. Enterprise Services comprise Premier product support services and Microsoft Consulting Services. We also offer developer tools, training and certification. Approximately 50% of Server and Tools revenue comes primarily from multi-year volume licensing agreements, approximately 30% is purchased through transactional volume licensing programs, retail packaged product and licenses sold to OEMs, and the remainder comes from Enterprise Services.

Three months ended March 31, 2011 compared with three months ended March 31, 2010

Server and Tools revenue increased reflecting growth in both product and Enterprise Services. Product revenue increased \$308 million or 10%, driven primarily by growth in Windows Server, SQL Server, and Enterprise Client Access License (CAL) Suites, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew \$90 million or 12%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by higher operating expenses. Sales and marketing expenses increased \$137 million or 13% reflecting increased corporate marketing activities and fees paid to third party enterprise software advisors. Cost of revenue increased \$115 million or 17% reflecting higher expenses from providing Enterprise Services and online offerings.

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

Server and Tools revenue increased reflecting growth in both product and Enterprise Services. Product revenue increased \$998 million or 11%, driven primarily by growth in Windows Server, SQL Server, Enterprise CAL Suites, and Windows Embedded, reflecting continued adoption of Windows platform applications. Enterprise Services revenue grew \$226 million or 10%, due to growth in both Premier product support and consulting services.

Server and Tools operating income increased primarily due to revenue growth, offset in part by higher operating expenses. Cost of revenue increased \$233 million or 11%, reflecting higher expenses from providing Enterprise Services and online offerings. Sales and marketing expenses increased \$117 million or 4% reflecting increased fees paid to third party enterprise software advisors and headcount-related expenses.

Online Services Division

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

(In millions, except percentages)	Three Months Ended		Percentage Change	Nine Months Ended		Percentage Change
	March 31,			March 31,		
	2011	2010		2011	2010	
Revenue	\$ 648	\$ 566	14%	\$ 1,866	\$ 1,633	14%
Operating loss	\$ (726)	\$ (709)	(2)%	\$ (1,829)	\$ (1,649)	(11)%

Table of Contents**PART I**

Item 2

Online Services Division (OSD) develops and markets information and content that help people simplify tasks and make more informed decisions online, and that help advertisers connect with audiences. OSD offerings include Bing, MSN, and advertiser and publisher tools. Bing and MSN generate revenue through the sale of search and display advertising.

Three months ended March 31, 2011 compared with three months ended March 31, 2010

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew \$84 million or 17% to \$586 million, reflecting continued growth in search and display revenue, offset in part by decreased third party advertising revenue. Search revenue grew due to increased volumes reflecting general market growth and relative share gains in the U.S., offset in part by decreased revenue per search primarily related to challenges associated with optimizing the adCenter platform for the new mix and volume of traffic from the combined Yahoo! and Bing properties. Bing's estimated U.S. market share increased approximately 25%.

OSD operating loss increased due to higher operating expenses, offset in part by increased revenue. Cost of revenue grew \$292 million driven by costs associated with the Yahoo! search agreement and increased traffic acquisition costs. General and administrative expenses decreased \$154 million due mainly to transition expenses in the prior year associated with the inception of the Yahoo! Commercial Agreement. Sales and marketing expenses decreased \$39 million or 13% primarily due to lower amortization of intangible assets.

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

OSD revenue increased primarily as a result of growth in online advertising revenue. Online advertising revenue grew \$255 million or 18% to \$1.7 billion, reflecting continued growth in search and display revenue, offset in part by decreased third party advertising revenue. Search revenue grew due to increased volumes reflecting general market growth and relative share gains in the U.S., offset in part by decreased revenue per search primarily related to challenges associated with optimizing the adCenter platform for the new mix and volume of traffic from the combined Yahoo! and Bing properties. Bing's estimated U.S. market share increased approximately 25%.

OSD operating loss increased due to higher operating expenses, offset in part by increased revenue. Cost of revenue grew \$476 million driven by costs associated with the Yahoo! search agreement and traffic acquisition costs. Research and development expenses grew \$128 million or 17%, primarily due to headcount-related expenses associated with the search portion of the business. General and administrative expenses decreased \$157 million due mainly to transition expenses in the prior year associated with the inception of the Yahoo! Commercial Agreement.

Microsoft Business Division

(In millions, except percentages)	Three Months Ended		Percentage Change	Nine Months Ended		Percentage Change
	March 31,			March 31,		
	2011	2010		2011	2010	
Revenue	\$ 5,252	\$ 4,341	21%	\$ 16,409	\$ 13,701	20%
Operating income	\$ 3,165	\$ 2,542	25%	\$ 10,506	\$ 8,285	27%

Microsoft Business Division (MBD) develops and markets software and services designed to increase personal, team, and organization productivity. MBD offerings include the Microsoft Office system (comprising mainly Office, SharePoint, Exchange and Lync), which generates over 90% of MBD revenue, and Microsoft Dynamics business solutions. We evaluate MBD results based upon the nature of the end user in two primary parts: business revenue, which includes Microsoft Office system revenue generated through volume licensing agreements and Microsoft Dynamics revenue; and consumer revenue, which includes revenue from retail packaged product sales and OEM revenue.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Three months ended March 31, 2011 compared with three months ended March 31, 2010

MBD revenue increased reflecting sales of the 2010 Microsoft Office system, which was released primarily during the fourth quarter of fiscal year 2010, as well as the \$305 million Office Deferral during the three months ended March 31, 2010. Consumer revenue increased \$525 million or 95%. Excluding the impact associated with the Office Deferral, consumer revenue increased \$220 million or 26% due to sales of the 2010 Microsoft Office system. Business revenue increased \$386 million or 10%, primarily reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year volume licensing revenue, and a 10% increase in Microsoft Dynamics revenue.

Table of Contents**PART I**

Item 2

MBD operating income increased due mainly to revenue growth, offset in part by higher operating expenses. Sales and marketing expenses increased \$150 million or 16%, due mainly to increased corporate and cross-platform marketing activities and charges related to intangible assets. Cost of revenue increased \$80 million or 24%, primarily driven by higher online costs, costs of providing services, and increased amortization of capitalized software development costs. Research and development costs increased \$58 million or 13%, primarily as a result of capitalization of certain Microsoft Office system software development costs in the prior year.

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

MBD revenue increased primarily reflecting sales of the 2010 Microsoft Office system, the \$305 million Office Deferral during the third quarter of fiscal year 2010, and the recognition of \$254 million of revenue associated with the Office Deferral during the nine months ended March 31, 2011. Business revenue increased \$1.5 billion or 13%, reflecting licensing of the 2010 Microsoft Office system to transactional business customers, growth in multi-year volume licensing revenue, and a 7% increase in Microsoft Dynamics revenue. Consumer revenue increased \$1.2 billion or 52%. The growth in consumer revenue includes the \$305 million Office Deferral and recognition of \$254 million of revenue associated with the Office Deferral. Excluding the impact associated with the Office Deferral, consumer revenue increased \$663 million or 25% due to sales of the 2010 Microsoft Office system.

MBD operating income increased due mainly to revenue growth, offset in part by higher operating expenses. Cost of revenue increased \$253 million or 28%, primarily driven by higher online costs and costs of providing services. Sales and marketing expenses increased \$171 million or 6%, due mainly to increased corporate and cross-platform marketing activities and charges related to intangible assets. Research and development costs increased \$73 million or 5%, primarily as a result of capitalization of certain Microsoft Office system software development costs in the prior year.

Entertainment and Devices Division

(In millions, except percentages)	Three Months Ended		Percentage Change	Nine Months Ended		Percentage Change
	March 31,			March 31,		
	2011	2010		2011	2010	
Revenue	\$ 1,935	\$ 1,210	60%	\$ 7,428	\$ 5,024	48%
Operating income	\$ 225	\$ 150	50%	\$ 1,292	\$ 790	64%

Entertainment and Devices Division (EDD) develops and markets products and services designed to entertain and connect people. EDD offerings include the Xbox 360 platform (which includes the Xbox 360 gaming and entertainment console, Kinect for Xbox 360, Xbox 360 video games, Xbox LIVE, and Xbox 360 accessories), Mediaroom (our Internet protocol television software), and Windows Phone. In November 2010, we released Kinect for Xbox 360 and the latest version of Windows Phone. Windows Phone revenue is recognized on a straight-line basis over the estimated economic life of the software.

Three months ended March 31, 2011 compared with three months ended March 31, 2010

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew \$712 million or 69%, led by sales of Kinect sensors, increased volumes of Xbox 360 consoles, and higher Xbox LIVE revenues. We shipped 2.7 million Xbox 360 consoles and 2.4 million Kinect sensors (including those sold with consoles) during the third quarter of fiscal year 2011, compared with 1.5 million Xbox 360 consoles during the third quarter of fiscal year 2010. On April 21, 2011, we entered into definitive agreements to formalize an alliance with Nokia to enhance our Windows Phone opportunities and strategies for smartphones, productivity tools, mobile marketplace, and services.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

EDD operating income increased primarily reflecting revenue growth, offset in part by higher cost of revenue. Cost of revenue increased \$640 million or 104% primarily reflecting higher volumes of Xbox 360 consoles and Kinect sensors sold, and increased royalty costs resulting from increased Xbox LIVE digital content sold.

Nine months ended March 31, 2011 compared with nine months ended March 31, 2010

EDD revenue increased primarily reflecting higher Xbox 360 platform revenue. Xbox 360 platform revenue grew \$2.4 billion or 52%, led by sales of Kinect sensors, increased volumes of Xbox 360 consoles and video games sold, and higher Xbox LIVE revenue. We shipped 11.9 million Xbox 360 consoles and 10.4 million Kinect sensors (including those sold with consoles) during the first nine months of fiscal year 2011, compared with 8.8 million Xbox 360 consoles during the first nine months of fiscal year 2010. Xbox 360 video game revenue increased primarily reflecting sales of Halo Reach and Kinect game titles.

Table of Contents**PART I**

Item 2

EDD operating income increased primarily reflecting revenue growth, offset in part by higher operating expenses. Cost of revenue increased \$1.7 billion or 58% primarily reflecting higher volumes of Xbox 360 consoles and Kinect sensors sold, and increased royalty costs resulting from increased Xbox LIVE digital content sold. Research and development expenses increased \$100 million or 14%, primarily reflecting higher headcount-related costs. Sales and marketing expenses grew \$93 million or 16% primarily reflecting increased Xbox 360 platform marketing activities.

Nokia Strategic Alliance

On February 11, 2011, Microsoft and Nokia announced a strategic alliance to jointly create new mobile products and services and to extend established products and services to new markets. On April 21, 2011, the parties entered into definitive agreements to formalize this alliance.

Microsoft will license to Nokia and Nokia will adopt Windows Phone as Nokia's primary smartphone platform. Microsoft will receive a running royalty at a competitive rate from Nokia for the Windows Phone platform, with minimum commitments reflecting the large volumes Nokia expects to ship. We will also provide Nokia with developer tools to accelerate developer support for Windows and Windows-related platforms. Microsoft and Nokia will collaborate on joint developer outreach and application sourcing. Microsoft's Windows Marketplace infrastructure will support a new Nokia-branded application store. Participants in the Windows Phone ecosystem will be able to take advantage of Nokia's billing agreements with operators in markets worldwide.

Nokia will deliver mapping, navigation, and location-based services to the Windows Phone ecosystem and will deliver a core set of mapping services for a broader set of Microsoft's map-based offerings. Microsoft's Bing and adCenter will power search and advertising on Nokia's devices and services. Nokia will innovate and customize on the Windows Phone platform, contributing its expertise on hardware, design, and language support and will help bring Windows Phone to a broader range of price points, market segments and geographies. Microsoft will make annual payments to Nokia, in recognition of the unique nature of Nokia's agreement with Microsoft and the contributions that Nokia is providing.

The agreements recognize the value of intellectual property portfolios and put in place mechanisms for exchanging rights to intellectual property. As part of these arrangements, Nokia will receive payments including consideration to be paid as part of a mutual release.

Corporate-Level Activity

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
Corporate-level activity	\$ (1,138)	\$ (1,153)	1%	\$ (3,151)	\$ (3,205)	2%

Certain corporate-level activity is not allocated to our segments, including costs of: broad-based sales and marketing; product support services; human resources; legal; finance; information technology; corporate development and procurement activities; research and development; and legal settlements and contingencies. For the three months ended March 31, 2011, corporate-level expenses decreased due mainly to lower sales and marketing costs retained in corporate, offset in part by newly legislated Puerto Rican excise taxes and a 7% increase in headcount-related expenses. For the nine months ended March 31, 2011, corporate-level expenses decreased due mainly to lower sales and marketing costs retained in corporate, offset in part by newly legislated Puerto Rican excise taxes and a 4% increase in headcount-related expenses.

OPERATING EXPENSES**Cost of Revenue**

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
Cost of revenue	\$ 3,897	\$ 2,755	41%	\$ 11,869	\$ 9,225	29%
As a percent of revenue	24%	19%	5ppt	23%	20%	3ppt

Cost of revenue includes: manufacturing and distribution costs for products sold and programs licensed; operating costs related to product support service centers and product distribution centers; costs incurred to include software on PCs sold by OEMs, to drive traffic to our Web sites and to acquire online advertising space (traffic acquisition costs); costs incurred to support and maintain Internet-based products and services; warranty costs; inventory valuation adjustments; costs associated with the delivery of consulting services; and the amortization of capitalized research and development costs. Cost of revenue increased primarily due to increased volumes of Xbox 360 consoles and Kinect sensors sold and higher costs associated with our online offerings, including traffic acquisition costs and royalty costs relating to Xbox LIVE digital content sold, as well as due to higher expenses from providing Enterprise Services.

Table of Contents**PART I**

Item 2

Research and Development

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
Research and development	\$ 2,269	\$ 2,220	2%	\$ 6,650	\$ 6,364	4%
As a percent of revenue	14%	15%	(1)ppt	13%	14%	(1)ppt

Research and development expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with product development. Research and development expenses also include third-party development and programming costs, localization costs incurred to translate software for international markets, and the amortization of purchased software code and services content. For the three months ended March 31, 2011, the increase in research and development expenses was primarily driven by a 2% increase in headcount-related expenses and the capitalization of certain software development costs in the prior year. For the nine months ended March 31, 2011, the increase in research and development expenses was primarily driven by a 4% increase in headcount-related expenses and the capitalization of certain software development costs in the prior year.

Sales and Marketing

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
Sales and marketing	\$ 3,393	\$ 3,203	6%	\$ 10,024	\$ 9,612	4%
As a percent of revenue	21%	22%	(1)ppt	19%	21%	(2)ppt

Sales and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related expenses associated with sales and marketing personnel and the costs of advertising, promotions, trade shows, seminars, and other programs. Sales and marketing expenses increased primarily as a result of increased advertising and marketing of the Xbox 360 platform, Windows Phone, and Windows and Windows Live, and a 5% and 3% increase in headcount-related expenses for the three and nine months ended March 31, 2011, respectively.

General and Administrative

(In millions, except percentages)	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2011	2010		2011	2010	
General and administrative	\$ 1,160	\$ 1,152	1%	\$ 3,043	\$ 3,076	(1)%
As a percent of revenue	7%	8%	(1)ppt	6%	7%	(1)ppt

General and administrative expenses include payroll, employee benefits, stock-based compensation expense, employee severance, and other headcount-related expenses associated with finance, legal, facilities, certain human resources and other administrative headcount, and legal and other administrative fees. The increase in general and administrative expenses was primarily due to newly legislated Puerto Rican excise taxes and an increase in headcount-related expenses, partially offset by transition expenses in the prior year associated with the inception of the Yahoo! Commercial Agreement and employee severance expenses in the prior year.

Table of Contents**PART I**

Item 2

OTHER INCOME AND INCOME TAXES**Other Income**

The components of other income were as follows:

(In millions)	Three Months Ended		Nine Months Ended	
	March 31,		March 31,	
	2011	2010	2011	2010
Dividends and interest income	\$ 216	\$ 204	\$ 631	\$ 604
Interest expense	(84)	(38)	(201)	(114)
Net recognized gains on investments	187	137	339	299
Net gains (losses) on derivatives	(65)	(69)	38	23
Net gains (losses) on foreign currency remeasurements	55	(56)	(14)	(24)
Other	7	(10)	(31)	33
Total	\$ 316	\$ 168	\$ 762	\$ 821

Dividends and interest income increased slightly due to higher average portfolio investment balances, offset in part by lower yields on our fixed-income investments. Interest expense increased due to our increased issuance of debt. Net recognized gains on investments increased in the three and nine months ended March 31, 2011 due primarily to higher gains on sales of equity securities. Net losses on derivatives in the three months ended March 31, 2011 were similar to the comparable period as losses on currency contracts used to hedge foreign currency revenues were offset in part by gains on commodity derivatives. Derivative gains increased in the nine months ended March 31, 2011 due primarily to higher gains on commodity derivatives offset in part by losses on currency contracts used to hedge foreign currency revenues. Changes in foreign currency remeasurements for the three months ended March 31, 2011 were primarily due to currency movements net of our hedging activities. Other includes a gain on the divestiture of Razorfish in the nine month period ending March 31, 2010.

Income Taxes

Our effective tax rates were approximately 13% and 25% for the three months ended March 31, 2011 and 2010, respectively, and 21% and 25% for the nine months ended March 31, 2011 and 2010, respectively. Our rates decreased and were lower than the U.S. federal statutory rate primarily due to the settlement of a portion of an I.R.S. audit of tax years 2004 to 2006, which reduced our income tax expense for the third quarter by \$461 million, and a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from continued emphasis on producing and distributing our products and services through our foreign regional operational centers in Ireland, Singapore and Puerto Rico, which are subject to lower income tax rates.

Tax contingencies and other tax liabilities were \$7.2 billion and \$6.9 billion as of March 31, 2011 and June 30, 2010, respectively, and were included in other long-term liabilities. While we settled a portion of the I.R.S. audit for tax years 2004 to 2006, we remain under audit for these years. Subsequent to quarter end, the I.R.S. issued proposed adjustments for tax years 2004 to 2006 that we have not agreed to and intend to contest through the administrative process. The impact of these proposed adjustments on years currently open to examination could have a significant impact on our financial statements if not resolved favorably. We do not believe it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months, as we do not believe the audit will be concluded within the next 12 months. We also continue to be subject to examination by the I.R.S. for tax years 2007 to 2010.

FINANCIAL CONDITION

Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and short-term investments totaled \$50.2 billion as of March 31, 2011, compared with \$36.8 billion as of June 30, 2010. Equity and other investments were \$10.7 billion as of March 31, 2011, compared with \$7.8 billion as of June 30, 2010. Our short-term investments are primarily to facilitate liquidity and for capital preservation. They consist predominantly of highly liquid investment-grade fixed-income securities, diversified among industries and individual issuers. The investments are predominantly U.S. dollar-denominated securities, but also include foreign currency-denominated securities in order to diversify risk. Our fixed-income investments are exposed to interest rate risk and credit risk. The credit risk and average maturity of our fixed-income portfolio are managed to

Table of Contents

PART I

Item 2

achieve economic returns that correlate to certain fixed-income indices. The settlement risk related to these investments is insignificant given that the short-term investments held are primarily highly liquid investment-grade fixed-income securities. While we own certain mortgage-backed and asset-backed fixed-income securities, our portfolio as of March 31, 2011 does not contain direct exposure to subprime mortgages or structured vehicles that derive their value from subprime collateral. The majority of our mortgage-backed securities are collateralized by prime residential mortgages and carry a 100% principal and interest guarantee, primarily from Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association.

Of the cash, cash equivalents, and short-term investments at March 31, 2011, approximately \$42 billion was held by our foreign subsidiaries and were subject to material repatriation tax effects. The amount of cash and investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was approximately \$267 million. As of March 31, 2011, approximately 70% of the short-term investments held by our foreign subsidiaries were invested in U.S. government and agency securities, approximately 11% were invested in corporate notes and bonds of U.S. companies, and 6% were invested in U.S. mortgage-backed securities, all of which are denominated in U.S. dollars.

Securities Lending

We lend certain fixed-income and equity securities to increase investment returns. The loaned securities continue to be carried as investments on our balance sheet. Cash and/or security interests are received as collateral for the loaned securities with the amount determined based upon the underlying security lent and the creditworthiness of the borrower. Cash received is recorded as an asset with a corresponding liability. Our securities lending payable balance was \$1.2 billion as of March 31, 2011. Our average and maximum securities lending payable balances for the three months ended March 31, 2011 were \$1.3 billion and \$1.4 billion, respectively. Our average and maximum securities lending payable balances for the nine months ended March 31, 2011 were \$1.7 billion and \$3.3 billion, respectively. Intra-quarter variances in the amount of securities loaned are mainly due to fluctuations in the demand for the securities.

Valuation

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine the fair value of our financial instruments. This pricing methodology applies to our Level 1 investments, such as exchange-traded mutual funds, domestic and international equities, and U.S. treasuries. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs other than the quoted prices that are observable either directly or indirectly. This pricing methodology applies to our Level 2 investments such as corporate notes and bonds, foreign government bonds, mortgage-backed securities, and agency securities. Level 3 investments are valued using internally developed models with unobservable inputs. Assets and liabilities measured using unobservable inputs are an immaterial portion of our portfolio.

A majority of our investments are priced by pricing vendors and are generally Level 1 or Level 2 investments as these vendors either provide a quoted market price in an active market or use observable inputs for their pricing without applying significant adjustments. Broker pricing is used mainly when a quoted price is not available, the investment is not priced by our pricing vendors, or when a broker price is more reflective of fair values in the market in which the investment trades. Our broker-priced investments are generally labeled as Level 2 investments because the broker prices these investments based on similar assets without applying significant adjustments. In addition, all of our broker-priced investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments. Our fair value processes include controls that are designed to ensure appropriate fair values are recorded. These controls include model validation, review of key model inputs, analysis of period-over-period fluctuations, and independent recalculation of prices where appropriate.

Cash Flows

Cash flows from operations increased \$2.6 billion to \$21.1 billion for the nine months ended March 31, 2011 due mainly to increased revenue and cash collections. Cash used in financing decreased \$3.2 billion to \$6.0 billion due mainly to a \$5.7 billion increase in proceeds from issuance of debt, net of repayments, offset in part by a \$2.9 billion increase in cash used for common stock repurchases. Cash used in investing increased \$6.5 billion to \$13.7 billion due mainly to a \$4.4 billion decrease in sales and maturities of investments, along with a \$1.7 billion increase in purchases of investments.

Table of Contents**PART I**

Item 2

Debt*Short-term Debt*

During the nine months ended March 31, 2011, we repaid \$1.0 billion of commercial paper, leaving zero outstanding.

On November 5, 2010, our \$1.0 billion 364-day credit facility expired. This facility served as a back-up for our commercial paper program. No amounts were drawn against the credit facility during any of the periods presented.

*Long-term Debt***Notes**

We issued debt during the periods presented to take advantage of favorable pricing and liquidity in the debt markets, reflecting our superior credit rating and the low interest rate environment. The proceeds of these issuances were used to partially fund discretionary business acquisitions and share repurchases.

As of March 31, 2011, both the total carrying value and estimated fair value of our long-term debt, including convertible debt, were \$11.9 billion. The estimated fair value is based on quoted prices for our publicly-traded debt as of March 31, 2011, as applicable.

The components of long-term debt, the associated interest rates, and the semi-annual interest record and payment dates were as follows as of March 31, 2011:

		Stated Interest	Effective Interest	Interest	Interest	Interest	Interest
Due Date	Face Value	Rate	Rate	Record Date	Pay Date	Record Date	Pay Date
(In millions)							
Notes							
September 27, 2013	\$ 1,000	0.875%	1.000%	March 15	March 27	September 15	September 27
June 1, 2014	2,000	2.950%	3.049%	May 15	June 1	November 15	December 1
September 25, 2015	1,750	1.625%	1.795%	March 15	March 25	September 15	September 25
February 8, 2016	750	2.500%	2.642%	February 1	February 8	August 1	August 8
June 1, 2019	1,000	4.200%	4.379%	May 15	June 1	November 15	December 1
October 1, 2020	1,000	3.000%	3.137%	March 15	April 1	September 15	October 1
February 8, 2021	500	4.000%	4.082%	February 1	February 8	August 1	August 8
June 1, 2039	750	5.200%	5.240%	May 15	June 1	November 15	December 1
October 1, 2040	1,000	4.500%	4.567%	March 15	April 1	September 15	October 1
February 8, 2041	1,000	5.300%	5.361%	February 1	February 8	August 1	August 8
Total	10,750						
Convertible debt							
June 15, 2013	1,250	0.000%	1.849%				
Total unamortized discount	(85)						

Total	\$ 11,915
-------	-----------

As of March 31, 2011, we had issued and outstanding \$10.8 billion of debt securities as illustrated in the table above (collectively the Notes), including \$4.75 billion issued in September 2010 and \$2.25 billion issued in February 2011. The Notes are senior unsecured obligations and rank equally with our other unsecured and unsubordinated debt outstanding.

Convertible Debt

In June 2010, we issued \$1.25 billion of zero coupon convertible unsecured debt due on June 15, 2013 in a private placement offering. Proceeds from the offering were \$1.24 billion, net of fees and expenses, which were capitalized. Each \$1,000 principal amount of notes is convertible into 29.94 shares of Microsoft common stock at a conversion price of \$33.40 per share.

Table of Contents**PART I**

Item 2

Prior to March 15, 2013, the notes will be convertible, only in certain circumstances, into cash and, if applicable, cash, shares of Microsoft's common stock, or a combination thereof, at our election. On or after March 15, 2013, the notes will be convertible at any time. Upon conversion, we will pay cash up to the aggregate principal amount of the notes and pay or deliver cash, shares of our common stock, or a combination of cash and shares of our common stock, at our election.

Because the convertible debt may be wholly or partially settled in cash, we are required to separately account for the liability and equity components of the notes in a manner that reflects our nonconvertible debt borrowing rate when interest costs are recognized in subsequent periods. The net proceeds of \$1.24 billion were allocated between debt for \$1.18 billion and stockholders' equity for \$58 million with the portion in stockholders' equity representing the fair value of the option to convert the debt.

In connection with the issuance of the notes, we entered into capped call transactions with certain option counterparties who are initial purchasers of the notes or their affiliates. The capped call transactions are expected to reduce potential dilution of earnings per share upon conversion of the notes. Under the capped call transactions, we purchased from the option counterparties capped call options that in the aggregate relate to the total number of shares of our common stock underlying the notes, with a strike price equal to the conversion price of the notes and with a cap price equal to \$37.16. The purchased capped calls were valued at \$40 million and recorded to stockholders' equity.

Unearned Revenue

Unearned revenue at March 31, 2011 comprised mainly unearned revenue from volume licensing programs. Unearned revenue from volume licensing programs represents customer billings for multi-year licensing arrangements paid for either at inception of the agreement or annually at the beginning of each billing coverage period and accounted for as subscriptions with revenue recognized ratably over the billing coverage period. Unearned revenue at March 31, 2011 also included payments for: post-delivery support and consulting services to be performed in the future; Xbox LIVE subscriptions; Microsoft Dynamics business solutions products; unspecified upgrades/enhancements of Windows Phone and Microsoft Internet Explorer on a when-and-if-available basis for Windows XP; and other offerings for which we have been paid in advance and earn the revenue when we provide the service or software, or otherwise meet the revenue recognition criteria.

The following table outlines the expected future recognition of unearned revenue as of March 31, 2011:

(In millions)

Three Months Ending,

June 30, 2011	\$ 5,043
September 30, 2011	3,342
December 31, 2011	2,473
March 31, 2012	1,029
Thereafter	1,132
Total	\$ 13,019

Share Repurchases

During the three months and nine months ended March 31, 2011, we repurchased approximately 30 million and 381 million shares of Microsoft common stock for \$827 million and \$9.8 billion, respectively, under the repurchase plan we announced on September 22, 2008. All repurchases were made using cash resources. As of March 31, 2011, approximately \$13.9 billion remained of the \$40.0 billion approved repurchase amount. The repurchase program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

Table of Contents**PART I**

Item 2

Dividends

Our Board of Directors declared the following dividends during the periods presented:

Declaration Date	Per Share Dividend	Record Date	Total Amount	Payment Date
(in millions)				
Fiscal Year 2011				
September 21, 2010	\$ 0.16	November 18, 2010	\$ 1,363	December 9, 2010
December 15, 2010	\$ 0.16	February 17, 2011	\$ 1,349	March 10, 2011
March 14, 2011	\$ 0.16	May 19, 2011	\$ 1,349	June 9, 2011
Fiscal Year 2010				
September 18, 2009	\$ 0.13	November 19, 2009	\$ 1,152	December 10, 2009
December 9, 2009	\$ 0.13	February 18, 2010	\$ 1,139	March 11, 2010
March 8, 2010	\$ 0.13	May 20, 2010	\$ 1,130	June 10, 2010

Off-Balance Sheet Arrangements

We provide indemnifications of varying scope and size to certain customers against claims of intellectual property infringement made by third parties arising from the use of our products and certain other matters. In evaluating estimated losses on these indemnifications, we consider factors such as the degree of probability of an unfavorable outcome and our ability to make a reasonable estimate of the amount of loss. To date, we have not encountered significant costs as a result of these obligations and have not accrued in our financial statements any liabilities related to these indemnifications.

Other Planned Uses of Capital

We will continue to invest in sales, marketing, product support infrastructure, and existing and advanced areas of technology. Additions to property and equipment will continue, including new facilities, data centers, and computer systems for research and development, sales and marketing, support, and administrative staff. We have operating leases for most U.S. and international sales and support offices and certain equipment. We have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of capital resources.

Liquidity

We earn a significant amount of our operating income outside the U.S., which is deemed to be permanently reinvested in foreign jurisdictions. As a result, as discussed above under Cash, Cash Equivalents, and Investments, the majority of our cash, cash equivalents, and short-term investments are held by foreign subsidiaries. We currently do not intend nor foresee a need to repatriate these funds. We expect existing domestic cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our domestic operating activities and cash commitments for investing and financing activities, such as regular quarterly dividends, debt repayment schedules, and material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future. In addition, we expect existing foreign cash, cash equivalents, short-term investments, and cash flows from operations to continue to be sufficient to fund our foreign operating activities and cash commitments for investing activities, such as material capital expenditures, for at least the next 12 months and thereafter for the foreseeable future.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

Should we require more capital in the U.S. than is generated by our operations domestically, for example to fund significant discretionary activities, such as acquisitions of businesses and share repurchases, we could elect to repatriate future earnings from foreign jurisdictions or raise capital in the U.S. through debt or equity issuances. These alternatives could result in higher effective tax rates, increased interest expense, or other dilution of our earnings. We have borrowed funds domestically and continue to have the ability to borrow funds domestically at reasonable interest rates.

As a result of the special dividend paid in the second quarter of fiscal year 2005 and shares repurchased, our retained deficit, including accumulated other comprehensive income, was \$9.8 billion at March 31, 2011. Our retained deficit is not expected to affect our future ability to operate, pay dividends, or repay our debt given our continuing profitability and strong financial position.

Table of Contents

PART I

Item 2

RECENT ACCOUNTING GUIDANCE

Recently Adopted Accounting Guidance

On July 1, 2010, we adopted guidance issued by the Financial Accounting Standards Board (FASB) on revenue recognition. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product are no longer within the scope of the software revenue recognition guidance, and software-enabled products are now subject to other relevant revenue recognition guidance. Additionally, the FASB issued guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. Adoption of the new guidance did not have a material impact on our financial statements.

On July 1, 2010, we adopted new guidance issued by the FASB on the consolidation of variable interest entities. The new guidance requires revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. Adoption of the new guidance did not have a material impact on our financial statements.

Recent Accounting Guidance Not Yet Adopted

In January 2010, the FASB issued guidance to amend the disclosure requirements related to fair value measurements. The guidance requires the disclosure of roll forward activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The guidance will become effective for us with the reporting period beginning July 1, 2011. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on our financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our financial statements and accompanying notes are prepared in accordance with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us include revenue recognition, impairment of investment securities, goodwill, research and development costs, contingencies, income taxes, stock-based compensation, and product warranties.

Revenue Recognition

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. A portion of revenue may be recorded as unearned due to undelivered elements. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

Impairment of Investment Securities

Investments are reviewed quarterly for indicators of other-than-temporary impairment. This determination requires significant judgment. In making this judgment, we employ a systematic methodology quarterly that considers available quantitative and qualitative evidence in evaluating potential impairment of our investments. If the cost of an investment exceeds its fair value, we evaluate, among other factors, general market conditions, credit quality of debt instrument issuers, the duration and extent to which the fair value is less than cost, and for equity securities, our

Table of Contents

PART I

Item 2

intent and ability to hold, or plans to sell, the investment. For fixed income securities, we also evaluate whether we have plans to sell the security or it is more likely than not that we will be required to sell the security before recovery. We also consider specific adverse conditions related to the financial health of and business outlook for the investee, including industry and sector performance, changes in technology, and operational and financing cash flow factors. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded to other income (expense) and a new cost basis in the investment is established. If market, industry, and/or investee conditions deteriorate, we may incur future impairments.

Goodwill

We allocate goodwill to reporting units based on the reporting unit expected to benefit from the business combination. We evaluate our reporting units on an annual basis and, if necessary, reassign goodwill using a relative fair value allocation approach. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis (May 1 for us) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. These events or circumstances could include a significant change in the business climate, legal factors, operating performance indicators, competition, or sale or disposition of a significant portion of a reporting unit.

Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Among our reporting units, the fair value of OSD has been the closest to its carrying value. The carrying value of OSD's goodwill was \$6.4 billion as of March 31, 2011.

The estimates used to calculate the fair value of a reporting unit change from year to year based on operating results and market conditions. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit.

Research and Development Costs

Costs incurred internally in researching and developing a computer software product are charged to expense until technological feasibility has been established for the product. Once technological feasibility is established, all software costs are capitalized until the product is available for general release to customers. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached after all high-risk development issues have been resolved through coding and testing. Generally, this occurs shortly before the products are released to manufacturing. The amortization of these costs is included in cost of revenue over the estimated life of the products.

Legal and Other Contingencies

The outcomes of legal proceedings and claims brought against us are subject to significant uncertainty. An estimated loss from a loss contingency such as a legal proceeding or claim is accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Disclosure of a contingency is required if there is at least a reasonable possibility that a loss has been incurred. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially impact our financial statements.

Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized

Table of Contents

PART I

Item 2, 3

upon ultimate settlement. Accounting literature also provides guidance on derecognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, and income tax disclosures. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Variations in the actual outcome of these future tax consequences could materially impact our financial statements.

Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period. Determining the fair value of stock-based awards at the grant date requires judgment, including estimating expected dividends. In addition, judgment is also required in estimating the amount of stock-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be impacted.

Product Warranties

We provide for the estimated costs of hardware and software warranties at the time the related revenue is recognized. For hardware warranty, we estimate the costs based on historical and projected product failure rates, historical and projected repair costs, and knowledge of specific product failures (if any). The specific hardware warranty terms and conditions vary depending upon the product sold and country in which we do business, but generally include parts and labor over a period generally ranging from 90 days to three years. For software warranty, we estimate the costs to provide bug fixes, such as security patches, over the life of the software. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

RISKS

We are exposed to economic risk from foreign currency exchange rates, interest rates, credit risk, equity prices, and commodity prices. A portion of these risks is hedged, but they may impact our financial statements.

Foreign Currency

Certain forecasted transactions, assets, and liabilities are exposed to foreign currency risk. We monitor our foreign currency exposures daily and use hedges where practicable to offset the risks and maximize the economic effectiveness of our foreign currency positions. Principal currencies hedged include the euro, Japanese yen, British pound, and Canadian dollar.

Interest Rate

Our fixed-income portfolio is diversified across credit sectors and maturities, consisting primarily of investment-grade securities. The credit risk and average maturity of the fixed-income portfolio is managed to achieve economic returns that correlate to certain global and domestic fixed-income indices. In addition, we use To Be Announced forward purchase commitments of mortgage-backed assets to gain exposure to agency and mortgage-backed securities.

Equity

Our equity portfolio consists of global, developed, and emerging market securities that are subject to market price risk. We manage the securities relative to certain global and domestic indices and expect their economic risk and return to correlate with these indices.

Commodity

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

We use broad-based commodity exposures to enhance portfolio returns and facilitate portfolio diversification. Our investment portfolio has exposure to a variety of commodities, including precious metals, energy, and grain. We manage these exposures relative to global commodity indices and expect their economic risk and return to correlate with these indices.

Table of Contents**PART I. II**

Item 3, 4, 1, 1A

VALUE-AT-RISK

We use a value-at-risk (VaR) model to estimate and quantify our market risks. VaR is the expected loss, for a given confidence level, in the fair value of our portfolio due to adverse market movements over a defined time horizon. The VaR model is not intended to represent actual losses in fair value, including determinations of other-than-temporary losses in fair value in accordance with accounting principles generally accepted in the United States (U.S. GAAP), but is used as a risk estimation and management tool. The distribution of the potential changes in total market value of all holdings is computed based on the historical volatilities and correlations among foreign currency exchange rates, interest rates, equity prices, and commodity prices, assuming normal market conditions.

The VaR is calculated as the total loss that will not be exceeded at the 97.5 percentile confidence level or, alternatively stated, the losses could exceed the VaR in 25 out of 1,000 cases. Several risk factors are not captured in the model, including liquidity risk, operational risk, and legal risk. The following table sets forth the one-day VaR for substantially all of our positions as of March 31, 2011 and June 30, 2010 and for the three months ended March 31, 2011:

(In millions)

Risk categories	Three Months Ended				
			March 31,		
	March 31, 2011	June 30, 2010	2011		
			Average	High	Low
Foreign currency	\$ 62	\$ 57	\$ 48	\$ 66	\$ 40
Interest rate	\$ 56	\$ 58	\$ 57	\$ 62	\$ 53
Equity	\$ 222	\$ 183	\$ 217	\$ 223	\$ 207
Commodity	\$ 25	\$ 19	\$ 24	\$ 26	\$ 22

Total one-day VaR for the combined risk categories was \$285 million at March 31, 2011 and \$235 million at June 30, 2010. The total VaR is 22% less at March 31, 2011, and 26% less at June 30, 2010, than the sum of the separate risk categories in the above table due to the diversification benefit of the combination of risks.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) 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 these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION**ITEM 1. LEGAL PROCEEDINGS**

See Note 14 Contingencies of the Notes to Financial Statements (Part I, Item 1 of this Form 10-Q) for information regarding certain legal proceedings in which we are involved.

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock.

The cloud-based computing model presents execution and competitive risks. We are transitioning to a computing environment characterized by cloud-based services used with smart client devices. Our competitors are rapidly developing and deploying cloud-based services for consumers and business customers. Pricing and delivery models are evolving. Devices and form factors influence how users access services in the cloud. We are devoting

Table of Contents

PART II

Item 1A

significant resources to develop and deploy our own competing cloud-based software plus services strategies. While we believe our expertise, investments in infrastructure, and the breadth of our cloud-based services provides us with a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. In addition to software development costs, we are incurring costs to build and maintain infrastructure to support cloud computing services. These costs may reduce the operating margins we have previously achieved. Whether we are successful in this new business model depends on our execution in a number of areas, including:

continuing to innovate and bring to market compelling cloud-based experiences that generate increasing traffic and market share;

maintaining the utility, compatibility, and performance of our cloud-based services on the growing array of computing devices, including smartphones, handheld computers, netbooks, tablets, and television set top devices; and

continuing to enhance the attractiveness of our cloud platforms to third-party developers.

Challenges to our business models may reduce our revenues or operating margins. Whether our software runs in the cloud or on a device, we continue to face challenges from alternative means of developing and licensing software. Under our license-based software model, software developers bear the costs of converting original ideas into software products through investments in research and development, offsetting these costs with the revenue received from the distribution of their products. Certain open source software business models challenge our license-based software model. Open source commonly refers to software whose source code is subject to a license allowing it to be modified, combined with other software and redistributed, subject to restrictions set forth in the license. A number of commercial firms compete with us using an open source business model by modifying and then distributing open source software to end users at nominal cost and earning revenue on complementary services and products. These firms do not bear the full costs of research and development for the software. In some cases, their products may infringe patents granted to Microsoft for our inventions. In addition, advertising-based business models seek revenue by delivering third party advertisements to end customers who receive the software and services at no direct costs. Gains in market acceptance of open source or advertising based software may adversely affect our sales, revenue, and operating margins.

An important element of our business model has been to create platform-based ecosystems on which many participants can build diverse solutions. A competing vertically-integrated model, in which a single firm controls both the software and hardware elements of a product, has been successful with certain consumer products such as personal computers, mobile phones, and digital music players. We also offer vertically-integrated hardware and software products; however, efforts to compete with the vertically integrated model may increase our cost of sales and reduce our operating margins.

We derive substantial revenue from licenses of Windows operating systems on personal computers. It is uncertain to what extent alternative devices and form factors will increase the number of computing devices that users own or will substitute for users' personal computer purchases. Alternative devices also run operating systems and applications developed by our competitors. These factors could impact our revenues and margins.

We face intense competition. We continue to experience intense competition across all markets for our products and services. Our competitors range in size from Fortune 100 companies to small, specialized single-product businesses and open source community-based projects. Although we believe the breadth of our businesses and product portfolio is a competitive advantage, our competitors that are focused on narrower product lines may be more effective in devoting technical, marketing, and financial resources to compete with us. In addition, barriers to entry in our businesses generally are low and products, once developed, can be distributed broadly and quickly at relatively low cost. Open source software vendors are devoting considerable efforts to developing software that mimics the features and functionality of our products, in some cases in violation of our intellectual property rights or on the basis of technical specifications for Microsoft technologies that we make available at little or no cost in connection with our interoperability initiatives. In response to competition, we continue to develop versions of our products with basic functionality that are sold at lower prices than the standard versions. These competitive pressures may result in decreased sales volumes, price reductions, and/or increased operating costs, such as for marketing and sales incentives, resulting in lower revenue, gross margins, and operating income.

We may not be able to adequately protect our intellectual property rights. Protecting our global intellectual property rights and combating unlicensed copying and use of software and other intellectual property is difficult.

Table of Contents

PART II

Item 1A

While piracy adversely affects U.S. revenue, the impact on revenue from outside the U.S. is more significant, particularly in countries where laws are less protective of intellectual property rights. As a result, our revenue in these markets likely will grow slower than the underlying PC market. Similarly, the absence of harmonized patent laws makes it more difficult to ensure consistent respect for patent rights. Throughout the world, we actively educate consumers about the benefits of licensing genuine products and obtaining indemnification benefits for intellectual property risks, and we educate lawmakers about the advantages of a business climate where intellectual property rights are protected. However, continued educational and enforcement efforts may fail to enhance revenue. Reductions in the legal protection for software intellectual property rights could adversely affect revenue.

Third parties may claim we infringe their intellectual property rights. From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. To resolve these claims we may enter into royalty and licensing agreements on less favorable terms, stop selling or redesign affected products, or pay damages to satisfy indemnification commitments with our customers. Such agreements may cause operating margins to decline. We have made and expect to continue making significant expenditures to settle claims related to the use of technology and intellectual property rights as part of our strategy to manage this risk.

We may not be able to protect our source code from copying if there is an unauthorized disclosure of source code. Source code, the detailed program commands for our operating systems and other software programs, is critical to our business. Although we license portions of our application and operating system source code to a number of licensees, we take significant measures to protect the secrecy of large portions of our source code. If an unauthorized disclosure of a significant portion of our source code occurs, we could potentially lose future trade secret protection for that source code. This could make it easier for third parties to compete with our products by copying functionality, which could adversely affect our revenue and operating margins. Unauthorized disclosure of source code also could increase the security risks described in the next paragraph.

Security vulnerabilities in our products and services could lead to reduced revenues or to liability claims. Maintaining the security of computers and computer networks is a critical issue for us and our customers. Hackers develop and deploy viruses, worms, and other malicious software programs that attack our products and gain access to our networks and data centers. Although this is an industry-wide problem that affects computers across all platforms, it affects our products in particular because hackers tend to focus their efforts on the most popular operating systems and programs and we expect them to continue to do so. We devote significant resources to address security vulnerabilities through:

engineering more secure products and services;

enhancing security and reliability features in our products and services;

helping our customers make the best use of our products and services to protect against computer viruses and other attacks;

improving the deployment of software updates to address security vulnerabilities;

investing in mitigation technologies that help to secure customers from attacks even when such software updates are not deployed;
and

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

providing customers online automated security tools, published security guidance, and security software such as firewalls and anti-virus software.

The cost of these steps could reduce our operating margins. Despite these efforts, actual or perceived security vulnerabilities in our products could lead some customers to seek to return products, to reduce or delay future purchases, or to use competing products. Customers may also increase their expenditures on protecting their existing computer systems from attack, which could delay adoption of new technologies. Any of these actions by customers could adversely affect our revenue. In addition, if third parties gain access to our networks or data centers they could obtain and exploit confidential business information and harm our competitive position. Finally, actual or perceived vulnerabilities may lead to claims against us. Although our license agreements typically contain provisions that eliminate or limit our exposure to such liability, there is no assurance these provisions will withstand all legal challenges.

Improper disclosure of personal data could result in liability and harm our reputation. We store and process large amounts of personally identifiable information as we sell software, provide support and offer cloud-based services to customers. It is possible that our security controls over personal data, our training of employees and vendors on data security, and other practices we follow may not prevent the improper disclosure of personally identifiable information. Improper disclosure of this information could harm our reputation, lead to legal exposure to

Table of Contents

PART II

Item 1A

customers, or subject us to liability under laws that protect personal data, resulting in increased costs or loss of revenue. Our software products and services also enable our customers to store and process personal data. Perceptions that our products or services do not adequately protect the privacy of personal information could inhibit sales of our products or services.

We may experience outages, data loss and disruptions of our online services if we fail to maintain an adequate operations infrastructure. Our increasing user traffic and complexity of our products and services demand more computing power. We have spent and expect to continue to spend substantial amounts to purchase or lease data centers and equipment and to upgrade our technology and network infrastructure to handle increased traffic on our Web sites and in our data centers, and to introduce new products and services and support existing services such as Bing, Exchange Online, SharePoint Online, Xbox LIVE, Windows Live, and Microsoft Office Web Apps. We also are growing our business of providing a platform and back-end hosting for services provided by third-party businesses to their end customers. Maintaining and expanding this infrastructure is expensive and complex. Inefficiencies or operational failures, including temporary or permanent loss of customer data, could diminish the quality of our products, services, and user experience resulting in contractual liability, claims by customers and other third parties, damage to our reputation and loss of current and potential users, subscribers, and advertisers, each of which may harm our operating results and financial condition.

We are subject to government litigation and regulatory activity that affects how we design and market our products. As a leading global software maker, we receive close scrutiny from government agencies under U.S. and foreign competition laws. Some jurisdictions also provide private rights of action for competitors or consumers to assert claims of anti-competitive conduct. For example, we have been involved in the following actions.

Lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. These proceedings imposed various constraints on our Windows operating system businesses. These constraints include limits on certain contracting practices, mandated disclosure of certain software program interfaces and protocols, and rights for computer manufacturers to limit the visibility of certain Windows features in new PCs. We believe we are in full compliance with these rules. We anticipate that the Consent Decree and Final Judgment will expire in May 2011, but we expect that federal and state antitrust authorities will continue to closely scrutinize our business.

The European Commission closely scrutinizes the design of high-volume Microsoft products and the terms on which we make certain technologies used in these products, such as file formats, programming interfaces, and protocols, available to other companies. In 2004, the Commission ordered us to create new versions of Windows that do not include certain multimedia technologies and to provide our competitors with specifications for how to implement certain proprietary Windows communications protocols in their own products. In 2009, the Commission accepted a set of commitments offered by Microsoft to address the Commission's concerns relating to competition in Web browsing software. The Commission's impact on product design may limit our ability to innovate in Windows or other products in the future, diminish the developer appeal of the Windows platform, and increase our product development costs. The availability of licenses related to protocols and file formats may enable competitors to develop software products that better mimic the functionality of our own products which could result in decreased sales of our products.

Government regulatory actions and court decisions such as these may hinder our ability to provide the benefits of our software to consumers and businesses, thereby reducing the attractiveness of our products and the revenues that come from them. New actions could be initiated at any time, either by these or other governments or private claimants, including with respect to new versions of Windows or other Microsoft products. The outcome of such actions, or steps taken to avoid them, could adversely affect us in a variety of ways, including:

We may have to choose between withdrawing products from certain geographies to avoid fines or designing and developing alternative versions of those products to comply with government rulings, which may entail a delay in a product release and removing functionality that customers want or on which developers rely.

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

We may be required to make available licenses to our proprietary technologies on terms that do not reflect their fair market value or do not protect our associated intellectual property.

The rulings described above may be cited as a precedent in other competition law proceedings.

Our software and services online offerings are subject to government regulation of the Internet domestically and internationally in many areas, including user privacy, telecommunications, data protection, and online content. The

Table of Contents

PART II

Item 1A

application of these laws and regulations to our business is often unclear and sometimes may conflict. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we stop the alleged noncompliant activity.

Our business depends on our ability to attract and retain talented employees. Our business is based on successfully attracting and retaining talented employees. The market for highly skilled workers and leaders in our industry is extremely competitive. We are limited in our ability to recruit internationally by restrictive domestic immigration laws. If we are less successful in our recruiting efforts, or if we are unable to retain key employees, our ability to develop and deliver successful products and services may be adversely affected. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution.

Delays in product development schedules may adversely affect our revenues. The development of software products is a complex and time-consuming process. New products and enhancements to existing products can require long development and testing periods. Our increasing focus on cloud-based software plus services also presents new and complex development issues. Significant delays in new product or service releases or significant problems in creating new products or services could adversely affect our revenue.

We make significant investments in new products and services that may not be profitable. Our growth depends on our ability to innovate by offering new, and adding value to our existing, software and service offerings. We will continue to make significant investments in research, development, and marketing for new products, services, and technologies, including the Windows PC operating system, the Microsoft Office system, Bing, Windows Phone, Windows Server, Zune, Windows Live, the Windows Azure Services platform and other cloud-based services offerings, and Xbox 360. Investments in new technology are speculative. Commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Our degree of success with Windows Phone, for example, will impact our ability to grow our share of the smartphone operating system market. It will also be an important factor in supporting our strategy of delivering value to end users seamlessly over PC, phone, and TV device classes. If customers do not perceive our latest offerings as providing significant new functionality or other value, they may reduce their purchases of new software products or upgrades, unfavorably impacting revenue. We may not achieve significant revenue from new product and service investments for a number of years, if at all. Moreover, new products and services may not be profitable, and even if they are profitable, operating margins for new products and businesses may not be as high as the margins we have experienced historically.

Adverse economic conditions may harm our business. Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower information technology spending and adversely affect our revenue. If demand for PCs, servers, and other computing devices declines, or consumer or business spending for those products declines, our revenue will be adversely affected. Our product distribution system also relies on an extensive partner network. The impact of economic conditions on our partners, such as the bankruptcy of a major distributor, could result in sales channel disruption. Challenging economic conditions also may impair the ability of our customers to pay for products and services they have purchased. As a result, reserves for doubtful accounts and write-offs of accounts receivable may increase. We maintain an investment portfolio of various holdings, types, and maturities. These investments are subject to general credit, liquidity, market, and interest rate risks, which may be exacerbated by unusual events that have affected global financial markets. If global credit and equity markets experience prolonged periods of decline, our investment portfolio may be adversely impacted and we could determine that more of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely impact our financial results.

We have claims and lawsuits against us that may result in adverse outcomes. We are subject to a variety of claims and lawsuits. Adverse outcomes in some or all of these claims may result in significant monetary damages or injunctive relief that could adversely affect our ability to conduct our business. Although management currently believes resolving all of these matters, individually or in the aggregate, will not have a material adverse impact on our financial statements, the litigation and other claims are subject to inherent uncertainties and management's view of these matters may change in the future. A material adverse impact on our financial statements also could occur for the period in which the effect of an unfavorable final outcome becomes probable and reasonably estimable.

We may have additional tax liabilities. We are subject to income taxes in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We

Table of Contents

PART II

Item 1A

regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions may result in higher effective tax rates for the company. In addition, there have been proposals to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form this proposed legislation may pass, if enacted it could have a material adverse impact on our tax expense and cash flow.

Our vertically-integrated hardware and software products may experience quality or supply problems. Our hardware products such as the Xbox 360 console are highly complex and can have defects in design, manufacture, or associated software. We could incur significant expenses, lost revenue, and reputational harm if we fail to detect or effectively address such issues through design, testing, or warranty repairs. We obtain some components of our hardware devices from sole suppliers. If a component delivery from a sole-source supplier is delayed or becomes unavailable or industry shortages occur, we may be unable to obtain timely replacement supplies, resulting in reduced sales. Either component shortages or excess or obsolete inventory may increase our cost of revenue. Xbox 360 consoles are assembled in Asia; disruptions in the supply chain may result in console shortages that would affect our revenues and operating margins. These same risks would apply to any other vertically-integrated hardware and software products we may offer.

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. Under accounting principles generally accepted in the United States (U.S. GAAP), we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is tested for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

We operate a global business that exposes us to additional risks. We operate in over 100 countries and a significant part of our revenue comes from international sales. Pressure to make our pricing structure uniform might require that we reduce the sales price of our software in the U.S. and other countries. Operations outside the U.S. may be affected by changes in trade protection laws, policies and measures, and other regulatory requirements affecting trade and investment, including the Foreign Corrupt Practices Act and local laws prohibiting corrupt payments. Emerging markets are a significant focus of our international growth strategy. The developing nature of these markets presents a number of risks. Deterioration of social, political, labor, or economic conditions in a specific country or region and difficulties in staffing and managing foreign operations may also adversely affect our operations or financial results. Although we hedge a portion of our international currency exposure, significant fluctuations in exchange rates between the U.S. dollar and foreign currencies may adversely affect our net revenues.

Catastrophic events or geo-political conditions may disrupt our business. A disruption or failure of our systems or operations in the event of a major earthquake, weather event, cyber-attack, terrorist attack, or other catastrophic event could cause delays in completing sales, providing services, or performing other mission-critical functions. Our corporate headquarters, a significant portion of our research and development activities, and certain other critical business operations are located in the Seattle, Washington area, and we have other business operations in the Silicon Valley area of California, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our critical business or information technology systems could harm our ability to conduct normal business operations and our operating results. Abrupt political change, terrorist activity, and armed conflict pose a risk of general economic disruption in affected countries, which may increase our operating costs. These conditions also may add uncertainty to the timing and budget for technology investment decisions by our customers, and may result in supply chain disruptions for hardware manufacturers, either of which may adversely affect our revenues. The long-term effects of climate change on the global economy in general or the information technology industry in particular are unclear. Environmental regulations or changes in the supply, demand or available sources of energy may affect the availability or cost of goods and services, including natural resources, necessary to run our business. Changes in weather where we operate may increase the costs of powering and cooling computer hardware we use to develop software and provide cloud-based services. New regulations may require us to find alternative compliant and cost-effective methods of distributing our products and services.

Table of Contents**PART II**

Item 1A, 2, 6

Acquisitions and joint ventures may have an adverse effect on our business. We expect to continue making acquisitions or entering into joint ventures as part of our long-term business strategy. These transactions involve significant challenges and risks including that the transaction does not advance our business strategy, that we don't realize a satisfactory return on our investment, or that we experience difficulty in the integration of new employees, business systems, and technology, or diversion of management's attention from our other businesses. These events could harm our operating results or financial condition.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Items 2(a) and (b) are not applicable.

(c) STOCK REPURCHASES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased and Approximate Dollar Value of Part of Public Shares that May Yet be Announced Purchased under the Plans or Programs	
			(in millions)	
January 1, 2011 – January 31, 2011	17,681,031	\$ 28.28	17,681,031	\$ 14,178
February 1, 2011 – February 28, 2011	0	\$ 0	0	\$ 14,178
March 1, 2011 – March 31, 2011	12,496,953	\$ 26.16	12,496,953	\$ 13,851
	30,177,984		30,177,984	

During the third quarter of fiscal year 2011, we repurchased 30.2 million shares of Microsoft common stock for \$827 million using cash resources. The repurchases occurred in the open market and pursuant to a trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934. As of March 31, 2011, approximately \$13.9 billion remained of our \$40.0 billion repurchase program that we announced on September 22, 2008. The program expires September 30, 2013 but may be suspended or discontinued at any time without notice.

ITEM 6. EXHIBITS

4.6	Third Supplemental Indenture for 2.500% Notes due 2016, 4.000% Notes due 2021, and 5.300% Notes due 2041, dated as of February 8, 2011, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Indenture, dated as of May 18, 2009, between Microsoft Corporation and The Bank of New York Mellon Trust Company, N.A., as Trustee (incorporated by reference to Current Report on Form 8-K dated February 8, 2011)
12	Computation of Ratio of Earnings to Fixed Charges
15	Letter regarding unaudited interim financial information
31.1	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Edgar Filing: INTERNATIONAL BUSINESS MACHINES CORP - Form 10-Q

32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase

Table of Contents

PART II

Item 6

101.DEF** XBRL Taxonomy Extension Definition Linkbase
101.LAB** XBRL Taxonomy Extension Label Linkbase
101.PRE** XBRL Taxonomy Extension Presentation Linkbase

* *Furnished, not filed.*

** *Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.*

Items 3 and 5 are not applicable and have been omitted.

Table of Contents

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.

MICROSOFT CORPORATION

/s/ Frank H. Brod

Frank H. Brod

Corporate Vice President, Finance and Administration;

Chief Accounting Officer (Duly Authorized Officer)

April 28, 2011