

INTERNATIONAL BUSINESS MACHINES CORP
Form 10-Q
October 31, 2006

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, 2006

1-2360

(Commission file number)

INTERNATIONAL BUSINESS MACHINES CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State of incorporation)

13-0871985

(IRS employer identification number)

Armonk, New York

(Address of principal executive offices)

10504

(Zip Code)

914-499-1900

(Registrant's telephone number)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The registrant has 1,506,351,844 shares of common stock outstanding at September 30, 2006.

Index

	Page
<u>Part I - Financial Information:</u>	
<u>Item 1. Consolidated Financial Statements</u>	
<u>Consolidated Statement of Earnings for the three and nine months ended September 30, 2006 and 2005</u>	1
<u>Consolidated Statement of Financial Position at September 30, 2006 and December 31, 2005</u>	3
<u>Consolidated Statement of Cash Flows for the nine months ended September 30, 2006 and 2005</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	27
<u>Item 4. Controls and Procedures</u>	72
<u>Part II - Other Information</u>	
<u>Item 1. Legal Proceedings</u>	73
<u>Item 2. Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Repurchases of Equity Securities</u>	73
<u>Item 6. Exhibits</u>	74

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		Nine Months Ended	
	September 30,		September 30,	
	2006	2005*	2006	2005*
Revenue:				
Global Services	\$ 12,017	\$ 11,697	\$ 35,478	\$ 35,407
Hardware	5,583	5,130	15,306	17,445
Software	4,406	4,059	12,554	11,930
Global Financing	591	600	1,755	1,802
Other	20	43	74	123
Total revenue	22,617	21,529	65,166	66,707
Cost:				
Global Services	8,676	8,648	25,768	26,381
Hardware	3,481	3,228	9,930	11,802
Software	647	611	1,932	1,864
Global Financing	304	273	862	834
Other	18	31	81	60
Total cost	13,126	12,791	38,573	40,940
Gross profit	9,492	8,738	26,594	25,767
Expense and other income:				
Selling, general and administrative	5,121	4,632	14,639	16,062
Research, development and engineering	1,543	1,447	4,520	4,383
Intellectual property and custom development income	(242)	(213)	(659)	(720)
Other (income) and expense	(174)	(99)	(616)	(1,788)
Interest expense	70	56	207	172
Total expense and other income	6,317	5,823	18,091	18,109
Income from continuing operations before income taxes	3,174	2,915	8,503	7,658
Provision for income taxes	952	1,399	2,551	2,884
Income from continuing operations	2,222	1,516	5,952	4,774

* Reclassified to conform with 2006 presentation; see Note 1 on page 6 for additional information.

(Amounts may not add due to rounding.)

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

1

(Dollars in millions except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Discontinued Operations				
Loss from discontinued operations, net of tax				27
Net income	\$ 2,222	\$ 1,516	\$ 5,952	\$ 4,747
Earnings/(loss) per share of common stock:				
Assuming dilution:				
Continuing operations	\$ 1.45	\$ 0.94	\$ 3.81	\$ 2.92
Discontinued operations	(0.00)	(0.00)	(0.00)	(0.02)
Total	\$ 1.45	\$ 0.94	\$ 3.81	\$ 2.90
Basic				
Continuing operations	\$ 1.47	\$ 0.95	\$ 3.87	\$ 2.97
Discontinued operations	(0.00)	(0.00)	(0.00)	(0.02)
Total	\$ 1.47	\$ 0.95	\$ 3.87	\$ 2.95
Weighted-average number of common shares outstanding: (millions)				
Assuming dilution	1,534.3	1,617.2	1,560.5	1,635.2
Basic	1,513.2	1,591.3	1,538.6	1,607.9
Cash dividends per common share	\$ 0.30	\$ 0.20	\$ 0.80	\$ 0.58

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION
AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(UNAUDITED)

ASSETS

(Dollars in millions)	At September 30, 2006	At December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 8,484	\$ 12,568
Marketable securities	2,417	1,118
Notes and accounts receivable - trade (net of allowances of \$226 in 2006 and \$267 in 2005)	9,235	9,540
Short-term financing receivables (net of allowances of \$308 in 2006 and \$422 in 2005)	12,400	13,750
Other accounts receivable (net of allowances of \$13 in 2006 and \$7 in 2005)	1,048	1,138
Inventories, at lower of average cost or market:		
Finished goods	842	902
Work in process and raw materials	2,292	1,939
Total inventories	3,135	2,841
Deferred income taxes	1,403	1,765
Prepaid expenses and other current assets	2,548	2,941
Total current assets	40,668	45,661
Plant, rental machines and other property	35,645	34,261
Less: Accumulated depreciation	21,586	20,505
Plant, rental machines and other property - net	14,059	13,756
Long-term financing receivables	9,434	9,628
Prepaid pension assets	23,204	20,625
Intangible assets - net	1,599	1,663
Goodwill	10,337	9,441
Investments and sundry assets	4,855	4,974
Total assets	\$ 104,155	\$ 105,748

(Amounts may not add due to rounding.)

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

LIABILITIES AND STOCKHOLDERS EQUITY

(Dollars in millions except per share amounts)	At September 30, 2006	At December 31, 2005
Liabilities and Stockholders Equity		
Current liabilities:		
Taxes	\$ 4,125	\$ 4,710
Short-term debt	8,555	7,216
Accounts payable and accruals	22,249	23,226
Total current liabilities	34,929	35,152
Long-term debt	13,436	15,425
Retirement and nonpension postretirement benefit obligations	13,012	13,779
Other liabilities	8,530	8,294
Total liabilities	69,907	72,650
Stockholders equity:		
Common stock - par value \$0.20 per share and additional paid-in capital	30,257	28,926
Shares authorized: 4,687,500,000		
Shares issued: 2006 - 1,995,246,297		
2005 - 1,981,259,104		
Retained earnings	49,402	44,734
Treasury stock - at cost	(45,096) (38,546
Shares: 2006 - 488,894,453		
2005 - 407,279,343		
Accumulated gains and (losses) not affecting retained earnings	(315) (2,016
Total stockholders equity	34,248	33,098
Total liabilities and stockholders equity	\$ 104,155	\$ 105,748

(Amounts may not add due to rounding.)

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

INTERNATIONAL BUSINESS MACHINES CORPORATION

AND SUBSIDIARY COMPANIES

CONSOLIDATED STATEMENT OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, (UNAUDITED)

(Dollars in millions)	2006	2005*
Cash flow from operating activities from continuing operations:		
Net income	\$ 5,952	\$ 4,747
Loss from discontinued operations		\$ 27
Adjustments to reconcile income from continuing operations to cash provided from operating activities:		
Depreciation	2,893	3,084
Amortization of intangibles	790	775
Stock-based compensation	621	796
Net gain on asset sales and other	(88)	(1,216)
Changes in operating assets and liabilities, net of acquisitions/divestitures	(483)	1,281
Net cash provided by operating activities from continuing operations	9,685	9,494
Cash flow from investing activities from continuing operations:		
Payments for plant, rental machines and other property, net of proceeds from dispositions	(2,776)	(2,455)
Investment in software	(585)	(601)
Acquisition of businesses, net of cash acquired	(882)	(1,298)
Divestiture of businesses, net of cash transferred		656
Purchases of marketable securities and other investments	(20,388)	(2,418)
Proceeds from disposition of marketable securities and other investments	18,715	3,124
Net cash used in investing activities from continuing operations	(5,915)	(2,992)
Cash flow from financing activities from continuing operations:		
Proceeds from new debt	292	4,236
Payments to settle debt	(1,448)	(3,264)
Short-term borrowings/(repayments) less than 90 days net	369	(1,803)
Common stock transactions net	(5,883)	(5,878)
Cash dividends paid	(1,231)	(934)
Net cash used in financing activities from continuing operations	(7,901)	(7,643)
Effect of exchange rate changes on cash and cash equivalents	56	(652)
Net cash used in discontinued operations - operating activities	(9)	(8)
Net change in cash and cash equivalents	(4,084)	(1,801)
Cash and cash equivalents at January 1	12,568	10,053
Cash and cash equivalents at September 30	\$ 8,484	\$ 8,252

* Reclassified to conform with 2006 presentation.

(Amounts may not add due to rounding.)

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

Notes to Consolidated Financial Statements

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the amounts of assets, liabilities, revenue and expenses that are reported in the Consolidated Financial Statements and accompanying disclosures. Actual results may be different. See the company's 2005 Annual Report for a discussion of the company's critical accounting estimates.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the company's 2005 Annual Report.

In the first quarter of 2006, the company made changes to its management system. These changes impacted the company's reportable segments and resulted in the reclassification of certain revenue and cost within its Consolidated Statement of Earnings. These changes did not impact the company's total revenue, cost, expense, net income, earnings per share, Consolidated Statement of Financial Position or Consolidated Statement of Cash Flows. See Note 10 for additional information regarding the changes in reportable segments. The periods presented in this Form 10-Q are reported on a comparable basis. The company filed a Form 8-K with the Securities and Exchange Commission (SEC) on June 13, 2006 to reclassify its historical financial statements and related footnotes to reflect these management system changes.

Within the financial tables in this Form 10-Q, certain columns and rows may not add due to the use of rounded numbers for disclosure purposes. Percentages presented are calculated from the underlying whole-dollar amounts.

2. The following table summarizes Net income plus gains and (losses) not affecting retained earnings (net of tax):

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	\$ 2,222	\$ 1,516	\$ 5,952	\$ 4,747
Gains and (losses) not affecting retained earnings (net of tax):				
Foreign currency translation adjustments	(74)	30	563	(995)
Minimum pension liability adjustments			1,432	2
Net unrealized gains on marketable securities	32	26	10	9
Net unrealized gains/(losses) on cash flow hedge derivatives	81	57	(305)	834
Total gains and (losses) not affecting retained earnings	39	113	1,701	(150)
Net income plus gains and (losses) not affecting retained earnings	\$ 2,261	\$ 1,629	\$ 7,652	\$ 4,597

3. Effective January 1, 2005, the company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment. Accordingly, stock-based compensation expense is measured at grant date, based on the fair value of the award and is recognized as expense over the employee requisite service period. The following table presents total stock-based compensation expense included in the Consolidated Statement of Earnings:

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Cost	\$ 54	\$ 82	\$ 162	\$ 253
Selling, general and administrative*	136	143	394	461
Research, development and engineering	22	26	64	82
Other (income) and expense				(8)
Pre-tax stock-based compensation expense	212	251	621	788
Income tax benefits	(75)	(87)	(220)	(269)
Total stock-based compensation expense	\$ 137	\$ 164	\$ 401	\$ 519

* Includes \$3 million and \$7 million of credits in the three- and nine-month periods ended September 30, 2005, respectively, as a result of awards forfeited in connection with the company's second-quarter 2005 workforce resource actions.

The reduction in pre-tax stock-based compensation expense for the three and nine-month periods ended September 30, 2006, as compared to the corresponding periods in the prior year, was principally the result of: (1) a reduction in the level and fair value of stock option grants (\$74 million and \$231 million, respectively), (2) changes to the terms of the company's employee stock purchase plan, which rendered it non-compensatory in the second quarter of 2005 in accordance with the provisions of SFAS 123(R) (no effect in three-month period and \$18 million decrease in nine-month period), offset by (3) increased expense for performance-based stock

units (\$3 million and \$30 million, respectively) resulting from changes in the probabilities of achieving performance metrics and (4) an increase in the level of restricted equity award grants (\$32 million and \$52 million, respectively). The effects on pre-tax stock-based compensation expense of the 2005 sale of the Personal Computing business were recorded in Other (income) and expense above and in the Consolidated Statement of Earnings for the nine-month period ended September 30, 2005.

As of September 30, 2006, \$1,330 million of total unrecognized compensation expense related to non-vested awards is expected to be recognized over a weighted average period of approximately 2 years.

There were no significant capitalized stock-based compensation expense at September 30, 2006 and 2005.

Under IBM's long-standing practices and policies, all stock option awards are approved prior to or on the date of grant. The exercise price of at-the-money stock options is the average of the high and low market price on the date of grant or, in the case of premium-priced stock options, 10 percent above such average. The options approval process specifies the individual receiving the grant, the number of options or the value of the award, the exercise price or formula for determining the exercise price and the date of grant. All option awards for senior management are approved by the Executive Compensation and Management Resources Committee of the Board of Directors (the Committee). All option awards for employees other than senior management are approved by senior management pursuant to a series of delegations that were approved by the Committee, and the grants made pursuant to these delegations are reviewed periodically with the Committee. Options that are awarded as part of annual total compensation for senior management and other employees are made on specific cycle dates scheduled in advance. With respect to option awards given in connection with promotions or new hires, IBM's policy requires approval of such awards prior to the grant date, which is typically the date of the promotion or the date of hire. The exercise price of these options is the average of the high and low market price on the date of grant in the case of at-the-money stock options or, in the case of premium-priced stock options, 10 percent above such average. See IBM's 2005 Annual Report, note U, "Stock-Based Compensation", for additional information on the company's stock-based incentive awards.

4. In September 2006, the Financial Accounting Standards Board (FASB) released SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" that requires employers to recognize the funded status of their postretirement plans in the statement of financial position and introduces additional net periodic benefit cost disclosure requirements. The funded status is measured as the difference between the fair value of plan assets and the benefit obligation. The company will adopt SFAS No. 158 as of December 31, 2006. Upon adoption of SFAS No. 158, the company will recognize the underfunded status of its defined benefit pension plans and non-pension postretirement benefit plans as a liability in its Consolidated Statement of Financial Position. The overfunded status of the company's defined benefit pension plans will be recognized as an asset in its Consolidated Statement of Financial Position. Gains or losses, prior service costs or credits, and transition assets that have not yet been included in net periodic benefit cost as of December 31, 2006, will be recognized, net of tax, as components of the ending

balance of Accumulated Gains and (Losses) not Affecting Retained Earnings. Subsequent to adoption, the company will recognize the gains or losses and prior service costs or credits, net of tax, that arise during the period but are not recognized in net periodic benefit cost as a component of Accumulated Gains and (Losses) not Affecting Retained Earnings. Those amounts will be adjusted as they are subsequently recognized in net periodic benefit cost. The company measures defined benefit plan assets and obligations as of December 31 and SFAS No. 158 will not affect the company's existing valuation practices.

The adoption of SFAS No. 158 as of December 31, 2006 is expected to reduce the company's assets between \$11 - 12 billion, decrease its liabilities between \$0.5 - 1.5 billion, and reduce its stockholders' equity between \$10 - 11 billion. The company's Total stockholders' equity was \$34.2 billion at September 30, 2006. The company estimated the effect of adoption based on the most current valuations of its significant pension and non-pension postretirement benefit obligations at December 31, 2005, adjusted for the remeasurement of certain non-U.S. benefit plans arising from plan amendments and changes in certain significant assumptions at September 30, 2006. Those assumptions include the discount rate, interest crediting rate, fair value of plan assets and foreign exchange rates. The current estimate is based on the expectation that deferred tax assets attributable to pension and non-pension postretirement benefits will be realized. The actual effect of adoption could materially differ from the estimate as a result of changes in assumptions used in the valuation of plan obligations and fair value of plan assets. As noted above, those assumptions include, but are not limited to, discount rates, interest crediting rates, actual fair value of plan assets, foreign exchange rates, country-specific tax treatment, and the realizability of deferred tax assets. In addition, the company estimates that approximately \$1.0 billion of the liability balance will be reclassified as a current liability in accordance with the provisions of SFAS 158. The adoption of SFAS No. 158 will have no impact on the company's existing debt covenants, credit ratings or financial flexibility.

In September 2006, the FASB finalized SFAS No. 157, Fair Value Measurements which will become effective in 2008. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements; however, it does not require any new fair value measurements. The provisions of SFAS No. 157 will be applied prospectively to fair value measurements and disclosures in the company's Consolidated Financial Statements beginning in the first quarter of 2008.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, codified as SAB Topic I.N, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 describes the approach that should be used to quantify the materiality of a misstatement and provides guidance for correcting prior year errors. The company early adopted SAB No. 108 in the third quarter of 2006 and accordingly, follows SAB No. 108 requirements when quantifying financial statement misstatements. The adoption of SAB No. 108 did not result in corrections of the company's Consolidated Financial Statements.

In July 2006, the FASB released FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The

company will adopt this Interpretation in the first quarter of 2007. The cumulative effects, if any, of applying this Interpretation will be recorded as an adjustment to Retained earnings, Goodwill, or Accumulated Gains and (Losses) not Affecting Retained Earnings, as appropriate, as of the beginning of the period of adoption. The company has commenced the process of evaluating the expected effect of FIN 48 on its Consolidated Financial Statements and does not presently expect a material impact upon adoption. However, the company does expect to reclassify a portion of its unrecognized tax benefits from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date. Prior period amounts also will be reclassified to conform to this change in presentation.

5. In May 2005, the company implemented a series of restructuring actions designed to improve the company's efficiencies, strengthen its client-facing operations and capture opportunities in high-growth markets. The company's actions primarily included voluntary and involuntary workforce reductions, with the majority impacting the Global Services business, primarily in Europe, as well as the vacating of leased facilities. These actions were in addition to the company's ongoing workforce reduction and rebalancing activities that occur each quarter.

The total charges expected to be incurred in connection with all second-quarter 2005 initiatives are approximately \$1,766 million, of which \$1,753 million has been recorded cumulatively through September 30, 2006. The remaining expected charges represent accretion/interest expense on the long-term portion of the company's workforce and vacant space obligations. Approximately \$1,623 million of the total charges require cash payments, of which approximately \$1,344 million has been made as of September 30, 2006 and \$75 million are expected to be made over the next 12 months.

Total pre-tax restructuring activity was as follows:

(Dollars in millions)	Pre-Tax Charges Recorded in 2Q 2005	Asset Impairments	Liability recorded in the 2nd Qtr. 2005	Payments	Other(2)	Liability as of 12/31/05
Workforce reductions	\$ 1,574	\$	\$ 1,574	\$ (1,013)	\$ (107)	\$ 454
Vacant space	141		141	(53)	(5)	83
Asset impairments	95	95				
Total restructuring charges for 2Q 2005 actions	\$ 1,810	(1)\$ 95	\$ 1,715	\$ (1,066)	\$ (112)	\$ 537 (3)

(1) \$1.6 billion recorded in Selling, general and administrative expense and \$0.2 billion recorded in Other (income) and expense in the Consolidated Statement of Earnings.

(2) Consists of foreign currency translation adjustments (\$38 million), net reclassifications to other balance sheet categories (\$41 million) and reversals of previously recorded liabilities (\$34 million) for changes in the estimated cost of employee terminations and vacant space, offset by approximately \$1 million of accretion expense. The reversals were recorded primarily in SG&A expense.

(3) \$391 million recorded as a current liability in Accounts payable and accruals and \$146 million as a non-current liability in Other liabilities in the Consolidated Statement of Financial Position.

(Dollars in millions)	Liability as of December 31, 2005	Payments	Other(4)	Liability as of September 30, 2006
Workforce reductions	\$ 454	\$ (246)	\$ 4	\$ 212
Vacant space	83	(32)	3	54
Total restructuring charges for 2Q 2005 actions	\$ 537	\$ (278)	\$ 7	\$ 266 (5)

(4) Consists of foreign currency translation adjustments (\$27 million), net balance sheet reclassifications (\$2 million) and accretion expense (\$5 million), offset by reversals of previous recorded liabilities (\$27 million) for changes in the estimated cost of employee terminations and vacant space. These reversals were primarily recorded in SG&A.

(5) \$75 million recorded as a current liability in Accounts payable and accruals and \$192 million as a non-current liability in Other liabilities in the Consolidated Statement of Financial Position.

Charges incurred for the workforce reductions consisted of severance/termination benefits for approximately 16,000 employees (14,500 of which were for the incremental second-quarter 2005 actions). All separations were substantially completed by March 31, 2006. The non-current portion of the liability associated with the workforce reductions relates to terminated employees who were granted annual payments to supplement their income in certain countries. Depending on individual country legal requirements, these required payments will continue until the former employee begins receiving pension benefits or is deceased. Cash payments made through September 30, 2006 associated with the workforce reductions were \$1,259 million.

The vacant space accruals are primarily for ongoing obligations to pay rent for vacant space, offset by estimated sublease income, over the respective lease term of the company's lease agreements. The length of these obligations varies by lease with the longest extending through 2019.

In connection with the company's restructuring activities initiated in the second quarter of 2005, the company recorded pre-tax impairment charges for certain real estate assets of approximately \$95 million during the year ended December 31, 2005. The principal component of such impairment charges resulted from the sale of a facility in Yasu-City, Japan, which closed during the third quarter of 2005. In connection with this sale, the company recorded an impairment charge to write the asset down to its fair value in the second quarter of 2005.

These restructuring activities had the following effect on the company's reportable segments:

At September 30, 2006: (Dollars in millions)	Total Pre-Tax Charges Expected to be Incurred for 2Q 2005 Actions*	Cumulative Pre-Tax Charges Recorded for 2Q 2005 Actions*
Global Technology Services	\$ 724	\$ 719
Global Business Services	443	441
Systems & Technology Group	132	132
Software	98	97
Global Financing	16	16
Total reportable segments	1,412	1,405
Unallocated corporate amounts	354	349
Total	\$ 1,766	\$ 1,753

* Amounts reclassified from previously reported amounts to reflect the new management system structure implemented in the first quarter of 2006; see Note 10 for additional information.

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

(Dollars in millions)	2006	2005	Yr. to Yr. Percent Change	
For the three months ended September 30:				
Retirement-related plans - cost:				
Defined benefit and contribution pension plans - cost	\$ 498	\$ 429	16.1	%
Nonpension postretirement benefits-cost	97	95	2.1	
Total	\$ 595	\$ 524	13.5	%

(Dollars in millions)	2006	2005	Yr. to Yr. Percent Change	
For the three months ended September 30:				
Retirement-related plans - cost:				
Defined benefit and contribution pension plans - cost	\$ 1,542	\$ 1,376	12.1	%
Nonpension postretirement benefits-cost	290	279	3.9	
Total	\$ 1,832	\$ 1,655	10.7	%

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

Cost/(Income) of Pension Plans

(Dollars in millions)	U.S. Plans		Non-U.S. Plans	
	2006	2005	2006	2005
For the three months ended September 30:				
Service cost	\$ 193	\$ 171	\$ 144	\$ 167
Interest cost	614	615	399	402
Expected return on plan assets	(904)	(918)	(583)	(548)
Amortization of transition assets			(2)	(1)
Amortization of prior service cost	15	16	(31)	5
Recognized actuarial losses	196	141	204	137
Net periodic pension cost - U.S. plan and material non-U.S. plans	114 *	25 *	131 **	162 **
Cost of other defined benefit plans	27	36	39	35
Cost of restructuring/divestiture actions				6
Total net periodic pension cost for all defined benefit plans	141	61	170	203
Cost of defined contribution plans	90	81	97	84
Total retirement plan cost recognized in the Consolidated Statement of Earnings	\$ 231	\$ 142	\$ 267	\$ 287

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

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

(Dollars in millions)	U.S. Plans		Non-U.S.Plans	
	2006	2005	2006	2005
For the nine months ended September 30:				
Service cost	\$ 577	\$ 512	\$ 457	\$ 520
Interest cost	1,841	1,847	1,169	1,240
Expected return on plan assets	(2,710)	(2,754)	(1,726)	(1,700)
Amortization of transition assets			(4)	(4)
Amortization of prior service cost	45	46	(59)	24
Recognized actuarial losses	589	425	607	415
Net periodic pension cost U.S. plan and material non-U.S. plans	342 *	76	*444	** 495 **
Cost of other defined benefit plans	82	108	117	106
Cost of restructuring/divestiture actions		3		65
Total net periodic pension cost for all defined benefit plans	424	187	561	666
Cost of defined contribution plans	282	267	275	256
Total retirement plan cost recognized in the Consolidated Statement of Earnings	\$ 706	\$ 454	\$ 836	\$ 922

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

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

In 2006, the company expects to contribute between \$1.7 - \$2 billion to its non-U.S. defined benefit plans. The legally mandated minimum contribution included in the amount above for the company's non-U.S. plans is expected to be approximately \$895 million. In the first nine months of 2006, the company contributed \$1,676 million to its non-U.S. plans.

The following table provides the components of the cost for the company's nonpension postretirement benefits:

Cost/(Income) of Nonpension Postretirement Benefits

(Dollars in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Service cost	\$ 15	\$ 10	\$ 46	\$ 33
Interest cost	78	81	230	243
Amortization of prior service cost	(16)	(15)	(47)	(46)
Recognized actuarial losses	7	7	22	19
Net periodic post-retirement benefit cost - U.S. plan	84	83	251	249
Cost of non-U.S. plans	13	12	39	30
Total nonpension postretirement plan cost recognized in the Consolidated Statement of Earnings	\$ 97	\$ 95	\$ 290	\$ 279

The Medicare Prescription Drug Improvement and Modernization Act of 2003 did not have a material impact on the company's Consolidated Financial Statements as of or for the periods ended September 30, 2006.

7. The changes in the carrying amount of goodwill, by reportable segment, for the nine months ended September 30, 2006, are as follows:

(Dollars in millions) Segment	Balance 12/31/05*	Goodwill Additions	Purchase Price Adjustments	Divestitures	Foreign Currency Translation Adjustments	Balance 9/30/06
Global Technology Services	\$ 1,530	\$ 5	\$ (88)	\$	\$ 107	\$ 1,554
Global Business Services	3,588		(16)		91	3,662
Systems and Technology Group	254		3		1	257
Software	4,069	860	(71)		5	4,863
Global Financing						
Total	\$ 9,441	\$ 865	\$ (171)	\$	\$ 203	\$ 10,337

* Amounts reclassified from previously reported amounts reflect the new management system structure implemented in the first quarter of 2006; see Note 10 for additional information.

There were no goodwill impairment losses recorded during the quarter.

The following schedule details the company's intangible asset balances by major asset class:

(Dollars in millions) Intangible asset class	At September 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized software	\$ 1,877	\$ (863)	\$ 1,013
Client-related	732	(382)	350
Completed technology	212	(98)	114
Strategic alliances	104	(83)	21
Patents/Trademarks	37	(23)	14
Other(a)	256	(168)	87
Total	\$ 3,217	\$ (1,618)	\$ 1,599

(Dollars in millions) Intangible asset class	At December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Capitalized software	\$1,805	\$(802)	\$1,003
Client-related	910	(490)	420
Completed technology	383	(270)	113
Strategic alliances	104	(68)	36
Patents/Trademarks	32	(17)	15
Other(a)	218	(142)	76
Total	\$ 3,452	\$ (1,789)	\$ 1,663

(a) Other intangibles are primarily acquired proprietary and non-proprietary business processes, methodologies and systems.

The net carrying amount of intangible assets decreased \$64 million during the first nine months of 2006 due to amortization of existing intangible asset balances partially offset by additions due to acquisitions. The aggregate intangible asset amortization expense was \$259 million and \$790 million for the third quarter and first nine months of 2006, respectively, versus \$266 million and \$775 million for the third quarter and first nine months of 2005, respectively. The aggregate intangible asset amortization expense related to acquired intangible assets was \$66 million and \$225 million for the third quarter and first nine months of 2006, respectively, versus \$95 million and \$281 million for the comparable prior year periods. In addition, in the first nine months of 2006, the company retired \$964 million of fully amortized intangible assets, impacting both the gross carrying amount and accumulated amortization for this amount.

The amortization expense for each of the five succeeding years relating to intangible assets currently recorded in the Consolidated Statement of Financial Position is estimated to be the following at September 30, 2006:

2006 (for Q4)	\$257 million
2007	\$780 million
2008	\$368 million
2009	\$130 million
2010	\$34 million

8. During the nine months ended September 30, 2006, the company completed nine acquisitions at an aggregate cost of \$1,042 million.

The Software segment completed seven acquisitions: in the first quarter, Micromuse, a publicly traded company; Cims Lab, a privately held company; and Language Analysis Systems, Inc., a privately held company; in the second quarter, Buildforge, a privately held company; Unicorn Solutions, Inc., a privately held company; and Rembo Technology, a privately held company; and, in the third quarter, Webify Solutions, a privately held company. Each acquisition further complemented and enhanced the company's portfolio of software product offerings.

Global Technology Services (GTS) completed one acquisition in the first quarter: Viacore, Inc., a privately held company. This acquisition augments GTS's supply chain optimization practice within its Business Transformation Outsourcing offerings.

Global Business Systems (GBS) completed one acquisition in the third quarter: Valchemy, Inc., a privately held company. This acquisition will enhance the company's Business Consulting Services offerings.

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

The table below reflects the purchase price related to these acquisitions and the resulting purchase price allocations as of September 30, 2006. The Micromuse acquisition is shown separately given its significant purchase price.

(Dollars in millions)	Amortization Life (yrs.)	Micromuse Original Amount Disclosed in		Purchase Adjustments	Total Allocation	Other Acquisitions
		First Qtr. 2006	201			
Current assets		\$	201	\$	\$ 201	\$ 19
Fixed assets/non-current			8		8	3
Intangible assets:						
Goodwill	N/A		694	6	700	165
Completed technology	3		46		46	4
Client relationships	3 - 5		46		46	14
Other identifiable assets			4		4	4
In-process research and development			1		1	
Total assets acquired			1,000	6	1,006	209
Current liabilities			(89)	(6)	(95)	(20)
Non-current liabilities			(49)		(49)	(9)
Total liabilities assumed			(138)	(6)	(144)	(29)
Total purchase price		\$	862	\$	\$ 862	\$ 180

The acquisitions were accounted for as purchase transactions, and accordingly, the assets and liabilities of the acquired entities were recorded at their estimated fair values at the date of acquisition. The primary items that generated the goodwill are the value of the synergies between the acquired companies and IBM and the acquired assembled workforce, neither of which qualify as an amortizable intangible asset. The company is currently analyzing the amount

of goodwill that is deductible for tax purposes. The overall weighted-average life of the identified amortizable intangible assets acquired is 4.2 years. With the exception of goodwill, these identified intangible assets will be amortized on a straight-line basis over their useful lives. Goodwill of \$865 million has been assigned to the Software (\$860 million) and Global Technology Services (\$5 million) segments. There was no goodwill recorded for the Global Business Services segment.

On August 3, 2006, the company announced that it had agreed to acquire MRO Software Inc., a publicly-held company, for approximately \$740 million. On October 5, 2006, the company completed its acquisition of MRO Software Inc. On August 9, 2006 the company announced that it had agreed to acquire FileNet Corporation, a publicly-held company, for approximately \$1.6 billion. On October 12, 2006, the company completed its acquisition of FileNet Corporation. On August 23, 2006 the company announced that it had agreed to acquire Internet Security Systems, Inc., a publicly-held company, for approximately \$1.3 billion. On October 20, 2006, the company completed its acquisition of Internet Security Systems. The details of these acquisitions will be included in the company's 2006 Form 10-K.

9. On April 30, 2005 (closing date), the company completed the divestiture of its Personal Computing Division (PCD) business to Lenovo Group Limited (Lenovo), a publicly traded company on the Hong Kong Stock Exchange. For the year ended December 31, 2005, the company recorded a total pre-tax gain of \$1,108 million of which \$1,112 million was recorded in the first nine months of 2005.

As part of the total consideration received at the closing date, the company received equity in Lenovo. The equity is subject to specific lock-up provisions that restrict the company from divesting the securities. The restrictions apply to specific equity tranches and expire over a three-year period from the closing date. In the second quarter of 2006, the company and Lenovo agreed to revise these restrictions such that the company can now fully divest its shares in Lenovo after November 1, 2007 versus the prior lock-up expiration date of May 1, 2008.

On August 4, 2006, the company signed an agreement with a financial institution to establish a structure, with the institution acting as agent, to facilitate the company's disposition of Lenovo shares from time-to-time, after their release from the lock-up provisions. At the end of the third quarter, the company had not divested any shares through the financial institution.

See IBM's 2005 Annual Report, note C, Acquisitions/Divestitures, for additional information.

10. The tables on pages 81 through 84 of this Form 10-Q reflect the results of the company's reportable segments consistent with the management system used by the company's chief operating decision maker. These results are not necessarily a depiction that is in conformity with GAAP. For example, employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments based on headcount. A different result may occur for any segment if actuarial assumptions unique to each segment were used. Performance measurement is based on income before income taxes (pre-tax income). These results are used, in part, by management, both in evaluating the performance of, and in allocating resources to, each of the segments.

As discussed in Note 1, in the first quarter of 2006, the company made changes to its management system that impacted the company's reportable segments. The Enterprise Investment segment was dissolved and the Product Lifecycle Management software business was transferred to the Software segment. Certain other investments and products previously managed as Enterprise Investments are now included in the Software, Systems and Technology Group and Global Services segments.

In addition, the company made changes in the management system of its Global Services business. These changes include the separation of the Global Services segment into two new reportable segments: Global Technology Services and Global Business Services.

The two new Global Services segments consist of the following:

The Global Technology Services (GTS) segment primarily reflects infrastructure services, delivering value through the company's global scale, standardization and automation. It includes outsourcing, both Strategic Outsourcing and Business Transformation Outsourcing, Integrated Technology Services and Maintenance.

The Global Business Services (GBS) segment primarily reflects professional services, delivering business value and innovation to clients through solutions which leverage industry and business process expertise. It includes consulting, systems integration and application management services (AMS).

In the second quarter of 2005, the company divested its Personal Computing business which was previously a part of the Personal Systems Group. The two remaining units of the former Personal Systems Group, Retail Store Solutions and Printing Systems, were combined with the Systems and Technology Group. The Personal Computing business financial results are displayed as part of the segment disclosures, for applicable periods presented, in a manner consistent with the segment disclosures.

Previously reported segment information on pages 81 through 84 has been reclassified for all periods presented to reflect these changes in the company's reportable segments.

11. The following table provides a rollforward of the liability balances for actions taken in the following periods: (1) the second quarter of 2005, discussed in Note 5; (2) the second-quarter of 2002 associated with the Microelectronics Division and rebalancing of both the company's workforce and leased space resources; (3) the fourth-quarter 2002 actions associated with the acquisition of the PricewaterhouseCoopers consulting business; (4) the 2002 actions associated with the hard disk drive (HDD) business for reductions in workforce, manufacturing capacity and space; (5) the actions taken in 1999; and (6) actions that took place prior to 1994.

(Dollars in millions)	Liability as of 12/31/2005	Payments	Other adjustments*	Liability as of 9/30/2006
Current:				
Workforce	\$ 461	\$ (324)	\$ (28)	\$ 110
Space	62	(75)	71	58
Other	6			6
Total Current	\$ 529	\$ (399)	\$ 43	\$ 174
Non-current:				
Workforce	\$ 497	\$	\$ 95	\$ 592
Space	236		(84)	152
Total Non-current	\$ 733	\$	\$ 12	\$ 744

* The other adjustments column in the table above principally includes the reclassification of non-current to current and foreign currency translation adjustments. In addition, during the nine-month period ended September 30, 2006, net adjustments to decrease previously recorded liabilities for changes in the estimated cost of employee terminations and vacant space were recorded for the 2002 actions (\$17 million) and the 2Q 2005 actions (\$27 million), offset by increases for the actions taken prior to 1999 (\$7 million). These adjustments resulted in net reductions of \$37 million, \$19 million were recorded in the Consolidated Statement of Earnings during the nine month period ended September 30, 2006, with \$16 million included in Selling, General and Administrative expense and \$3 million in Other (income) and expense. Additionally, adjustments of \$18 million for the nine-month period ended September 30, 2006, were recorded to Goodwill for changes to estimated vacant space and workforce reserves associated with the 2002 actions.

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

On July 31, 2003, the U.S. District Court for the Southern District of Illinois, in Cooper et al. v. The IBM Personal Pension Plan and IBM Corporation, held that the company's pension plan violated the age discrimination provisions of the Employee Retirement Income Security Act of 1974 (ERISA). On September 29, 2004, the company announced that IBM and plaintiffs agreed in principle to resolve certain claims in the litigation. That agreement was finalized by the parties in May 2005, and received final approval from the District Court on August 16, 2005. Under the terms of the agreement, plaintiffs will receive an incremental pension benefit in exchange for the settlement of some claims and a stipulated remedy on remaining claims if plaintiffs prevail on appeal. This settlement, together with a previous settlement of a claim referred to as the partial plan termination claim resulted in the company taking a one-time charge of \$320 million in the third quarter of 2004.

This agreement ends the litigation on all claims except the two claims associated with IBM's cash balance formula. The company continues to believe that its pension plan formulas are fair and legal. The company reached this agreement in the interest of the business and the company's shareholders, and to allow for a review of its cash balance formula by the Court of

Appeals. The agreement stipulated that if the company was not successful on appeal of the two remaining claims, the agreed remedy would be increased by up to \$1.4 billion \$780 million for the claim that the company's cash balance formula is age discriminatory, and \$620 million for the claim that the method used to establish opening account balances during the 1999 conversion discriminated on the basis of age (referred to as the "always cash balance" claim). The maximum additional liability the company could face in this case were it not successful on appeal is therefore capped at \$1.4 billion.

On August 30, 2005, the company filed its Notice of Appeal of the liability rulings on the cash balance claims with the Seventh Circuit Court of Appeals and the matter was subsequently fully briefed. On February 16, 2006, oral arguments on the appeal were heard by the Court of Appeals. On August 7, 2006, the Court of Appeals ruled in favor of IBM's appeal. The Court of Appeals found that neither IBM's cash balance formula, nor the method by which opening account balances were established during the 1999 conversion, were age discriminatory. On August 21, 2006, plaintiffs petitioned the Court of Appeals for a rehearing of the appeal. On September 1, 2006, the Court of Appeals denied plaintiffs petition for a rehearing. Plaintiffs have until November 30, 2006 to request that the Supreme Court agree to consider their appeal of the ruling of the Court of Appeals.

The company is a defendant in an action filed on March 6, 2003 in state court in Salt Lake City, Utah by The SCO Group. The company removed the case to Federal Court in Utah. Plaintiff is an alleged successor in interest to some of AT&T's Unix IP rights, and alleges copyright infringement, unfair competition, interference with contract and breach of contract with regard to the company's distribution of AIX and Dynix and contribution of code to Linux. The company has asserted counterclaims, including breach of contract, violation of the Lanham Act, unfair competition, intentional torts, unfair and deceptive trade practices, breach of the General Public License that governs open source distributions, promissory estoppel and copyright infringement. In October 2005, the company withdrew its patent counterclaims in an effort to simplify and focus the issues in the case and to expedite their resolution. Each of the parties has filed a motion for summary judgment. A trial date has not been set.

In May 2005, the Louisiana Supreme Court denied the company's motion to review and reverse a Louisiana state court's certification of a nationwide class in a case filed against the company in 1995. The class consists of certain former employees who left the company in 1992, and their spouses. They claim damages based on the company's termination of an education assistance program. On April 4, 2006, the trial court denied the company's motion for summary judgment. On June 26, 2006, the Louisiana Court of Appeals denied IBM's writ seeking an interlocutory appeal of the trial court's decision to deny summary judgment. On July 26, 2006 IBM filed a writ seeking a discretionary appeal with the Louisiana Supreme Court. The court has not yet ruled on the writ. No date has been set for trial.

On June 2, 2003, the company announced that it received notice of a formal, nonpublic investigation by the Securities and Exchange Commission (SEC). The SEC sought information relating to revenue recognition in 2000 and 2001 primarily concerning certain types of client transactions. The company believes that the investigation arises from a separate investigation by the SEC of Dollar General Corporation, a client of the company's Retail Stores Solutions unit, which markets and sells point-of-sale products.

On January 8, 2004, the company announced that it received a Wells Notice from the staff of the SEC in connection with the staff's investigation of Dollar General Corporation, which as noted above, is a client of the company's Retail Stores Solutions unit. It is the company's understanding that an employee in the company's Sales & Distribution unit also received a Wells Notice from the SEC in connection with this matter. The Wells Notice notifies the company that the SEC staff is considering recommending that the SEC bring a civil action against the company for possible violations of the U.S. securities laws relating to Dollar General's accounting for a specific transaction, by participating in and aiding and abetting Dollar General's misstatement of its 2000 results. In that transaction, the company paid Dollar General \$11 million for certain used equipment as part of a sale of IBM replacement equipment in Dollar General's 2000 fourth fiscal quarter. Under the SEC's procedures, the company responded to the SEC staff regarding whether any action should be brought against the company by the SEC. The separate SEC investigation noted above, relating to the recognition of revenue by the company in 2000 and 2001 primarily concerning certain types of client transactions, is not the subject of this Wells Notice.

On June 27, 2005, the company announced that it had received a request to voluntarily comply with an informal investigation by the staff of the SEC concerning the company's disclosures relating to the company's first quarter 2005 earnings and expensing of equity compensation. On January 12, 2006, the company announced that it received notice of a formal, nonpublic investigation by the SEC of this matter. The company has been cooperating with the SEC, and will continue to do so. The SEC has informed the company that the investigation should not be construed as an indication that any violations of law have occurred.

In July 2005, two lawsuits were filed in the United States District Court for the Southern District of New York related to the company's disclosures concerning first-quarter 2005 earnings and the expensing of equity compensation. One lawsuit named as defendants IBM and IBM's Senior Vice President and Chief Financial Officer. The other lawsuit named as defendants IBM, IBM's Senior Vice President and Chief Financial Officer, and IBM's Chairman and Chief Executive Officer. Both complaints alleged that defendants made certain misrepresentations in violation of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. On September 6, 2005, counsel in one of these lawsuits filed a motion seeking to have the lawsuits consolidated, and for the appointment of lead plaintiff and lead counsel. Pursuant to an Order from the Court dated March 28, 2006, the two lawsuits were consolidated into a single action captioned *In re International Business Machines Corp. Securities Litigation*. Pursuant to a schedule set by the Court, Plaintiffs served on the company an Amended Consolidated Complaint on May 19, 2006. IBM filed a Motion to Dismiss the Amended Consolidated Complaint on June 23, 2006. Plaintiffs filed their response to IBM's Motion on July 21, 2006; and IBM filed its final brief in support of its Motion on August 2, 2006. On September 20, 2006, the Court denied IBM's Motion to Dismiss.

In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid-rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG Electronics, which has since been dissolved, effective January, 2005) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Debarment orders

were imposed at different times, covering a period of no more than a year from the date of issuance, which barred IBM Korea from doing business directly with certain government controlled entities in Korea. All debarment orders have since expired and when they were in force did not prohibit IBM Korea from selling products and services to business partners who sold to government-controlled entities in Korea. In addition, the U.S. Department of Justice and the SEC have both contacted the company in connection with this matter.

On January 24, 2006, a putative class action lawsuit was filed against IBM in federal court in San Francisco on behalf of technical support workers whose primary responsibilities are or were to install and maintain computer software and hardware. The complaint was subsequently amended on March 13, 2006. The First Amended Complaint, among other things, adds four additional named plaintiffs and modifies the definition of the workers purportedly included in the class. The suit, *Rosenburg, et. al., v. IBM*, alleges the company failed to pay overtime wages pursuant to the Fair Labor Standards Act and state law, and asserts violations of various state wage requirements, including recordkeeping and meal-break provisions. The suit also asserts certain violations of ERISA. Relief sought includes back wages, corresponding 401K and pension plan credits, interest, and attorneys' fees.

On October 23, 2006, the company filed two lawsuits against Amazon.com, Inc. (Amazon), in the United States District Court for the Eastern District of Texas, one in the Lufkin Division and one in the Tyler Division. The Lufkin suit alleges that Amazon has unlawfully infringed three IBM patents. The Tyler suit alleges that Amazon has unlawfully infringed two IBM patents. The Lufkin Division patents cover methods for storing data, presenting applications and presenting advertising on a computer network. The Tyler Division patents cover an electronic catalog requisition system and related information retrieval and ordering methods and a computer-implemented hypertext system and method for operating a computer implemented object-oriented hypertext system. Each suit seeks, among other things, compensatory damages and injunctive relief. No date has been set for trial in either lawsuit.

The company is party to, or otherwise involved in, proceedings brought by U.S. federal or state environmental agencies under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), known as Superfund, or laws similar to CERCLA. Such statutes require potentially responsible parties to participate in remediation activities regardless of fault or ownership of sites. The company is also conducting environmental investigations or remediations at or in the vicinity of several current or former operating sites pursuant to permits, administrative orders or agreements with state environmental agencies, and is involved in lawsuits and claims concerning certain current or former operating sites.

The company is also subject to ongoing tax examinations and governmental assessments in various jurisdictions. Similar to many other U.S. companies doing business in Brazil, the company is involved in various challenges with Brazilian authorities regarding non income tax assessments and non income tax litigation matters. These matters principally relate to claims for taxes on the importation of computer software. The total amounts related to these matters are approximately \$1.4 billion, including amounts currently in litigation and other amounts. The company believes it will prevail on these matters and that these amounts are not meaningful indicators of liability.

In accordance with SFAS No. 5, Accounting for Contingencies, the company records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a

liability has been incurred and the amount of the loss can be reasonably estimated. Any provisions are reviewed at least quarterly and are adjusted to reflect the impact and status of settlements, rulings, advice of counsel and other information pertinent to a particular matter. Any recorded liabilities for the above items, including any changes to such liabilities for the quarter ended September 30, 2006, were not material to the Consolidated Financial Statements. Based on its experience, the company believes that the damage amounts claimed in the matters referred to above are not a meaningful indicator of the potential liability. Claims, suits, investigations and proceedings are inherently uncertain and it is not possible to predict the ultimate outcome of the matters previously discussed. While the company will continue to defend itself vigorously in all such matters, it is possible that the company's business, financial condition, results of operations, or cash flows could be affected in any particular period by the resolution of one or more of these matters.

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

13. The company's extended lines of credit to clients and other third parties include unused amounts of \$3,341 million and \$3,019 million at September 30, 2006 and December 31, 2005, respectively. A portion of these amounts was available to the company's business partners to support their working capital needs. In addition, the company committed to provide future financing to its customers in connection with customer purchase agreements for approximately \$2,449 million and \$2,155 million at September 30, 2006 and December 31, 2005, respectively.

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

The company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts entered into by the company, under which the company customarily agrees to hold the party harmless against losses arising from a breach of representations and covenants related to such matters as title to the assets sold, certain IP rights, specified environmental matters, and certain income taxes. In each of these circumstances, payment by the company is conditioned on the other party making an adverse claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party's claims. Further, the company's obligations under these agreements may be limited in terms of time and/or amount, and in some instances, the company may have recourse against third parties for certain payments made by the company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the company under these agreements did not have a material effect on the company's business, financial condition or results of operations. The company believes that if it were to incur a loss in any of these matters, such loss would not have a material effect on the company's business, financial condition or results of operations.

In addition, the company guarantees certain loans and financial commitments. The maximum potential future payment under these financial guarantees was \$31 million and \$39 million at September 30, 2006 and December 31, 2005, respectively.

Changes in the company's warranty liability balance are presented in the following table:

(Dollars in millions)	2006	2005
Balance at January 1	\$ 754	\$ 944
Current period accruals	337	467
Accrual adjustments to reflect actual experience	70	10
Charges incurred	(571)	(633)
Balance at September 30	\$ 590	\$ 788

The decrease in the warranty liability balance was primarily driven by the divestiture of the company's Personal Computing business in April 2005.

14. Subsequent Events: On October 5, 2006, October 12, 2006 and October 20, 2006 the company completed the acquisitions of MRO Software Inc., FileNet Corporation and Internet Security Systems Inc., respectively. See Note 8 on pages 18 and 19 for additional information.

On October 31, 2006, the company announced that the Board of Directors approved a quarterly dividend of \$0.30 per common share. The dividend is payable December 9, 2006 to shareholders of record on November 10, 2006.

On October 31, 2006, the company announced that the Board of Directors authorized the company to repurchase up to an additional \$4.0 billion of IBM common shares. The company plans to repurchase the shares in the open market or in private transactions from time to time, based on market conditions.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006*

Snapshot

(Dollars in millions except per share amounts)	2006	2005	Yr. To Yr. Percent/ Margin Change	
Three months ended September 30:				
Revenue	\$ 22,617	\$ 21,529	5.1	%**
Gross profit margin	42.0	% 40.6	% 1.4	pts.
Total expense and other income	\$ 6,317	\$ 5,823	8.5	%
Total expense and other income to revenue ratio	27.9	% 27.0	% 0.9	pts.
Provision for income taxes	\$ 952	\$ 1,399	(32.0))%
Income from continuing operations	\$ 2,222	\$ 1,516	46.6	%
Earnings per share from continuing operations:				
Assuming dilution	\$ 1.45	\$ 0.94	54.3	%
Basic	\$ 1.47	\$ 0.95	54.7	%
Weighted average shares outstanding:				
Assuming dilution	1,534.3	1,617.2	(5.1))%
Basic	1,513.2	1,591.3	(4.9))%

* The following Results of Continuing Operations discussion does not include the Hard Disk Drive (HDD) business that the company sold to Hitachi, Ltd. on December 31, 2002. The HDD business was accounted for as a discontinued operation under generally accepted accounting principles. There was no loss from Discontinued Operations in the third quarter and first nine months of 2006, respectively, versus no losses in the third quarter of 2005 and \$27 million in the first nine months of 2005. The 2005 charges were for additional costs associated with parts warranty as agreed upon by the company and Hitachi Ltd., under the terms of the agreement for the sale of the HDD business to Hitachi Ltd.

** 3.7 percent adjusted for currency

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

(Dollars in millions except per share amounts)	2006	2005	Yr. To Yr. Percent/ Margin Change	
Nine months ended September 30:				
Revenue	\$ 65,166	\$ 66,707	(2.3)%**
Gross profit margin	40.8	% 38.6	% 2.2	pts.
Total expense and other income	\$ 18,091	\$ 18,109	(0.1)%
Total expense and other income to revenue ratio	27.8	% 27.1	% 0.6	pts.
Provision for income taxes	\$ 2,551	\$ 2,884	(11.6)%
Income from continuing operations	\$ 5,952	\$ 4,774	24.7	%
Earnings per share from continuing operations:				
Assuming dilution	\$ 3.81	\$ 2.92	30.5	%
Basic	\$ 3.87	\$ 2.97	30.3	%
Weighted average shares outstanding:				
Assuming dilution	1,560.5	1,635.2	(4.6)%
Basic	1,538.6	1,607.9	(4.3)%

	9/30/06	12/31/05	Yr. To Yr. Percent Change	
Assets	\$ 104,155	\$ 105,748	(1.5)%
Liabilities	\$ 69,907	\$ 72,650	(3.8)%
Equity	\$ 34,248	\$ 33,098	3.5	%

** (1.6) percent adjusted for currency

The company's third-quarter 2006 diluted earnings per common share from continuing operations of \$1.45 increased 54 percent versus \$0.94 in the third quarter of 2005. The third-quarter 2005 diluted earnings per share from continuing operations included a \$0.32 per share one-time tax charge related to the repatriation of foreign earnings under the American Jobs Creation Act of 2004; excluding the one-time tax charge, the third quarter diluted earnings per share increased 15 percent versus the prior year quarter.

Third quarter and first nine months of 2006 income from continuing operations was \$2,222 million and \$5,952 million versus \$1,516 million and \$4,774 million for the comparable periods in 2005, respectively. The third-quarter 2005 results included a one-time tax charge of \$525 million associated with the repatriation of \$9.5 billion of foreign earnings. The first nine months of 2005 included the third quarter tax repatriation charge and the pretax charges for the company's incremental restructuring actions of \$1,731 million, offset by a \$1,112 million gain on the divestiture of the Personal Computing business and a \$775 million legal settlement received from Microsoft.

Total revenue increased 5.1 percent and declined 2.3 percent (up 3.7 percent and down 1.6 percent adjusted for currency) for the third quarter and first nine months of 2006 versus the same periods in 2005. The decline in the first nine months of 2006 was primarily driven by the

divestiture of the Personal Computing business in April 2005. The nine months of 2005 results have four months of Personal Computing revenue versus no activity in 2006. Excluding revenue from the divested Personal Computing business, the first nine months revenue of 2006 increased 2.1 percent (2.9 percent adjusted for currency).

In the third quarter, the company's performance reflected the strength of its business model, with good contribution from the company's high value, high margin businesses. The company also benefited from good sales execution at the end of the quarter which enabled closure of key transactions that contributed to the revenue and profit growth.

The company's Software business had solid growth in revenue and pre-tax profit and was the largest profit contributor in the quarter. The software results once again reflected strong demand for products deploying Services Oriented Architecture and Information on Demand, as well as the value of the company's systems management, security, and storage offerings. The company is continuing to invest both internally and to execute a targeted acquisition strategy. In the third quarter the company announced acquisitions that will continue to build its capabilities, while contributing growth and cash flow to the overall portfolio.

In Hardware, the company also had solid results, led by strong growth in its System z business and good performance in System p, Systems Storage, and Microelectronics.

Global Services revenue grew modestly, however the growth rate improved versus the second quarter. The Global Services business continues to provide a solid profit base and continued profit dollar and margin improvement for the company.

On a geographic basis, Asia Pacific had the best year-to-year revenue growth, adjusted for currency, helped by improved results in Japan. In addition, each of the other four major regions in the geography posted double-digit revenue growth in the third quarter. The company's ongoing investment in its emerging countries, in aggregate, yielded continued strong growth in those markets.

The gross profit margin was 42.0 percent and 40.8 percent in the third quarter and first nine months of 2006 versus 40.6 percent and 38.6 percent in the third quarter and first nine months of 2005. The year-to-year improvement in the third-quarter 2006 gross profit margin was primarily driven by the benefits from the company's ongoing productivity initiatives and a favorable mix of revenue towards the company's higher margin businesses. The increase in the first nine months of 2006 gross profit margin was primarily driven by the divestiture of the Personal Computing business (1.4 points) and benefits from the productivity initiatives implemented in the second quarter of 2005.

In the third quarter of 2006, total expense and other income increased over the prior year period, primarily due to increased Selling, general and administrative expense associated with the company's ongoing investments in sales skills, emerging markets and its strategic acquisitions. In addition, continued workforce rebalancing and retirement-related plans expense increased in the third quarter of 2006 versus the third quarter of 2005. In the first nine months of 2006, total expense and other income declined versus the same period in 2005, primarily due to the divestiture of the Personal Computing business and benefits from the productivity initiatives initiated in the second quarter of 2005. The ratio of Total expense to revenue increased 0.9

points and 0.6 points to 27.9 percent and 27.8 percent, for the third quarter and first nine months of 2006 versus the comparable periods of 2005, respectively.

The effective tax rates for the third quarter of 2006 and 2005 were 30.0 percent and 48.0 percent, respectively. The corresponding effective tax rates for the first nine months of 2006 and 2005 were 30.0 percent and 37.7 percent, respectively. The decreases in the quarterly and nine months tax rates were primarily attributable to the absence of the foreign earnings repatriation-related tax charge recorded in the third quarter of 2005.

Assets declined approximately \$1.6 billion from December 31, 2005 to September 30, 2006 primarily due to lower cash and cash equivalents and marketable securities of \$2.8 billion due to pension funding, acquisitions, tax payments, dividend payments and share repurchases in the first nine months of 2006. In addition, receivables declined by \$1.9 billion during the first nine months of 2006. These decreases were partially offset by an increase in pension assets of \$2.6 billion and goodwill of approximately \$0.9 billion.

Total Global Services signings were \$10.5 billion in the third quarter of 2006 as compared to \$11.0 billion for the three months ended September 30, 2005. The estimated total Global Services backlog was \$109 billion at September 30, 2006, flat versus June 30, 2006 and down \$2 billion from December 31, 2005.

Third Quarter and First Nine Months in Review*Results of Continuing Operations*Revenue

(Dollars in millions)	2006	2005*	Yr. to Yr. Percent Change	Yr. to Yr. Percent Change Adjusted for Currency	
For the three months ended September 30:					
Statement of Earnings Revenue Presentation:					
Global Services	\$ 12,017	\$ 11,697	2.7	% 1.6	%
Hardware	5,583	5,130	8.9	7.7	
Software	4,406	4,059	8.5	6.7	
Global Financing	591	600	(1.5)) (3.2))
Other	20	43	(54.5)) (54.2))
Total	\$ 22,617	\$ 21,529	5.1	% 3.7	%

(Dollars in millions)	2006	2005*	Yr. to Yr. Percent Change	Yr. to Yr. Percent Change Adjusted for Currency	
For the nine months ended September 30:					
Statement of Earnings Revenue Presentation:					
Global Services	\$ 35,478	\$ 35,407	0.2	% 1.3	%
Hardware	15,306	17,445	(12.3)) (12.1))
Software	12,554	11,930	5.2	5.9	
Global Financing	1,755	1,802	(2.6)) (2.4))
Other	74	123	(39.9)) (39.3))
Total	\$ 65,166	\$ 66,707	(2.3))%(1.6))%

* Reclassified to conform with 2006 presentation.

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(Dollars in millions)	2006	2005*	Yr. to Yr Percent Change	Yr. to Yr Percent Change Adjusted for Currency	
For the three months ended September 30:					
Industry Sector**:					
Financial Services	\$ 6,238	\$ 5,774	8.0	% 6.5	%
Public	3,379	3,359	0.6	(0.9)
Industrial	2,813	2,779	1.2	0.1	
Distribution	2,156	2,154	0.1	(1.3)
Communications	2,187	2,014	8.6	7.5	
Small & Medium	4,181	3,918	6.7	5.3	
OEM	1,011	814	24.3	24.3	
Other	651	718	(9.2)	(9.4)
Total	\$ 22,617	\$ 21,529	5.1	% 3.7	%