INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
October 31, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10 - Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED SEPTEMBER 30, 2017

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York	**13-0871985**
(State of incorporation)	(IRS employer identification number)
Armonk, New York	**10504**
(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 l3 or l5(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

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

Large accelerated filer x

Accelerated filer o

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

Smaller reporting company o

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act). o

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

The registrant had 925,791,378 shares of common stock outstanding at September 30, 2017.

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Part I - Financial Information

Item 1. Consolidated Financial Statements:

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF EARNINGS

(UNAUDITED)

(Dollars in millions except per share amounts)	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Revenue:				
Services	$ 12,703	$ 12,938	$ 37,592	$ 38,347
Sales	6,017	5,872	17,744	18,542
Financing	433	417	1,260	1,260
Total revenue	19,153	19,226	56,597	58,149
Cost:				
Services	8,426	8,418	25,502	25,492
Sales	1,605	1,536	4,839	4,496
Financing	322	259	890	760
Total cost	10,353	10,213	31,232	30,748
Gross profit	8,800	9,013	25,365	27,401
Expense and other (income):				
Selling, general and administrative	4,648	4,732	14,959	16,093
Research, development and engineering	1,342	1,397	4,360	4,320
Intellectual property and custom development income	(308)	(528)	(1,118)	(1,110)
Other (income) and expense	(114)	(8)	(218)	281
Interest expense	168	158	451	473
Total expense and other (income)	5,735	5,751	18,434	20,056
Income from continuing operations before income taxes	3,065	3,263	6,931	7,345
Provision for/(benefit from) income taxes	339	409	120	(31)
Income from continuing operations	$ 2,726	$ 2,854	$ 6,811	$ 7,375
Loss from discontinued operations, net of tax	0	(1)	(3)	(4)
Net income	$ 2,726	$ 2,853	$ 6,807	$ 7,371
Earnings/(loss) per share of common stock:				
Assuming dilution:				
Continuing operations	$ 2.92	$ 2.98	$ 7.24	$ 7.67
Discontinued operations	0.00	0.00	0.00	0.00
Total	$ 2.92	$ 2.98	$ 7.24	$ 7.67
Basic:				
Continuing operations	$ 2.93	$ 2.99	$ 7.28	$ 7.70
Discontinued operations	0.00	0.00	0.00	0.00
Total	$ 2.93	$ 2.99	$ 7.28	$ 7.70
Weighted-average number of common shares outstanding: (millions)				

Assuming dilution	933.2	957.3	940.2	960.7
Basic	929.4	954.0	935.6	957.7
Cash dividend per common share	$ 1.50	$ 1.40	$ 4.40	$ 4.10

(Amounts may not add due to rounding.)

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

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INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

(Dollars in millions)	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Net income	$ 2,726	$ 2,853	$ 6,807	$ 7,371
Other comprehensive income/(loss), before tax:				
Foreign currency translation adjustments	89	(99)	213	(109)
Net changes related to available-for-sale securities:				
Unrealized gains/(losses) arising during the period	(1)	(1)	2	(36)
Reclassification of (gains)/losses to net income	0	(1)	1	36
Total net changes related to available-for-sale securities	(2)	(2)	2	0
Unrealized gains/(losses) on cash flow hedges:				
Unrealized gains/(losses) arising during the period	(70)	35	(198)	(221)
Reclassification of (gains)/losses to net income	(73)	15	(347)	26
Total unrealized gains/(losses) on cash flow hedges	(143)	50	(545)	(195)
Retirement-related benefit plans:				
Prior service costs/(credits)	0		0	
Net (losses)/gains arising during the period	1	11	106	(57)
Curtailments and settlements	2	4	3	19
Amortization of prior service (credits)/costs	(22)	(28)	(66)	(81)
Amortization of net (gains)/losses	733	696	2,156	2,079
Total retirement-related benefit plans	713	683	2,200	1,960
Other comprehensive income/(loss), before tax	658	632	1,869	1,656
Income tax (expense)/benefit related to items of other comprehensive income	11	(192)	7	(213)
Other comprehensive income/(loss)	669	440	1,877	1,442
Total comprehensive income/(loss)	$ 3,394	$ 3,293	$ 8,684	$ 8,813

(Amounts may not add due to rounding.)

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

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INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(UNAUDITED)

ASSETS

(Dollars in millions)		At September 30, 2017		At December 31, 2016
Assets:				
Current assets:				
Cash and cash equivalents	$	10,915	$	7,826
Marketable securities		600		701
Notes and accounts receivable - trade (net of allowances of $296 in 2017 and $290 in 2016)		8,150		9,182
Short-term financing receivables (net of allowances of $270 in 2017 and $337 in 2016)		18,050		19,006
Other accounts receivable (net of allowances of $39 in 2017 and $48 in 2016)		926		1,057
Inventories, at lower of average cost or market:				
Finished goods		430		358
Work in process and raw materials		1,281		1,195
Total inventories		1,711		1,553
Prepaid expenses and other current assets		4,389		4,564
Total current assets		44,742		43,888
Property, plant and equipment		31,937		30,133
Less: Accumulated depreciation		20,880		19,303
Property, plant and equipment net		11,057		10,830
Long-term financing receivables (net of allowances of $84 in 2017 and $101 in 2016)		8,459		9,021
Prepaid pension assets		4,521		3,034
Deferred taxes		7,289		5,224
Goodwill		36,782		36,199
Intangible assets net		3,981		4,688
Investments and sundry assets		4,806		4,585
Total assets	$	121,636	$	117,470

(Amounts may not add due to rounding.)

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

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**INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES**

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

LIABILITIES AND EQUITY

(Dollars in millions)	At September 30, 2017	At December 31, 2016
Liabilities:		
Current liabilities:		
Taxes	$ 3,038	$ 3,235
Short-term debt	4,299	7,513
Accounts payable	5,442	6,209
Compensation and benefits	3,918	3,577
Deferred income	10,649	11,035
Other accrued expenses and liabilities	4,352	4,705
Total current liabilities	31,697	36,275
Long-term debt	41,327	34,655
Retirement and nonpension postretirement benefit obligations	17,554	17,070
Deferred income	3,579	3,600
Other liabilities	7,723	7,477
Total liabilities	101,879	99,078
Equity:		
IBM stockholders equity:		
Common stock, par value $0.20 per share, and additional paid-in capital	54,395	53,935
Shares authorized: 4,687,500,000		
Shares issued: 2017 - 2,228,489,401		
2016 - 2,225,116,815		
Retained earnings	155,565	152,759
Treasury stock - at cost	(162,812)	(159,050)
Shares: 2017 - 1,302,698,023		
2016 - 1,279,249,412		
Accumulated other comprehensive income/(loss)	(27,521)	(29,398)
Total IBM stockholders equity	19,627	18,246
Noncontrolling interests	130	146
Total equity	19,757	18,392
Total liabilities and equity	$ 121,636	$ 117,470

(Amounts may not add due to rounding.)

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

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INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)

(Dollars in millions)	Nine Months Ended September 30, 2017	2016
Cash flows from operating activities:		
Net income	$ 6,807	$ 7,371
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation	2,231	2,106
Amortization of intangibles	1,161	1,148
Stock-based compensation	388	403
Net (gain)/loss on asset sales and other	92	100
Changes in operating assets and liabilities, net of acquisitions/divestitures	312	1,978* **
Net cash provided by operating activities	10,991	13,105* **
Cash flows from investing activities:		
Payments for property, plant and equipment	(2,273)	(2,594)
Proceeds from disposition of property, plant and equipment	337	234
Investment in software	(411)	(441)
Acquisition of businesses, net of cash acquired	(442)	(5,445)
Divestitures of businesses, net of cash transferred	35	35
Non-operating finance receivables net	469	1,441*
Purchases of marketable securities and other investments	(3,770)	(4,021)
Proceeds from disposition of marketable securities and other investments	2,778	3,501
Net cash used in investing activities	(3,278)	(7,289)*
Cash flows from financing activities:		
Proceeds from new debt	9,355	8,368
Payments to settle debt	(6,252)	(5,616)
Short-term borrowings/(repayments) less than 90 days net	(794)	(864)
Common stock repurchases	(3,674)	(2,632)
Common stock repurchases for tax withholdings	(153)	(115)**
Common stock transactions other	137	166
Cash dividends paid	(4,119)	(3,927)
Net cash used in financing activities	(5,499)	(4,619)**
Effect of exchange rate changes on cash and cash equivalents	875	155
Net change in cash and cash equivalents	3,089	1,352
Cash and cash equivalents at January 1	7,826	7,686
Cash and cash equivalents at September 30	$ 10,915	$ 9,039

* Revised classification of certain financing receivables.

** Reclassified to reflect adoption of the FASB guidance on share-based compensation.

(Amounts may not add due to rounding.)

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

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INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES
CONSOLIDATED STATEMENT OF 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, 2017	$ 53,935	$ 152,759	$ (159,050)	$ (29,398)	$ 18,246	$ 146	$ 18,392
Cumulative effect of change in accounting principle *		102			102		102
Net income		6,807			6,807		6,807
Other comprehensive income/(loss)				1,877	1,877		1,877
Total comprehensive income/(loss)					$ 8,684		$ 8,684
Cash dividends paid common stock		(4,119)			(4,119)		(4,119)
Common stock issued under employee plans (3,372,586 shares)	460				460		460
Purchases (960,186 shares) and sales (363,335 shares) of treasury stock under employee plans net		15	(106)		(91)		(91)
Other treasury shares purchased, not retired (22,851,760 shares)			(3,655)		(3,655)		(3,655)
Changes in noncontrolling interests						(16)	(16)
Equity - September 30, 2017	$ 54,395	$ 155,565	$ (162,812)	$ (27,521)	$ 19,627	$ 130	$ 19,757

(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		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

* Reflects the adoption of the FASB guidance on intra-entity transfers of assets in the first-quarter 2017.

(Amounts may not add due to rounding.)

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

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Notes to Consolidated Financial Statements:

1. Basis of Presentation: The accompanying Consolidated Financial Statements and footnotes of the International Business Machines Corporation (IBM or the company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The financial statements and footnotes are unaudited. In the opinion of the company s management, these statements include all adjustments, which are 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 2016 Annual Report on pages 71 to 74, for a discussion of the company s critical accounting estimates.

The company revised the classification of certain financing receivables for the three and nine months ended September 30, 2016, decreasing net cash provided by operating activities and net cash used in investing activities in the amount of $99 million and $311 million, respectively, which the company concluded to be immaterial to the periods presented. The twelve-month revision for the period ended December 31, 2016 was provided in the company s 2016 Annual Report on page 26. There was no impact to total GAAP cash flows or free cash flow.

In the first quarter of 2017, the company reported a benefit from income taxes of $329 million, and its effective tax rate was (23.1) percent. This was primarily driven by a discrete tax benefit of $582 million from a first-quarter 2017 transaction accounted for under the new Financial Accounting Standards Board (FASB) guidance related to intra-entity transfers of assets. This benefit was partially offset by a discrete tax charge related to foreign audit activity of $99 million. The company had additional discrete tax benefits of $170 million in second-quarter 2017. For the nine months ended September 30, 2017, the company reported a provision for income taxes of $120 million and its effective tax rate was 1.7 percent, primarily as a result of the first and second quarter discrete items. For the nine months ended September 30, 2016, the company reported a benefit from income taxes of $31 million and its effective tax rate was (0.4) percent. The negative effective tax rate in the comparable period of 2016 was due to the resolution of a long-standing Japan tax matter in February 2016. Refer to note 2, Accounting Changes, and the Taxes section of the Management Discussion for additional information.

Noncontrolling interest amounts of $4.4 million and $3.1 million, net of tax, for the three months ended September 30, 2017 and 2016, respectively, and $11.5 million and $7.5 million, net of tax, for the nine months ended September 30, 2017 and 2016, respectively, are included as a reduction within other (income) and expense in the Consolidated Statement of Earnings.

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 2016 Annual Report.

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 August 2017, the FASB issued guidance to simplify the application of current hedge accounting in certain areas, better portray the economic results of an entity s risk management activities in its financial statements and make targeted improvements to presentation and disclosure requirements. The guidance is effective January 1, 2019 with early adoption permitted. The company plans to adopt the guidance as of January 1, 2018. The guidance is not expected to have a material impact in the consolidated financial results.

In March 2017, the FASB issued guidance that impacts the presentation of net periodic pension and postretirement benefit costs. Under the guidance, the service cost component of net benefit cost will continue to be presented in the same line items as other employee compensation costs, unless eligible for capitalization in the Consolidated Statement of Financial Position. The other components of net benefit costs will be presented separately from service cost as non-operating costs in the Consolidated Statement of Earnings or Notes to the Consolidated Financial Statements. The guidance is effective

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Notes to Consolidated Financial Statements (continued)

January 1, 2018 with early adoption permitted. The company will adopt the guidance as of the effective date. The guidance is primarily a change in financial statement presentation and is not expected to have a material impact in the consolidated financial results.

In June 2016, the 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 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 third-party 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 will adopt the guidance as of the effective date. A cross-functional implementation team has been established which is evaluating the lease portfolio, system, process and policy change requirements. The company is currently evaluating the impact of the new guidance on its consolidated financial results and expects it will have a material impact on the Consolidated Statement of Financial Position. The company s operating lease commitments were $6.9 billion at December 31, 2016. In 2016, the use of third-party residual value guarantee insurance resulted in the company recognizing $220 million of sales-type lease revenue that would otherwise have been recognized over the lease period as operating lease revenue.

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 company will adopt the guidance on January 1, 2018 and apply the cumulative catch-up transition method. The transition adjustment to be recorded to stockholders equity upon adoption of the new standard is not expected to be material.

Given the scope of work required to implement the recognition and disclosure requirements under the new standard, the company began its assessment process in 2014 and has identified changes to policy, processes, systems and controls. This also includes the assessment of data availability and presentation necessary to meet the additional disclosure requirements of the guidance in the Notes to the Consolidated Financial Statements.

The company expects revenue recognition for its broad portfolio of hardware, software and services offerings to remain largely unchanged. However, the guidance is expected to change the timing of revenue recognition in certain areas, including accounting for certain software licenses. These impacts are not expected to be material. The company expects to continue to recognize revenue for term license (recurring license charge) software arrangements on a monthly basis over the period that the client is entitled to use the license due to the contractual terms in these arrangements.

Since the company currently expenses sales commissions as incurred, the requirement in the new standard to capitalize certain in-scope sales commissions will result in an accounting change for the company. However, the impact to the consolidated financial statements is not expected to be material, with no impact to cash flows.

The company continues to assess all potential impacts of the guidance and given normal ongoing business dynamics, preliminary conclusions are subject to change.

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Notes to Consolidated Financial Statements (continued)

Standards Implemented

In January 2017, the FASB issued guidance which clarifies the definition of a business. The guidance provides a more robust framework to use in determining when a set of assets and activities acquired or sold is a business. The guidance is effective January 1, 2018 and early adoption is permitted. The company adopted the guidance effective January 1, 2017, and it did not have a material impact in the consolidated financial results.

In October 2016, the FASB issued guidance which requires an entity to recognize the income tax consequences of intra-entity transfers of assets, other than inventory, at the time of transfer. Assets within the scope of the guidance include intellectual property and property, plant and equipment. The guidance is effective January 1, 2018 and early adoption is permitted. The company adopted the guidance on January 1, 2017 using the required modified retrospective method. At adoption, $95 million and $47 million were reclassified from investments and sundry assets and prepaid expenses and other current assets, respectively into retained earnings. Additionally, net deferred taxes of $244 million were established in deferred taxes in the Consolidated Statement of Financial Position, resulting in a cumulative-effect net credit to retained earnings of $102 million. In January 2017, the company had one transaction that generated a $582 million benefit to income tax expense, income from continuing operations and net income and a benefit to both basic and diluted earnings per share of $0.62 per share for the nine months ended September 30, 2017. There was no impact in the consolidated financial results for the three months ended September 30, 2017. The ongoing impact of this guidance will be dependent on any transaction that is within its scope.

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 was effective and adopted by the company on January 1, 2017, and it did not have a material impact in the Consolidated Statement of Financial Position. The ongoing impact of the guidance could result in increased volatility in the 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, however these impacts are not expected to be material. These impacts are recorded on a prospective basis. See note 5, Stock-Based Compensation, for additional information. The company continues to estimate forfeitures in conjunction with measuring stock-based compensation cost. The guidance also requires cash payments on behalf of employees for shares directly withheld for taxes to be presented as financing outflows in the Consolidated Statement of Cash Flows. Prior to adoption, the company reported this activity as an operating cash outflow and as a result, prior periods have been reclassified as required. The FASB also issued guidance in May 2017, which relates to the accounting for modifications of share-based payment awards. The company adopted the guidance in the second quarter of 2017. The guidance had no impact in the consolidated financial results.

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 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.

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Notes to Consolidated Financial Statements (continued)

3. Financial Instruments:

Fair Value Measurements

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

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

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

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

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

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

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

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

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

Certain financial assets are measured at fair value on a nonrecurring basis. These assets include equity method investments that are recognized at fair value at the measurement date to the extent that they are deemed to be other-than-temporarily impaired. Certain assets that are measured at fair value on a recurring basis can be subject to nonrecurring fair value measurements. These assets include available-for-sale equity investments that are deemed to be other-than-temporarily 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 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, 2017.

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, 2017 and December 31, 2016.

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At September 30, 2017	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	$	$ 5,553	$	$ 5,553
Money market funds	1,375			1,375
U.S. government securities		200		200
Canadian government securities		460		460
Total	1,375	6,214		7,589(6)
Debt securities - current (2)		599		599(6)
Debt securities - noncurrent (3)	4	7		11
Available-for-sale equity investments (3)	5			5
Derivative assets (4)				
Interest rate contracts		517		517
Foreign exchange contracts		416		416
Equity contracts		23		23
Total		957		957(7)
Total assets	$ 1,384	$ 7,775	$	$ 9,159(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	$	$ 333	$	$ 333
Equity contracts		4		4
Interest rate contracts		15		15
Total liabilities	$	$ 352	$	$ 352(7)

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

(2) U.S. government securities 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, 2017 were $269 million and $687 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, 2017 were $332 million and $20 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 $274 million.

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At December 31, 2016	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents (1)				
Time deposits and certificates of deposit	$	$ 3,629	$	$ 3,629
Money market funds	1,204			1,204
Total	1,204	3,629		4,832(6)
Debt securities - current (2)		699		699(6)
Debt securities - noncurrent (3)	1	6		8
Available-for-sale equity investments (3)	7			7
Derivative assets (4)				
Interest rate contracts		555		555
Foreign exchange contracts		560		560
Equity contracts		11		11
Total		1,126		1,126(7)
Total assets	$ 1,212	$ 5,460	$	$ 6,672(7)
Liabilities:				
Derivative liabilities (5)				
Foreign exchange contracts	$	$ 188	$	$ 188
Equity contracts		10		10
Interest rate contracts		8		8
Total liabilities	$	$ 206	$	$ 206(7)

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

(2) U.S government securities 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, 2016 were $532 million and $594 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, 2016 were $145 million and $61 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 $116 million.

There were no transfers between Levels 1 and 2 for the nine months ended September 30, 2017 and the year ended December 31, 2016.

Financial Assets and Liabilities Not Measured at Fair Value

Short-Term Receivables and Payables

Notes and other accounts receivable and other investments are financial assets with carrying values that approximate fair value. Accounts payable, other accrued expenses and short-term debt (excluding the current portion of long-term debt) are financial liabilities with carrying values that approximate fair value. If measured at fair value in the financial statements, these financial instruments would be classified as Level 3 in the fair value hierarchy, except for short-term debt, which would be classified as Level 2.

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, 2017 and December 31, 2016, 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.

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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 $41,327 million and $34,655 million, and the estimated fair value was $43,623 million and $36,838 million at September 30, 2017 and December 31, 2016, respectively. If measured at fair value in the financial statements, long-term debt (including the current portion) would be classified as Level 2 in the fair value hierarchy.

Debt and Marketable Equity Securities

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

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

(Dollars in millions) At September 30, 2017:	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities noncurrent(1)	$ 7	$ 3	$	$ 11
Available-for-sale equity investments(1)	$ 1	$ 4	$ 0	$ 5

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

(Dollars in millions) At December 31, 2016:	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities noncurrent(1)	$ 5	$ 3	$	$ 8
Available-for-sale equity investments(1)	$ 3	$ 5	$ 0	$ 7

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

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:	2017	2016
Proceeds	$ 0	$ 1
Gross realized gains (before taxes)	0	1
Gross realized losses (before taxes)		

(Dollars in millions) For the nine months ended September 30:	2017	2016
Proceeds	$ 5	$ 150
Gross realized gains (before taxes)	1	1
Gross realized losses (before taxes)	2	37

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:

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) For the three months ended September 30:	2017	2016
Net unrealized gains/(losses) arising during the period	$ 1	$ (1)
Net unrealized (gains)/losses reclassified to net income*	0	(1)

*There were no writedowns for the three months ended September 30, 2017 and 2016, respectively.

(Dollars in millions) For the nine months ended September 30:	2017	2016
Net unrealized gains/(losses) arising during the period	$ 1	$ (22)
Net unrealized (gains)/losses reclassified to net income*	0	22

* There were no writedowns for the nine months ended September 30, 2017 and 2016, respectively.

The contractual maturities of substantially all available-for-sale debt securities are less than one year at September 30, 2017.

Derivative Financial Instruments

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

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

The company is also a party to collateral security arrangements with most of its major derivative counterparties. These arrangements require the company to hold or post collateral (cash or U.S. Treasury securities) when the derivative fair values exceed contractually established thresholds.

Posting thresholds can be fixed or can vary based on credit default swap pricing or credit ratings received from the major credit agencies. The aggregate fair value of all derivative instruments under these collateralized arrangements that were in a liability position at September 30, 2017 and December 31, 2016 was $45 million and $11 million, respectively, for which no collateral was posted at either date. Full collateralization of these agreements would be required in the event that the company s credit rating falls below investment grade or if its credit default swap spread exceeds 250 basis points, as applicable, pursuant to the terms of the collateral security arrangements. The aggregate fair value of derivative instruments in asset positions as of September 30, 2017 and December 31, 2016 was $957 million and $1,126 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 $274 million and $116 million at September 30, 2017 and December 31, 2016, respectively, of liabilities included in master netting arrangements with those counterparties. Additionally, at September 30, 2017 and December 31, 2016, this exposure was reduced by $123 million and $141 million of cash collateral, respectively, and $35 million of non-cash collateral in U.S. Treasury securities at December 31, 2016. There were no non-cash collateral balances in U.S. Treasury securities at September 30, 2017. At September 30, 2017 and December 31, 2016, the net exposure related to derivative assets recorded in the Consolidated Statement of Financial Position was $559 million and $834 million, respectively. At September 30, 2017 and December 31, 2016, the net position related to derivative liabilities recorded in the Consolidated Statement of Financial Position was $78 million and $90 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

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Notes to Consolidated Financial Statements (continued)

against the fair values of the related derivative instruments. No amount was recognized in other receivables at September 30, 2017 or December 31, 2016 for the right to reclaim cash collateral. The amount recognized in accounts payable for the obligation to return cash collateral was $123 million and $141 million at September 30, 2017 and December 31, 2016, 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, 2017 and December 31, 2016.

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, 2017 and December 31, 2016, the total notional amount of the company s interest rate swaps was $9.1 billion and $7.3 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2017 and December 31, 2016 was approximately 5.0 years and 6.2 years, respectively.

Forecasted Debt Issuance

The company is exposed to interest rate volatility on future debt issuances. To manage this risk, the company may use forward starting interest-rate swaps to lock in the rate on the interest payments related to the forecasted debt issuance. These swaps are accounted for as cash flow hedges. The company did not have any derivative instruments relating to this program outstanding at September 30, 2017 and December 31, 2016.

At December 31, 2016, net gains of less than $1 million (before taxes) were recorded in accumulated other comprehensive income/(loss) in connection with cash flow hedges of the company s borrowings. During 2017, all gains and losses associated with this program that were recorded in other comprehensive income/(loss) were reclassified to net income and there are no gains and losses remaining in accumulated other comprehensive income/(loss) at September 30, 2017.

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, 2017 and December 31, 2016, the total notional amount of derivative instruments designated as net investment hedges was $8.8 billion and $6.7 billion, respectively. At September 30, 2017 and December 31, 2016, the weighted-average remaining maturity of these instruments was approximately 0.1 years and 0.2 years, respectively.

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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 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, 2017 and December 31, 2016, the total notional amount of forward contracts designated as cash flow hedges of forecasted royalty and cost transactions was $7.9 billion and $8.3 billion, respectively. The weighted-average remaining maturity of these instruments at September 30, 2017 and December 31, 2016 was 0.7 years at both periods.

At September 30, 2017 and December 31, 2016, in connection with cash flow hedges of anticipated royalties and cost transactions, the company recorded net losses of $70 million and net gains of $462 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $161 million of losses and $397 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, 2017 and December 31, 2016, the total notional amount of cross-currency swaps designated as cash flow hedges of foreign currency denominated debt was $1.4 billion at both periods.

At September 30, 2017 and December 31, 2016, in connection with cash flow hedges of foreign currency denominated borrowings, the company recorded net gains of $16 million and net gains of $29 million (before taxes), respectively, in accumulated other comprehensive income/(loss). Within these amounts, $34 million of gains and $27 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 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, 2017 and December 31,

2016, the total notional amount of derivative instruments in economic hedges of foreign currency exposure was $10.8 billion and $12.7 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, 2017 and December 31, 2016, the total notional amount of derivative instruments in economic hedges of these compensation obligations was $1.2 billion at both periods.

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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, 2017 and December 31, 2016.

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, 2017 and December 31, 2016.

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, 2017 and December 31, 2016, the company did not have any derivative instruments relating to this program outstanding.

The following tables provide a quantitative summary of the derivative and non-derivative instrument-related risk management activity as of September 30, 2017 and December 31, 2016, as well as for the three and nine months ended September 30, 2017 and 2016, respectively.

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Notes to Consolidated Financial Statements (continued)

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

As of September 30, 2017 and December 31, 2016

	Fair Value of Derivative Assets			Fair Value of Derivative Liabilities		
(Dollars in millions)	Balance Sheet Classification	9/30/2017	12/31/2016	Balance Sheet Classification	9/30/2017	12/31/2016
Designated as hedging instruments:						
Interest rate contracts:	Prepaid expenses and other current assets	$	$	Other accrued expenses and liabilities	$ 1	$
	Investments and sundry assets	517	555	Other liabilities	15	8
Foreign exchange contracts:	Prepaid expenses and other current assets	208	421	Other accrued expenses and liabilities	272	46
	Investments and sundry assets	170	17	Other liabilities	5	35
	Fair value of derivative assets	$ 896	$ 993	**Fair value of derivative liabilities**	$ 292	$ 89
Not designated as hedging instruments:						
Foreign exchange contracts:	Prepaid expenses and other current assets	$ 38	$ 100	Other accrued expenses and liabilities	$ 56	$ 89
	Investments and sundry assets		22	Other liabilities		18
Equity contracts:	Prepaid expenses and other current assets	23	11	Other accrued expenses and liabilities	4	10
	Investments and sundry assets			Other liabilities		
	Fair value of derivative assets	$ 61	$ 133	**Fair value of derivative liabilities**	$ 60	$ 117
Total Derivatives		$ 957	$ 1,126		$ 352	$ 206
Total debt designated as hedging instruments(1):						
Short-term debt		N/A	N/A		$ 377	$ 1,125
Long-term debt		N/A	N/A		11,469	7,844
		N/A	N/A		$ 11,846	$ 8,969
Total		$ 957	$ 1,126		$ 12,198	$ 9,175

N/A - not applicable

(1) Debt designated as hedging instruments are reported at carrying value.

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Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings

For the three months ended September 30, 2017 and 2016

(Dollars in millions) For the three months ended September 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings: Recognized on Derivatives 2017	Recognized on Derivatives 2016	Attributable to Risk Being Hedged(2) 2017	Attributable to Risk Being Hedged(2) 2016
Derivative instruments in fair value hedges(1)(5):					
Interest rate contracts	Cost of financing	$ (3)	$ (20)	$ 20	$ 40
	Interest expense	(3)	(21)	20	43
Derivative instruments not designated as hedging instruments:					
Foreign exchange contracts	Other (income) and expense	(35)	30	N/A	N/A
Interest rate contracts	Other (income) and expense		0	N/A	N/A
Equity contracts	SG&A expense	31	45	N/A	N/A
	Other (income) and expense		0	N/A	N/A
Total		$ (10)	$ 34	$ 41	$ 83

(Dollars in millions) For the three months ended September 30:	Effective Portion Recognized in OCI 2017	Effective Portion Recognized in OCI 2016	Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI 2017	Effective Portion Reclassified from AOCI 2016	Ineffectiveness and Amounts Excluded from Effectiveness Testing(3) 2017	Ineffectiveness and Amounts Excluded from Effectiveness Testing(3) 2016
Derivative instruments in cash flow hedges:							
Interest rate contracts	$	$	Interest expense	$ (7)	$ (7)	$	$
Foreign exchange contracts	(70)	35	Other (income) and expense	64	(6)	(1)	(1)
			Cost of sales*	1	(7)		
			Cost of services*	20	3		
			SG&A expense	(6)	2		
Instruments in net investment hedges(4):							
Foreign exchange contracts	(507)	(131)	Cost of financing			0	
			Interest expense			8	25
Total	$ (577)	$ (96)		$ 73	$ (15)	$ 7	$ 24

* Reclassified to conform to 2017 presentation

N/A - not applicable

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

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

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

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

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

(5) For the three month periods ended September 30, 2017 and 2016, fair value hedges resulted in a loss of less than $1 million and a loss of $3 million in ineffectiveness, respectively.

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Notes to Consolidated Financial Statements (continued)

The Effect of Derivative Instruments in the Consolidated Statement of Earnings

For the nine months ended September 30, 2017 and 2016

(Dollars in millions) For the nine months ended September 30:	Consolidated Statement of Earnings Line Item	Gain (Loss) Recognized in Earnings: Recognized on Derivatives 2017	Recognized on Derivatives 2016	Attributable to Risk Being Hedged(2) 2017	Attributable to Risk Being Hedged(2) 2016
Derivative instruments in fair value hedges(1)(5):					
Interest rate contracts	Cost of financing	$ 37	$ 195	$ 22	$ (127)
	Interest expense	34	214	20	(140)
Derivative instruments not designated as hedging instruments:					
Foreign exchange contracts	Other (income) and expense	74	335	N/A	N/A
Interest rate contracts	Other (income) and expense		0	N/A	N/A
Equity contracts	SG&A expense	88	87	N/A	N/A
	Other (income) and expense		(1)	N/A	N/A
Total		$ 233	$ 830	$ 42	$ (267)

(Dollars in millions) For the nine months ended September 30:	Effective Portion Recognized in OCI 2017	Effective Portion Recognized in OCI 2016	Consolidated Statement of Earnings Line Item	Effective Portion Reclassified from AOCI 2017	Effective Portion Reclassified from AOCI 2016	Ineffectiveness and Amounts Excluded from Effectiveness Testing(3) 2017	Ineffectiveness and Amounts Excluded from Effectiveness Testing(3) 2016
	Gain (Loss) Recognized in Earnings and Other Comprehensive Income						
Derivative instruments in cash flow hedges:							
Interest rate contracts	$	$	Interest expense	$ (21)	$ (17)	$	$
Foreign exchange contracts	(198)	(221)	Other (income) and expense	275	6	2	(1)
			Cost of sales*	23	(5)		
			Cost of services*	47	(9)		
			SG&A expense	23	(1)		
Instruments in net investment hedges(4):							
Foreign exchange contracts	(1,513)	(1,071)	Cost of financing			0	
			Interest expense			34	51
Total	$ (1,712)	$ (1,292)		$ 347	$ (26)	$ 37	$ 49

* Reclassified to conform to 2017 presentation.

N/A-not applicable

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

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

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

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

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

(5) For the nine month periods ended September 30, 2017 and 2016, fair value hedges resulted in a loss of less than $1 million and a gain of less than $1 million in ineffectiveness, respectively.

For the three and nine months ending September 30, 2017 and 2016, there were no significant gains or losses excluded from the assessment of hedge effectiveness (for fair value hedges), or associated with an underlying exposure that did not or was not expected to occur (for cash flow hedges); nor are there any anticipated in the normal course of business.

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Notes to Consolidated Financial Statements (continued)

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

(Dollars in millions)	At September 30, 2017	At December 31, 2016
Current:		
Net investment in sales-type and direct financing leases	$ 3,092	$ 2,909
Commercial financing receivables	8,563	9,706
Client loan and installment payment receivables (loans)	6,395	6,390
Total	$ 18,050	$ 19,006
Noncurrent:		
Net investment in sales-type and direct financing leases	$ 3,579	$ 3,950
Client loan and installment payment receivables (loans)	4,879	5,071
Total	$ 8,459	$ 9,021

Net investment in sales-type and direct financing leases relates principally to the company s Systems products and are for terms ranging generally from two to six years. Net investment in sales-type and direct financing leases includes unguaranteed residual values of $567 million and $585 million at September 30, 2017 and December 31, 2016, respectively, and is reflected net of unearned income of $459 million and $513 million, and net of allowance for credit losses of $118 million and $133 million at those dates, respectively.

Commercial financing receivables, net of allowance for credit losses of $21 million and $28 million at September 30, 2017 and December 31, 2016, respectively, relate primarily to inventory and accounts receivable financing for dealers and remarketers of IBM and OEM products. Payment terms for inventory and accounts receivable financing generally range from 30 to 90 days.

Client loan and installment payment receivables (loans), net of allowance for credit losses of $215 million and $276 million at September 30, 2017 and December 31, 2016, respectively, are loans that are provided primarily to clients to finance the purchase of hardware, software and services. Payment terms on these financing arrangements are generally for terms up to seven years.

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

The company utilizes certain of its financing receivables as collateral for nonrecourse borrowings. Financing receivables pledged as collateral for borrowings were $640 million and $689 million at September 30, 2017 and December 31, 2016, respectively.

The company did not have any financing receivables held for sale as of September 30, 2017 and December 31, 2016.

Financing Receivables by Portfolio Segment

The following tables present financing receivables on a gross basis, excluding the allowance for credit losses and residual value, by portfolio segment and by class, excluding commercial financing receivables and other miscellaneous financing receivables at September 30, 2017 and December 31, 2016. The company determines its allowance for credit losses based on two portfolio segments: lease receivables and loan receivables, and further segments the portfolio into three classes: Americas, Europe/Middle East/Africa (EMEA), and Asia Pacific. This portfolio segmentation was changed from growth markets and major markets in 2017 as the company no longer manages the business under those market delineations. There was no impact to segment reporting or the company s Consolidated Financial Statements.

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At September 30, 2017	Americas	EMEA	Asia Pacific	Total
Financing receivables				
Lease receivables	$ 3,541	$ 1,297	$ 1,304	$ 6,142
Loan receivables	6,180	3,120	2,189	11,489
Ending balance	$ 9,721	$ 4,417	$ 3,493	$ 17,631
Collectively evaluated for impairment	$ 9,581	$ 4,386	$ 3,391	$ 17,358
Individually evaluated for impairment	$ 140	$ 31	$ 102	$ 273
Allowance for credit losses				
Beginning balance at January 1, 2017				
Lease receivables	$ 54	$ 4	$ 76	$ 133
Loan receivables	169	18	89	276
Total	$ 223	$ 22	$ 165	$ 410
Write-offs	$ (49)	$ 0	$ (63)	$ (112)
Recoveries	0	0	0	0
Provision	11	9	(4)	16
Other	12	5	2	19
Ending balance at September 30, 2017	$ 197	$ 36	$ 100	$ 333
Lease receivables	$ 77	$ 6	$ 35	$ 118
Loan receivables	$ 120	$ 29	$ 65	$ 215
Collectively evaluated for impairment	$ 66	$ 12	$ 6	$ 85
Individually evaluated for impairment	$ 131	$ 23	$ 94	$ 248

(Dollars in millions) At December 31, 2016:*	Americas	EMEA	Asia Pacific	Total
Financing receivables:				
Lease receivables	$ 3,830	$ 1,171	$ 1,335	$ 6,336
Loan receivables	6,185	3,309	2,243	11,737
Ending balance	$ 10,015	$ 4,480	$ 3,578	$ 18,073
Collectively evaluated for impairment	$ 9,847	$ 4,460	$ 3,419	$ 17,726
Individually evaluated for impairment	$ 168	$ 20	$ 159	$ 347
Allowance for credit losses				
Beginning balance at January 1, 2016				
Lease receivables	$ 52	$ 17	$ 143	$ 213
Loan receivables	122	55	200	377
Total	$ 175	$ 72	$ 343	$ 590
Write-offs	$ (36)	$ (48)	$ (154)	$ (237)
Recoveries	2	0	0	2
Provision	65	(1)	(6)	58
Other	17	(1)	(18)	(3)
Ending balance at December 31, 2016	$ 223	$ 22	$ 165	$ 410
Lease receivables	$ 54	$ 4	$ 76	$ 133
Loan receivables	$ 169	$ 18	$ 89	$ 276
Collectively evaluated for impairment	$ 62	$ 13	$ 15	$ 90
Individually evaluated for impairment	$ 161	$ 9	$ 150	$ 320

* Reclassified to conform to 2017 presentation.

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

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Notes to Consolidated Financial Statements (continued)

Financing Receivables on Non-Accrual Status

The following table presents the recorded investment in financing receivables which were on non-accrual status at September 30, 2017 and December 31, 2016.

(Dollars in millions)	At September 30, 2017	At December 31, 2016*
Americas	$ 25	$ 23
EMEA	0	2
Asia Pacific	4	14
Total lease receivables	$ 30	$ 40
Americas	$ 79	$ 128
EMEA	53	5
Asia Pacific	10	12
Total loan receivables	$ 142	$ 145
Total receivables	$ 172	$ 185

* Reclassified to conform to 2017 presentation.

Impaired Receivables

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

The following tables present impaired receivables. This presentation includes both loan and lease receivables.

	At September 30, 2017		At December 31, 2016*	
(Dollars in millions)	Recorded Investment	Related Allowance	Recorded Investment	Related Allowance
Americas	$ 140	$ 131	$ 168	$ 161
EMEA	31	23	20	9
Asia Pacific	102	94	159	150
Total	$ 273	$ 248	$ 347	$ 320

* Reclassified to conform to 2017 presentation.

(Dollars in millions) For the three months ended September 30, 2017:		Average Recorded Investment		Interest Income Recognized		Interest Income Recognized on Cash Basis
Americas	$	156	$	0	$	
EMEA		31		0		
Asia Pacific		101		0		
Total	$	288	$	0	$	

(Dollars in millions) For the three months ended September 30, 2016:*		Average Recorded Investment		Interest Income Recognized		Interest Income Recognized on Cash Basis
Americas	$	182	$	0	$	
EMEA		61		0		
Asia Pacific		302		0		
Total	$	545	$	0	$	

* Reclassified to conform to 2017 presentation.

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) For the nine months ended September 30, 2017:	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Americas	$ 165	$ 0	$
EMEA	27	0	
Asia Pacific	131	0	
Total	$ 323	$ 0	$

(Dollars in millions) For the nine months ended September 30, 2016:*	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized on Cash Basis
Americas	$ 158	$ 0	$
EMEA	65	0	
Asia Pacific	322	0	
Total	$ 545	$ 0	$

* Reclassified to conform to 2017 presentation.

Credit Quality Indicators

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

The following tables present the net recorded investment for each class of receivables, by credit quality indicator, at September 30, 2017 and December 31, 2016. Receivables with a credit quality indicator ranging from Aaa to Baa3 are considered investment grade. All others are considered non-investment grade. The credit quality indicators do not reflect mitigation actions that the company takes to transfer credit risk to third parties.

(Dollars in millions) At September 30, 2017:	Lease Receivables Americas	 EMEA	 Asia Pacific	Loan Receivables Americas	 EMEA	 Asia Pacific
Credit Ratings:						
Aaa Aa3	$ 358	$ 52	$ 56	$ 626	$ 124	$ 94
A1 A3	715	126	543	1,251	302	908
Baa1 Baa3	807	404	329	1,412	968	550
Ba1 Ba2	762	415	172	1,333	993	289

Ba3 B1		421		197		86		736		473		143
B2 B3		345		83		69		604		200		116
Caa D		56		13		15		98		31		25
Total	$	3,465	$	1,290	$	1,269	$	6,059	$	3,091	$	2,124

At September 30, 2017, the industries which made up Global Financing s receivables portfolio consisted of: Financial (33 percent), Government (14 percent), Manufacturing (14 percent), Services (13 percent), Retail (8 percent), Communications (7 percent), Healthcare (6 percent) and Other (5 percent).

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Notes to Consolidated Financial Statements (continued)

(Dollars in millions) At December 31, 2016:*	Lease Receivables Americas	EMEA	Asia Pacific	Loan Receivables Americas	EMEA	Asia Pacific
Credit Ratings:						
Aaa Aa3	$ 447	$ 51	$ 53	$ 712	$ 143	$ 90
A1 A3	782	113	486	1,246	318	832
Baa1 Baa3	772	366	330	1,230	1,032	565
Ba1 Ba2	822	350	185	1,309	987	316
Ba3 B1	574	208	106	914	585	182
B2 B3	297	71	84	472	201	143
Caa D	83	9	15	133	25	25
Total	$ 3,776	$ 1,167	$ 1,259	$ 6,016	$ 3,291	$ 2,154

* Reclassified to conform to 2017 presentation.

At December 31, 2016, the industries which made up Global Financing s receivables portfolio consisted of: Financial (34 percent), Government (14 percent), Manufacturing (13 percent), Services (12 percent), Retail (8 percent), Communications (7 percent), Healthcare (6 percent) and Other (6 percent).

Past Due Financing Receivables

(Dollars in millions) At September 30, 2017:	Total Past Due > 90 days (1)	Fully Reserved Financing Receivables	<90 Days or Unbilled Financing Receivables	Total Financing Receivables	Recorded Investment > 90 Days and Accruing (2)
Americas	$ 28	$ 51	$ 3,463	$ 3,541	$ 255
EMEA	9	4	1,283	1,297	15
Asia Pacific	5	32	1,266	1,304	19
Total lease receivables	$ 42	$ 87	$ 6,012	$ 6,142	$ 290
Americas	$ 43	$ 80	$ 6,057	$ 6,180	$ 401
EMEA	26	19	3,076	3,120	46
Asia Pacific	6	61	2,122	2,189	9
Total loan receivables	$ 75	$ 160	$ 11,255	$ 11,489	$ 456
Total	$ 117	$ 247	$ 17,267	$ 17,631	$ 746

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

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

Fully	<90 Days	Recorded

(Dollars in millions) At December 31, 2016:*	Total Past Due > 90 days (1)	Reserved Financing Receivables	or Unbilled Financing Receivables	Total Financing Receivables	Investment > 90 Days and Accruing (2)
Americas	$ 17	$ 20	$ 3,793	$ 3,830	$ 66
EMEA	2	10	1,159	1,171	6
Asia Pacific	12	59	1,264	1,335	40
Total lease receivables	$ 31	$ 89	$ 6,216	$ 6,336	$ 111
Americas	$ 19	$ 90	$ 6,075	$ 6,185	$ 80
EMEA	5	5	3,299	3,309	15
Asia Pacific	6	87	2,150	2,243	46
Total loan receivables	$ 31	$ 182	$ 11,524	$ 11,737	$ 141
Total	$ 62	$ 271	$ 17,740	$ 18,073	$ 253

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

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

* Reclassified to conform to 2017 presentation.

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Notes to Consolidated Financial Statements (continued)

Troubled Debt Restructurings

The company did not have any significant troubled debt restructurings during the nine months ended September 30, 2017 or for the year ended December 31, 2016.

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

(Dollars in millions)	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
Cost	$ 22	$ 23	$ 68	$ 67
Selling, general and administrative	88	105	277	295