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February 14, 1924
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DAY 2
IBM commits to equal pay for equal work 28 years before it becomes the law of the land. August 15, 1935

DAY 3
Despite the Great Depression, IBM repositions itself for a recovery, keeps making tabulating machines—and it pays off big, as the new Social Security Administration adopts the technology for “the biggest accounting operation of all time.” September 18, 1936
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SEPTEMBER 28, 1936
DAY 4
We launch the system/360 and change the course of modern computing—and modern business. April 7, 1964
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DAY 5

Gerd Binnig and Heinrich Rohrer earn a Nobel Prize in Physics for the invention of the scanning tunneling microscope, allowing the first-ever view of individual atoms—and presaging a new golden age for IBM Research. December 8, 1986

DAY 6

With the formation of IBM Global Services, we define the outlines of a new model for the IT industry. December 12, 1996

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Over the course of our 92-year history, we've experienced our share of important days—days when fundamental change was in the air.

Those moments can be uncertain, often unsettling.

But of course, they're also the times when the need for leadership is the greatest. When one company—one team of people—can step forward to drive the change, and in the process, invent a whole new agenda—technical, social or cultural, in the workplace, and in the marketplace.

Today, once again, there's a change in the air. We're on the cusp of one more defining moment, and it's rippling across business models, technical models, and the very expectations people have for any enterprise they'll call a leader.

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Today, as I reflect on my first year as chief executive, I believe we stand our best chance in decades of returning IBM to a position of leadership—in all the ways that a business should lead.

I want to talk to you about that in this letter. It’s important that you understand how we define leadership for IBM, because it is the context for understanding what we accomplished in 2002 and the framework for how we will manage IBM in the decade ahead.

SEIZING THE MOMENT

There’s no question that 2002 tested our company. We had to deal with a continuing tough economic climate, particularly for the information technology industry, which contracted for the second year in a row.

Although our revenue from continuing operations of $81.2 billion was off 2 percent from 2001 and our earnings decreased 35 percent, to $5.3 billion, all of our core businesses—from servers to storage systems, to middleware, to services—gained market share in 2002. This is important. It means we will emerge in an even stronger position, relative to our competitors.

An environment like this, for all its challenges, is the ideal time to make decisive moves for future growth. Because of our ability to generate strong cash flows, last year we invested $4.8 billion in
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Financial Highlights

INTERNATIONAL BUSINESS MACHINES CORPORATION and Subsidiary Companies

(In millions except per share amounts)

FOR THE YEAR

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<tr>
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<tr>
<td>Revenue</td>
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</tr>
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<td>Income from continuing operations</td>
<td>5,344</td>
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</tr>
<tr>
<td>Loss from discontinued operations</td>
<td>(1,755)</td>
<td>(423)</td>
</tr>
<tr>
<td>Net income</td>
<td>3,579</td>
<td>7,723</td>
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<td></td>
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<tr>
<td>Net cash provided by operating activities from continuing operations</td>
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</tr>
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AS OF DECEMBER 31:

Cash, cash equivalents and current marketable securities | 5,975    | 6,391   |
Total assets                                            | 96,484  | 90,303  |
Working capital                                         | 7,102   | 7,342   |
Total debt                                              | 26,017  | 27,131  |
Stockholders’ equity                                    | 22,782  | 23,448  |
Common shares outstanding—basic (in millions)            | 1,722   | 1,723   |
Market capital                                           | 135,483 | 209,438 |
Stock price per common share                           | 77.50   | 120.96  |
Number of employees in IBM/subsidiary companies          | 315,889 | 319,876 |

* Redefined to conform with 2002 presentation.

research and development, $4.8 billion in capital expenditures and $4 billion in acquisitions. We took advantage of reasonable valuation levels and acquired several companies, including PricewaterhouseCoopers Consulting and six strategic software firms. Early this year, we acquired Rational, a leader in software development tools, for $2.1 billion. We opened the most advanced semiconductor development and manufacturing facility in the world. And we also improved our competitiveness. We revamped our PC and microelectronics businesses, and both our Personal Systems and Technology segments had returned to profitability by the fourth quarter. Our inventory levels now stand at a 20-year low. Through progress on our integrated supply chain, we took $5.6 billion in costs out of the business, and we believe we’ll achieve about the same this year.

One of the most important investments we made in 2002 was to contribute just under $4 billion, in cash and IBM stock, to fully fund the accumulated benefit obligation of our U.S. pension plan—which was underfunded mainly due to low interest rates and continued weakness in capital markets.

After all of these investments, we had sufficient cash to return to shareholders directly—$1 billion in dividend payments—and indirectly—$4.2 billion in repurchased IBM common stock.

In some ways, the IT industry will remain familiar. It will still thrive on fundamental technology innovation—an area of unparalleled strength for your company. In 2002, IBM scientists and engineers scored their tenth straight year as the world’s most prolific inventors, earning 1,268 U.S. patents, nearly double the number of the next closest company. Over the past decade, the U.S. Patent Office has issued IBM 22,357 patents—more than for ten of our top U.S. competitors combined.

But in other profound ways, the industry will be very different. How? Most people don’t realize it, but the IT industry has always been two, interrelated industries. One, of course, is computing. This is more than the chips, databases, operating systems, application software and other technology elements that are in a constant state of change. This is about computing as an architecture, a model, a system—what all of those individual pieces, when put together, make possible. The computing model doesn’t change very often, but it’s changing now.

The other “industry” is the application of computing to improve or transform some aspect of business (and by “business,” I mean the work of every kind of enterprise and institution). This wasn’t visible for many years, because these services—helping customers apply and manage the technology—were bundled with the hardware or software. But it was there all the same, and hugely important. For example, although IBM pioneered the mainframe model of computing,
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* Reclassified to conform with 2002 presentation.
it would not have taken the market by storm if we had only brought customers a new machine. We had to bring them a new idea about business, and we had to show them how to apply mainframe systems to transform back-office functions like accounting, payroll and inventory management.

I don’t think it’s an overstatement to say that IBM has been unique in stepping to the forefront of both these capabilities—computing and its application to business—for most of IT’s history.

Today, once again, both are changing in significant and interconnected ways.

Consider what’s happening in computing. Our customers have stopped thinking of their technology needs just in terms of data centers, or storage systems, or PCs, or even the network. Today, it’s the entire technical infrastructure on which their businesses run, a vital infrastructure that must connect with and support relationships and transactions with other businesses, devices of all kinds and all the people using those devices.

My point is, if customers are going to look to you as the leader in computing, you have to be able to drive forward the entire computing agenda, not just a piece of it.

We see a parallel situation in how computing is being applied by customers. For the most part, businesses and institutions have automated and digitized their standalone operations and processes—the back office, the manufacturing floor, procurement, logistics, customer-facing systems. They’ve extracted great efficiencies by doing so. Now they want to transform processes that cut across all of those systems. Why? Because they want to build a business that can respond dynamically to whatever the world throws at it.

And goodness knows, the world has been doing a lot of throwing lately.

A NEW GAME FOR BUSINESS

All of this is what we mean by “e-business on demand,” which you will be hearing a lot about in the months and years to come. The promise of on demand is that a company or institution can provide products, services, information, health care, education, government services and so on—all “on demand” for customers, citizens, patients and students. These “sense-and-respond” or “real-time” enterprises enjoy enormous competitive advantages. They are able to convert fixed costs into variable costs. They can greatly reduce inventories. And, most compellingly, they are extremely responsive to the needs of their customers, employees and partners.

That is obviously very appealing, especially in times like these. However, consider the magnitude of the business transformation it requires. It’s almost as if a business were turned on its side—moving from a collection of vertical “silos” to a seamlessly integrated, horizontal flow across value chains. That’s a major, major shift—in business design and in management thinking—and pulling it off requires deep business expertise and know-how.

This may sound rather grandiose, to some. And, of course, all technology companies envision ways in which their products will change business and society. Most do so with great bravado. More often than not, though, they are just plain wrong. The dot-com era was just the latest reminder that creators of databases, PCs and printers have no special qualifications to understand the future of serious business. In fact, they are probably the last people customers should look to for this kind of insight.

To be honest, when we at IBM began to understand the future course of technology and its sweeping implications for business, we looked in the mirror and saw some serious deficiencies in our own company. True, we had in recent years built...
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![Comparison of five-year cumulative total return for IBM, S&P 500 stock index, and S&P computers index (excluding IBM)]
Through IBM Global Services, we lack a critical mass of business expertise to help our customers become on demand enterprises. It was this realization that drove us to acquire PwC Consulting. We now have nearly 60,000 professionals in industries ranging from financial services to health care, with business process expertise in areas like supply chain, customer relationship management, human capital solutions and business transformation outsourcing.

We considered forming a web of alliances to gain the business insight we lacked. Others have chosen this path, and it’s a perfectly respectable strategy—but not for us. IBM’s brand and business model are very different from those of our competitors. Fundamental to our identity as a corporation is this fusion of business insight and technology leadership. Our learning in each realm informs what we do in the other. So we need an intimate linkage between them.

**LEADERSHIP ON DEMAND**

We have mobilized the entire IBM company and our expanding network of partners to make our e-business on demand strategy a reality. That work comes down to three main thrusts:

1. **Helping our customers become “on demand businesses.”** Through IBM Global Services, we are applying IBM’s considerable business process and industry expertise to help customers build businesses that are almost intuitive in their responsiveness to changes in demand, supply, pricing, labor, capital markets and customer needs. This requires a great deal of integration—of business processes and operations, and of applications and the underlying IT systems. It means making them resilient in the face of changes and threats, from hackers to hurricanes. And it means helping them focus on what differentiates them, on their core competencies—and outsource or tightly integrate with strategic partners to supply the rest.

2. **Evolving the computing model to an On-Demand Operating Environment.** On demand business creates new rules for IT infrastructure. Computing must be integrated and must support integration of business processes and operations, which is why our WebSphere software is growing so rapidly. Computing must be built on open technical standards and platforms, which is why IBM will continue to be a leader of the open standards movement—a leader in Linux, Web services and other emerging technical standards. Applications must be developed for this new, open model, which is why we acquired Rational; it gives software developers a compelling alternative to proprietary approaches.

In addition, an emerging technology called grid computing, built around another set of open specifications, allows the sharing and managing of separate computing resources as if they were one huge, virtual computer. This will dramatically increase utilization rates and give customers access to enormous computing capacity. Finally, IBM technologists are also pioneering ways to make IT systems “autonomic”—more self-managing and self-healing. This, too, is critical, as the increasing complexity of systems is making them unreasonably costly to manage and maintain.

3. **Establishing utility computing—computing on demand—as a viable and attractive alternative for accessing and paying for IT.** This effort has gotten a lot of attention. Yes, we intend to be a leader in utility computing services, so that customers can acquire computing and applications and pay only for what they use. IBM Global Services is already pioneering such services—server and storage capacity, as well as business processes like procurement and claims processing—for companies such as American Express, The Dow Chemical Company and Mobil Travel Guide. But we also want to equip and help customers to build their own internal utilities—software to manage and balance workloads, and server and storage systems to provide additional capacity on demand.

Clearly, the bet we’re placing on e-business on demand is a big one. And part of what makes it big is that it encompasses where both computing and business are headed. Driving both at the same time requires a lot of work, but it’s necessary, if you aspire to lead this industry.

**IBM’S CENTER OF GRAVITY**

Throughout IBM’s history, we have reinvented ourselves over and over again. The most visible manifestation of this has been how radically our product line has changed over time—from clocks and scales to tabulating machines, to mainframes, to Selectric typewriters, to everything we do today.

How were we able to make those transitions without having a jarring identity crisis? It’s because we never defined ourselves as a clock and scale company, or a mainframe company, or a typewriter maker, even when we were the undisputed leader in those markets. We simply committed ourselves to being the leader in inventing state-of-the-art technology and helping customers apply it to solve their problems. When technology and the nature of customer problems change—we do, too.

As I said earlier, the one time we forgot that and held on too long to products and ideas that were giving way to new ones, we nearly lost the whole ball game. That’s a lesson we will not forget.

Today, with e-business on demand, we are again redefining the value we bring to customers. It’s driving us to grow certain businesses aggressively—especially services and software—and to de-emphasize others, as we did in 2002. I have no doubt whatsoever that 15 or 20 years from now, we will be in a bunch of new and different businesses, because technology and customer problems will have marched on, hopefully with our company at the forefront. But we will still be IBM.

**THE PURPOSE OF A BUSINESS**

As you might guess by now, we have been doing a lot of thinking about what leadership means for IBM. To lead our industry, we must be the company to which our customers look to understand the future of IT and how it can help them create business value. But there are additional aspects of leadership that are also important aspirations for our company: as an investment, as an employer, as a member of the community.

Now, companies often say that being a great employer or a responsible citizen is as important to them as creating shareholder value or delighting customers or beating competitors. But they don’t elevate them as business priorities, to be managed with the same kind of investment and discipline—and competitive passion—that they apply to managing R&D, manufacturing and sales. We do.

Why? Because over time, failure to understand change in these realms can be as damaging as failure to stay abreast of markets or technology. Maybe more so. What do investors value? What will attract and motivate the best workforce in the world? What do communities—nations and neighbors—expect of companies? As with technology and customer requirements, these are all moving targets.

We believe investors, particularly those who invest in the technology sector, reward companies that adapt, that continually create and lead the high-value spaces—because that’s the only way to
up quite a bit of consulting capability. But we lacked a critical mass of business expertise to help our customers become on demand enterprises.

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In addition, an emerging technology called grid computing, built around another set of open specifications, allows the sharing and managing of separate computing resources as if they were one huge, virtual computer. This will dramatically increase utilization rates and give customers access to enormous computing capacity. Finally, IBM technologists are also pioneering ways to make IT systems “autonomic”—more self-managing and self-healing. This, too, is critical, as the increasing complexity of systems is making them unreasonably costly to manage and maintain.

3. Establishing utility computing—computing on demand—as a viable and attractive alternative for accessing and paying for IT. This effort has gotten a lot of attention. Yes, we intend to be a leader in utility computing services, so that customers can acquire computing and applications and pay only for what they use. IBM Global Services is already pioneering such services—server and storage capacity, as well as business processes like procurement and claims processing—for companies such as American Express, The Dow Chemical Company and Mobil Travel Guide. But we also want to equip and help customers to build their own internal utilities—software to manage and balance workloads, and server and storage systems to provide additional capacity on demand.

Clearly, the bet we’re placing on e-business on demand is a big one. And part of what makes it big is that it encompasses where both computing and business are headed. Driving both at the same time requires a lot of work, but it’s necessary, if you aspire to lead this industry.

IBM’s CENTER OF GRAVITY

Throughout IBM’s history, we have reinvented ourselves over and over again. The most visible manifestation of this has been how radically our product line has changed over time—from clocks and scales to tabulating machines, to mainframes, to Selectric typewriters, to everything we do today. How were we able to make those transitions without having a jarring identity crisis? It’s because we never defined ourselves as a clock and scale company, or a mainframe company, or a typewriter maker, even when we were the undisputed leader in those markets. We simply committed ourselves to being the leader in inventing state-of-the-art technology and helping customers apply it to solve their problems. When technology and the nature of customer problems change—we do, too.

As I said earlier, the one time we forgot that and held on too long to products and ideas that were giving way to new ones, we nearly lost the whole ball game. That’s a lesson we will not forget.

Today, with e-business on demand, we are again redefining the value we bring to customers. It’s driving us to grow certain businesses aggressively—especially services and software—and to de-emphasize others, as we did in 2002. I have no doubt whatsoever that 15 or 20 years from now, we will be in a bunch of new and different businesses, because technology and customer problems will have marched on, hopefully with our company at the forefront. But we will still be IBM.

THE PURPOSE OF A BUSINESS

As you might guess by now, we have been doing a lot of thinking about what leadership means for IBM. To lead our industry, we must be the company to which our customers look to understand the future of IT and how it can help them create business value. But there are additional aspects of leadership that are also important aspirations for our company: as an investment, as an employer, as a member of the community.

Now, companies often say that being a great employer or a responsible citizen is as important to them as creating shareholder value or delighting customers or beating competitors. But they don’t elevate them as business priorities, to be managed with the same kind of investment and discipline—and competitive passion—that they apply to managing R&D, manufacturing and sales. We do.

Why? Because over time, failure to understand change in these realms can be as damaging as failure to stay abreast of markets or technology. Maybe more so. What do investors value? What will attract and motivate the best workforce in the world? What do communities—nations and neighbors—expect of companies? As with technology and customer requirements, these are all moving targets.

We believe investors, particularly those who invest in the technology sector, reward companies that adapt, that continually create and lead the high-value spaces—because that’s the only way to
deliver consistent, long-term earnings growth in an industry that is constantly evolving. We believe investors reward companies that manage for the long haul, run highly efficient operations and are managed by experienced and disciplined leaders. And, at a time when industry growth projections are highly unreliable, investors reward companies that outperform their competitors—no matter the rate at which the industry is growing or contracting. This is why we have made marketshare a top priority.

I joined a company that was the place to work. It was progressive, fair and principled, and it invested in its people and their development. All of that stemmed from the commitment to have the best talent in the world, a commitment we reaffirm today. How you achieve that with programs and benefits depends on the times. As the composition of the workforce and their expectations changed, so did IBM, often far ahead of other companies or government mandates.

We know that employees today value flexibility and mobility, yet they want to feel part of a team, a community of colleagues. They value skill enhancement, but they want lifelong learning, not just classroom training. Most of all, while they are attracted to IBM’s breadth and global presence, they don’t want to get lost in a big company. They want to make a difference, have impact. All of this represents opportunities for us once again to innovate as an employer.

Finally, we need to adapt if we aspire to be a respected and engaged participant in our communities. This is more, far more, than philanthropy—although IBM takes a back seat to no one in contributions and volunteerism. (IBMers volunteered four million hours last year.) It’s about building relationships based on respect, trust and integrity—IBM’s bedrock values. And it’s about using our remarkable scientific, managerial and analytic assets—some of the best minds on the planet—to help local, national and international communities solve problems and stimulate economic growth.

Right now, we have as many questions as answers, and more a sense of where we must go as a company than a clear path to get there. Yet we believe these are all appropriate and worthy aspirations for IBM and IBMers. They are consistent with the kind of company we want to be and have been for most of our history. This is IBM’s DNA. The challenge, of course, is to bring the best of that forward without for a moment taking our eye off the customer, marketplace execution and strong results.

In the end, this goal of leadership, broadly defined, is what makes our company unique. It’s why people come to work at IBM—and why millions more have wanted to be associated with it. There are certainly many places where a person can earn a very good living and build a highly gratifying career. You come to a big, complex company like ours if you want to be a part of something whose impact is larger. And you come to this particular enterprise to be a part of something whose impact will last, a company that explores, a company that matters.

That was the company I joined 30 years ago. Yes, the world has changed, and there’s no going back. But my 316,000 colleagues welcome the challenge. We are determined to make IBM a truly great company—a great partner, investment and employer—for our generation and for our times.

Samuel J. Palmisano
Chairman, President and
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SAMUEL J. PALMISANO
Chairman, President and
Chief Executive Officer
Why customers will invest the *next trillion dollars* in information technology

This much is certain. It won’t be for the same reasons they invested the *last trillion*.

What’s driving customer strategies and spending today is the need to *integrate* processes, people, ideas and work to create wholly new kinds of business designs and business value.

Rather than talk about automation, efficiency or reengineering, they use a new set of terms to describe the kind of enterprise they want to build: a company that is *intuitive* in sensing and responding to change; *flexible* in terms of structuring costs and adapting processes; *focused* on the unique things that set it apart; and *resilient* in managing change and threats.

This is what IBM calls an on demand business, and yes, it requires lots of rock-solid technology. But in a fundamental departure for the IT industry, that’s not where the discussion starts now. It starts with a deep understanding of the customer’s industry, of business model design, and the nontrivial culture change that comes with this kind of transformation.

The technology companies that can lead their customers to these new ways of seeing and managing themselves will set the agenda for business and for the IT industry, and stand at the forefront of the next trillion dollars in IT spending. (And those that can’t, won’t.)

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**Industry Solutions**

IBM’s client teams are specialized in the competitive pressures and dynamics of 18 industries, from automotive and government, to life sciences and wholesale distribution.
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Business Consulting Services was RATED NUMBER ONE in Consulting Monitor’s survey for “understanding the client’s industry” in 2002

Nearly 60,000 PROFESSIONALS serving customers in 160 countries

Customers who are increasingly interested in focusing on core competencies are turning to strategic partners to manage and operate their IT infrastructures. In 2002, IBM was awarded 42 strategic outsourcing contracts exceeding $100 million each, and 5 contracts exceeding $1 billion.

In 2002, IBM won the LARGEST OUTSOURCING CONTRACT in its history. JPMorgan Chase will invest $5 billion over seven years to reduce operational costs, increase internal efficiencies, accelerate innovation, and improve its ability to respond to changing market conditions by using on demand technologies and services.

IBM is the leader in e-business hosting, with revenue equal to that of its three largest competitors combined.

20 PERCENT INCREASE in hosting revenue for 2002

500 NEW CUSTOMERS worldwide in 2002—350 were first-time IBM customers

IBM Global Financing

IBM Global Financing is the largest IT financier in the world, with an asset base of $38 billion. If it were a commercial bank, it would rank among the top 25 in the United States.

$35 BILLION in new financial agreements signed in 2002.

Of that total, $22 BILLION in commercial financing was provided primarily to business partners.

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Small and Medium Business Market and Business Partners

Small and medium businesses represent a $300 billion market opportunity that continues to grow faster than the rest of the industry. In 2002, IBM outperformed this sector globally.

- 50,000 business partners worldwide generate 50% of IBM's small and medium business sales
- IBM will invest $500 million in 2003 to help business partners generate demand and sales

Strategic Outsourcing

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E-commerce On Demand Hosting Services

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- 20 percent increase in hosting revenue for 2002
- 500 new customers worldwide in 2002—350 were first-time IBM customers

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- IBM will invest $500 million in 2003 to help business partners generate demand and sales

Revamping a customer’s IT infrastructure into an integrated, intuitive system is hard. But that's actually the easy part. Helping the business and human infrastructure learn how to sense and respond at the speed of the market... well, that takes a unique collection of business transformation skills and industry-specific experience.

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Why it’s time for a new computing model

Because the old approach is based on what technology can do, not on what business needs to do.

The existing computing model in most companies today has hard edges. It was built to drive the productivity and efficiency of a particular business process, or department, or functional unit. The benefits were substantial, but they were fragmented.

Here’s the problem: Businesses today need to respond in real time to whatever the day brings—a change in supply or demand, a shift in the preferences of buyers, students or citizens, the vagaries of capital markets or the aftermath of a natural disaster. And that requires an infrastructure that's different in concept and capability from anything that has come before it. It’s what we at IBM call the On Demand Operating Environment.

First, and most important, this new model is ultimately open and collaborative.

It shares resources—by allowing the computing assets within any individual enterprise, or across the networked systems of the world, to work together on common problems.

It masks technical complexity—by behaving a lot like the human autonomic nervous system, spontaneously performing functions like fending off attacks, balancing workloads, or isolating and repairing failing components.

And it creates variable options—by allowing customers to access and pay for computing just as they do with water or electricity.
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LIKE PRIOR COMPUTING ARCHITECTURES, the model that supports
on demand business is composed of individual systems, hardware,
software, components and platforms. None of that goes away.
Then again, in a way, it does.

Because what’s coming (thanks to open communications standards
and protocols) is the ability to integrate it all, mask the complexity, and
extract dramatically higher levels of learning, productivity and savings
from what customers already own, without forcing them to do what
they are doing today—spend about 40 percent of their IT investments
to make all the pieces work together.

Middleware Is the Integrating Platform
If the world of on demand business is premised on
open communications, it’s fueled by open software.
Applications that were written for standalone hardware
products and a particular computer operating system
now will be written for middleware—products such as
Web application server software, databases and software
for collaboration, content and systems management—
that transcend the limitations of proprietary systems
and organizational constructs.

DB2 GREW FASTER than the industry and
faster than its nearest competitor in 2002.
The WebSphere family of products
GREW MORE THAN 20%
Content management software revenue
INCREASED 16%

The Grid Gets Down to Business
In simplest terms, “grids” are systems that get
connected—across one room, or across the world—
creating one big virtual computer that shares processing,
storage and other operations. Most of the early work
has been in the far-flung supercomputing networks of
places like Oxford University, the University of
Pennsylvania and the National Science Foundation in
the United States. Corporations like Charles Schwab
have a different take. They’re looking inside—using
grids to boost the utilization of their complex
infrastructures, in order to lower their costs and to bring
the management and security of traditional mainframes
to masses of distributed UNIX and Intel-based systems.

IBM is working with The Globus Project and
the rest of the open grid community TO DELIVER
AN OPEN ARCHITECTURE that aligns
the emerging grid standards with
established standards for Web services.
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IBM is working with The Globus Project and the rest of the open grid community to deliver an open architecture that aligns the emerging grid standards with established standards for Web services.
In Storage, the Word Is ‘Software’

The value proposition in storage is no longer just hardware. The next big storage battle is the software that allows customers to plug into, and manage, all of their information as though it were in one place. “Virtualizing” the data will supercharge applications that rely on real-time information in everything from customer service to fraud detection. Later this year, new IBM storage software offerings will move intelligence that’s locked inside individual servers out across the storage network, where it can be available to all application servers.

A More Self-Reliant Model

Computers can no longer depend on human babysitters. To operate at on demand speeds, the systems themselves must take over functions that today require human management. That’s not a statement of what’s to come. IBM delivered broad-based autonomic capabilities in 2002.

Linux Breaks Out

In 2002, the open software environment called Linux—once famously labeled a “bathtub of code”—went primetime. Linux crossed into enterprise applications in industries from telecommunications to life sciences. Importantly, governments around the world embraced Linux and open computing for use in their own infrastructures and as catalysts for economic development. Today, more than 75 IBM government customers—including ministries and agencies in Germany, Australia, the United States and Japan—are using Linux to cut costs, increase efficiency and enact e-government transformations.

The New Idea in Small Systems

They call them “blades,” and not because they’re the bleeding edge of low-end server computing. Our blades deliver twice the density and superior management and integration to the world of rack-mounted systems—meaning customers can bring sanity and lower operational costs to infrastructure sprawl.
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Based on data through the first three quarters of 2002, IDC forecast IBM’s external storage share to grow 5.8%, while the market leader’s share was predicted to decline.

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Technology in IBM eServer iSeries

AUTOMATICALLY DETECTS INTRUSIONS, and deflects “denial of service” attacks that flood a system or website with meaning messages

Storage Manager from Tivoli has SELF-CONFIGURING, SELF-HEALING, SELF-DIAGNOSING and SELF-PROTECTING functions—from automated data protection to disaster recovery

HIGH-END SERVER TECHNOLOGIES “LEARN” drawn Internet traffic patterns or the ebb and flow of application use, and improve performance—in real time—across a diverse set of systems

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More than 15% of the IBM mainframe capacity shipped in 2002 was for Linux workloads

IBM is working with alliance partners such as LinuxWorks, Red Hat, SuSE, Nortel and Cisco towards the vision of an industry standard for blade servers

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Why high-tech isn’t for everyone
(but why it’s good that someone is doing it)

THE FACT IS, few IT companies have the imagination or the financial model to do much real scientific exploration. And that’s all well and good. There’s plenty of money to be made leveraging the innovations of others, and occupying commodity segments of the marketplace where low price is the most important criterion.

We’ve chosen to live at the other end of the spectrum—at the frontier of inquiry and game-changing innovation. This is where 3,000-plus IBM researchers probe mind-stretching problems such as the folding of proteins or the manipulation of atomic-scale structures. More and more, they also venture out of the lab to immerse themselves in the marketplace, working on grand challenges brought to them by our customers.

Over the past 10 years, we’ve steadily invested about $5 billion annually in research, development and engineering. We consider it the price of entry for those who want to play in the arena where world-altering discovery takes place.

Information Please
Why is it still so hard to find the information we need and use the information we have? One reason: its many flavors, from simple text to video, music, images, diagrams, 3D, digital and analog. One answer: “integrated information,” which would let us tap into all this structured and unstructured information without first converting it to a standard format, and analyze it without humans having to digest it first. We’d better hurry—more data will be generated over the next three years than in all of recorded history. More than 200 IBM researchers are on the case—making information discovery, synthesis and analysis (leading to genuine insight) more than a blue-sky ideal. Products are scheduled for release later this year.

Alfred Spector
Vice President
Services and Software Research

Andrew Tomkins
WebFountain Chief Scientist
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Sweating the Small Stuff

The quest is always to get more with less. More processing power, more storage, but less electrical power, running at lower temperatures and created at lower cost. So physicists probe the unimaginably small realms of nanotechnology—finding alternatives to traditional silicon and building the tools to work at the level of atomic structures, paving the way for capabilities that we can’t yet imagine. The potential size of silicon transistors was reduced by a factor of 10 in 2002, with the creation of a transistor measuring just six nanometers.

Imagine a high-density storage device capable of holding a trillion bits of information—the equivalent of 10 million textbook pages of data—so small that the size of a postage stamp. It’s code-named “MILLIPEDE” for its thousands of nano-size “feet” (or tips), used to punch single-bit indentations into plastic film.

What Is Life?

What began as a grand challenge for computer scientists will, when completed, have meaning for all humanity. And its pursuit has led IBM to a market that represents one of the fastest-growing segments of the global IT industry. When IBM launched a $100 million project to build a supercomputer to fathom the intricacies of protein folding in humans, we crossed the threshold of exploration into personalized medicines, more precise diagnoses and new insights into disease and prevention. Today, our life sciences business includes more than 1,800 employees—bioinformaticians, biologists, chemists and computer scientists. They’re forging partnerships with leading-edge organizations like Aventis, deCODE genetics, Celera Genomics and the Mayo Clinic to transform drug discovery and development, and deliver information-based medicine.

Making a Material Difference

Tiny is great—but at very small scales, “quantum” behavior takes over, degrading the reliability of some materials. Which only means that continued progress in computing depends on the discovery or creation of new materials better suited to molecular-level construction. Beyond increasing processor speed with innovations such as copper wiring or silicon germanium, we’ll need an array of organic and inorganic materials—many assembled an atom at a time—for their ability to “behave” predictably at the quantum level.

What happens when silicon transistors can’t get any tinier? IBM researchers think devices made from TINY CYLINDERS of CARBON ATOMS might be the answer. Carbon nanotubes are a chicken-wire-like mesh of carbon atoms rolled up into tubes about 50,000 times thinner than the average human hair—roughly 5 atoms across, but with five times the strength of steel.

Search This

Search engines are sadly lacking in insight and judgment. Getting beyond those limitations is the impetus for a new IBM technology called WebFountain. Using sophisticated analytical tools, it combs through billions of documents from the Web, news sources and a company’s own information stockpiles to uncover valuable business insights—insight human researchers would be hard pressed to piece together. It applies techniques like machine learning, probability theory and pattern recognition to the data, processing tens of thousands of documents per second.

‘Cells’ Multiply

IBM and Sony Computer Entertainment, Inc., in partnership with Toshiba, are at work on a breakthrough microprocessor architecture that puts broadband communications right on the chip. Just as the cells in a body unite to form complete physical systems, this “Cell” architecture will allow all kinds of electronic devices—from consumer products to supercomputers—to work together, signaling a new era in Internet entertainment, communications and collaboration.

In July 2002, IBM opened the world's MOST TECHNOLOGICALLY ADVANCED CHIP-MAKING FACILITY—the only one producing chips on 300mm (12-inch) silicon wafers, which feature IBM breakthroughs such as silicon-on-insulator transistors, copper wiring and low-k insulation.

Lab Meets World

On Demand Innovation Services, a new unit we formed in 2002, combines the talents of IBM Research with our Business Consulting Services experts to bring our researchers into a whole new type of “lab.” They’re working on some of our customers’ most pressing challenges, bringing those real-world problems back into the traditional lab to be solved with new technology. As our scientists spread their wings (and their impact) as consultants, On Demand Innovation Services will become a primary channel for bringing the fruits of our investment in research directly to our customers.

PEGGY KENNELLY
Vice President
On Demand Innovation Services

JOHN KELLY
Senior Vice President
Technology Group

KEN KUTARAGI
President and CEO
Sony Computer Entertainment, Inc.
Sweating the Small Stuff
The quest is always to get more with less. More processing power, more storage, but less electrical power, running at lower temperatures and created at lower cost. So physicists probe the unimaginably small realms of nanotechnology—finding alternatives to traditional silicon and building the tools to work at the level of atomic structures, paving the way for capabilities that we can’t yet imagine. The potential size of silicon transistors was reduced by a factor of 10 in 2002, with the creation of a transistor measuring just six nanometers.

Imagine a high-density storage device capable of holding a trillion bits of information—the equivalent of 15 billion (5 x 3,000) pages of data—so small that the size of a postage stamp. It’s code-named “MILLIPEDe,” for six thousands of nano-size “feet” or tips, used to punch single-bit indentations into plastic film.

What Is Life?
What began as a grand challenge for computer scientists will, when completed, have meaning for all humanity. And its pursuit has led IBM to a market that represents one of the fastest-growing segments of the global IT industry. When IBM launched a $100 million project to build a supercomputer to fathom the intricacies of protein folding in humans, we crossed the threshold of exploration into personalized medicines, more precise diagnoses and new insight into disease and prevention.

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Web conferences:
9,000 e-meetings
per month, avoiding
$50 million in cuts in 2002

ManagerJam:
In July 2002, more than
8,000 managers came together
in a GLOBAL
THREE-DAY INTRANET
EVENT to generate
and share ideas on the
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“I’ve worked in plenty of small
companies and know the advantages
and disadvantages. The cool thing
about today is that we have all the
benefits of being CAREFULLY CONNECTED—
like in a small company—but we also
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MARIA ARBUETO
Senior Manager, IBM Intranet

“T’d love this job even if we were
just working on behalf of
people with disabilities.
But since I believe every person,
at some stage in life, will develop
a disability or limitation, I take
a very broad view of why
TECHNOLOGY HAS TO BE
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Why
every big company
will want to be small

WE’RE LEARNING IT FIRSTHAND.
In an on demand business, you know your customers by their first
names, and your co-workers by theirs. Decisions get made fast. Every
action is based on trust and accountability. And every relationship is
built on a level of intimacy that compels the place and its people to act
as good neighbors, responsible citizens and trusted partners.

In effect, even the biggest business takes
in the attributes of being small.
Adopting attitudes and approaches
normally associated with “small”
becomes ever more important in a
world that is growing perceptibly less
personal, where businesses are subject
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So, whether the issue is business
efficiency, customer care or the broader
agendas of societal change and corporate
responsibility, we’ve always come at
them with equal measures of personal
involvement and management discipline.

Now, as we enter this new day and
confront its new challenges, we draw on
the experience and learning of the last
92 years. And we feel, more than ever,
the urgency of business matters, and of
being a business that matters.
we’re learning it firsthand.

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Why every big company will want to be small

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“Through our e-business transformation, we optimized our supply chain processes. Through our on demand transformation, we are linking those processes together. It’s making IBM faster, smarter, easier to do business with—and the savings enable us to protect profit margins, and make opportunistic acquisitions in the face of a soft market.”

ROB MOFFAT
Senior Vice President
Integrated Supply Chain

“This is more than incremental improvements. It is a fundamental change in how IBM operates. IBM’s on demand supply chain achieved $5.6 billion in cost reductions in 2002, with a target of $5 billion more in 2003.

Time between requisition and supplier order placement has gone from 2-3 weeks to 2 hours, allowing IBM to react faster to changes in market pricing.

Rated the technology industry’s number one supply chain by Supply Chain Technology News.

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“In addition to the savings and dramatic process improvements in how we interact with customers, suppliers, partners and employees, e-business on demand is really changing IBM at a deeper level. We’re replacing vertical silos with a fluid, ‘horizontal’ flow of information, knowledge and collaboration.”

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I trained to be an engineer, but I’ve always cared about the environment. When you imagine the sheer number of our products in use around the world, even small improvements in energy efficiency have a profound impact on energy consumption and the environment.”

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Director, Corporate Environmental Affairs and Engineering Center for Environmentally Conscious Products

“I remember that even as a little girl, I’d decided that being hard of hearing wasn’t going to hold me back. What I tell young people today is partly about me, partly about the company where I work and mainly that you can be anything you want to be.”

DEBORAH DOLGIN
Global Web Applications Availability Manager, IBM Global Services, and volunteer, IBM MentorPlace

“I met Tom Watson, Jr., some years after he retired, and asked him why he wrote what many believe is the first equal opportunity policy letter in 1954. He said that during negotiations with two Southern governors over new IBM facilities in their states, he made it clear there would be no ‘separate but equal’ racial policies at IBM. To make sure they knew he was serious, he wrote the letter to his management team and then made it public. That’s the legacy that we’re living, and extending, today.”

TED CHILDS
Vice President, Global Workforce Diversity

IBM became the first semiconductor manufacturer to set a voluntary climate protection goal for emissions reductions of perfluorocompounds—then beat the target, reducing PFC emissions by 40% relative to semiconductor product output since 1995.

In 2002, IBM recycled or recovered 97% of 38,000 metric tons of end-of-life IT products and product waste.

IBM’s environmental excellence was recognized with Top Honors in 2002 in Japan and the U.K.

Through the MentorPlace program more than 6,000 IBM volunteers provide academic assistance and career counseling to students in grades 3-12 in 13 countries—part of the 4 million hours IBM employees volunteered to community organizations in 2002.

Since 1993, IBM has invested $70 million in its Reinventing Education program, which will touch 100,000 teachers and 10 million students in 20 countries by the end of 2003.

Employees and retirees gave more than $30 million in more than 10,000 health and human services agencies through the Employee Charitable Contribution Campaign in 2002.

Working Mother Magazine in 2002 ranked IBM among the top 10 companies for working mothers for the 15th year in a row.

Over the last five years, the number of female executives in IBM has risen from 1,851 to 6,922.

For 12 of the last 14 years, the National Society of Black Engineers has voted IBM the company its members would most like to work for.
I trained to be an engineer, but I’ve always cared about the environment. When you imagine the sheer number of our products in use around the world, even small improvements in energy efficiency have a profound impact on energy consumption and the environment.”

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COMPANY MISSION At IBM, we strive to lead in the invention, development and manufacture of the industry's most advanced information technologies, including computer systems, software, storage systems and microelectronics.

We translate these advanced technologies into value for our customers through our professional solutions, services and consulting businesses worldwide.
Financial Report

Report of Management
Report of Independent Accountants
Management Discussion
Consolidated Financial Statements

Earnings
Financial Position
Stockholders' Equity
Cash Flows

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Accounting Changes
Acquisitions/Divestitures
Financial Instruments (excluding derivatives)
Inventories
Financing Receivables
Plant, Rental Machines and Other Property
Investments and Sundry Assets
Goodwill
Sale and Securitization of Receivables
Borrowings
Derivatives and Hedging Transactions
Other Liabilities
Stockholders' Equity Activity
Contingencies and Commitments
Taxes
Advertising and Promotional Expense
Research, Development and Engineering
2002 Actions
Earnings Per Share of Common Stock
Rental Expense and Lease Commitments
Stock-Based Compensation Plans
Retirement-Related Benefits
Segment Information
Subsequent Events

Five-Year Comparison of Selected Financial Data
Selected Quarterly Data
Stockholder Information
Board of Directors and Senior Executive Officers
Report of Management

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in conformity with generally accepted accounting principles, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. We believe this structure provides reasonable assurance that transactions are executed in accordance with management authorization, and that they are appropriately recorded in order to permit preparation of financial statements in conformity with generally accepted accounting principles and to adequately safeguard, verify and maintain accountability of assets. An important element of the control environment is an ongoing internal audit program.

To assure the effective administration of internal controls, we carefully select and train our employees, develop and disseminate written policies and procedures, provide appropriate communication channels, and foster an environment conducive to the effective functioning of controls. We believe that it is essential for the company to conduct its business affairs in accordance with the highest ethical standards, as set forth in the IBM Business Conduct Guidelines. These guidelines translated into numerous languages, are distributed to employees throughout the world, and reemphasized through internal programs to assure that they are understood and followed.

PricewaterhouseCoopers LLP, independent accountants, is retained to examine IBM’s financial statements. This accompanying report is based on an examination conducted in accordance with generally accepted auditing standards, including a review of the internal control structure and tests of accounting procedures and records.

The Audit Committee of the Board of Directors is composed solely of outside directors, and is responsible for recommending to the Board the independent accounting firm to be retained for the coming year, subject to stockholder approval. The Audit Committee meets periodically and privately with the independent accountants, with the company’s internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.

Samuel J. Palmisano
Chairman of the Board, President and Chief Executive Officer

John R. Joyce
Senior Vice President
Chief Financial Officer

Report of Independent Accountants

To the Stockholders and Board of Directors of International Business Machines Corporation:

In our opinion, based on our audits and the report of other auditors, the accompanying consolidated financial statements appearing on pages 64 through 104 present fairly, in all material respects, the financial position of International Business Machines Corporation and subsidiary companies as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP
New York, New York
January 16, 2003
except for note y, as in which the date is February 23, 2003

Management Discussion

Road Map

The financial section of the International Business Machines Corporation (IBM) 2002 Annual Report consisting of this Management Discussion, the Consolidated Financial Statements that follow and the related notes thereto comprises 64 pages of information. This Road Map is designed to provide you with some perspective regarding the information contained in the financial section and a few helpful hints for reading these 64 pages.

IBM’s Business Model

IBM’s business model is built to support two principal components: helping customers become more efficient and competitive through the use of information technology (IT) solutions; and providing long-term value to shareholders. In support of these objectives, the business model has been developed over time through strategic investments in services and technologies that have the best long-term growth and profitability prospects based on the value they deliver to customers.

The model is designed to allow for flexibility and periodic recalibration, as demonstrated in 2002 with the acquisition of PricewaterhouseCoopers Consulting (PwCC), the agreement to acquire Rational Software Corp. (Rational), and the divestiture of the company’s hard disk drive (HDD) business.

The company’s portfolio of capabilities ranges from services that include business transformation consulting to software, hardware, fundamental research, financing and the component technologies used to build larger systems.

In terms of financial performance, this breadth of capabilities generally results in less volatile returns, because each capability has unique financial attributes. Some involve contractual long-term cash and income streams while others involve cyclical transactional-based sales. Each performs differently in strong and weak economic environments.

In terms of marketplace performance — i.e., the ability to deliver customer value — it is important to understand that the fundamental strength of this business model is not found in the breadth of the portfolio alone, but in the way the company’s components work in harmony to create business solutions.

Transparency

Transparency is a primary goal of successful financial reporting. The following are additional improvements you will find in this year’s Annual Report.

- In the 2001 Annual Report, the company introduced a Road Map section that included a list of certain recurring and nonrecurring items. These items may contribute to or reduce earnings, sometimes in unpredictable or uncontrollable ways. This “Road Map table of expense items” was also used in the company’s 2002 quarterly earnings presentations.

For 2002, the following are examples of such items:

<table>
<thead>
<tr>
<th>Item Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher provision for bad debts</td>
<td>53</td>
</tr>
<tr>
<td>Lower goodwill expense</td>
<td>53</td>
</tr>
<tr>
<td>Lower intellectual property and custom development income</td>
<td>52</td>
</tr>
<tr>
<td>Lower foreign currency transaction gains</td>
<td>52</td>
</tr>
<tr>
<td>Lower net realized gains from certain real estate activities</td>
<td>52</td>
</tr>
<tr>
<td>Lower writedowns on certain equity investments</td>
<td>52</td>
</tr>
<tr>
<td>Lower net gains on sales of securities and other investments</td>
<td>52</td>
</tr>
<tr>
<td>Lower retirement-related plans income</td>
<td>52 and 53</td>
</tr>
</tbody>
</table>

It is management’s responsibility to deal with these events over time within the context of the company’s business model. It is, however, just as or more important to maintain a longer-term perspective and to consider income from continuing operations in the context of revenue and cash flow. A fundamentally sound and strong company should have strength in all three of these measures.

- The Results of Continuing Operations section of the Management Discussion from pages 44 to 51 is expanded to include a brief overview of the company’s and each segment’s business model and key success drivers. The goal is to enable the reader to understand the historical results as well as a new forward-looking section in the context of the business drivers.

- The Management Discussion contains a new separate section dedicated to the company’s Global Financing business on pages 60 through 65. This section includes a new forward-looking section in the context of the business drivers.

- In order to help readers of the Annual Report place IBM’s services accounting policies in the proper context, the description of IBM’s services revenue recognition accounting policies has been expanded in additional detail on page 70.

Helpful Hints

ORGANIZATION OF INFORMATION

- This Management Discussion section provides the reader of the financial statements with a narrative on the company’s financial results. It contains the results of operations for each segment of the business and is followed by a description of the company’s financial position as well as certain employee data. The new section dedicated to the company’s Global Financing business follows the employee data. It is useful to read the Management Discussion in conjunction with note x, “Segment Information,” on pages 100 to 104.

INTERNATIONAL BUSINESS MACHINES CORPORATION and Subsidiary Companies

40
INTERNATIONAL BUSINESS MACHINES CORPORATION and Subsidiary Companies

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January 16, 2003
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IBM’s business model is built to support two principal components: helping customers become more efficient and competitive through the use of information technology (IT) solutions; and providing long-term value to shareholders. In support of these objectives, the business model has been developed over time through strategic investments in services and technologies that have the best long-term growth and profitability prospects based on the value they deliver to customers.

The model is designed to allow for flexibility and periodic re-balancing, as demonstrated in 2002 with the acquisition of PriceWaterhouseCoopers Consulting (PwCC), the agreement to acquire Rational Software Corp. (Rational), and the divestiture of the company’s hard disk drive (HDD) business.

The company’s portfolio of capabilities ranges from services that include business transformation consulting to software, hardware, fundamental research, financing and the component technologies used to build larger systems.

In terms of financial performance, this breadth of capabilities generally results in less volatile returns, because each capability has unique financial attributes. Some involve contractual long-term cash and income streams while others involve cyclical transactional-based sales. Each performs differently in strong and weak economic environments.

In terms of marketplace performance — i.e., the ability to deliver customer value — it is important to understand that the fundamental strength of this business model is not found in the breadth of the portfolio alone, but in the way the company’s components work in harmony to create business solutions.

Transparency

Transparency is a primary goal of successful financial reporting. The following are additional improvements you will find in this year’s Annual Report.

• In the 2001 Annual Report, the company introduced a Road Map section that included a list of certain recurring and nonrecurring items. These items may contribute to or reduce earnings, sometimes in unpredictable or uncontrollable ways. This “Road Map table of expense items” was also used in the company’s 2002 quarterly earnings presentations.

For 2002, the following are examples of such items:

Page
Higher provision for bad debts 51
Lower goodwill expenses 51
Lower intellectual property and custom development income 52
Lower foreign currency transaction gains 52
Lower net realized gains from certain real estate activities 52
Lower writedowns on certain equity investments 52
Lower net gains on sales of securities and other investments 52
Lower retirement-related plan income 52 and 53

It is management’s responsibility to deal with these events over time within the context of the company’s business model. It is, however, just as or more important to maintain a longer-term perspective and to consider income from continuing operations in the context of revenue and cash flow. A fundamentally sound and strong company should have strength in all three of these measures.

• The Results of Continuing Operations section of the Management Discussion from pages 44 to 51 is expanded to include a brief overview of the company’s and each segment’s business model and key success drivers. The goal is to enable the reader to understand the historical results as well as a new forward-looking section in the context of the business drivers.

• The Management Discussion contains a new separate section dedicated to the company’s Global Financing business on pages 60 through 63. This section includes a discussion of the company’s Global Financing balance sheet.

• In order to help readers of the Annual Report place IBM’s services accounting policies in the proper context, the description of IBM’s services revenue recognition policies has been expanded in additional detail on page 70.

Helpful Hints

ORGANIZATION OF INFORMATION

• This Management Discussion section provides the reader of the financial statements with a narrative on the company’s financial results. It contains the results of operations for each segment of the business and is followed by a description of the company’s financial position as well as certain employee data. The new section dedicated to the company’s Global Financing business follows the employee data. It is useful to read the Management Discussion in conjunction with note X, “Segment Information,” on pages 100 to 104.

Report of Management

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with IBM management. The accompanying financial statements have been prepared in conformity with generally accepted accounting principles, applying certain estimates and judgments as required.

IBM maintains an effective internal control structure. It consists, in part, of organizational arrangements with clearly defined lines of responsibility and delegation of authority, and comprehensive systems and control procedures. We believe this structure provides reasonable assurance that transactions are executed in accordance with management authorization, and that they are appropriately recorded in order to permit preparation of financial statements in conformity with generally accepted accounting principles and to adequately safeguard, verify and maintain accountability of assets. An important element of the control environment is an ongoing internal audit program.

To assure the effective administration of internal controls, we carefully select and train our employees, develop and disseminate written policies and procedures, provide appropriate communication channels, and foster an environment conducive to the effective functioning of controls. We believe it is essential for the company to conduct its business affairs in accordance with the highest ethical standards, as set forth in the IBM Business Conduct Guidelines. These guidelines, translated into numerous languages, are distributed to employees throughout the world, and reemphasized through internal programs to assure that they are understood and followed.

PriceWaterhouseCoopers LLP, independent accountants, is retained to examine IBM’s financial statements. Its accompanying report is based on an examination conducted in accordance with generally accepted auditing standards, including a review of the internal control structure and tests of accounting procedures and records.

The Audit committee of the Board of Directors is composed solely of outside directors, and is responsible for recommending to the Board the independent accounting firm to be retained for the coming year, subject to stockholder approval. The Audit Committee meets periodically and privately with the independent accountants, with the company’s internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.

Samuel J. Palmisano
Chairman of the Board, President and Chief Executive Officer

John H. Joyce
Senior Vice President
Chief Financial Officer

PricewaterhouseCoopers LLP
New York, New York
January 14, 2003
except for note Y, as in which the date is February 23, 2003
**Results of Continuing Operations**

**Description of Business**

As mentioned in the "IBM's Business Model" section of the Road Map on page 43, IBM's strategy is to lead customers into a new era of business transformation and computing. The company calls this e-business on demand. An on demand business is an enterprise that has integrated its processes end-to-end inside the company and across its extended value chain. On demand businesses manage themselves as a far more integrated whole, meaning they are able to respond with flexibility and speed to customer demands, market opportunities or external threats. There are four key attributes of an on demand business:

- **Responsive**: On demand businesses seem to have the ability to sense and respond to dynamic, unpredictable changes in demand, supply, pricing, labor, competitor's moves, capital markets and the needs of all its constituencies—customers, partners, suppliers and employees.

- **Variable**: On demand businesses use variable cost structures and adapt proactively. This flexibility will enable them to reduce risk and do business at high levels of productivity, cost control, capital efficiency and financial predictability.

- **Focused**: On demand businesses concentrate on their core competencies and the things that set them apart in the marketplace. Businesses will forge tightly integrated partnerships and allow third parties to manage selected tasks such as manufacturing, logistics and fulfillment, or HR and financial operations.

- **Resilient**: On demand businesses manage change and threats—from the ebbs and flows of system usage to viruses or natural disasters—with consistent availability and security.

Key business drivers that will influence IBM’s future results are:

- the continued adoption of open technology standards;
- technology innovations; IBM’s internal business transformation and efficiency initiatives; and the external economic environment and corporate IT budgets.

**Open Technology Standards**

Open technology standards—"Open standards" is not a complex high technology catch phrase. The way we use electricity is a good example of an open standard. The outlets in each house and the electrical appliance. An example of closed standards would be if every television maker required you to buy a certain type of television, perhaps from the television maker itself. So if you wanted to switch television brands, you would also need to rewire your house's electricity. In many ways, this is how the technology industry is today. Many different software products do not run on certain hardware or are not compatible with other software. Certain hardware does not communicate with other hardware. Open standards will solve this situation.

The broad adoption of open standards is essential to the computing model for e-business on demand. Without the open standards that enable all manner of computing platforms to communicate and work with one another, the integration of any customer's internal systems, applications and processes remains a monumental and expensive task.

- **Technology innovations**: IBM has been moving away from commoditized segments of the IT industry and into areas in which it can differentiate itself through innovation, and by leveraging its investments in research and development (R&D). Examples include IBM's leadership position in the design and fabrication of Application Specific Integrated Circuits; work on designing smaller, faster and lower-power-consuming semiconductor devices (using such innovations as copper technology, silicon on insulator, silicon germanium and low-K dielectrics); work to design "autonomic" or self-managing computing systems and build the "grid" computing networks that allow computers to go beyond sharing communications and actually combine processing power; and the company's efforts to advance open technology standards such as Linux.

**Internal Business Transformation and Efficiency Initiatives**

A critical element of the company's strategy to improve shareholder value is improving productivity and efficiency. The company continues to execute on the following three ongoing initiatives.

1. **Internal implementation of the same business transformation activities that the company provides for its customers.** Over the past ten years, IBM's cost and expense infrastructure has been improved by numerous simplification and transformation efforts. The following are a few examples:

   - **Internal IT Infrastructure**—Internal MVS/VM host data centers reduced from 155 to 11.
   - **Customers**—More than 80 percent of sales to business partners are achieved through the Web. Suppliers—Number of electronically connected suppliers now exceeds 31,000.

2. **Outsourcing or process redesign of certain hardware manufacturing to lower-cost contract manufacturers in order to increase the variability of the company's manufacturing cost structure.** An example is the company's 2002 outsourcing of desktop personal computer manufacturing to Sanmina-SCI.

3. **Intense focus on improving employee and process productivity in order to drive a more efficient expense structure.**

**Economic Environment and Corporate IT Spending Budgets**

Although the diverse nature of IBM's capabilities somewhat mitigates the economic volatility of IBM's results, the company's financial performance is impacted by overall marketplace spending. Although IT spending is an important driver of IBM's financial results, a key objective is to outperform key competitors and gain market share during strong and weak economic environments.

**Historical Results** (dollars in millions except per share amounts)

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$81,186</td>
<td>$83,067</td>
</tr>
<tr>
<td>Cost</td>
<td>50,902</td>
<td>53,511</td>
</tr>
<tr>
<td>Gross profit</td>
<td>30,284</td>
<td>29,556</td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>57.3%</td>
<td>57.4%</td>
</tr>
<tr>
<td>Total expense and other income</td>
<td>22,760</td>
<td>20,419</td>
</tr>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>$7,524</td>
<td>$11,450</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$5,334</td>
<td>$7,874</td>
</tr>
</tbody>
</table>

Earnings per share of common stock from continuing operations:

- **Assuming dilution**: $3.07 4.59 4.32
- **Basic**: $3.11 4.69 4.45

The average number of common shares outstanding assuming dilution was lower by 40.3 million shares in 2002 versus 2001 and 40.9 million shares in 2001 versus 2000. Primarily as a result of the company's common share repurchase program. To the extent the company chooses to contribute additional funds to its pension plans in 2003, such actions may impact the amount of common shares that will be repurchased during the year. The decision to fund the pension plans will depend upon economic conditions, employee demographics, mortality rates and investment performance. The average number of common shares outstanding assuming dilution was 1,730.9 million, 1,771.2 million and 1,812.1 million in 2002, 2001 and 2000, respectively.

Revenue in 2002 totaled $81.2 billion, a decline of 2.3 percent (3 percent at constant currency) compared with revenue of $83.1 billion in 2001. This was primarily attributable to lower corporate spending on IT. Despite this decline, the company estimates that it is maintaining or gaining market share in most of its key business areas. Global Services and Software revenue grew year over year, but was more than offset by lower Hardware and Global Financing revenue.

**Notes**

- Pages 64 through 69 include the Consolidated Financial Statements and notes thereto. These financial reports provide an overview of the company's income and cash flow performance and its financial position.
- The notes follow the Consolidated Financial Statements. Among other things, the notes contain the company's accounting policies and other detailed information on specific items within the financial statements, certain contingencies and commitments (pages 88 and 89), and the results of each IBM segment (pages 100 to 104).
- **Discontinued Operations**: On December 31, 2002, the company sold its HDD business to Hitachi, Ltd. (Hitachi). The HDD business is being accounted for as a discontinued operation under generally accepted accounting principles (GAAP). This means that income statement and cash flow information were reclassified for all years presented to separate the divested business from the company's continuing operations. This presentation is required by GAAP and facilitates historical and future trend analysis of IBM's continuing operations. On page 80 the company discusses this transaction and the accounting for the divestiture.

**Forward-Looking and Cautionary Statements**

Certain statements contained in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to be materially different, as discussed more fully elsewhere in this Annual Report and in the company's filings with the Securities and Exchange Commission, including the company's 2002 Form 10-K filed on March 10, 2003.
and Subsidiary Companies

Focused:

Variable:

$7,524

$11,450

$11,411

$30,284

On demand businesses manage changes and

More than 80 percent of sales to business

$81,186

2002

Responsive:

Resilient:

IBM has been moving away from

Economic Environment and Corporate IT Spending Budgets —

$4.69

$4.45

$3.13

$5,334

Residual businesses seem to have the ability

On demand businesses manage changes and

to sense and respond to dynamic, unpredictable changes

3. Outsourcing or process redesign of certain hardware

management infrastructure to more easily absorb new

51,178

53,511

On demand businesses manage changes and

to communicate and work with one another, the

the open standards that enable all manner of computing

and facilitates historical and future trend analysis of IBM's

continuing operations. On page 80 the company discusses this

the technology industry is today. Many different

the computing infrastructure to more easily absorb new

standards because they benefit customers, because they

57.3%

37.4%

17.1%

Total expense and

other income

22,760

20,419

20,167

Income from continuing

operations before income
taxes

$7,524

$11,450

$13,411

Income from continuing

operations

$5,334

$8,146

$7,874

Earnings per share

of common stock from

continuing operations

Assuming dilution

$3.07

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$4.32

Basic

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$4.45

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dilution was lower by 40.3 million shares in 2002 versus 2001
and 40.9 million shares in 2001 versus 2000, primarily as a
result of the company's common share repurchase program.
To the extent the company chooses to contribute additional
funds to its pension plans in 2003, such actions may impact
the amount of common shares that will be repurchased during
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upon economic conditions, employee demographics, mortality
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common shares outstanding assuming dilution was 1,731.9
million, 1,771.2 million and 1,812.1 million in 2002, 2001
and 2000, respectively.
Revenue in 2002 totaled $81.2 billion, a decline of 2.3 per-
cent (3 percent at constant currency) compared with revenue
of $83.1 billion in 2001. This was primarily attributable to
lower corporate spending on IT. Despite this decline, the
company estimates that it is maintaining or gaining market
share in most of its key business areas. Global Services and
Software revenue grew year over year, but was more than
offset by lower Hardware and Global Financing revenue.

Historical Results (dollars in millions except per share amounts)

FOR THE YEAR ENDED DECEMBER 31:

2002

2001

2000

Revenue

$81,186

$83,106

$85,089

Cost

50,902

51,178

51,514

Gross profit

30,284

31,889

33,576

Gross profit margin

37.3%

37.4%

17.1%

Total expense and

other income

22,760

20,419

20,167

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Results of Continuing Operations

Description of Business

As mentioned in the “IBM’s Business Model” section of the
Road Map on page 43, IBM's strategy is to lead customers into
a new era of business transformation and computing. The company
calls this e-business on demand. On an demand business is an enterprise that has integrated its processes end-
to-end inside the company and across its extended value
chain. On demand businesses manage changes and

Employee —

Number of electronically connected

suppliers now exceeds 31,000.

Customers —

More than 80 percent of sales to business

partners are achieved through the Web.

Internal IT Infrastructure —

Internal VT Infrastructure — Internal MVS/VM host data

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cent (3 percent at constant currency) compared with revenue
of $83.1 billion in 2001. This was primarily attributable to
lower corporate spending on IT. Despite this decline, the
compensation that they use — are one way to build flexibility and

this is how the technology industry is today. Many different
software products do not run on certain hardware or are not
compatible with other software. Certain hardware
does not communicate with other hardware. Open stan-
dards will solve this situation.

The broad adoption of open standards is essential to
the computing model for e-business on demand. Without
the open standards that enable all manner of computing
platforms to communicate and work with one another, the
integration of any customer's internal systems, applica-
tions and processes remains a monumental and expensive

task. The broad-based acceptance of open standards—
rather than closed, proprietary architectures—also allows
the computing infrastructure to more easily absorb new
technical innovations. IBM is committed to fostering open
standards because they benefit customers, because they
are vital to the on demand computing model, and because their
acceptance will expand growth opportunities across the
entire IT industry.

For a discussion of the factors that could cause actual
results to be materially different, as discussed more fully
elsewhere in this Annual Report and in the company's filings with the Securities and Exchange
Commission, including the company's 2002 Form 10-K filed
on March 10, 2003.

DISCONTINUED OPERATIONS
On December 31, 2002, the company sold its HDD business to
Hitachi, Ltd. (Hitachi). The HDD business is being accounted for
as a discontinued operation under generally accepted accounting
principles (GAAP). This means that income state-
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presented to separate the divested business from the company
continuing operations. This presentation is required by GAAP
and facilitates historical and future trend analysis of IBM's
continuing operations. On page 80 the company discusses this
transaction and the accounting for the divestiture. 2002


customer's 2002 Form 10-K filed

as discussed more fully elsewhere in this Annual Report and

factors that could cause actual results to be materially different,

as discussed more fully elsewhere in this Annual Report and

factors that could cause actual results to be materially different,

as discussed more fully elsewhere in this Annual Report and
The following discussion is based on the Consolidated Financial Statements on pages 64 through 69, which reflect, in all material respects, the company’s segment results on an external basis. Additional financial information about each segment including the results of certain intercompany transactions is included in note X, “Segment Information,” on pages 103 to 104. The Global Financing results of operations are included in the new Global Financing section on pages 60 through 63.

Global Services

**Maintenance** is an important part of the company’s strategy of providing insight and solutions to customers. The application of technology is becoming increasingly critical to customers’ advantage in the marketplace. As a result, the value that customers place on IBM’s business insight and solutions is increasing. As the company continues to evolve, the expectation is that Global Services will play a larger role interfacing with IBM’s customers. Global Services comprises three main lines of business:

- **Strategic Outsourcing Services (S0)** provides customers with competitive cost advantages by outsourcing customers’ processes and operations.
- **Business Consulting Services (BCS), formerly Business Innovation Services**, delivers value to customers through business process innovation, business and integration services. The acquisition of PwCC greatly enhances IBM’s capabilities in these areas.
- **Integrated Technology Services (ITS) designs, implements, and maintains customers’ technology infrastructures.**

**HISTORICAL RESULTS**

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>FOR THE YEAR ENDED DECEMBER 31</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Services revenue</td>
<td>$36,560</td>
<td>$34,956</td>
<td>$31,172</td>
<td></td>
</tr>
<tr>
<td>Global Services cost</td>
<td>26,812</td>
<td>25,355</td>
<td>24,309</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>$ 9,748</td>
<td>$ 9,401</td>
<td>$ 6,863</td>
<td></td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>26.3%</td>
<td>27.5%</td>
<td>28.7%</td>
<td></td>
</tr>
</tbody>
</table>

Global Services revenue increased 4.6 percent (3 percent at constant currency) in 2002 over 2001 and 7.4 percent (10 percent at constant currency) in 2001 over 2000. The increase in 2002 resulted from the acquisition of PwCC on October 1, 2002 and growth in the SO Business. Global Services revenue, excluding maintenance, increased 4.5 percent (4 percent at constant currency) in 2002 versus 2001 and 6.8 percent (11 percent at constant currency) in 2001 versus 2000. Maintenance revenue improved 1.3 percent to $5,070 million (1 percent at constant currency) in 2002 versus 2001 and declined 2.2 percent (up 1 percent at constant currency) in 2001 when compared to 2000. SO revenue increased 2.4 percent to $18,995 million (2 percent at constant currency) in 2002 versus 2001. SO remains attractive to customers in both strong and weak economies.

SO revenue in 2001 increased versus 2000 primarily as a result of strength in growth in Asia Pacific.

BCS revenue increased 8.8 percent to $93,311 million (7 percent at constant currency) in 2002 versus 2001. The increase was due to the addition of PwCC results in the fourth quarter. BCS’s results, including PwCC would have declined year over year. BCS continues to be impacted by the industry pressure on consulting services. The integration of PwCC is on schedule. BCS revenue in 2001 increased versus 2000. The fourth quarter 2002 results of BCS, which include the PwCC business acquired from PricewaterhouseCoopers (PwC) on October 1, 2002, were not audited by PwC; instead, such results were audited by another Big 4 auditing firm.

ITS revenue, excluding maintenance, increased 5.1 percent to $6,593 million (4 percent in constant currency) in 2002 versus 2001. This revenue growth resulted from increases in the deployment of network hardware and communications services, business continuity services and OEM alliances. ITS revenue increased in 2001 versus 2000 in support of server consolidations, business continuity services and OEM alliances.

Global Services gross profit dollars decreased 0.6 percent in 2002 compared to 2001 and increased 8.6 percent in 2001 versus 2000. The gross profit margin decreased 1.2 points in 2002 versus 2001 and increased 0.8 points in 2001 versus 2000. The declines in gross profit dollars and gross profit margins in 2002 were attributable to market conditions, particularly in the Communications and Financial sectors, and continued weakness in the consulting and systems integration businesses. Transition costs were partially offset by improvements in gross profit for maintenance, driven by increased productivity and lower parts costs. The increases in both gross profit dollars and gross profit margin in 2001 versus 2000 followed primarily a result of increased productivity and lower parts costs across all geographies for maintenance offerings and cost reductions across all services offerings.

**GLOBAL SERVICES SIGNINGS**

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>FOR THE YEAR ENDED DECEMBER 31</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Longer-term*</td>
<td>$13,088</td>
<td>$12,016</td>
<td></td>
</tr>
<tr>
<td>Shorter-term*</td>
<td>20,020</td>
<td>19,261</td>
<td></td>
</tr>
<tr>
<td>Total*</td>
<td>$33,108</td>
<td>$31,277</td>
<td></td>
</tr>
</tbody>
</table>

* Longer-term are contracts generally 7 to 5 years in length and represent 90 contracts and three BCS contracts with the U.S. Federal Government and its agencies. Shorter-term are contracts generally 5 to 6 months in length and represent the remaining BCS contracts and ITS contracts.

In 2002, the company signed Global Services contracts totaling $13 billion as compared to $51 billion in 2001. Signings in 2002 included 42 contracts in excess of $100 million, five of which exceeded $1 billion, as well as $1.2 billion of new signings during the fourth quarter associated with the acquired PwCC business. The pace of signings accelerated in the fourth quarter of 2002. Contracts totaling $3.1 billion acquired as part of the PwCC acquisition are not included in the signings number. Instead, these contracts were added as an adjustment to backlog. Backlog estimates are subject to change and are affected by currency assumptions used in the company’s plans, changes in the scope of contracts—mainly long-term contracts—and periodic revalidations. After adjustments for changes in the scope of contracts, the estimated backlog including SO, BCS, ITS and maintenance was $112 billion at December 31, 2002, as compared to $102 billion at December 31, 2001.

**LOOKING FORWARD**

The addition of PwCC into IBM Global Services on October 1, 2002, will play a significant role in the company’s ability to help customers transform themselves into on demand businesses. As of the acquisition date, the company added about 10,000 professionals bringing with them industry-specific business transformation skills that can leverage existing IBM and business partner capabilities to deliver e-business on demand solutions.

**Hardware**

The company recently changed the names of its hardware segments, whereby Enterprise Systems is now the Systems Group and Personal and Printing Systems is now the Personal Systems Group.

**DESCRIPTION OF BUSINESS**

Systems Group

The Systems Group comprises eServer and Storage products. The eServer systems (Servers are based upon IBM operating systems (s0x and iSeries), as well as UNIX (iSeries) and the Microsoft Windows operating system (iSeries). All of these server lines have the capability to run large e-business systems. Data storage products include disk, tape and storage area networks included within the Storage brand. The Systems Group provides business solutions to customers. Approximately half of the Systems Group’s sales transactions are through business partners and approximately 40 percent direct to customers, slightly more than half of which are through the Web at ibm.com. In addition, while not directly reported as external revenue, hardware is also deployed internally in support of IBM Global Services offerings and contracts.

**PERSONAL SYSTEMS GROUP**

The Personal Systems Group includes the company’s lines of personal computers; printers and point-of-sale terminals. The personal computer business is characterized by a high degree of commoditization, short product life cycles, and intense price competition. Leaders in personal computers execute intense cost control and generate customer loyalty through the offering of differentiated features such as the company’s new ThinkVantage technologies, superior post-sale support, and maintenance.
In the Americas, full-year 2002 revenue was $36,423 million, down 2.7 percent (3 percent at constant currency) from the 2001 period. Revenue from Europe/Middle East/Africa was $24,260 million, an increase of 1.1 percent (down 4 percent at current currency). Asia Pacific revenue declined 0.5 percent (flat at constant currency). OEM alliances.

Global Services (SO) revenue increased 2.4 percent to $14,995 million (2 percent at constant currency) in 2002 versus 2001. The gross profit margin was 32 percent (33 percent at constant currency) in 2002 versus 2001. The overall gross profit margin of 37.3 percent decreased 1.1 points from 2001, following a 1.3 point increase in 2001 versus 2000. This decrease in 2002 gross profit margin was primarily driven by lower gross profit in Global Services and Hardware, partially offset by improved gross profit margins in Software and Global Financing. The increase in 2001 gross profit margin was primarily driven by improvement in Global Services, Hardware, Software and Global Financing gross profit margins.

Total expense and other income increased primarily due to the company's special actions associated with its Microelectronics Division, productivity initiatives, and the PwCC acquisition. The provision for bad debts also increased in 2002. These increases were offset by lower advertising expense, the elimination of goodwill amortization and con- tinued ongoing business transformation and efficiency initiatives as described on pages 50 and 51. Looking Forward

The outlook for 2003 is dependent upon the following key factors, among others:

• The market for IT products and services and the company's ability to gain market share
• The acceptance of open standards such as Linux
• The ability to continue converting the company's technology leadership into product and services leadership
• The transformation of IBM's business into an on demand business and the streamlining and cost reduction initiatives associated with the company's Integrated Supply Chain

The following discussion is based on the Comparted Financial Statements on pages 64 through 69, which reflect, in all material respects, the company's segment results on an external basis. Additional financial information about each segment including the results of certain intercompany transactions is included in note 8. “Segment Information.” on pages 100 to 104. The Global Financing results of operations are included in the new Global Financing section on pages 60 through 61.

Global Services DESCRIPTION OF BUSINESS

Global Services is an important part of the company's strategy of providing insight and solutions to customers. The application of technology is becoming increasingly critical to customers’ advantage in the marketplace. As a result, the value that customers place on IBM's business insight and solutions is increasing. As the company continues to evolve, the expectation is that Global Services will play a larger role interfacing with IBM's customers. Global Services comprises three main lines of business:

• Strategic Outsourcing Services (SO) provides customers with competitive cost advantages by outsourcing customers' processes and operations.
• Business Consulting Services (BCS), formerly Business Innovation Services, delivers value to customers through business process innovation, outage management and integration services. The acquisition of PwCC greatly enhances IBM's capabilities in these areas.
• Integrated Technology Services (ITS) designs, implements, and maintains customers' technology infrastructures.

HISTORICAL RESULTS

The following discussion is based on the Consolidated Financial Statements on pages 64 through 69, which reflect, in all material respects, the company's segment results on an external basis. Additional financial information about each segment including the results of certain intercompany transactions is included in note 8. “Segment Information.” on pages 100 to 104. The Global Financing results of operations are included in the new Global Financing section on pages 60 through 61.

Global Services description of business

Global Services

for the year ended December 31:

$ in millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Global Services revenue</th>
<th>Global Services cost</th>
<th>Gross profit</th>
<th>Gross profit margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>36,360</td>
<td>26,812</td>
<td>9,548</td>
<td>26.3%</td>
</tr>
<tr>
<td>2002</td>
<td>34,956</td>
<td>24,309</td>
<td>10,647</td>
<td>30.7%</td>
</tr>
</tbody>
</table>

Global Services revenue increased 4.0 percent (3 percent at constant currency) in 2002 over 2001 and 7.4 percent (10 percent at constant currency) in 2001 over 2000. The increase in 2002 resulted from the acquisition of PwCC on October 1, 2001 and growth in the SO Business. Global Services revenue, excluding maintenance, increased 4.5 percent (4 percent at constant currency) in 2002 versus 2001 and 6.8 percent (1 percent at constant currency) in 2001 versus 2000. Maintenance revenue improved 1.3 percent to $5,070 million (1 percent at constant currency) in 2002 versus 2001 and declined 2.2 percent (up 1 percent at constant currency) in 2001 when compared to 2000. SO revenue increased 2.4 percent to $14,995 million (2 percent at constant currency) in 2002 versus 2001. SO remains attractive to customers in both strong and weak economies.

SO revenue in 2001 increased versus 2000 primarily as a result of strong growth in Asia Pacific. BCS revenue increased 8.8 percent to $9,131 million (7 percent at constant currency) in 2002 versus 2001. The increase was due to the addition of PwCC results in the fourth quarter. BCS was included in SO in 2002. However, PwCC, which would have declined year over year. BCS continues to be impacted by the industry pressure on consulting services. The integration of PwCC is on sched- ule. BCS revenue in 2001 increased versus 2000. The fourth quarter of 2002 results of BCS, which include the PwCC business acquired from PricewaterhouseCoopers (PwC) on October 1, 2002, were not audited by PwC; instead, such results were audited by another Big 4 auditing firm. ITS revenue, excluding maintenance, increased 5.1 percent to $6,593 million (4 percent in constant currency) in 2002 versus 2001. This revenue growth resulted from increased revenue in the deployment of network hardware and commu- nication services, business continuity services and OEM alliances. ITS revenue increased in 2001 versus 2000 in sup- port of server consolidations, business continuity services and OEM alliances.

Global Services gross profit dollars decreased 0.6 percent in 2002 compared to 2001 and increased 8.6 percent in 2001 versus 2000. The gross profit margin decreased 1.2 points in 2002 versus 2001 and increased 0.8 points in 2001 versus 2000. The changes in both gross profit dollars and gross profit margins in 2002 were attributable to market conditions, par- ticularly in the Communications and Financial sectors, and continued weakness in the consulting and systems integration business. The declines were partially offset by improve- ments in gross profit for maintenance, driven by increased productivity and lower parts costs. The increases in both gross profit dollars and gross profit margin in 2001 versus 2000 were primarily a result of increased productivity and lower parts costs across all geographies for maintenance offerings and cost reductions across all services offerings.

GLOBAL SERVICES SIGNINGS

$d in millions

for the year ended December 31:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total*</th>
<th>Longer-term*</th>
<th>Shorter-term*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$3,088</td>
<td>$1,216</td>
<td>20,028</td>
</tr>
<tr>
<td>2002</td>
<td>$3,088</td>
<td>$1,217</td>
<td>19,261</td>
</tr>
</tbody>
</table>

* Longer-term contracts generally 7 to 9 years in length and represent 50 contracts and those BCS contracts with the U.S. Federal Government and its agencies. Shorter-term are contracts generally 6 to 9 months in length and represent the remaining BCS contracts and ITS contracts.

In 2002, the company signed Global Services contracts total- ing $31 billion as compared to $31 billion in 2001. Signings in 2002 included 42 contracts in excess of $100 million, five of which exceeded $1 billion, as well as $1.2 billion of new signings during the fourth quarter associated with the acquired PwCC business. The pace of signings accelerated in the fourth quarter of 2002. Contracts totaling $3.1 billion acquired as part of the PwCC acquisition are not included in the signings number. Instead, these contracts were added as an adjustment to backlog. Backlog estimates are subject to change and are affected by currency assumptions used in the company's plans, changes in the scope of contracts—mainly long-term contracts—and periodic revaluations. After adjustments for changes in the scope of contracts, the esti- mated backlog including SO, BCS, ITS and maintenance was $112 billion at December 31, 2002, as compared to $102 bil- lion at December 31, 2001.

Looking Forward

The addition of PwCC into IBM Global Services on October 1, 2002, will play a significant role in the company's ability to help customers transform themselves into on demand busi- nesses. As of the acquisition date, the company added about 10,000 professionals bringing with them industry-specific business transformation skills that can leverage existing IBM and business partner capabilities to deliver e-business on demand solutions.

Hardware

The company recently changed the names of its hardware seg- ments, whereby Enterprise Systems is now the Systems Group and Personal and Printing Systems is now the Personal Systems Group.

DESCRIPTION OF BUSINESS Systems Group

The Systems Group comprises eServer and Storage products. eServers are based upon IBM operating systems (iSeries and iSeries), as well as UNIX (iSeries) and the Microsoft Windows operating system (xSeries). All of these server lines have the capability to run multiple operating systems. Data storage products include disk, tape and storage area net- works included with the Storage brand. The Systems Group provides business solutions to cus- tomers. Approximately half of the Systems Group's sales transac- tions are through business partners and approximately 40 percent direct to customers, slightly more than half of which are through the Web at ibm.com. In addition, while appropriately not reported as external revenue, hardware is also deployed internally in support of IBM Global Services offerings and contracts.

Personal Systems Group

The Personal Systems Group includes the company's lines of personal computers, printers and point-of-sale terminals. The personal computer business is characterized by a high degree of commoditization, short product life cycles, and intense price competition. Leaders in personal computers execute intense cost control and generate customer loyalty through the offering of differentiation from companies such as the company's new ThinkVantage technologies, superior post- sale support, and maintenance.
Technology Group
The Technology Group, primarily consisting of the Microelectronics Division, provides leading semiconductor technology, packaging solutions and engineering technology services to OEM customers and, although appropriately not reported as external revenue, to the Systems Group. The Microelectronics Division develops and manufactures products for three in several general categories:

- Application Specific Integrated Circuits — The company manufactures and tests custom semiconductor products for customers. The customers design these custom products following a set of design standards developed by IBM, and then deliver them to IBM for fabrication and assembly by 3rd party manufacturers.
- Foundry — Semiconductors products provide IBM with its custom designs based primarily on IBM’s Power PC platform. IBM uses these custom designs to fabricate and assemble its products for customers. IBM also provides these products to other companies for use in its own products.
- Microelectronics — The company’s microelectronics business provides leading semiconductor technology, packaging solutions and engineering technology services to OEM customers and, although appropriately not reported as external revenue, to the Systems Group.

Historical Results

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hardware revenue</td>
<td>$27,466</td>
<td>$30,939</td>
<td>$34,470</td>
</tr>
<tr>
<td>Hardware cost</td>
<td>20,620</td>
<td>22,231</td>
<td>24,207</td>
</tr>
<tr>
<td>Gross profit</td>
<td>6,846</td>
<td>8,708</td>
<td>10,263</td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>27.1%</td>
<td>30.6%</td>
<td>29.8%</td>
</tr>
</tbody>
</table>

Hardware revenue declined 10.1 percent (11 percent at constant currency) in 2002 from $30,939 million in 2001, following a decrease of 11.2 percent (8 percent at constant currency) in 2001 compared with 2000. In 2002, Systems Group revenue declined 8.0 percent (10 percent at constant currency) to $12,598 million from 2001, following a decrease of 0.6 percent (2 percent at constant currency) in 2001 compared with 2000.

Revenue from the majority of the Systems Group products was affected by the continuing weak IT spending during 2002. iSeries revenue declined in 2002 following an increase in 2001. Total deliveries of iSeries computing power increased approximately 6 percent as measured in MIPS (millions of instructions per second) versus 2001, while the price per MIPS continued to decline from 2000 to 2002. Revenue from pSeries UNIX servers decreased in 2002 versus 2001 due to the sevenday low in the semiconductor industry in 2001. Hardware gross profit dollars decreased 20.6 percent in 2002 from 2001, following an 8.8 percent decrease in 2001 versus 2000. The hardware gross profit margin decreased 1.0 points in 2002 from 2001, following an increase of 0.1 points in 2001 versus 2000. The revenue in 2002 resulted from lower revenue associated with iSeries, zSeries and pSeries and storage products, which more than offset the benefits from hardware manufacturing infrastructure cost reductions. The decline in gross profit dollars in 2002 was primarily due to lower volumes in the company’s Technology Group and pressures in pricing in personal computers.

The increase in 2001 gross profit margin was primarily driven by a shift toward servers selling at lower gross profit margin products, such as personal computers.

Looking Forward
- The key product lines recently announced product refreshes. As discussed on page 48, the company experienced strong demand for its new products.
- Indications are that Linux is gaining additional support and popularity and is recognized as an open standard operating system. Linux servers are competitive with IBM.
- The new Engineering and Technology Services Division is bringing entirely new value offerings to a broader customer base than traditionally associated with the Technology Group. These new offerings have the potential to generate more stable financial returns with characteristics similar to a services business.
- Autonomic computing is a key competitive differentiator for the company.
- The company outsourced its desktop manufacturing in January 2002 and recently announced an agreement to outsource the manufacturing of a significant portion of its mid-range and mid-maximum servers and to outsource certain mobile PC configurations to be effective in 2003. The outsourcing initiatives will increase the company’s responsiveness to changes in demand. Initiatives along with internal initiatives to streamline the company’s integrated supply chain have yielded, and will continue to yield, additional cost savings.

Software

Software and Services

The company announced a major refresh of its iSeries midrange product line that allows customers to buy and pay for only the computing capacity they need.

- Indications are that Linux is gaining additional support and popularity and is recognized as an open standard operating system. IBM ships systems with Linux and other open source software.
- The new Engineering and Technology Services Division is bringing entirely new value offerings to a broader customer base than traditionally associated with the Technology Group. These new offerings have the potential to generate more stable financial returns with characteristics similar to a services business.
- Autonomic computing is a key competitive differentiator for the company.
- The company outsourced its desktop manufacturing in January 2002 and recently announced an agreement to outsource the manufacturing of a significant portion of its mid-range and mid-maximum servers and to outsource certain mobile PC configurations to be effective in 2003. The outsourcing initiatives will increase the company’s responsiveness to changes in demand. Initiatives along with internal initiatives to streamline the company’s integrated supply chain have yielded, and will continue to yield, additional cost savings.

Software

Software sales include direct to end users (70 percent) and business partners (21 percent). The remainder, while appropriately not reported as external revenue, is deployed internally in support of Global Services offerings and contracts. Approximately 40 percent of software revenue relates to one-time charge (OTC) arrangements whereby the customer pays one up-front payment for a lifetime license. Typically, arrangements for the sale of OTC software include one-year maintenance. The customer can also purchase ongoing support and updates after the first year, which includes product upgrades and technical support. The remaining software is sold on a monthly license charge arrangement.

Historical Results

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software revenue</td>
<td>$13,074</td>
<td>$13,939</td>
<td>$12,598</td>
</tr>
<tr>
<td>Software cost</td>
<td>2,043</td>
<td>2,265</td>
<td>2,283</td>
</tr>
<tr>
<td>Gross profit</td>
<td>11,031</td>
<td>$10,674</td>
<td>$10,315</td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>84.4%</td>
<td>82.5%</td>
<td>81.9%</td>
</tr>
</tbody>
</table>

Software revenue increased 1.0 percent (flat at constant currency) in 2002, following an increase of 2.7 percent (percent at constant currency) in 2001 from 2000. The software market remained challenged in 2002. The company noted two trends driving this challenging market. First, customers were spending more time on the selection process for software solutions. Second, customers were more inclined to negotiate smaller software arrangements, which are perceived to provide a faster return on investment. The company’s continued focus on customer base expansion, including mid-sized customers, offset these two trends. Despite the difficult software environment, the company believes it continued to gain share in key markets.

The company’s middleware products revenue grew 4 percent (3 percent at constant currency) to $10,315 million in 2002 and increased 5 percent (9 percent at constant currency) in 2002 versus 2000. Middleware revenue increased in 2002 were driven by growth in data management software, WebSphere and Tivoli, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months. Revenue for middleware software and WebSphere.
Revenue from iSeries products was driven by growth in 2002 and 2001.

Looking forward:
- Tech 2002 product lines recently announced product refreshes. As discussed on page 48, the company experienced strong demand for its new pSeries products announcement in November. In January 2003, the company announced a major refresh of its xSeries midrange product line that allows customers to buy and pay for only the computing capacity they need.
- Indications are that Linux is gaining additional support and popularity and is recognized as an open standard operating system. Systems Group servers are compatible with Linux.
- The new Engineering and Technology Services Division is bringing entirely new value offerings to a broader customer base than traditionally associated with the Technology Group. These new offers have the potential to generate more stable financial returns with characteristics similar to a services business.
- Autonomic computing is a key competitive differentiator for the company.
- The company outsourced its desktop manufacturing in January 2002 and recently announced an agreement to outsource the manufacturing of a significant portion of its midrange xSeries servers and to outsource certain mobile PC configuration processes to be effective in 2003. The outsourcing initiatives will increase the company's responsiveness to changes in demand. These initiatives along with internal initiatives to streamline the company's integrated supply chain will have yielded, and will continue to yield, additional cost savings.


The Software Group no longer includes HDDs and Complementary Metal-Oxide-Semiconductor (CMOS) customers.

The decline in gross profit dollars in 2001 was primarily due to lower volumes in the company’s Technology Group and pricing pressures in personal computers.

The increase in 2001 gross profit margin was primarily driven by a shift from the pSeries server product’s lower gross profit margin products, such as personal computers.

The company’s middleware products revenue grew 4 percent (3 percent at constant currency) to $10.4 billion in 2002 and increased 3 percent (9 percent at constant currency) in 2001 versus 2000. Middleware revenue increases in 2002 were driven by growth in data management software, WebSphere and Tivoli, partially offset by revenue declines in Lotus. The increase in 2001 resulted from strong growth in twelve months in management software and WebSphere, partially offset by revenue declines in Tivoli and Lotus. Revenue from the acquisition of the Informix database business in July 2001 contributed approximately 60 percent of the middleware software growth in 2002 and 2001.

Operating systems software revenue declined 1 percent (4 percent at constant currency) to $2.169 billion in 2002 versus 2001 and declined 3 percent (up 1 percent at constant currency) in 2001 compared with the prior year. The decline in 2002 resulted from lower revenue associated with xSeries, iSeries and pSeries offerings. The decline in 2001 resulted from lower revenue associated with iSeries and pSeries server products.

Software gross profit dollars increased 3.3 percent in 2002 from 2001, following an increase of 3.5 percent in 2001 from 2000. The Software gross profit margin improved 1.9 points in 2002 following an increase of 0.6 points in 2001 compared to 2000. Lower support and services costs contributed to the increases. In addition, the company continues to leverage productivity initiatives such as shared component development.
The company develops software building blocks that may be used in multiple products to satisfy a wide range of customer needs. This has led to efficiencies, cost savings in the production of code, and improved time to market with new offerings. The increase in gross profit dollars and gross profit margin in 2001 versus 2000 was primarily due to higher Software revenue, lower service costs and purchased vendor software, partially offset by higher amortization costs and vendor royalty payments.

**Looking forward**

The company purchased Rational on February 21, 2003 for approximately $2.1 billion in cash. Rational provides software tools that allow users to effectively capture and analyze requirements to create designs for software applications, test applications, and manage the software development process. Rational’s software development tools can be used to develop and upgrade any other company’s software products. Accordingly, this acquisition is a critical part of IBM’s open standard strategy. Rational’s revenue for the fiscal year ended March 31, 2002 was $487 million.

Major IBM customers are embracing the Linux operating system. Prior to open standard operating systems, a customer may have been more likely to purchase middleware from the software vendor that owns and sells the proprietary operating system used by that customer. An open standard operating system gives customers another reason to consider IBM middleware.

**Enterprise Investments/Other**

**Description of business**

The Enterprise Investments segment develops and provides industry-specific information technology solutions supporting the Hardware, Software and Global Services segments of the company. Primary product lines include product life cycle management software and document processing technologies. Product life cycle management software primarily serves the industrial sector and helps customers manage the development and manufacturing of their products. Document processing products service the financial sector and include products that enable electronic banking.

**Historical Results**

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise Investments/ Other</td>
<td>$1,153</td>
<td>$1,404</td>
<td>$18,738</td>
</tr>
<tr>
<td>Other cost</td>
<td>$453</td>
<td>$453</td>
<td>$453</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$697</td>
<td>$644</td>
<td>$727</td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>42.6%</td>
<td>41.0%</td>
<td>40.6%</td>
</tr>
</tbody>
</table>

**Expense and Other Income**

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling, general and administrative</td>
<td>$18,738</td>
<td>$17,048</td>
<td>$17,193</td>
</tr>
<tr>
<td>Percentage of revenue</td>
<td>23.1%</td>
<td>20.5%</td>
<td>20.4%</td>
</tr>
<tr>
<td>Research, development and engineering</td>
<td>4,701</td>
<td>4,986</td>
<td>5,084</td>
</tr>
<tr>
<td>Percentage of revenue</td>
<td>5.9%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Intellectual property and development income</td>
<td>(1,100)</td>
<td>(1,476)</td>
<td>(1,664)</td>
</tr>
<tr>
<td>Other (income) and expense</td>
<td>227</td>
<td>(151)</td>
<td>(90)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>149</td>
<td>234</td>
<td>344</td>
</tr>
<tr>
<td>Total expense and other income</td>
<td>$22,760</td>
<td>$20,439</td>
<td>$20,167</td>
</tr>
</tbody>
</table>

**Selling, General and Administrative Expense**

**Historical Results**

Total Selling, general and administrative (SG&A) expense increased 9.9 percent (9 percent at constant currency) in 2002 versus 2001, following a decrease of 2.0 percent (flat at constant currency) in 2001 compared with 2000. The increase in 2002 was due to actions taken in the second quarter and fourth quarter of 2002 totaling $1,469 million. See note 9, “2002 Actions,” on pages 90 through 92 for additional details regarding these actions.

**PwCC acquisition-related costs of $292 million were incurred in 2002 and included the PwCC compensation costs discussed on page 78. These costs relate to the acquired PwCC business that are of a nonrecurring nature and also contributed to the increase in SG&A.**

**Workforce reductions, which are the ongoing reductions and rebalancing that occur each quarter, were $300 million in 2002, $285 million in 2001 and $167 million in 2000.**

**The 2002 amount excludes workforce reductions that took place in the 2002 second quarter. These 2002-second quarter workforce reductions were recorded in the second-quarter actions amount disclosed in note 9, “2002 Actions,” on pages 90 through 92 and included in the 2002 actions amount mentioned on page 50. The annual increases in workforce reductions are attributable to the difficult economic environment during 2001 and 2002, as well as the company’s rebalancing of the workforce for shifts in required skills.**

Advertising and promotional expense was $1,427 million in 2002, a decline of $188 million from 2001 following a decline of $127 million in 2001 versus 2000. The declines from 2000 to 2002 are primarily due to a strategic initiative to consolidate and centralize certain advertising at the corporate level in order to gain additional efficiencies. The decreases in 2002 were primarily in spending associated with direct response advertising, business partner programs and customer sales events. The decline in 2001 was primarily driven by lower spending on brand advertising and promotional spending.

The provision for bad debt expense in 2002, 2001 and 2000 was $671 million, $490 million and $270 million, respectively. The increases were related primarily to the company’s Global Financing receivables portfolio and were the result of the weakening economy and exposures in the Communications sector. See page 62 for further information about the company’s financing receivables.

As described in “Standards Implemented,” on pages 75 and 76, the company adopted new accounting rules that eliminate the amortization of goodwill starting January 1, 2002. Page 76 includes income and earnings per share amounts that are adjusted to present comparative amounts as if the new goodwill rules were in place prior to 2002. Goodwill expense, net of tax, was $262 million in 2001 and $146 million in 2000. The remaining base SG&A expense includes all the other expenses that are not separately discussed above and amounted to $14,357 million, $14,396 million and $14,778 million in 2002, 2001 and 2000, respectively. The increase in 2002 was solely due to the acquired PwCC business. Base SG&A expense reductions, excluding the impact of PwCC, were primarily due to the company’s business transformation and efficiency initiatives as well as concentrated and focused control of day-to-day discretionary spending.

**Looking forward**

The company will continue to execute on its business transformation and efficiency initiatives.

The second quarter 2002 actions are estimated to reduce cost and expense by at least an incremental $900 million, pre-tax, in 2003 as compared to 2002. Approximately half of these incremental cost and expense reductions are estimated to benefit Global Services, approximately 25 percent for the Technology Group and approximately 20 percent for the Systems Group.

The future level of provision for bad debts will depend upon economic conditions and the health of each sector in which the company has a concentration of financing receivables. Refer to pages 61 to 65 for additional information about the company’s financing receivables.

**Research, Development and Engineering**

**Description**

Once again, the company had more patents awarded in the United States in 2002 than any other company. This marks the 10th year in a row that IBM achieved this distinction. Being the leader in patents contributes to IBM’s ability to gain market share in key areas. Recent significant achievements and initiatives that have given IBM an edge in the marketplace include autonomic (self-healing) computing capabilities and copper chip and silicon-on-insulator technology, and the ongoing support of the open standard Linux operating system. Another significant benefit of being the leader in patents is the ability to generate income through sales of IP and custom development arrangements. The level of R&D spending is determined based upon IBM’s projections of future customer technology needs and areas offering significant long-term growth opportunities for shareholders.

**Historical Results**

Research, development and engineering (RD&E) expense declined 4.7 percent in 2002 from 2001, following a decrease of 1.9 percent in 2001 from 2000. The declines in 2002 and 2001 were a result of actions taken to improve productivity. In addition, the company reprioritized its spending to increase its investment in high-growth opportunities such as e-business, initiatives to support Linux, middleware software products, autonomic computing and e-business on demand.

**Looking forward**

In November 2002, the company announced On Demand Innovation Services, a new services arm located in its Research Division, which provides customers access to a discrete team of researchers who specialize in high-end business transformation and technology consulting. The new organization will be staffed with up to 200 IBM Research consultants worldwide.
The company develops software building blocks that may be used in multiple products to satisfy a wide range of cus-
tomer needs. This has led to efficiencies, cost savings in the production of code, and improved time to market with new offerings. The increase in gross profit dollars and gross profit margin in 2003 versus 2002 was primarily due to higher Software revenue, lower service costs and purchased vendor software, partially offset by higher amortization costs and vendor royalty payments.

LOOKING FORWARD
The company purchased Rational on February 21, 2003 for approximately $2.1 billion in cash. Rational provides software tools that allow users to effectively capture and analyze requirements to create designs for software applications, test applications, and manage the software development process. Rational's software development tools can be used to develop and upgrade any other company's software products. Accordingly, this acquisition is a critical part of IBM's open standard strategy. Rational's revenue for the fiscal year ended March 31, 2002 was $689 million.

Major IBM customers are embracing the Linux operating system. Prior to open standard operating systems, a cus-
tomer may have been more likely to purchase middleware from the software vendor that owns and sells the proprietary operating system used by that customer. An open standard operating system gives customers another reason to consider IBM middleware.

Enterprise Investments/Other

DESCRIPTION OF BUSINESS
The Enterprise Investments segment develops and provides industry-specific information technology solutions supporting the Hardware, Software and Global Services segments of the company. Primary product lines include product life cycle management software and document processing technologies. Product life cycle management software primarily serves the industrial sector and helps customers manage the development and manufacturing of their products. Document processing products service the financial sector and include products that enable electronic banking.

HISTORICAL RESULTS

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling, general and</td>
<td>$18,738</td>
<td>$17,049</td>
<td>$17,193</td>
</tr>
<tr>
<td>administrative</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research, development</td>
<td>22.1%</td>
<td>20.5%</td>
<td>20.4%</td>
</tr>
<tr>
<td>and engineering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intellectual property</td>
<td>5.9%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>and engineering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (income) and</td>
<td>1,000</td>
<td>1,476</td>
<td>1,664</td>
</tr>
<tr>
<td>expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>149</td>
<td>234</td>
<td>344</td>
</tr>
<tr>
<td>Total expense</td>
<td>$22,760</td>
<td>$20,439</td>
<td>$20,167</td>
</tr>
</tbody>
</table>

SELLING, GENERAL AND ADMINISTRATIVE EXPENSE

Historical Results

Total Selling, general and administrative (SG&A) expense increased 9.9 percent (9 percent at constant currency) in 2003 versus 2002, following a decrease of 2.0 percent (flat at constant currency) in 2001 compared with 2000. The increase in 2003 was due to actions taken in the second quarter and fourth quarter of 2002 totaling $1,489 million. See note s, “2002 Actions,” on pages 90 through 92 for additional details regarding these actions.

PwCC acquisition-related costs of $292 million were incurred in 2002 and included the PwCC compensation costs discussed on page 78. These costs relate to the acquired PwCC business that are of a nonrecurring nature and also contributed to the increase in SG&A.

Workforce reductions, which are the ongoing reductions and rebalancing that occur each quarter, were $380 million in 2003, $285 million in 2001 and $167 million in 2000. The 2002 amount includes workforce reductions that took place in the 2002 second quarter. These 2002 second-quarter workforce reductions were recorded in the second-quarter actions amount disclosed in note s, “2002 Actions,” on pages 90 through 92 and included in the 2002 actions amount mentioned on page 50. The annual increases in workforce reductions are attributable to the difficult economic environ-
ment during 2001 and 2002, as well as the company’s rebalancing of the workforce for shifts in required skills.

Advertising and promotional expense was $1,437 million in 2002, a decline of $188 million from 2001 following a decline of $127 million in 2001 versus 2000. The declines from 2000 to 2002 are primarily due to a strategic initiative to consolidate and centralize certain advertising at the corporate level in order to gain additional efficiencies. The decreases in 2002 were primarily in spending associated with direct response advertising, business partner programs and customer and sales events. The decline in 2001 was primarily driven by lower spending on brand advertising and promo-
tional spending.

The provision for bad debts expense in 2002, 2001 and 2000 was $675 million, $490 million and $270 million, respec-

Looking Forward

The company will continue to execute on its business trans-
formation and efficiency initiatives.

The second quarter 2002 actions are estimated to reduce cost and expense by at least an incremental $900 million, pre-tax, in 2003 as compared to 2002. Approximately half of these incremental cost and expense reductions are estimated to benefit Global Services, approximately 25 percent for the Technology Group and approximately 20 percent for the Systems Group.

The future level of provision for bad debts will depend upon economic conditions and the health of each sector in which the company has a concentration of financing receiv-
ables. Refer to pages 61 to 65 for additional information about the company’s financing receivables.

RESEARCH, DEVELOPMENT AND ENGINEERING

Description

Once again, the company had more patents awarded in the United States in 2002 than any other company. This marks the 10th year in a row that IBM achieved this distinction. Being the leader in patents contributes to IBM’s ability to gain market share in key areas. Recent significant achievements and initiatives that have given IBM an edge in the marketplace include autonomic (self-healing) computing capabilities and copper chip and silicon-on-insulator technology, and the ongoing support of the open standard Linux operating system. Another significant benefit of being the leader in patents is the ability to generate income through sales of IP and custom development arrangements. The level of R&D spending is determined based upon IBM’s projections of future customer technology needs and areas offering significant long-term growth opportunities for shareholders.

Historical Results

Research, development and engineering (R&D&E) expense declined 4.7 percent from 2002 to 2001, following a decrease of 1.9 percent in 2001 from 2000. The declines in 2002 and 2001 were a result of actions taken to improve productivity. In addition, the company repositioned in spending to increase its investment in high-growth opportunities such as e-business, initiatives to support Linux, middleware software products, autonomic computing and e-business on demand.

Looking Forward

In November 2002, the company announced On Demand Innovation Services, a new services arm located in its Research Division, which provides customers access to a discrete team of researchers who specialize in high-end business transformation and technology consulting. The new organization will be staffed with up to 200 IBM Research consultants worldwide.
INTELLECTUAL PROPERTY AND CUSTOM DEVELOPMENT INCOME

Description

As described above, the company’s world-class R&D function results in superior products for the company’s customers, and also results in IP income. Some of the technological break-throughs that IBM achieves are used exclusively in IBM products while other breakthroughs are used by others when the new technology is not strategic to IBM’s business goals. A third group is both used internally and licensed externally. IP and custom development income comprises the three categories in the table below. Sales and other transfers of IP are typically transaction-based lump sums and are relatively less predictable in amount and timing than licensing/royalty-based fees. Licensing/royalty-based fees involve ongoing cash inflow and income streams. The key factors impacting the amount of income earned in these two categories are the timing and availability of the company’s licensable IP. IBM also earns income from performing custom developments for specific customers.

In addition to the IP income sources in the table below, the company also generates value from its patent portfolio through cross-licensing arrangements and IP licensed in divestiture transactions. Cross-licensing arrangements involve licensing of the company’s IP to a third party in exchange for the third party’s IP. The company does not record income on these transactions except to the extent that cash is received. The value received by IBM for IP transferred in divestiture transactions is included in the overall gain or loss from the divestiture and is therefore excluded from the table below.

Historical Results

<table>
<thead>
<tr>
<th>Category</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intellectual property</td>
<td>$511</td>
<td>$727</td>
<td>$913</td>
</tr>
<tr>
<td>Licensing/royalty-based</td>
<td>$351</td>
<td>$465</td>
<td>$528</td>
</tr>
<tr>
<td>Custom development</td>
<td>218</td>
<td>284</td>
<td>223</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>$1,476</td>
<td>$1,664</td>
</tr>
</tbody>
</table>

The decreases in sales and other transfers of IP in 2002 versus 2001 and 2001 versus 2000 were primarily due to a greater number of larger dollar sales and other transfers during the prior years. The amount of income from licensing/royalty-based fees has been declining due to economic conditions and fewer licensing opportunities resulting from industry consolidation.

Looking Forward

The timing and amount of sales and other transfers of IP may vary significantly from year to year depending upon the timing of new patents and know-how development, economic conditions, and the extent of further industry consolidation, if any.

OTHER (INCOME) AND EXPENSE

The primary reason for the reduction in Other (income) and expense in 2002 was the actions taken by the company in the second and fourth quarters of 2002 amounting to $511 million. See note s, “2002 Actions,” on pages 90 through 92 for further information. The remaining items of Other (income) and expense largely offset. These offsetting items include the lower write-downs of certain equity investments for other than temporary market declines of $8 million in 2002, as compared to $89 million in 2001. There were no such write-downs in 2000. Net realized gains on sales of securities and other investments were $61 million in 2002, $(236) million in 2001 and $(265) million in 2000. These write-downs and sales activity are related to the dynamics in the equity markets over the past few years. Additionally, net realized gains from certain real estate activities were $66 million in 2002, $(135) million in 2001 and $(222) million in 2000. The company recorded interest income (from securities and other investments excluding the Global Financing business transactions) of $(127) million in 2002, $(175) million in 2001 and $(308) million in 2000. Foreign currency transaction gains were $(19) million, $(190) million and $(124) million in 2002, 2001 and 2000, respectively. The reduction of Other (income) and expense from 2000 to 2001 was primarily attributable to the 2001 writedown of certain equity investments for other than temporary market declines.

INTEREST EXPENSE

Interest expense is presented in Cost of Global Financing in the Consolidated Statement of Earnings only if the related external borrowings are to support the Global Financing external business. See page 63 for additional information regarding Global Financing debt and interest expense.

Interest expense, excluding amounts recorded in Cost of Global Financing, declined 17.9 percent in 2002 from 2001 and 31.4 percent in 2001 versus 2000. The declines were primarily due to lower average interest rates and a decline in average debt outstanding in the periods.

Retirement-Related Benefits

The company provides a number of retirement-related benefits to its employees including defined benefit pension plans and defined contribution pension plans. The company also provides nonpension postretirement benefits comprising retiree medical and life insurance plans.

HISTORICAL RESULTS

The following table provides the total pre-tax (income)/cost for all retirement-related plans. (Income)/cost amounts are included as a reduction of/addition to, respectively, the company’s cost and expense amounts in the Consolidated Statement of Earnings within the caption (e.g., Cost, NGA, RDA, ETC) relating to the job function of the individuals participating in the plans.

<table>
<thead>
<tr>
<th>Category</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensable</td>
<td>$1,249</td>
<td>$1,493</td>
<td>$1,349</td>
</tr>
<tr>
<td>Defined benefit and</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>contribution pension plans</td>
<td>$619</td>
<td>$986</td>
<td>$775</td>
</tr>
<tr>
<td>Nonpension postretirement</td>
<td>$371</td>
<td>$391</td>
<td>$387</td>
</tr>
<tr>
<td>benefits—cost</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total retirement-related plans income decreased $245 million in 2002 as compared to 2001. This was primarily due to the defined benefit plans. The primary driver of the decrease in retirement-related plans income relates to the 2002 change in defined benefit plan assumptions.

See note w, “Retirement-Related Benefits,” on pages 95 to 100 for detailed information about the company’s plans including the components of defined benefit plan income, the funded status of defined benefit plans, the historical effects of actuarial assumptions on retirement-related plans (income)/cost, the company’s accounting policy for retirement-related benefits, the company’s funding of the U.S. defined benefit plan in the fourth quarter of 2002, the impact of certain plan amendments on retirement-related plans (income)/cost, and descriptions of the major plans.

Looking Forward

On January 1, 2003, the company reduced its expected return on plan assets for its U.S. defined benefit plan from 9.5 percent to 8.0 percent. and on December 31, 2002, the company lowered its discount rate assumption from 7.0 percent to 6.75 percent, and its rate of compensation increase from 6.0 percent to 4.0 percent. Reductions in these rates also occurred in certain non-U.S. countries. As discussed on page 99, the company contributed cash and IBM stock to the main U.S. defined benefit plan. As a result, it remains fully funded on an Accumulated Benefit Obligation (ABO) basis. The collective effect of these actions will be an estimated reduction in the 2003 Retirement-related plans income of approximately $300 million as compared to 2002 Retirement-related plans income.

Future impacts of pension plans, including the changes noted above, on the operating results of the company depend on economic conditions, employee demographics, mortality rates and investment performance.

Allocation of Expense to Segments

The primary reason for “Segment Information,” on pages 100 to 104 for additional information about the pre-tax income/(loss) of each segment, as well as the methodologies employed by the company to allocate shared expenses to the segments.

PROVISION FOR INCOME TAXES

HISTORICAL RESULTS

The continuing operations provision for income taxes resulted in an effective tax rate of 29.1 percent for 2002, compared with the 2001 effective tax rate of 28.9 percent and the 2000 effective tax rate of 31.0 percent. Excluding the tax effect of the Microelectronics Division’s portion of the 2002 actions as described in note s, “2002 Actions,” on pages 90 through 92, the 2002 rate was 29.5 percent. This 0.6 point increase from the 2001 rate was principally attributable to a less favorable mix of geographic income. The 2.1 point decrease in the 2001 rate from the 2000 rate was primarily the result of a more favorable mix of income in countries with low tax rates as well as adjustments to estimated tax liabilities relating to prior years.

Looking Forward

In the normal course of business, the company expects that its effective tax rate will approximate 30 percent. The rate will change year to year based on nonrecurring events (such as the tax effect of the Microelectronics Division’s actions in 2002) as well as recurring factors including the geographical mix of income before taxes, the timing and amount of foreign dividends, state and local taxes, and the interaction of various global tax strategies.

In 2007, the World Trade Organization (WTO) determined that tax provisions of the FSC Repeal and Extraterritorial Income (ETI) Exclusion Act of 2000 constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures Agreement. The U.S. government appealed the panel’s decision and lost its appeal. The President of the United States has stated that the United States will comply with the WTO ruling. During 2002, the House Ways and Means Committee Chairman introduced the American Competitiveness and Corporate Accountability Act of 2002. This proposed bill would repeal the ETI regime and introduce broad-based international tax reform. If the ETI exclusion is repealed and replacement legislation is not enacted, the loss of the ETI tax benefit may adversely impact the company’s tax rate.

Additional Information

In addition to the information in this Management Discussion section regarding the company’s business, pages 1 through 3 of the IBM 2002 Form 10-K, filed with the Securities and Exchange Commission on March 10, 2003, provide additional information regarding IBM’s business, focusing on high-level organization and certain key risk factors.
Management Discussion

INTELLECTUAL PROPERTY AND CUSTOM DEVELOPMENT INCOME

Description

As discussed above, the company’s world-class R&D function results in superior products for the company’s customers, and also results in IP income. Some of the technological break-throughs that IBM achieve are used exclusively in IBM products while other break-throughs are used by others when the new technology is not strategic to IBM’s business goals. A third group is both used internally and licensed externally.

IP and custom development income comprises the three categories in the table below. Sales and other transfers of IP are typically transaction-based lump sums and are relatively less predictable in amount and timing than licensing/royalty-based fees. Licensing/royalty-based fees involve ongoing cash inflow and income streams. The key factors impacting the amount of income earned in these two categories are the timing and availability of the company’s licenable IP. IBM also earns income from performing custom development for specific customers.

In addition to the IP income sources in the table below, the company also generates value from its patent portfolio through cross-licensing arrangements and IP licensed in divestiture transactions. Cross-licensing arrangements involve licensing of the company’s IP to a third party in exchange for the third party’s IP. The company does not record income on these transactions except to the extent that cash is received. The value received by IBM for IP transferred in divestiture transactions is included in the overall gain or loss from the divestiture and is therefore excluded from the table below.

Historical Results

<table>
<thead>
<tr>
<th>Description</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales and other transfers of intellectual property</td>
<td>$511</td>
<td>$727</td>
<td>$913</td>
</tr>
<tr>
<td>Licensing/royalty-based fees</td>
<td>511</td>
<td>465</td>
<td>528</td>
</tr>
<tr>
<td>Custom development income</td>
<td>218</td>
<td>284</td>
<td>223</td>
</tr>
<tr>
<td>Total</td>
<td>$1,160</td>
<td>$1,176</td>
<td>$1,664</td>
</tr>
</tbody>
</table>

The decreases in sales and other transfers of IP in 2002 versus 2001 and 2001 versus 2000 were largely a result of a number of larger dollar sales and other transfers during the prior years. The amount of income from licensing/royalty-based fees has been declining due to economic conditions and fewer licensing opportunities resulting from industry consolidation.

Looking Forward

The timing and amount of sales and other transfers of IP may vary significantly from year to year depending upon the timing of new patents and know-how development, economic conditions, and the extent of further industry consolidation, if any.

OTHER INCOME (EXPENSE) AND EXPENSE

The primary reason for the reduction in Other (income) and expense in 2002 was the actions taken by the company in the second and fourth quarters of 2002 amounting to $511 million. See note x, “2002 Actions,” on pages 90 through 92 for further information. The remaining items of Other (income) and expense largely offset each other. These offsetting items include the lower write-downs of certain equity investments for other than temporary market declines of $8 million in 2002, as compared to $885 million in 2001. There were no such write-downs in 2000. Net realized gains on sales of securities and other investments were $(61) million in 2002, $(216) million in 2001 and $(265) million in 2000. These write-downs and sales activity are related to the dynamics in the equity markets over the past few years. Additionally, net realized gains from certain real estate activities were $66 million in 2002, $(135) million in 2001 and $(222) million in 2000. The company recorded interest income (from securities and other investments excluding the Global Financing business transactions) of $(127) million in 2002, $(175) million in 2001 and $(308) million in 2000. Foreign currency transaction gains were $(19) million, $(190) million and $(124) million in 2002, 2001 and 2000, respectively. The reduction of Other (income) and expense from 2000 to 2001 was primarily attributable to the 2001 writedown of certain equity investments for other than temporary market declines.

INTEREST EXPENSE

Interest expense is presented in Cost of Global Financing in the Consolidated Statement of Earnings only if the related external borrowings are to support the Global Financing external business. See page 63 for additional information regarding Global Financing debt and interest expense.

Interest expense, excluding amounts recorded in Cost of Global Financing, declined 37.9 percent in 2002 from 2001 and 31.4 percent in 2001 versus 2000. The declines were primarily due to lower average interest rates and a decline in average debt outstanding in the periods.

Retirement-Related Benefits

Description

The company provides a number of retirement-related benefits to its employees including defined benefit pension plans and post-employment benefits—cost. The company also provides nonpension postretirement benefits comprising retiree medical and life insurance plans.

Historical Results

The following table provides the total pre-tax (income)/cost for all retirement-related plans. (Income)/cost amounts are included as a reduction of/addition to, respectively, the company’s cost and expense amounts in the Consolidated Statement of Earnings within the caption (e.g., Cost, NGA, RDA/E) relating to the job function of the individuals participating in the plans.

<table>
<thead>
<tr>
<th>Description</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined benefit and contribution pension plans—income</td>
<td>$619</td>
<td>$896</td>
<td>$775</td>
</tr>
<tr>
<td>Nonpension postretirement benefits—cost</td>
<td>371</td>
<td>393</td>
<td>187</td>
</tr>
</tbody>
</table>

The amounts disclosed in this retirement-related benefits table are for continuing operations.

Allocation of Expense to Segments

The primary reason for the reduction in Other (income) and expense in 2002 was the actions taken by the company in the second and fourth quarters of 2002 amounting to $511 million. See note x, “2002 Actions,” on pages 90 through 92 for additional information about the pre-tax income/(loss) of each segment, as well as the methodologies employed by the company to allocate shared expenses to the segments.

PROVISION FOR INCOME TAXES

HISTORICAL RESULTS

The continuing operations provision for income taxes resulted in an effective tax rate of 29.1 percent for 2002, compared with the 2001 effective tax rate of 28.9 percent and the 2000 effective tax rate of 31.0 percent. Excluding the tax effect of the Microelectronics Division’s portion of the 2002 actions as described in note x, “2002 Actions,” on pages 90 through 92, the 2002 rate was 29.5 percent. This 0.6 point increase from the 2001 rate was principally attributable to a less favorable mix of geographic income. The 2.1 point decrease in the 2001 rate from the 2000 rate was primarily the result of a more favorable mix of income in countries with low tax rates as well as adjustments to estimated tax liabilities relating to prior years.

Looking Forward

In the normal course of business, the company expects that its effective tax rate will approximate 30 percent. The rate will change year to year based on nonrecurring events (such as the tax effect of the Microelectronics Division’s actions in 2002) as well as recurring factors including the geographical mix of income before taxes, the timing and amount of foreign dividends, state and local taxes, and the interaction of various global tax strategies.

In 2001, the World Trade Organization (WTO) determined that tax provisions of the FSC Repeal and Extraterritorial Income (ETI) Exclusion Act of 2002 constitute an export subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures Agreement. The U.S. government appealed the panel’s decision and lost its appeal. The President of the United States has stated that the United States will comply with the WTO ruling. During 2002, the House Ways and Means Committee Chairman introduced the American Competitiveness and Corporate Accountability Act of 2002. This proposed bill would repeal the ETI regime and introduce broad-based international tax reform. If the ETI exclusion is repealed and replacement legislation is not enacted, the loss of the ETI tax benefit may adversely impact the company’s tax rate.

Additional Information

In addition to the information in this Management Discussion section regarding the company’s business, pages 1 through 3 of the IBM 2002 Form 10-K, filed with the Securities and Exchange Commission on March 10, 2003, provide additional information regarding IBM’s business, focusing on high-level organization and certain key risk factors.
Results of Discontinued Operations

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Pre-tax (loss)/income</th>
<th>Income tax benefit</th>
<th>(Loss)/income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1.946M</td>
<td>$12.037M</td>
<td>$(282)</td>
<td>$(1.755M)</td>
</tr>
<tr>
<td>2001</td>
<td>$2.799M</td>
<td>$12.037M</td>
<td>$(497)</td>
<td>$(3.307M)</td>
</tr>
<tr>
<td>2000</td>
<td>$3.037M</td>
<td>$12.037M</td>
<td>$(74)</td>
<td>$(3.307M)</td>
</tr>
</tbody>
</table>

For the Year Ended December 31:

- In the Americas, revenue was $10.13 billion, an increase of 4.6 percent (7 percent at constant currency) from the first quarter of 2001.
- In EMEA, revenue was $4.2 billion, an increase of 16.4 percent (14 percent at constant currency) from the first quarter of 2001.
- Japan revenues increased 1.7 percent in the first quarter of 2002 compared with the first quarter of 2001.
- Asia-Pacific revenue grew 7.4 percent (4 percent at constant currency) to $8.4 billion.
- In the Americas, revenue was $10.13 billion, an increase of 4.6 percent (7 percent at constant currency) from the first quarter of 2001.
- In EMEA, revenue was $4.2 billion, an increase of 16.4 percent (14 percent at constant currency) from the first quarter of 2001.
- Asia-Pacific revenue grew 7.4 percent (4 percent at constant currency) to $8.4 billion.
- In the Americas, revenue was $10.13 billion, an increase of 4.6 percent (7 percent at constant currency) from the first quarter of 2001.
- In EMEA, revenue was $4.2 billion, an increase of 16.4 percent (14 percent at constant currency) from the first quarter of 2001.

Management Discussion

Revenues

- Total revenues grew 12.3 percent (10 percent at constant currency) to $6.5 billion in the first quarter of 2002, compared with the first quarter of 2001.
- The year-over-year revenue growth was 17.1 percent at constant currency.
- The company's overall gross profit margin was 38.8 percent in the first quarter of 2002, compared with 48.0 percent in the first quarter of 2001.
- The company's cash flow from operating, investing and financing activities was $23.7 billion in the first quarter of 2002.

Discontinued Operations

- Revenue from discontinued operations for the first quarter of 2002 was $548 million, a 15.9 percent decrease from the first quarter of 2001.
- Net loss from discontinued operations for the first quarter of 2002 was $89 million, a 32.6 percent decrease from the first quarter of 2001.

Financial Condition

- The company's cash flow from operating, investing and financing activities was $23.7 billion in the first quarter of 2002.
- The company's cash flow from investing activities was $23.7 billion in the first quarter of 2002.
- The company's cash flow from financing activities was $23.7 billion in the first quarter of 2002.
Results of Discontinued Operations

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Pre-tax (loss)/income</th>
<th>Income tax benefit</th>
<th>Loss/(income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,946</td>
<td>$2,799</td>
<td>(282)</td>
<td>$(1,946)</td>
</tr>
<tr>
<td>2003</td>
<td>$2,799</td>
<td>$12,079</td>
<td>(977)</td>
<td>$(2,037)</td>
</tr>
<tr>
<td>2004</td>
<td>$3,307</td>
<td>$2,799</td>
<td>(82)</td>
<td>$(2,327)</td>
</tr>
</tbody>
</table>

See the “Basis of Presentation” section in note 1, “Significant Accounting Policies” on page 70 and note c, “Acquisitions/Divestitures” on pages 78 to 80 for a discussion of the company's divestiture of the HDD business.

Revenue from discontinued operations in 2002 totaled $1,946 million, a decline of 30.5 percent compared with revenue of $2,799 million in 2001. Revenue from discontinued operations decreased 15.4 percent in 2001 compared with 2000 revenue of $3,107 million. The HDD revenue declined as the company's ability to sell HDDs is highly dependent on the personal computer industry, which experienced a significant downturn from 2000, as well as a result of general industry price declines.

Loss from discontinued operations in 2002 was $1,755 million as compared to a loss of $423 million in 2001 and income of $219 million in 2000. The loss in 2002 was primarily attributable to the operational loss of $1,173 million, net of tax, and an estimated loss on disposal of the HDD business of $812 million, net of tax. Included in the operational net loss in 2002 was $158 million, net of tax, for certain actions taken by the company in the second and fourth quarters of 2002, a $217 million, net of tax, increase for inventory write-offs as compared to 2001 and a $57 million, net of tax, increase in warranty costs. The announcement of the Hitachi transaction led the company to a strategic decision to cease reworking and selling efforts for some of the company's older HDD products. The increase in inventory write-offs was expected to continue for these older products.

The second quarter actions primarily included charges for the abandonment and associated removal costs for machinery, equipment and tooling that are no longer needed by the company and will not be purchased by Hitachi. The fourth quarter actions primarily included the abandonment and associated removal costs for machinery and equipment and tooling, workforce reduction-related charges and excess leased space charges associated with the HDD business, all as a result of the final agreement completed with Hitachi.

The 2002 and 2001 discontinued operations tax rates of approximately 14 percent and 13 percent, respectively, resulted primarily from the mix of losses in countries with low tax rates. Additionally, the 2002 tax rate included an incremental U.S. tax charge of $248 million attributable to the December repatriation of non-U.S. transaction proceeds. The 2000 discontinued operations tax rate was impacted by the geographic mix of income and changes in the value of IP rights that were previously transferred to several non-U.S. subsidiaries.

Four Quarter

Continuing Operations

The company's fourth-quarter 2002 diluted earnings per common share from continuing operations were $1.11, compared with diluted earnings per common share of $1.46 in the fourth quarter of 2001. Fourth-quarter income from continuing operations was $1.9 billion compared with $2.6 billion in fourth quarter 2001. Revenue from continuing operations for the fourth quarter was $23.7 billion, up 7 percent (4 percent at constant currency) compared with the fourth quarter of 2001 revenue of $22.1 billion.

In the Americas, revenue was $10.1 billion, an increase of 4.6 percent (7 percent at constant currency) from the 2001 period. Revenue from Europe/Middle East/Africa was $7.8 billion, up 12 percent (1 percent at constant currency). Asia-Pacific revenue grew 7.1 percent (4 percent at constant currency) to $4.8 billion. OEM revenue decreased 11.1 percent (1 percent at constant currency) to $828 million compared with the fourth quarter of 2001.

Revenue from Global Services, including maintenance, increased 16.7 percent (13 percent at constant currency) in the fourth quarter to $10.6 billion, driven by the PwCC acquisition. Global Services revenue, excluding maintenance, increased 10 percent (15 percent at constant currency). IBM signed more than $18 billion in services contracts in the quarter compared with $9 billion in the 2002 third quarter.

Hardware revenue increased 1.3 percent (down 1 percent at constant currency) from the fourth quarter of 2001. Revenue from iSeries zSeries and Power7 products declined due to lower server demand. Net software and services revenue was $4.3 billion, an increase of 2.0 percent (3 percent at constant currency). Systems revenue, excluding maintenance, increased 16 percent (20 percent at constant currency). Systems revenue from zSeries and Power7 products increased 13 percent (17 percent at constant currency).

The company's overall gross profit margin was 38.8 percent in the fourth quarter, compared to 40.3 percent in the 2001 fourth quarter, primarily due to lower Global Services margin as a result of PwCC being at a lower gross profit margin than the company's base business. Also, signings in the company's ITS Services business came late in the quarter, which resulted in the company's utilization rates being lower. This decline was partially offset by an increase in Software and Hardware gross profit margins in the fourth quarter of 2002.

In the fourth quarter, total expense and other income of $6.5 billion increased 21.8 percent over the year-earlier period, including charges of $614 million associated with the acquisition and integration of PwCC and related restructuring as well as one-time compensation costs, which are partially offset by a $40 million benefit from net adjustments to restructuring charges from the second-quarter 2002 actions. Specifically, SG&A expense increased 16 percent, reflecting the PwCC charges offset by the benefit from net adjustments related to second-quarter actions and lower goodwill expense due to the implementation of new accounting rules. R&D&E expense decreased 2.9 percent in the fourth quarter. Lower IP and custom development income had a negative impact on results compared with the year-earlier period, despite two sizable contracts totaling, in the aggregate, approximately $170 million in the quarter. Other (income) and expense was negatively affected by foreign exchange losses as well as lower gains from certain real estate activities. Overall, IBM continues to benefit from the company's continuing e-business transformation and productivity enhancements.

The company's effective tax rate in the fourth quarter was 29.5 percent compared with 28.6 percent in the fourth quarter of 2001.

The company spent $74 million on common share repurchases in the fourth quarter. The average number of common shares outstanding assuming dilution was lower by 29.3 million shares in fourth quarter 2002 versus the fourth quarter of 2001, primarily as a result of the ongoing common share repurchase program. The average number of shares assuming dilution was 1,724.7 million in fourth-quarter 2002 versus 1,758.0 million in fourth-quarter 2001.

Global Financing revenue decreased 10.5 percent (11 percent at constant currency) in the fourth quarter of 2002 to $829 million. Revenue from the Enterprise Investments/ Other area, which includes industry-specific IT solutions, increased 1.1 percent (down 6 percent at constant currency) compared to the fourth quarter of 2001 to $434 million.

The company's overall gross profit margin was 38.8 percent in the fourth quarter, compared to 40.3 percent in the 2001 fourth quarter, primarily due to lower Global Services margin as a result of PwCC being at a lower gross profit margin than the company's base business. Also, signings in the company's ITS Services business came late in the quarter, which resulted in the company's utilization rates being lower. This decline was partially offset by an increase in Software and Hardware gross profit margins in the fourth quarter of 2002.

In the fourth quarter, total expense and other income of $6.5 billion increased 21.8 percent over the year-earlier period, including charges of $614 million associated with the acquisition and integration of PwCC and related restructuring as well as one-time compensation costs, which are partially offset by a $40 million benefit from net adjustments to restructuring charges from the second-quarter 2002 actions. Specifically, SG&A expense increased 16 percent, reflecting the PwCC charges offset by the benefit from net adjustments related to second-quarter actions and lower goodwill expense due to the implementation of new accounting rules. R&D&E expense decreased 2.9 percent in the fourth quarter. Lower IP and custom development income had a negative impact on results compared with the year-earlier period, despite two sizable contracts totaling, in the aggregate, approximately $170 million in the quarter. Other (income) and expense was negatively affected by foreign exchange losses as well as lower gains from certain real estate activities. Overall, IBM continues to benefit from the company's continuing e-business transformation and productivity enhancements.

The company's effective tax rate in the fourth quarter was 29.5 percent compared with 28.6 percent in the fourth quarter of 2001.

The company spent $74 million on common share repurchases in the fourth quarter. The average number of common shares outstanding assuming dilution was lower by 29.3 million shares in fourth quarter 2002 versus the fourth quarter of 2001, primarily as a result of the ongoing common share repurchase program. The average number of shares assuming dilution was 1,724.7 million in fourth-quarter 2002 versus 1,758.0 million in fourth-quarter 2001.

Discontinued Operations

Revenue from discontinued operations for the fourth quarter of 2002 was $548 million, a 1.9 percent decrease from the fourth quarter of 2001. Net loss from discontinued operations for the fourth quarter of 2002 was $893 million as compared to a loss of $232 million in 2001. The underlying business dynamics causing these fourth quarter financial trends are consistent with those underlying the full-year 2002 and 2001 trends discussed in the Results of Discontinued Operations section on page 54, including the additional loss of $247 million, net of tax, incurred in the fourth quarter on disposal of the HDD business.

Financial Condition

Dynamics

The assets and debt associated with the company's Global Financing business are a significant part of IBM's financial condition. Accordingly, although the financial position amounts appearing below and on pages 56 and 57 are the company's consolidated amounts including Global Financing, to the extent the Global Financing business is a major driver of the consolidated financial position, reference in the narrative section will be made to a separate Global Financing section in this Management Discussion on pages 60 through 63. The amounts appearing in the separate Global Financing section are supplementary data presented to facilitate an understanding of the company's Global Financing business.

Overall

During 2002, the company made significant acquisitions as well as ongoing investments in R&D&E and in fixed assets. In addition, the company fully funded, on an ABO basis, the IBM Personal Pension Plan (PPP). In spite of this activity, the company ended the year with $5,975 million in Cash and cash equivalents and current Marketable securities. In the fourth quarter, the company took advantage of the low interest rate environment to execute some term-debt financing that increased the non-Global Financing debt to $2,189 million at December 31, 2002. The debt-to-capital ratio of 10.2 percent is well within the company's target.

Cash Flows

The company's cash flow from operating, investing and financing activities, as reflected in the Consolidated Statement of Cash Flows on page 69, are summarized in the table on page 56. These amounts include the cash flows associated with the company's Global Financing business, which are presented on pages 60 through 61.
Management Discussion

Net cash provided by/ (used in) continuing operations:

Operating activities $13,788 $13,966 $8,817
Investing activities (6,897) (5,862) (4,031)
Financing activities (7,265) (5,309) (6,539)

Effect of exchange rate changes on cash and cash equivalents 148 (83) (147)
Net cash (used in)/provided by discontinued operations(1) (722) $1 $190

Net change in cash and cash equivalents (948) $2,167 $(3,480)

* Does not include approximately $1,270 million of net proceeds from the sale of the HDS business. Such proceeds are included in Net cash used in and from financing activities in the table above.

Working Capital

(at dollars in millions)

2002 2003
Current assets $41,652 $42,461
Current liabilities 34,550 31,119
Working capital $7,102 $7,342
Current ratio 1.21:1 1.21:1

In 2002 the company continued to focus on cash generation and improved its performance in several key working capital components, particularly accounts receivable and inventory. The $809 million decrease in Current assets was due primarily to the decline of $3,156 million in Inventories due to improvements in inventory levels across all business units and divestitures. The company's inventory levels now stand at a 20-year low and inventory turnover increased year to year. In addition, there was a decrease of $418 million in Cash and cash equivalents and Marketable securities, resulting from the $2,852 million cash payment for the purchase of PwCC, the $2,092 million cash contribution to fund the PPP, and $887 million in restructuring payments. These cash outlays were partially offset by the $1,170 million of net cash received from the sale of the HDS business to Hitachi, approximately $650 million received from the monetization of interest rate swaps associated with the company's debt portfolio, and the collection of a receivable for prior years' taxes and interest of $460 million. The decline of $660 million in Short-term financing receivables (see pages 60 through 63 and page 81) was offset by the $814 million increase in Notes and accounts receivable—trade, which resulted from the acquisition of PwCC and the stronger fourth quarter revenue in 2002 as compared to 2001.

Current liabilities decreased $569 million primarily due to the $5,157 million decline in Short-term debt (primarily associated with the company's Global Financing business, see pages 6 through 63), partially offset by increases in Accounts payable of $583 million, which was driven by the acquisition of PwCC and previous intercompany payables that were converted to external accounts payable as a result of the HDS divestiture on December 31, 2002, as well as increases in Other accrued liabilities of $2,192 million primarily due to the 2002 actions taken by the company as described in note 2, “2002 Actions,” on pages 90 through 92 and due to increases in short-term derivatives that are in a liability position, as well as increases in Deferred income of $1,853 million primarily due to the impact of foreign currencies.

Investments

The company made strategic acquisitions in 2002, totaling $7,342 million, including the purchase of PwCC for $3,474 million ($2,882 million in cash, $294 million primarily in the form of restricted shares of IBM common stock and $128 million in notes convertible to restricted shares of IBM common stock). In addition, $4,750 million was invested in RD&E and the company capitalized external software costs of $224 million and $143 million of internal-use software costs. The company invested $4,753 million for Plant, rental machines and other property. This comprises continuing investments in the Microelectronics Division 300 millimeter chip-making facility in East Fishkill, New York. In addition, Global Services purchased equipment for its SO business and Global Financing invested in equipment for leasing to customers.

In 2002, the company spent $4,212 million for the repurchase of the company's common shares. At December 31, 2002, the company has remaining authorization to purchase $3,864 million of IBM common shares on the open market from time to time, based on market conditions.

The company funded all of these investments primarily from cash from operations.

Debt and Equity

The company's funding requirements are continually monitored and strategies are executed to manage the company's overall asset and liability profile. Additionally, the company maintains sufficient flexibility to access global funding sources as needed. During 2002, the company issued debt denominated in U.S. dollars and Japanese yen to meet existing financing needs.

The major rating agencies’ ratings of the company's debt securities at December 31, 2002, appear in the table below and remain unchanged from December 31, 2001:

<table>
<thead>
<tr>
<th>Rating Agency</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard &amp; Poor’s</td>
<td>A+</td>
</tr>
<tr>
<td>Moody’s</td>
<td>A1</td>
</tr>
<tr>
<td>Fitch</td>
<td>A+</td>
</tr>
</tbody>
</table>

Senior long-term debt A+ A1 A3
Commercial paper A-1 Prime-1 F-1+

The company's total consolidated Stockholders’ equity decreased $666 million to $22,782 million at December 31, 2002, primarily due to a decline in Accumulated gains and losses, not affecting retained earnings that resulted from a $2,765 million charge, net of a tax benefit of $1,574 million, to establish a minimum pension liability for certain of the company’s non-U.S. pension plans. See page 95 for further information about this accounting. The decline was partially offset by an increase in common stock primarily due to the common stock issued or to be issued for a purchase of the PwCC acquisition ($284 million), the funding of the PPP through the issuance of treasury shares ($1,871 million) and a reduction in the company's ongoing stock repurchase activity. See note n, “Stockholders’ Equity Activity,” on pages 87 and 88.

Critical Accounting Estimates

The application of GAAP involves the exercise of various degrees of judgment. While the resulting accounting estimates will, by definition, not precisely equal the related actual results, seven of these estimates involve more judgment than others. Two of these estimates are the allowance for uncollectible financing receivables and the fair value of lease residual values. See page 63 for a discussion of these estimates. The others are discussed below.

Useful Lives of Technology Group Equipment

The company determines the useful lives and related depreciation charges for plant and equipment in the Technology Group based on projected product life cycles that could change significantly due to technical innovations and competitor actions in response to relatively severe industry cycles. To the extent actual useful lives are less than previously estimated lives, the company will increase its depreciation charge or write-off or writedown technically obsolete or non-strategic assets that have been abandoned or sold.

Management Discussion
In 2002 the company continued to focus on cash generation and improved its performance in several key working capital components, particularly accounts receivable and inventory. The $809 million decrease in Current assets was due primarily to the decline of $1,156 million in Inventories due to divestitures. The company's inventory levels now stand at a 20-year low and inventory turnover increased year to year. In addition, there was a decrease of $418 million in Cash and cash equivalents and Marketable securities, resulting from the $2,852 million cash payment for the purchase of PwCC and previous intercompany payables that were partially offset by the $1,700 million increase in Notes and accounts payable. This comprised continuing investments in the Microelectronics Division 300 millimeter chip-making facility in East Fishkill, New York. In addition, Global Services purchased equipment for its SO business and Global Financing invested in equipment for leasing to customers.

In 2002, the company spent $4,212 million for the repurchase of the company's common shares. At December 31, 2002, the company has remaining authorization to purchase $3,864 million of IBM common shares in the open market from time to time, based on market conditions. The company funded all of these investments primarily from cash from operations. Current liabilities decreased $569 million primarily due to the $814 million increase in Notes and accounts payable, which were converted to external accounts payable as a result of the HDD divestiture on December 31, 2002, as well as increases in Other accrued liabilities of $2,192 million primarily due to the 2002 actions taken by the company as described in note 2, “2002 Actions,” on pages 90 through 92 and due to increases in short-term derivatives that are in a liability position, as well as increases in Deferred income of $1,853 million primarily due to the impact of foreign currencies.

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The company regularly assesses these risks and has established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, the company does not anticipate any material losses from these risks.

The company’s debt in support of the Global Financing business and the geographic breadth of the company’s operations contain an element of market risk from changes in interest and currency rates. The company manages this risk, in part, through the use of a variety of financial instruments including derivatives, as explained in note 1, “Derivatives and Hedging Transactions,” on pages 84 to 86.

To meet disclosure requirements, the company performs a sensitivity analysis to determine the effects that market risk exposures may have on the fair values of the company’s debt and other financial instruments.

The financial instruments that are included in the sensitivity analysis comprise all of the company’s cash and cash equivalents, marketable securities, long-term non-lease receivables, investments, long-term and short-term debt and all derivative financial instruments. The company’s portfolio of derivative financial instruments generally includes interest rate swaps, interest rate options, foreign currency swaps, forward contracts and option contracts.

To perform the sensitivity analysis, the company assesses the risk of loss in fair values from hypothetical changes in interest rates and foreign currency exchange rates on market-sensitive instruments. The market values for interest and foreign currency exchange risk are computed based on the present value of future cash flows as affected by the changes in rates that are attributable to the market risk being measured. The discount rates used for the present value computations were selected based on market interest and foreign currency exchange rates in effect at December 31, 2002 and 2001. The differences in this comparison are the hypothetical gains or losses associated with each type of risk.

Information provided by the sensitivity analysis does not necessarily represent the actual changes in fair value that the company would incur under normal market conditions because, due to practical limitations, all variables other than the specific market risk factor are held constant. In addition, the results of the model are constrained by the fact that certain items are specifically excluded from the analysis, while the financial instruments relating to the financing or hedging of those items are included by definition. Excluded items include leased assets, forecasted foreign currency cash flows, and the company’s net investment in foreign operations. As a consequence, reported changes in the values of some of the financial instruments impacting the results of the sensitivity analysis are not matched with the offsetting changes in the values of the items that those instruments are designed to finance or hedge.

The results of the sensitivity analysis at December 31, 2002, and December 31, 2001, are as follows:

Interest Rate Risk
At December 31, 2002, a 10 percent decrease in the levels of interest rates with all other variables held constant would result in a decrease in the fair market value of the company’s financial instruments of $217 million as compared with a decrease of $177 million at December 31, 2001. A 10 percent increase in the levels of interest rates with all other variables held constant would result in an increase in the fair value of the company’s financial instruments of $210 million as compared to $151 million at December 31, 2001. Changes in the relative sensitivity of the fair value of the company’s financial instrument portfolio for these theoretical changes in the level of interest rates are primarily driven by changes in the company’s debt maturity, interest rate profile and amount. In 2002 versus 2001, the reported increase in interest rate sensitivity is primarily due to an increase in the proportion of long-term fixed rate debt outstanding at December 31, 2002.

Foreign Currency Exchange Rate Risk
At December 31, 2002, a 10 percent weaker U.S. dollar against foreign currencies with all other variables held constant would result in a decrease in the fair value of the company’s financial instruments of $640 million as compared with a decrease of $1,401 million at December 31, 2001. Conversely, a 10 percent stronger U.S. dollar against foreign currencies with all other variables held constant would result in an increase in the fair value of the company’s financial instruments of $660 million compared to $1,490 million at December 31, 2001. In 2002 versus 2001, the reported decrease in foreign currency exchange rate sensitivity was primarily due to a reduction in the amount of hedge net investment related currency debt outstanding after taking into account the effect of “receive euro/pay U.S. dollar” and “receive yen/pay U.S. dollar” cross-currency swaps executed during 2002.

Financing Risks
See page 60 for a discussion of the financing risks associated with the company’s Global Financing and business management’s goals to mitigate such risks while striving for superior return on Global Financing’s equity.
The company regularly assesses these risks and has established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, the company does not anticipate any material losses from these risks.

The company's debt in support of the Global Financing business and the geographic breadth of the company's operations contain an element of market risk from changes in interest and currency rates. The company manages this risk, in part, through the use of a variety of financial instruments including derivatives, as explained in note 1, "Derivatives and Hedging Transactions," on pages 84 to 86.

To meet disclosure requirements, the company performs a sensitivity analysis to determine the effects that market risk exposures may have on the fair values of the company's debt and other financial instruments. The financial instruments that are included in the sensitivity analysis comprise all of the company's cash and cash equivalents, marketable securities, long-term non-lease receivables, investments, long-term and short-term debt and all derivative financial instruments. The company's portfolio of derivative financial instruments generally includes interest rate swaps, interest rate options, foreign currency swaps, forward contracts and option contracts.

To perform the sensitivity analysis, the company assesses the effect of changes in interest rates and foreign currency exchange rates on market-sensitive instruments. The market values for interest and foreign currency exchange rate risk are computed based on the present value of future cash flows as affected by the changes in rates that are attributable to the market risk being measured. The discount rates used for the present value computations were selected based on market interest and foreign currency exchange rates at December 31, 2002 and 2001. The differences in this comparison are the hypothetical gains or losses associated with each type of risk.

Information provided by the sensitivity analysis does not necessarily represent the actual changes in fair value that the company would incur under normal market conditions because, due to practical limitations, all variables other than the specific market risk factor are held constant. In addition, the results of the model are constrained by the fact that certain items are specifically excluded from the analysis, while the financial instruments relating to the financing or hedging of those items are included by definition. Excluded items include leased assets, forecasted foreign currency cash flows, and the company's net investment in foreign operations. As a consequence, reported changes in the values of some of the financial instruments impacted by the sensitivity analysis are not matched with the offsetting changes in the values of the items that those instruments are designed to finance or hedge.

The results of the sensitivity analysis at December 31, 2002, and December 31, 2001, are as follows:

**Interest Rate Risk**

At December 31, 2002, a 10 percent decrease in the levels of interest rates with all other variables held constant would result in a decrease in the fair market value of the company's financial instruments of $227 million as compared with a decrease of $177 million at December 31, 2001. A 10 percent increase in the levels of interest rates with all other variables held constant would result in an increase in the fair value of the company's financial instruments of $210 million as compared to $851 million at December 31, 2001. Changes in the relative sensitivity of the fair value of the company's financial instrument portfolio for these theoretical changes in the level of interest rates are primarily driven by changes in the company's debt maturity, interest rate profile and amount. In 2002 versus 2001, the reported increase in interest rate sensitivity is primarily due to an increase in the proportion of long-term fixed rate debt outstanding at December 31, 2002.

**Foreign Currency Exchange Rate Risk**

At December 31, 2002, a 10 percent weaker U.S. dollar against foreign currencies with all other variables held constant would result in a decrease in the fair value of the company's financial instruments of $640 million as compared with a decrease of $1,401 million at December 31, 2001. Conversely, a 10 percent stronger U.S. dollar against foreign currencies with all other variables held constant would result in an increase in the fair value of the company's financial instruments of $660 million compared to $1,490 million at December 31, 2001. In 2002 versus 2001, the reported decrease in foreign currency exchange rate sensitivity was primarily due to a reduction in the amount of hedge of net investment related currency debt outstanding after taking into account the effect of "receive euro/pay U.S. dollar" and "receive yen/pay U.S. dollar" cross-currency swaps executed during 2002.

**Financing Risks**

See page 60 for a discussion of the financing risks associated with the company's Global Financing and management's goals to mitigate such risks while striving for superior return on Global Financing's equity.
Management Discussion

Employees and Related Workforce

Employees at IBM and its wholly owned subsidiaries in 2002 decreased 3,987 from last year. The decrease was due primarily to workforce rephrasing initiatives designed to improve IBM’s competitiveness in the marketplace. The major initiatives contributing to this decline include: the divestiture of the HDD business and 2002 workforce rephrasing and productivity actions offset by the acquisition of PwCC.

In less-than-wholly owned subsidiaries, the number of employees decreased from last year, primarily in China, as a result of the HDD divestiture.

The company’s comprehensive workforce is an approximation of equivalent full-time employees hired under temporary, part-time and limited-term employment arrangements to meet specific business needs in a flexible and cost-effective manner.

Global Financing

Description of Business

Global Financing is a business segment within IBM, but is managed (on an arm’s-length basis) and measured as if it were a standalone entity. Accordingly, the information presented in this section is consistent with this separate company view.

The mission of Global Financing is to generate a return on equity. It also facilitates the acquisition of IBM hardware, software and services.

Global Financing invests in financing assets, manages the associated risks, and leverages with debt, all with the objective of generating consistently strong returns on equity. The focus on IBM product and IBM customers mitigates the risks normally associated with a financing company. Global Financing has the benefit of both a deep knowledge of its customer base and a clear insight into the products that are being leased. This pairing allows Global Financing to manage two of the major risks (credit and residual value) that are normally associated with financing.

Global Financing comprises three lines of business:

- Customer financing provides lease and loan financing to end users and internal customers for terms generally between two and five years. Internal financing is predominately in support of Global Services’ long-term customer service contracts. Global Financing also factors a selected portion of the company’s accounts receivable, primarily for cash management purposes. All of these internal financing arrangements are at arm’s-length rates and are based upon market conditions.

- Commercial financing provides primarily short-term inventory and accounts receivable financing to dealers and remarketers of IT products. Commercial financing also participates as a lender in selected syndicated loan facilities which originated from 1999 through 2001. Syndicated loans are loans in which Global Financing purchased a fixed percentage of a loan facility from a bank or other lending institution. Global Financing no longer participates in new syndicated loan programs. There are, however, remaining amounts committed and outstanding. Oustandings represent less than 2 percent of total Global Financing assets at December 31, 2002, as compared to 4 percent at December 31, 2001.

- Remarketing includes the sale and lease of used equipment to new or existing customers. This equipment is primarily sourced from the conclusion of lease transactions.

Results of Operations

($ in millions)

FOR THE YEAR ENDED DECEMBER 31

2001 2002 2001

Global Financing revenue $3,203 $3,407 $1,000

Global Financing internal revenue 919 836 944

Total Global Financing revenue 4,124 4,243 4,444

Global Financing gross profit 1,803 2,016 2,390

Global Financing cost $2,319 $2,227 $2,054

Global Financing gross profit margin 48.2% 49.2% 53.2%

Pre-tax income $998 $1,343 $1,176

After-tax income $627 $727 $761

Return on equity* 17.2% 18.4% 16.5%

* Return on equity is calculated using a five-point average of equity and an estimated tax rate principally based on Global Financing’s geographic mix of earnings as IBM’s provision for income taxes determined on a consolidated basis. See page 59 for the IBM consolidated tax rate.

Global Financing total revenue declined 2.4 percent in 2002 from 2001, following a decline of 4.8 percent in 2001 versus 2000. The decline in 2002 was driven by a lower asset base, primarily due to decreases in demand for IT equipment caused by the current economic environment. The decline in 2001 was also driven by a lower asset base and a decline in used equipment sales.

Global Financing gross profit dollars increased 5.0 percent in 2002 versus 2001, following an increase of 8.8 percent in 2001 versus 2000. Global Financing gross profit margin improved 4.0 points in 2002 following an increase of 6.3 points in 2001 as compared to 2000. The increases in 2002 gross profit dollars and gross profit margin were primarily driven by lower borrowing costs related to the current interest rate environment.

The increase in 2001 was driven by lower borrowing costs discussed above and improved margins in used equipment sales due to a mix change to higher margin products.

Global Financing pre-tax income decreased 16.4 percent in 2002 versus 2001, following a decrease of 2.8 percent in 2001 versus 2000. The decrease in 2002 was driven by an increase in the provision for bad debts due to the current economic environment. See page 62 for an additional discussion of Global Financing Allowance for Doubtful Accounts. The decrease in 2001 was due to increases in provision for bad debts partially offset by an increase in gross profit discussed above.

The decline in return on equity from 2001 to 2002 was due to lower earnings primarily associated with an increased provision for bad debts expense. The increase in return on equity from 2000 to 2001 was primarily due to the decline in the equity balance from 2000 to 2001 as evidenced by the increase in the debt to equity ratio from 6.6x to 6.8x. See page 62 for a discussion of the allowance for doubtful accounts and page 63 for a discussion on debt.

Financial Condition

BALANCE SHEET

($ in millions)

AS OF DECEMBER 31

2001 2002

Cash $1,157 $785

Net investment in sales-type leases 12,104 12,563

Equipment under operating leases:

External customers $1,922 $2,213

Internal customers* 1,701 1,385

Customer loans 9,621 9,466

Total customer financing assets 25,558 26,187

Commercial financing receivables 8,523 6,500

Intercompany financing receivables* 1,666 1,883

Other receivables 445 597

Other assets 941 738

Total financing assets $35,242 $36,670

Intercompany payables* $5,183 $4,420

Debt 23,828 25,500

Other liabilities 2,256 2,548

Total financing liabilities 31,767 32,913

Total financing equity 3,475 3,757

Total financing liabilities and equity $35,242 $36,670

* Amounts eliminated for purposes of IBM’s consolidated results and therefore do not appear on pages 65 or 66. These assets, along with the other assets in this table, are included pursuant to Global Financing debt.

Sources and uses of funds

The primary use of funds in Global Financing is to originate customer and commercial financing assets. Customer financing assets for end users consist primarily of IBM hardware, software and services, but also include non-IBM equipment, software and services to meet IBM customers’ total solutions requirements. Customer financing assets include software license, direct financing, and operating leases for equipment as well as loans for software and services with terms generally for two to five years.

Commercial financing origination arise primarily from inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory financing generally range from 10 to 75 days. Payment terms for accounts receivable financing generally range from 10 to 90 days. Also included in commercial financing assets are syndicated loans.

The following are the total external and internal financing origination:

($ in millions)

AS OF DECEMBER 31

2002 2001

Customer finance:

External $12,845 $15,629

Internal 6,277 5,931

Commercial finance 21,546 21,073

Total $36,642 $34,622

The decrease in originations was due to a lower demand for IT equipment associated with the current economic environment.

Cash collections of both customer and commercial financing assets exceeded new financing origination in both 2002 and 2001, which resulted in a net decline in financing assets in these years. Cash collections in 2002 and 2001 included $218 million and zero, respectively, generated through sales of portions of Global Financing’s syndicated loan portfolio.

These sales transactions did not have a material impact on the company’s Consolidated Statement of Earnings. Additionally, funds were generated through the sales and lease of used equipment sourced primarily from prior year’s lease originations. Cash generated by Global Financing was deployed to pay dividends to IBM and to reduce debt.

FINANCING ASSETS BY SECTOR

The following are the percentage of external financing assets by industry sector.

AS OF DECEMBER 31

2002 2001

Financial Services 31% 27%

Communications 12 12

Business Partners* 14 13

Other 10 12

Total 100% 100%

* Business Partner financing assets represent a portion of commercial financing inventory and accounts receivable financing for terms generally less than 90 days.
Employees and Related Workforce

Employees at IBM and its wholly owned subsidiaries in 2002 decreased 3,987 from last year. The decrease was due primarily to workforce rebalancing initiatives designed to improve IBM’s competitiveness in the marketplace. The major initiatives contributing to this decline include: the divestiture of the HDD business and 2002 workforce rebalancing and productivity actions offset by the acquisition of PwCC.

In less-than-wholly owned subsidiaries, the number of employees decreased from last year, primarily in China, as a result of the HDD divestiture.

The company’s complementary workforce is an approximation of equivalent full-time employees hired under temporary, part-time and limited-term employment arrangements to meet specific business needs in a flexible and cost-effective manner.

Global Financing

Description of Business

Global Financing is a business segment within IBM, but is managed (on an arm’s-length basis) and measured as if it were a standalone entity. Accordingly, the information presented in this section is consistent with this separate company view.

The mission of Global Financing is to generate a return on equity. It also facilitates the acquisition of IBM hardware, software and services.

Global Financing invests in financing assets, manages the associated risks, and leverages with debt, all with the objective of generating consistently strong returns on equity. The focus on IBM product and IBM customers mitigates the risks associated with financing.

Global Financing has the benefit of both a deep knowledge of its customer base and a clear insight into the products that are being leased. This pairing allows Global Financing to manage two of the major risks (credit and residual value) that are normally associated with financing.

Global Financing comprises three lines of business:

- **Customer financing** provides lease and loan financing to end users and internal customers for terms generally between two and five years. Internally generated funds are used to support Global Financing’s geographic mix of earnings or IBM’s provision for income taxes determined on a consolidated basis. See page 59 for the IBM consolidated tax rate.

- **Commercial financing** provides primarily short-term inventory and accounts receivable financing to dealers and remarketers of IT products. Global Financing also participates as a lender in selected syndicated loan facilities which originated from 1999 through 2001. Syndicated loans are loans in which Global Financing purchased a fixed percentage of a loan facility from a bank or other lending institution.

- **Remarketing** includes the sale and lease of used equipment to new or existing customers. This equipment is primarily sourced from the conclusion of lease transactions.

Results of Operations

($ in millions)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM/wholly owned subsidiaries</td>
<td>315,889</td>
<td>119,876</td>
<td>116,303</td>
</tr>
<tr>
<td>Less-than-wholly owned subsidiaries</td>
<td>22,282</td>
<td>25,403</td>
<td>21,866</td>
</tr>
<tr>
<td>Complementary</td>
<td>17,210</td>
<td>21,300</td>
<td>25,150</td>
</tr>
</tbody>
</table>

*Employee equivalents hired under temporary, part-time and limited-term employment arrangements to meet specific business needs in a flexible and cost-effective manner.*

- **Commercial financing** provides primarily short-term inventory and accounts receivable financing to dealers and remarketers of IT products. Global Financing also participates as a lender in selected syndicated loan facilities which originated from 1999 through 2001. Syndicated loans are loans in which Global Financing purchased a fixed percentage of a loan facility from a bank or other lending institution.

- **Remarketing** includes the sale and lease of used equipment to new or existing customers. This equipment is primarily sourced from the conclusion of lease transactions.

Global Financing totaling declined 2.4 percent in 2002 from 2001, following a decline of 4.5 percent in 2001 versus 2000. The decline in 2002 was driven by a lower asset base, primarily due to decreases in demand for IT equipment caused by the current economic environment. The decline in 2001 was also driven by a lower asset base and a decline in used equipment sales.

Global Financing gross profit dollars increased 5.0 percent in 2002 versus 2001, following an increase of 8.4 percent in 2001 versus 2000. Global Financing gross profit margin improved 4.0 points in 2002 following an increase of 6.5 points in 2001 as compared to 2000. The increases in 2002 gross profit dollars and gross profit margin were primarily driven by lower borrowing costs related to the current interest rate environment. The increase in 2001 was driven by lower borrowing costs discussed above and improved margins in used equipment sales due to a mix change to higher margin products.

Global Financing pre-tax income decreased 16.4 percent in 2002 versus 2001, following a decrease of 2.8 percent in 2001 versus 2000. The decrease in 2002 was driven by an increase in the provision for bad debts due to the current economic environment. See page 62 for an additional discussion of Global Financing Allowance for Doubtful Accounts. The decrease in 2001 was due to increases in provision for bad debts partially offset by an increase in gross profit discussed above.

The decline in return on equity from 2001 to 2002 was due to lower earnings primarily associated with an increased provision for bad debts expense. The increase in return on equity from 2000 to 2001 was primarily due to the decline in the equity balance from 2000 to 2001 as evidenced by the increase in the debt to equity ratio from 6.6x to 5.8x. See page 62 for a discussion of the allowance for doubtful accounts and page 63 for a discussion on debt.

Financial Condition

Balance Sheet

($ in millions)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 1,157</td>
<td>$ 785</td>
</tr>
<tr>
<td>Net investment in sales-type leases</td>
<td>12,164</td>
<td>12,563</td>
</tr>
<tr>
<td>Equipment operating leases</td>
<td>6,397</td>
<td>7,107</td>
</tr>
<tr>
<td>External customers</td>
<td>1,750</td>
<td>1,883</td>
</tr>
<tr>
<td>Internal customers*</td>
<td>1,001</td>
<td>1,001</td>
</tr>
<tr>
<td>Customer loans</td>
<td>3,752</td>
<td>3,752</td>
</tr>
<tr>
<td>Total customer financing assets</td>
<td>25,888</td>
<td>26,193</td>
</tr>
<tr>
<td>Commercial financing receivables</td>
<td>6,525</td>
<td>6,500</td>
</tr>
<tr>
<td>Intercompany financing receivables*</td>
<td>1,627</td>
<td>1,785</td>
</tr>
<tr>
<td>Other receivables</td>
<td>495</td>
<td>97</td>
</tr>
<tr>
<td>Other assets</td>
<td>941</td>
<td>77</td>
</tr>
<tr>
<td>Total financing assets</td>
<td>$35,242</td>
<td>$36,452</td>
</tr>
<tr>
<td>Intercorporate payables*</td>
<td>$3,383</td>
<td>$4,320</td>
</tr>
<tr>
<td>Debt</td>
<td>23,828</td>
<td>24,558</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>2,556</td>
<td>2,548</td>
</tr>
<tr>
<td>Total financing liabilities</td>
<td>31,767</td>
<td>32,931</td>
</tr>
<tr>
<td>Total financing equity</td>
<td>5,475</td>
<td>5,525</td>
</tr>
<tr>
<td>Total financing liabilities and equity</td>
<td>$35,242</td>
<td>$36,452</td>
</tr>
</tbody>
</table>

*Inventory and accounts receivable financing to dealers and remarketers of IT products. Global Financing also participated as a lender in selected syndicated loan facilities which originated from 1999 through 2001. Syndicated loans are loans in which Global Financing purchased a fixed percentage of a loan facility from a bank or other lending institution.

**Revenue:** The primary use of funds in Global Financing is to originate and commercial financing assets. Customer financing assets for end users consist primarily of IBM hardware, software and services, but also include non-IBM equipment, software and services to meet IBM customers’ total solutions requirements. Customer financing assets are primarily funded through direct, financing, and operating leases for equipment as well as loans for software and services with terms generally for two to five years.

**Financial Summary:** Commercial financing origination activity increased primarily due to inventory and accounts receivable financing for dealers and remarketers of IBM and non-IBM products. Payment terms for inventory financing generally range from 30 to 75 days. Payment terms for accounts receivable financing generally range from 10 to 90 days. Also included in commercial financing assets are syndicated loans.

**Originations:** The following are total external and internal financing origination activities.

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>External</td>
<td>$12,845</td>
<td>$15,620</td>
</tr>
<tr>
<td>Internal</td>
<td>931</td>
<td>1,922</td>
</tr>
<tr>
<td>Total</td>
<td>13,776</td>
<td>17,542</td>
</tr>
<tr>
<td>Commercial financing</td>
<td>2,213</td>
<td>3,233</td>
</tr>
<tr>
<td>Total</td>
<td>15,989</td>
<td>20,775</td>
</tr>
<tr>
<td>Total</td>
<td>$18,265</td>
<td>$20,517</td>
</tr>
</tbody>
</table>

* The decreases in originations were due to a lower demand for IT equipment associated with the current economic environment.

**Financial Assets by Sector:** Cash collections of both customer and commercial financing assets exceeded new financing origination in both 2002 and 2001, which resulted in a net decline in financing assets in these years. Cash collections in 2002 and 2001 included $218 million and zero, respectively, generated through sales of portions of Global Financing’s syndicated loan portfolio. These sales transactions did not have a material impact on the company’s Consolidated Statement of Earnings. Additionally, funds were generated through the sale and lease of used equipment sourced primarily from prior years’ lease origination.

**Financial Assets by Sector:** Cash generated by Global Financing was deployed to pay dividends to IBM and to reduce debt.

**Financing Assets by Sector:** The following are the percentage of external financing assets by industry sector.

<table>
<thead>
<tr>
<th>Industry Sector</th>
<th>2001 (%)</th>
<th>2002 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services</td>
<td>15%</td>
<td>14%</td>
</tr>
<tr>
<td>Business Partners*</td>
<td>13%</td>
<td>14%</td>
</tr>
<tr>
<td>Communications</td>
<td>12%</td>
<td>13%</td>
</tr>
<tr>
<td>Distribution</td>
<td>9%</td>
<td>11%</td>
</tr>
<tr>
<td>Public</td>
<td>10%</td>
<td>13%</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

* Business Partner financing assets represent a portion of commercial financing inventory and accounts receivable financing for terms generally less than 90 days.
FINANCING RECEIVABLES AND ALLOWANCES

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

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing receivables</td>
<td>$28,007</td>
<td>$29,331</td>
</tr>
<tr>
<td>Specific allowance for doubtful accounts</td>
<td>787</td>
<td>531</td>
</tr>
<tr>
<td>Unallocated allowance for doubtful accounts</td>
<td>184</td>
<td>160</td>
</tr>
<tr>
<td>Total allowance for doubtful accounts</td>
<td>971</td>
<td>691</td>
</tr>
<tr>
<td>Net financing receivables</td>
<td>$27,036</td>
<td>$28,640</td>
</tr>
<tr>
<td>Allowance for doubtful account coverage</td>
<td>3.5%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

ROLL-FORWARD OF FINANCING RECEIVABLES ALLOWANCE FOR DOUBTFUL ACCOUNTS

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>DEC. 31, 2002</th>
<th>RESERVE</th>
<th>ADDITIONS BAD DEBT EXPENSE</th>
<th>WRITE-OFFS</th>
<th>DEC. 31, 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>$691</td>
<td>($111)</td>
<td>$576</td>
<td>$23</td>
<td>$973</td>
<td></td>
</tr>
</tbody>
</table>

* Represents reversal write-offs, not of receivables, that were debited during the period.

** Primarily represents translation adjustments.

The percentage of financing receivables reserved increased from 2.4 percent at December 31, 2001, to 3.5 percent at December 31, 2002. Unallocated reserves increased 15.0 percent from $160 million in 2001 to $184 million in 2002, even though the average receivables balance declined 4.7 percent over the same period. While the overall asset quality of the portfolio remains stable, the increase reflects the company's concern with the impact of the current economic environment on customer accounts. Specific reserves increased 48.2 percent from $511 million in 2001 to $787 million in 2002. The increase in specific reserves was due to continued weak economic conditions in the Communications industry, and deterioration in certain companies in this and other industries. Global Financing's bad debt expense increased to $576 million for the year ended 2002, compared with $419 million for 2001 primarily attributable to the matters referred to above.

RESIDUAL VALUE

Residual value is a risk unique to the financing business and management of this risk is dependent upon the ability to accurately project future equipment values. As previously stated, Global Financing has clear insight into product plans and cycles for the IBM product under lease. Based upon this product information, Global Financing continually monitors projections of future equipment values and compares them to the residual values reflected in the portfolio. See note x, “Significant Accounting Policies,” on page 74 for the company's accounting policy for residual values.

Sales of equipment, which are primarily sourced from equipment returned at end of lease, represented 32.1 percent of Global Financing's revenue in 2002 and 27.7 percent in 2001. The gross margin on these sales was 28.5 percent and 27.5 percent in 2002 and 2001, respectively. In addition to selling assets that are sourced from end of lease, Global Financing also leases used equipment to new customers or extends leasing arrangements with current customers. These are other ways that Global Financing profitably recovers the residual values. The following table presents the recorded amount of unguaranteed residual value for sales-type and operating leases at December 31, 2001 and 2002. In addition, the table presents the residual value as a percentage of the original amount financed, and a run out of the unguaranteed residual value over the remaining lives of these leases at December 31, 2002.

RESIDUAL VALUE

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>TOTAL</th>
<th>RUN OUT OF 2002 BALANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>2001</td>
<td>2002</td>
</tr>
<tr>
<td>Sales-type leases</td>
<td>$791</td>
<td>$821</td>
</tr>
<tr>
<td>Operating leases</td>
<td>134</td>
<td>242</td>
</tr>
<tr>
<td>Total unguaranteed residual value</td>
<td>$1,325</td>
<td>$1,063</td>
</tr>
<tr>
<td>Related original amount financed</td>
<td>$23,979</td>
<td>$23,019</td>
</tr>
<tr>
<td>Percentage</td>
<td>4.7%</td>
<td>6.0%</td>
</tr>
</tbody>
</table>

The company's Global Financing business provides funding predominantly for the company's external customers but also provides intercompany financing for the company (internal), as described in the “Description of Business” on page 60. As previously stated, IBM manages and measures Global Financing as if it were a standalone entity and accordingly, interest relating to debt supporting Global Financing's external customer and internal business is included in the “Global Financing Results of Operations” on page 60 and in note x, “Segment Information,” on pages 100 to 104.

In the company's Consolidated Statement of Earnings on page 64, however, the interest expense supporting Global Financing's internal financing to the company is reclassified from Cost of financing to Interest expense.

LIQUIDITY

Global Financing is a segment of IBM and as such is supported by IBM's liquidity position and access to capital markets. Global Financing generated cash in 2002, which was primarily driven by net income and a decline in assets. Cash was deployed to reduce debt and pay dividends in order to maintain an appropriate debt to equity ratio.

Critical Accounting Estimates

As discussed in note x, “Significant Accounting Policies,” on pages 70 to 75, the application of GAAP involves the exercise of varying degrees of judgment. The following areas require more judgment relative to the others and relate to Global Financing:

- **Debt to equity ratios**: 6.5% to 6.4%

Global Financing funds its operations primarily through borrowings using a debt-to-equity ratio of approximately 7 to 1. The following table illustrates the correlation between Global Financing assets and Global Financing debt. Both assets and debt are presented in the Global Financing balance sheet on page 61.

**GLOBAL FINANCING ASSETS AND DEBT**

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt to equity ratios</td>
<td>6.5%</td>
<td>6.4%</td>
</tr>
</tbody>
</table>

**Market Risk**

See pages 58 and 59 for discussion of the company's overall market risk.

Looking Forward

Given Global Financing's mission of supporting IBM's hardware, software and services, originations for both customer and commercial finance businesses will be dependent upon the overall demand for IT equipment.

Interest rates and the overall economy (including currency fluctuations) will have an effect on both revenue and gross profit. The company's interest rate risk management policy, however, combined with the Global Financing funding strategy (see page 60), should mitigate gross profit erosion due to changes in interest rates. The company's policy of matching asset and liability positions in foreign currencies will limit the impacts of currency fluctuations.

The economy could impact the credit quality of the Global Financing receivables portfolio and therefore the level of provision for bad debts. Global Financing will continue to apply rigorous credit policies in both the origination of new business and the evaluation of the existing portfolio.

As seen above, Global Financing has historically been able to manage residual value risk through both insight into the product cycles as well as through its remarketing business. Global Financing has policies in place to manage each of the key risks involved in financing. These policies, combined with product and customer knowledge, should allow for the prudent management of the business going forward, even with the uncertainty of the current economy.
FINANCING RECEIVABLES AND ALLOWANCES

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

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financing receivables</td>
<td>$28,007</td>
<td>$29,331</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specific allowance for doubtful accounts</td>
<td>787</td>
<td>531</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unallocated allowance for doubtful accounts</td>
<td>184</td>
<td>160</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total allowance for doubtful accounts</td>
<td>971</td>
<td>691</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net financing receivables</td>
<td>$27,036</td>
<td>$28,007</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful account coverage</td>
<td>3.5%</td>
<td>2.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The percentage of financing receivables reserved increased from 2.4 percent at December 31, 2001, to 3.5 percent at December 31, 2002. Unallocated reserves increased 15.0 percent from $160 million in 2001 to $184 million in 2002, even though the average receivables balance declined 4.5 percent over the same period. While the overall asset quality of the portfolio remains stable, the increase reflects the company’s concern with the impact of the current economic environment on customer accounts. Specific reserves increased 48.2 percent from $511 million in 2001 to $787 million in 2002. The increase in specific reserves was due to continued weak economic conditions in the Communications industry, and deterioration in certain companies in this and other industries. Global Financing’s bad debts expense increased to $776 million for the year ended 2002, compared with $149 million for 2001 primarily attributable to the matters referred to above.

RESIDUAL VALUE

Residual value is a risk unique to the financing business and management of this risk is dependent upon the ability to accurately project future equipment values. As previously stated, Global Financing has clear insight into product plans and cycles for the IBM product under lease. Based upon this product information, Global Financing continually monitors projections of future equipment values and compares them to the residual values reflected in the portfolio. See note a, “Significant Accounting Policies” on page 74 for the company’s accounting policy for residual values.

Sales of equipment, which are primarily sourced from equipment returned at end of lease, represented 32.1 percent of Global Financing’s revenue in 2002 and 27.7 percent in 2001. The gross margin on these sales were 28.5 percent and 27.5 percent in 2002 and 2001, respectively. In addition to selling assets that are sourced from end of lease, Global Financing also leases used equipment to new customers or extends leasing arrangements with current customers. These are other ways that Global Financing profitably recovers the residual values. The following table presents the recorded amount of unguaranteed residual value for sales-type and operating leases at December 31, 2001 and 2002. In addition, the table presents the residual value as a percentage of the original amount financed, and a run out of the unguaranteed residual value over the remaining lives of these leases at December 31, 2002.

<table>
<thead>
<tr>
<th></th>
<th>Run-out of 2002 balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Sales-type leases</td>
<td>$791</td>
</tr>
<tr>
<td>Operating leases</td>
<td>234</td>
</tr>
<tr>
<td>Total unguaranteed residual value</td>
<td>$1,125</td>
</tr>
<tr>
<td>Related original amount financed</td>
<td>$23,919</td>
</tr>
<tr>
<td>Percentage</td>
<td>4.7%</td>
</tr>
</tbody>
</table>

The company’s Global Financing business provides funding primarily for the company’s external customers but also provides intercompany financing for the company (internal), as described in the “Description of Business” on page 60. As previously stated, IBM manages and measures Global Financing as if it were a standalone entity and accordingly, interest expense relating to debt supporting Global Financing’s external customer and internal business is included in the “Global Financing Results of Operations” on page 60 and in note x, “Segment Information,” on pages 100 to 104.

In the company’s Consolidated Statement of Earnings on page 64, however, the interest expense supporting Global Financing’s internal financing to the company is reclassified from Cost of financing to Interest expense.

LIQUIDITY

Global Financing is a segment of IBM and as such is supported by IBM’s liquidity position and access to capital markets. Global Financing generated cash in 2002, which was primarily driven by net income and a decline in assets. Cash was deployed to reduce debt and pay dividends in order to maintain an appropriate debt to equity ratio.

Critical Accounting Estimates

As discussed in note a, “Significant Accounting Policies,” on pages 70 to 75, the application of GAAP involves the exercise of varying degrees of judgment. The following areas require more judgment relative to the others and relate to Global Financing:
Consolidated Statement of Financial Position

(dollars in millions except per share amounts)

<table>
<thead>
<tr>
<th>NOTE</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>3,382</td>
<td>3,415</td>
<td>3,470</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>993</td>
<td>63</td>
<td>63</td>
</tr>
<tr>
<td>Notes and accounts receivable—trade, net of allowances</td>
<td>9,915</td>
<td>9,101</td>
<td>9,101</td>
</tr>
<tr>
<td>Short-term financing receivables</td>
<td>15,996</td>
<td>16,616</td>
<td>16,616</td>
</tr>
<tr>
<td>Other accounts receivable</td>
<td>1,441</td>
<td>1,284</td>
<td>1,284</td>
</tr>
<tr>
<td>Inventories</td>
<td>3,104</td>
<td>4,304</td>
<td>4,304</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>2,617</td>
<td>2,464</td>
<td>2,464</td>
</tr>
<tr>
<td>Prepaid expenses and other current assets</td>
<td>2,554</td>
<td>2,344</td>
<td>2,344</td>
</tr>
<tr>
<td>Total current assets</td>
<td>41,652</td>
<td>42,461</td>
<td>42,461</td>
</tr>
<tr>
<td>Plant, rental machines and other property</td>
<td>6,083</td>
<td>6,575</td>
<td>6,575</td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td>21,645</td>
<td>21,871</td>
<td>21,871</td>
</tr>
<tr>
<td>Plant, rental machines and other property—net</td>
<td>14,440</td>
<td>16,504</td>
<td>16,504</td>
</tr>
<tr>
<td><strong>LIABILITIES AND STOCKHOLDERS’ EQUITY</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>5,476</td>
<td>4,644</td>
<td>4,644</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>6,011</td>
<td>11,188</td>
<td>11,188</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>7,630</td>
<td>7,047</td>
<td>7,047</td>
</tr>
<tr>
<td>Compensation and benefits</td>
<td>3,724</td>
<td>3,796</td>
<td>3,796</td>
</tr>
<tr>
<td>Deferred income</td>
<td>5,276</td>
<td>4,474</td>
<td>4,474</td>
</tr>
<tr>
<td>Other accrued expenses and liabilities</td>
<td>4,115</td>
<td>4,222</td>
<td>4,222</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>34,550</td>
<td>35,119</td>
<td>35,119</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>19,997</td>
<td>21,645</td>
<td>21,645</td>
</tr>
<tr>
<td>Retirement and nonpension postretirement benefit obligations</td>
<td>13,215</td>
<td>16,504</td>
<td>16,504</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>5,991</td>
<td>5,464</td>
<td>5,464</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>46,844</td>
<td>69,303</td>
<td>69,303</td>
</tr>
<tr>
<td>Common stock, par value $.20 per share</td>
<td>14,858</td>
<td>14,248</td>
<td>14,248</td>
</tr>
<tr>
<td>Shares authorized: 4,687,500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares issued (2002—1,920,957,772; 2001—1,913,513,218)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>13,555</td>
<td>10,142</td>
<td>10,142</td>
</tr>
<tr>
<td>Accumulated gains and (losses) not affecting retained earnings</td>
<td>(2,416)</td>
<td>(828)</td>
<td>(828)</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>13,555</td>
<td>10,142</td>
<td>10,142</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>59,409</td>
<td>79,445</td>
<td>79,445</td>
</tr>
</tbody>
</table>

* Does not total due to rounding.

The accompanying notes on pages 70 through 104 are an integral part of the financial statements.
### Consolidated Statement of Financial Position

**Consolidated Statement of Earnings**

**Consolidated Statement of Financial Position**

<table>
<thead>
<tr>
<th>Notes</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Services</td>
<td>$36,360</td>
<td>$34,956</td>
<td>$33,152</td>
</tr>
<tr>
<td>Hardware</td>
<td>27,456</td>
<td>30,593</td>
<td>34,470</td>
</tr>
<tr>
<td>Software</td>
<td>13,074</td>
<td>12,999</td>
<td>12,198</td>
</tr>
<tr>
<td>Global Financing</td>
<td>3,212</td>
<td>3,462</td>
<td>3,630</td>
</tr>
<tr>
<td>Enterprise Investments/Other</td>
<td>1,064</td>
<td>1,133</td>
<td>1,404</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>81,186</td>
<td>83,067</td>
<td>85,089</td>
</tr>
<tr>
<td><strong>Cost:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Services</td>
<td>26,812</td>
<td>25,355</td>
<td>24,309</td>
</tr>
<tr>
<td>Hardware</td>
<td>20,020</td>
<td>21,231</td>
<td>24,207</td>
</tr>
<tr>
<td>Software</td>
<td>2,043</td>
<td>2,265</td>
<td>2,283</td>
</tr>
<tr>
<td>Global Financing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Investments/Other</td>
<td>1,064</td>
<td>1,153</td>
<td>1,404</td>
</tr>
<tr>
<td><strong>Total Cost</strong></td>
<td>50,902</td>
<td>51,178</td>
<td>53,511</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>30,284</td>
<td>31,889</td>
<td>31,578</td>
</tr>
<tr>
<td><strong>Expense and Other Income:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research, development and engineering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intellectual property and custom development income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (income) and expense</td>
<td>227</td>
<td>(353)</td>
<td>(990)</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Expense and Other Income</strong></td>
<td>22,760</td>
<td>20,439</td>
<td>20,167</td>
</tr>
<tr>
<td><strong>Income from Continuing Operations Before Income Taxes</strong></td>
<td>7,524</td>
<td>11,450</td>
<td>11,411</td>
</tr>
<tr>
<td><strong>Provision for Income Taxes</strong></td>
<td>2,190</td>
<td>3,304</td>
<td>3,537</td>
</tr>
<tr>
<td><strong>Income from Continuing Operations</strong></td>
<td>5,334</td>
<td>8,146</td>
<td>7,874</td>
</tr>
<tr>
<td><strong>Discontinued Operations:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Loss)/income from discontinued operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>3,579</td>
<td>7,713</td>
<td>8,073</td>
</tr>
<tr>
<td><strong>Earnings/(Loss) Per Share of Common Stock:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assuming Dilution:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>$1.07</td>
<td>$4.59</td>
<td>$4.32</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(0.01)</td>
<td>(0.24)</td>
<td>(0.12)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2.06</td>
<td>4.35</td>
<td>4.24</td>
</tr>
<tr>
<td><strong>Basic:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>$1.13</td>
<td>$4.69</td>
<td>$4.47</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(0.09)</td>
<td>(0.24)</td>
<td>(0.12)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2.10</td>
<td>4.45</td>
<td>4.36</td>
</tr>
</tbody>
</table>

**Average Number of Common Shares Outstanding:**

- Assuming dilution: 1,738,941,054
- Basic: 1,703,246,345

*Does not total due to rounding. The accompanying notes on pages 70 through 104 are an integral part of the financial statements.*

---

**Assets:**

- Current assets: $5,382
- Marketable securities: 993
- Notes and accounts receivable — trade, net of allowances: 9,915
- Short-term financing receivables: 15,996
- Long-term financing receivables: 11,440
- Prepaid pension assets: 16,003
- Prepaid expense: 16,031
- Inventories: 4,115
- Deferred taxes: 2,617
- Other assets: 2,554

**Liabilities and Stockholders' Equity:**

- Current liabilities: $5,476
- Accounts payable: 7,650
- Compensation and benefits: 3,724
- Deferred income: 5,276
- Other accrued expenses and liabilities: 6,413
- Total current liabilities: 34,550
- Long-term debt: 19,986
- Other liabilities: 5,951
- Total liabilities: 73,702
- Stockholders' equity: 22,782
- Total liabilities and stockholders' equity: 96,484

*Redescribed to conform with 2002 presentation. The accompanying notes on pages 70 through 104 are an integral part of the financial statements.*
### Consolidated Statement of Stockholders’ Equity

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Preferred Stock</th>
<th>Common Stock</th>
<th>Retained Earnings</th>
<th>Employee Benefits</th>
<th>Trust Earnings</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2001</strong>&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stockholders’ equity, January 1, 2000</td>
<td>$247</td>
<td>$11,762</td>
<td>$16,878</td>
<td>(7,175)</td>
<td>(2,162)</td>
<td>$1,076</td>
</tr>
<tr>
<td>Net income plus gains and (losses) not affecting retained earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>8,093</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$8,093</td>
</tr>
<tr>
<td>Gains and (losses) not affecting retained earnings (net of tax)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency translation adjustments</td>
<td>(538)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(538)</td>
</tr>
<tr>
<td>Minimum pension liability adjustment</td>
<td>18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>18</td>
</tr>
<tr>
<td>Net unrealized losses on marketable securities (net of tax benefit of $516)</td>
<td>(925)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(925)</td>
</tr>
<tr>
<td>Total gains and (losses) not affecting retained earnings</td>
<td>(4,445)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(4,445)</td>
</tr>
<tr>
<td>Subtotal: Net income plus gains and (losses) not affecting retained earnings</td>
<td></td>
<td></td>
<td>$6,648</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash dividends declared—common stock</td>
<td>(909)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(909)</td>
</tr>
<tr>
<td>Cash dividends declared—preferred stock</td>
<td>(20)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(20)</td>
</tr>
<tr>
<td>Common stock issued under employee plans (17,277,150 shares)</td>
<td>615</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>616</td>
</tr>
<tr>
<td>Purchases (8,799,182 shares) and sales (9,074,212 shares) of treasury stock under employee plans—net</td>
<td>(259)</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td>(253)</td>
</tr>
<tr>
<td>Other treasury shares purchased, not retired (18,867,226 shares)</td>
<td>(6,431)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(6,431)</td>
</tr>
<tr>
<td>Fair value adjustment of employee benefits trust</td>
<td>(439)</td>
<td>450</td>
<td></td>
<td></td>
<td></td>
<td>11</td>
</tr>
<tr>
<td>Increase due to shares remaining to be issued in acquisition</td>
<td>40</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Tax effect—stock transactions</td>
<td>422</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>422</td>
</tr>
<tr>
<td><strong>Stockholders’ equity, December 31, 2000</strong></td>
<td>$247</td>
<td>$12,400</td>
<td>$23,784</td>
<td>(11,800)</td>
<td>(1,712)</td>
<td>$20,550</td>
</tr>
</tbody>
</table>

<sup>a</sup> Reclassified to conform with 2002 presentation.

### Consolidated Statement of Stockholders’ Equity

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Preferred Stock</th>
<th>Common Stock</th>
<th>Retained Earnings</th>
<th>Employee Benefits</th>
<th>Trust Earnings</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2001</strong>&lt;sup&gt;a&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stockholders’ equity, December 31, 2000</td>
<td>$247</td>
<td>$12,400</td>
<td>$23,784</td>
<td>(13,800)</td>
<td>(1,712)</td>
<td>$20,550</td>
</tr>
<tr>
<td>Net income plus gains and (losses) not affecting retained earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7,723</td>
</tr>
<tr>
<td>Gains and (losses) not affecting retained earnings (net of tax)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative effect of adoption of SFAS No. 133 on Jan. 1 (net of tax expense of $120)</td>
<td>219</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>219</td>
</tr>
<tr>
<td>Net unrealized gains on SFAS No. 133 cash flow hedge derivatives during 2001 (net of tax expense of $44)</td>
<td></td>
<td></td>
<td>22 18</td>
<td></td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Foreign currency translation adjustments (net of tax expense of $513)</td>
<td></td>
<td></td>
<td></td>
<td>(513)</td>
<td>(513)</td>
<td></td>
</tr>
<tr>
<td>Minimum pension liability adjustment (net of tax benefit of $226)</td>
<td></td>
<td></td>
<td>90 51</td>
<td></td>
<td></td>
<td>141</td>
</tr>
<tr>
<td>Net unrealized gains on marketable securities (net of tax expense of $88)</td>
<td></td>
<td></td>
<td></td>
<td>92 92</td>
<td></td>
<td>184</td>
</tr>
<tr>
<td>Total gains and (losses) not affecting retained earnings</td>
<td></td>
<td></td>
<td></td>
<td>(479)</td>
<td>(479)</td>
<td></td>
</tr>
<tr>
<td>Subtotal: Net income plus gains and (losses) not affecting retained earnings</td>
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<td></td>
<td></td>
<td>7,264</td>
<td>7,264</td>
<td></td>
</tr>
<tr>
<td>Cash dividends declared—common stock</td>
<td>(956)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(956)</td>
</tr>
<tr>
<td>Cash dividends declared—preferred stock</td>
<td>(10)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(10)</td>
</tr>
<tr>
<td>Common stock issued under employee plans (17,277,150 shares)</td>
<td>615</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>616</td>
</tr>
<tr>
<td>Purchases (8,799,182 shares) and sales (9,074,212 shares) of treasury stock under employee plans—net</td>
<td>(259)</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td>(253)</td>
</tr>
<tr>
<td>Other treasury shares purchased, not retired (18,867,226 shares)</td>
<td>(6,431)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(6,431)</td>
</tr>
<tr>
<td>Fair value adjustment of employee benefits trust</td>
<td>(439)</td>
<td>450</td>
<td></td>
<td></td>
<td></td>
<td>11</td>
</tr>
<tr>
<td>Increase due to shares remaining to be issued in acquisition</td>
<td>40</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Tax effect—stock transactions</td>
<td>422</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>422</td>
</tr>
<tr>
<td><strong>Stockholders’ equity, December 31, 2001</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup> Reclassified to conform with 2002 presentation.
## Consolidated Statement of Stockholders' Equity

### International Business Machines Corporation and Subsidiary Companies

**2001**

<table>
<thead>
<tr>
<th>Added (in millions)</th>
<th>Preferred Stock</th>
<th>Common Stock</th>
<th>Treasury Stock</th>
<th>Employee Benefits Trust</th>
<th>Total</th>
<th>Accumulated Gains and (Losses) Not Affecting Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders' equity, December 31, 2000</td>
<td>$247</td>
<td>$12,400</td>
<td>$23,784</td>
<td>($13,800)</td>
<td>$(3,712)</td>
<td>$169</td>
</tr>
</tbody>
</table>

Net income plus gains and (losses) not affecting retained earnings:

- **Net income**: 7,723
- **Gains and (losses) not affecting retained earnings** (net of tax):
  - **Cumulative effect of adoption of SFAS No. 133 on Jan. 1 (net of tax expense of $120)**: 219
  - **Net unrealized gains on SFAS No. 133 cash flow hedge derivatives during 2001 (net of tax expense of $44)**: 77
  - **Foreign currency translation adjustments (net of tax expense of $123)**: 77
  - **Minimum pension liability adjustment (net of tax benefit of $226)**: 92
  - **Net unrealized gains on marketable securities (net of tax expense of $18)**: 92

Total gains and (losses) not affecting retained earnings: (459)

Subtotal: **Net income plus gains and (losses) not affecting retained earnings**: 7,264

- **Cash dividends declared — common stock**: (956)
- **Cash dividends declared — preferred stock**: (10)
- **Common stock issued under employee plans (57,750,000 shares)**: 615
- **Purchases of stock, including sales of treasury stock under employee stock plans — net**: (259)
- **Other treasury shares purchased, not retired**: (6,431)
- **Fair value adjustment of employee benefits trust**: (439)
- **Increase due to shares remaining to be issued in acquisition**: 40
- **Tax effect — stock transactions**: 422

Stockholders' equity, December 31, 2000: $247, $12,400, $23,784, $(13,800), $(3,712), $169, $20,510

### 2000

<table>
<thead>
<tr>
<th>Added (in millions)</th>
<th>Preferred Stock</th>
<th>Common Stock</th>
<th>Treasury Stock</th>
<th>Employee Benefits Trust</th>
<th>Total</th>
<th>Accumulated Gains and (Losses) Not Affecting Retained Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders' equity, January 1, 2000</td>
<td>$247</td>
<td>$11,762</td>
<td>$16,878</td>
<td>($7,175)</td>
<td>$(2,162)</td>
<td>$1,076</td>
</tr>
</tbody>
</table>

Net income plus gains and (losses) not affecting retained earnings:

- **Net income**: 8,093
- **Gains and (losses) not affecting retained earnings (net of tax)**:
  - **Foreign currency translation adjustments (net of tax expense of $289)**: 538
  - **Minimum pension liability adjustment (net of tax expense of $12)**: 18
  - **Net unrealized losses on marketable securities (net of tax expense of $516)**: (925)

Total gains and (losses) not affecting retained earnings: (1,445)

Subtotal: **Net income plus gains and (losses) not affecting retained earnings**: 6,648

- **Cash dividends declared — common stock**: (909)
- **Cash dividends declared — preferred stock**: (20)
- **Common stock issued under employee plans (77,750,000 shares)**: 615
- **Purchases of stock, including sales of treasury stock under employee stock plans — net**: (259)
- **Other treasury shares purchased, not retired**: (6,431)
- **Fair value adjustment of employee benefits trust**: (439)
- **Increase due to shares remaining to be issued in acquisition**: 40
- **Tax effect — stock transactions**: 422

Stockholders' equity, December 31, 2000: $247, $12,400, $23,784, $(13,800), $(3,712), $169, $20,510

*Reclassified to conform with 2002 presentation.*
### Consolidated Statement of Stockholders’ Equity

<table>
<thead>
<tr>
<th>Year</th>
<th>Common Stock</th>
<th>Retained Earnings</th>
<th>Treasury Stock</th>
<th>Employee Benefits Trust</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>14,248</td>
<td>$30,114</td>
<td>$20,114</td>
<td>$628</td>
<td>23,448</td>
</tr>
</tbody>
</table>

Net income plus gains and (losses) not affecting retained earnings:

- **Net income**: $3,579
- **Gains and (losses) not affecting retained earnings (net of tax)**:
  - **Net unrealized losses on SFAS No. 133 cash flow hedge derivatives during 2002 (net of tax benefit of $872)**: $659
  - **Foreign currency translation adjustments (net of tax benefit of $197)**: 810
  - **Minimum pension liability adjustment (net of tax benefit of $1,574)**: 2,765
  - **Net unrealized losses on marketable securities (net of tax benefit of $8)**: 16

Total gains and (losses) not affecting retained earnings: 2,960

Stockholders’ equity, December 31, 2002: $14,858 $31,595 $20,213 $5,418 $22,782

The accompanying notes on pages 70 through 104 are an integral part of the financial statements.

### Consolidated Statement of Cash Flows

**For the year ended December 31:**

#### Cash Flow from Operating Activities from Continuing Operations:

- Income from continuing operations: $5,134
- Adjustments to reconcile net income from continuing operations to cash provided by operating activities:
  - Depreciation: 3,691
  - Amortization of software: 688
  - Deferred income taxes: 654
  - Net gain on assets sales and other: 343
  - Other than temporary declines in securities and other investments: 59
  - Noncash portion of special actions: 130
  - Change in operating assets and liabilities, net of acquisitions/divestitures:
    - Receivables: 4,125
    - Inventories: 793
    - Pension assets: 4,227
    - Other assets: 79
    - Accounts payable: 55
    - Pension liabilities: 123
    - Other liabilities: 2,288

Net cash provided by operating activities from continuing operations: 13,798

#### Cash Flow from Investing Activities from Continuing Operations:

- Payments for plant, rental machines and other property: (6,753)
- Proceeds from disposition of plant, rental machines and other property: 775
- Investment in software: (597)
- Purchases of marketable securities and other investments: (1,803)
- Proceeds from disposition of marketable securities and other investments: 1,185
- Divestiture of businesses: 1,233
- Acquisition of businesses: (1,198)

Net cash used in investing activities from continuing operations: (6,897)

#### Cash Flow from Financing Activities from Continuing Operations:

- Proceeds from new debt: 6,726
- Short-term (repayments)/borrowings less than 90 days — net: (4,087)
- Payments to settle debt: (5,912)
- Preferred stock transactions — net: (254)
- Common stock transactions — net: (3,087)
- Cash dividends paid: (1,005)

Net cash used in financing activities from continuing operations: (5,561)

#### Cash and Cash Equivalents at December 31:

- $3,382

**Supplemental Data:**

- Cash paid during the year for the total company:
  - Income taxes: $1,441
  - Interest: $1,441

**Noncash Investing and Financing Activities:**

The noncash portion of the purchase price paid for PwCC is a significant noncash investing activity. This transaction is described on page 78.

*Redescribed to conform with 2002 presentation.*

The accompanying notes on pages 70 through 104 are an integral part of the financial statements.
Consolidated Statement of Stockholders’ Equity

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders’ equity, December 31, 2001</td>
<td>$14,248</td>
<td>$30,114</td>
<td>$20,114</td>
</tr>
<tr>
<td>Net income plus gains and (losses) not affecting retained earnings</td>
<td>3,579</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Gains and (losses) not affecting retained earnings (net of tax):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net unrealized losses on SFAS No. 133</td>
<td>(659)</td>
<td>(659)</td>
<td></td>
</tr>
<tr>
<td>Foreign currency translation adjustments (net of tax benefit of $197)</td>
<td>(810)</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>Minimum pension liability adjustment (net of tax benefit of $1,574)</td>
<td>(2,765)</td>
<td>(2,765)</td>
<td></td>
</tr>
<tr>
<td>Net unrealized losses on marketable securities (net of tax benefit of $8)</td>
<td>(16)</td>
<td>(16)</td>
<td></td>
</tr>
<tr>
<td>Total gains and (losses) not affecting retained earnings</td>
<td>(2,796)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal: Net income plus gains and (losses) not affecting retained earnings</td>
<td>3,563</td>
<td>3,054</td>
<td>1,958</td>
</tr>
<tr>
<td>Cash dividends declared—common stock</td>
<td>(1,005)</td>
<td>(1,005)</td>
<td></td>
</tr>
<tr>
<td>Common stock issued under employee plans (7,235,993 shares)</td>
<td>440</td>
<td>4</td>
<td>444</td>
</tr>
<tr>
<td>Purchases (1,169,043 shares) and sales</td>
<td>(12,873,502 shares) of treasury stock under employee plans—net</td>
<td>(475)</td>
<td>1,210</td>
</tr>
<tr>
<td>Other treasury shares purchased, not retired (47,501,854 shares)</td>
<td>(4,113)</td>
<td>(4,113)</td>
<td></td>
</tr>
<tr>
<td>Treasury shares issued to fund the U.S. pension fund (24,073,354 shares)</td>
<td>(576)</td>
<td>2,447</td>
<td>1,871</td>
</tr>
<tr>
<td>Shares issued/to be issued in the PwCC acquisition (3,677,213 shares issued)</td>
<td>43</td>
<td>(114)</td>
<td>353</td>
</tr>
<tr>
<td>Decrease in shares remaining to be issued in acquisition</td>
<td>(9)</td>
<td>(9)</td>
<td></td>
</tr>
<tr>
<td>Tax effect—stock transactions</td>
<td>136</td>
<td>136</td>
<td></td>
</tr>
<tr>
<td>Stockholders’ equity, December 31, 2002</td>
<td>$14,858</td>
<td>$31,555</td>
<td>$20,213</td>
</tr>
</tbody>
</table>

The accompanying notes on pages 70 through 94 are an integral part of the financial statements.

Consolidated Statement of Cash Flows

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2004</th>
<th>2003*</th>
<th>2002*</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH FLOW FROM OPERATING ACTIVITIES FROM CONTINUING OPERATIONS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$5,134</td>
<td>$8,146</td>
<td>$7,874</td>
</tr>
<tr>
<td>Adjustments to reconcile net income from continuing operations to cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>3,691</td>
<td>3,881</td>
<td>4,224</td>
</tr>
<tr>
<td>Amortization of software</td>
<td>688</td>
<td>621</td>
<td>482</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(67)</td>
<td>664</td>
<td>4</td>
</tr>
<tr>
<td>Net gain on assets sales and other</td>
<td>(343)</td>
<td>(340)</td>
<td>(731)</td>
</tr>
<tr>
<td>Other than temporary declines in securities and other investments</td>
<td>58</td>
<td>401</td>
<td>—</td>
</tr>
<tr>
<td>Noncash portion of special actions</td>
<td>1,310</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Change in operating assets and liabilities, net of acquisitions/divestitures:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>4,125</td>
<td>2,837</td>
<td>(4,692)</td>
</tr>
<tr>
<td>Inventories</td>
<td>793</td>
<td>287</td>
<td>(22)</td>
</tr>
<tr>
<td>Pension assets</td>
<td>(4,227)</td>
<td>(7,758)</td>
<td>(3,333)</td>
</tr>
<tr>
<td>Other assets</td>
<td>79</td>
<td>2,244</td>
<td>671</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(55)</td>
<td>(916)</td>
<td>2,134</td>
</tr>
<tr>
<td>Pension liabilities</td>
<td>83</td>
<td>(69)</td>
<td>(237)</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>2,268</td>
<td>(1,036)</td>
<td>441</td>
</tr>
<tr>
<td>NET CASH PROVIDED BY OPERATING ACTIVITIES FROM CONTINUING OPERATIONS</td>
<td>13,788</td>
<td>11,966</td>
<td>8,847</td>
</tr>
<tr>
<td>CASH FLOW FROM INVESTING ACTIVITIES FROM CONTINUING OPERATIONS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from plant, rental machines and other property</td>
<td>(4,753)</td>
<td>(5,400)</td>
<td>(3,219)</td>
</tr>
<tr>
<td>Proceeds from disposition of plant, rental machines and other property</td>
<td>775</td>
<td>1,149</td>
<td>1,569</td>
</tr>
<tr>
<td>Investment in software</td>
<td>(597)</td>
<td>(655)</td>
<td>(583)</td>
</tr>
<tr>
<td>Purchases of marketable securities and other investments</td>
<td>(1,922)</td>
<td>(778)</td>
<td>(700)</td>
</tr>
<tr>
<td>Proceeds from disposition of marketable securities and other investments</td>
<td>1,185</td>
<td>738</td>
<td>1,393</td>
</tr>
<tr>
<td>Divestiture of businesses</td>
<td>1,213</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Acquisition of businesses</td>
<td>(1,158)</td>
<td>(916)</td>
<td>(329)</td>
</tr>
<tr>
<td>NET CASH USED IN INVESTING ACTIVITIES FROM CONTINUING OPERATIONS</td>
<td>(6,997)</td>
<td>(5,862)</td>
<td>(4,003)</td>
</tr>
<tr>
<td>CASH FLOW FROM FINANCING ACTIVITIES FROM CONTINUING OPERATIONS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from new debt</td>
<td>6,726</td>
<td>4,531</td>
<td>9,604</td>
</tr>
<tr>
<td>Short-term (repayments)/borrowings less than 90 days—net</td>
<td>(4,087)</td>
<td>2,926</td>
<td>(3,408)</td>
</tr>
<tr>
<td>Payments to settle debt</td>
<td>(5,142)</td>
<td>(7,909)</td>
<td>(7,581)</td>
</tr>
<tr>
<td>Preferred stock transactions—net</td>
<td>(254)</td>
<td>(254)</td>
<td></td>
</tr>
<tr>
<td>Common stock transactions—net</td>
<td>(1,087)</td>
<td>(3,652)</td>
<td>(6,073)</td>
</tr>
<tr>
<td>Cash dividends paid</td>
<td>(1,005)</td>
<td>(965)</td>
<td>(929)</td>
</tr>
<tr>
<td>NET CASH USED IN FINANCING ACTIVITIES FROM CONTINUING OPERATIONS</td>
<td>(7,265)</td>
<td>(5,305)</td>
<td>(8,359)</td>
</tr>
<tr>
<td>Effect of exchange rate changes on cash and cash equivalents</td>
<td>148</td>
<td>(81)</td>
<td>(147)</td>
</tr>
<tr>
<td>Net cash (used in)/provided by discontinued operations</td>
<td>(712)</td>
<td>58</td>
<td>196</td>
</tr>
<tr>
<td>Net change in cash and cash equivalents</td>
<td>(948)</td>
<td>2,767</td>
<td>(1,486)</td>
</tr>
<tr>
<td>Cash and cash equivalents at January 1</td>
<td>6,330</td>
<td>5,561</td>
<td>5,043</td>
</tr>
<tr>
<td>CASH AND CASH EQUIVALENTS AT DECEMBER 31</td>
<td>$5,382</td>
<td>$6,130</td>
<td>$3,565</td>
</tr>
</tbody>
</table>

SUPPLEMENTAL DATA:
Cash paid during the year for the total company:
Income taxes | $1,841 | $2,279 | $2,697 |
Interest | $831 | $1,247 | $1,447 |

NONCASH INVESTING AND FINANCING ACTIVITIES:
The noncash portion of the purchase price paid for PwCC is a significant noncash investing activity. This transaction is described on page 78.

* Redescribed to conform with 2002 presentation.

The accompanying notes on pages 70 through 104 are an integral part of the financial statements.
**A Significant Accounting Policies**

**Basis of Presentation**
On December 31, 2002, the company sold its hard-disk drive (HDD) business to Hitachi, Ltd. (Hitachi). See note c, "Acquisitions/Diversitumers," on pages 78 to 80. The HDD business was part of the company’s Technology Group reporting segment. The HDD business was accounted for as a discontinued operation under generally accepted accounting principles (GAAP) and therefore, the HDD results of operations and cash flows have been removed from the company’s results of continuing operations and cash flows for all periods presented in this document. The financial results reported as discontinued operations include the external original equipment manufacturer (OEM) HDD business and charges related to HDDs used in the company’s server and storage products that were reported in the Technology Group segment. The discontinued operations results do not reflect HDD shipments to the company’s internal customers.

**Principles of Consolidation**
The Consolidated Financial Statements include the accounts of International Business Machines Corporation (IBM) and its controlled subsidiary companies, which in general are majority owned. Investments in business entities in which the company does not have control, but has the ability to exercise significant influence over operating and financial policies (generally 20-50 percent ownership), are accounted for by the equity method. Other investments are accounted for by the cost method. The accounting policy for other investments in securities is described on page 74 within “Marketable Securities.”

**Use of Estimates**
The preparation of Consolidated Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts that are reported in the Consolidated Financial Statements and accompanying disclosures. Although these estimates are based on management’s best knowledge of current events and actions that the company may undertake in the future, actual results may be different from the estimates.

**Revenue**
The company recognizes revenue when it is realized or realizable and earned. The company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services are performed and customer acceptance has been obtained in the case of services. Revenue from sales and operating leases is recognized when the related receivables are expected to be billed and collected generally within four months, rarely exceeding nine months.

**Hardware**
Revenue from hardware sales or sales-type leases is recognized when the product is shipped to the customer. Revenues from contracts that provide for the delivery of the product in a series of phases are recognized as the related delivery obligations are met. The statement also discusses the recognition of revenue for multiple-element arrangements, which may include any combination of services, hardware, software and/or financing. When one or more elements are delivered prior to others in an arrangement and all of the following criteria are met, revenue for the delivered element is recognized upon delivery of such item. Otherwise, revenue is deferred until the delivery of the last element. Revenue from service contracts is recognized during the period in which the loss first becomes apparent. Revenue from maintenance is recognized over the contractual period or as the services are performed. In some of the company’s service contracts, the company bills the customer prior to performing the services. This situation gives rise to deferred income of $2.6 billion and $3.6 billion at December 31, 2002 and 2001, respectively, reported as Deferred income in the Consolidated Statement of Financial Position. In other service contracts, the company performs the services prior to billing the customer. This situation gives rise to unbilled receivables of $1.3 billion at both December 31, 2002 and 2001, recorded as Notes and accounts receivable—trade in the Consolidated Statement of Financial Position. In these circumstances, unbilled receivables usually occur shortly after the company performs the services and can range up to six months later. Unbilled receivables are expected to be billed and collected generally within four months, rarely exceeding nine months.

**Software**
Revenue from one-time charge licensed software is recognized at the inception of the license term. Revenue from monthly license charge arrangements is recognized on a subscription basis over the period in which the enterprise is using the program. Revenue from maintenance, unspecified upgrades and support is recognized over the period such items are delivered. See “Multiple-Element Arrangements” below for further information.

**Financing**
Finance income attributable to sales-type leases, direct financing leases and loans is recognized at level rates of return over the term of the leases or loans. Operating lease income is recognized on a straight-line basis over the term of the lease.

**Multiple-Element Arrangements**
The company enters into transactions that include multiple-element arrangements, which may include any combination of services, hardware, software and/or financing. When some elements are delivered prior to others in an arrangement and all of the following criteria are met, revenue for the delivered element is recognized upon delivery of such item. Otherwise, revenue is deferred until the delivery of the last element.

- Vendor-specific objective evidence (VSOE) of fair value of the undelivered elements.
- The functionality of the delivered elements is not dependent on the undelivered elements.
- Delivery of the delivered element represents the culmination of the earnings process.

VSOE is the price charged by the company to an external customer for the same element when such element is sold separately.

**Expense and Other Income**

**Selling, General and Administrative**
Selling, general and administrative (SG&A) expense is charged to income as incurred. Expenses of promoting and selling products and services are classified as selling expense and include such items as advertising, sales commissions and travel. General and administrative expense includes such items as officers’ salaries, office supplies, non-income taxes, insurance and office rental. In addition, general and administrative expense includes other operating items such as a provision for doubtful accounts, workforce accruals for contractually obligated payments to employees terminated in the ongoing course of business, amortization of intangible assets and environmental remediation costs. Certain special actions discussed in note s “2002 Actions” on pages 90 through 92 are also included in SG&A. The cost of internal environmental protection programs that are preventive in nature are expensed as incurred. The company accrues for all known environmental liabilities when it becomes probable that the company will incur cleanup costs and those costs can be reasonably estimated. In addition, estimated environmental costs that are associated with post-closure activities (for example, the removal and restoration of chemical storage facilities and monitoring) are accrued when the decision is made to close a facility.

**Depreciation and Amortization**
Plant, real estate, and other property are carried at cost and depreciated over their estimated useful lives using the straight-line method.

The estimated useful lives of depreciable properties generally are as follows: buildings, 50 years; building equipment, 20 years; land improvements, 20 years; plant, laboratory and operating equipment, 15 to 30 years; and computer equipment, 5 to 10 years.

Capitalized software costs incurred or acquired after technological feasibility are amortized over periods up to 3 years. See “Software Costs” on page 74 for additional information.

**Research, Development and Engineering**
Research and development (R&D) costs are expensed as incurred.

**Intelectual Property and Custom Development Income**
As part of the company’s ongoing business model and as a result of the company’s ongoing investment in research and development (R&D), the company licenses and sells the rights to certain of its intellectual property (IP) including internally developed products, trade secrets and technological know-how. Certain transfers of IP to third parties are licensing/royalty fee based and other transfers are transaction-based sales and other transfers. Licensing/royalty-based fees involve transfers in which the company earns the income over time or the amount of income is not fixed and determinable until the licensee sells future related products (i.e., variable royalty, based upon licensee’s revenue). Sales and other transfers typically include transfers of IP whereby the company has fulfilled its obligations and the fee is received and is not fixed and determinable. The company also earns income from custom development projects for specific customers. The company records the income from these projects when the fee is earned, is not refundable, and is not dependent upon the success of the project.

**Other (Income) and Expense**
Gain or loss from the sale of businesses, investments in securities and other investments, realized gains and losses from certain real estate activity, and foreign exchange transaction gains and losses.

**Retirement-Related Benefits**
See note w, “Retirement-Related Benefits,” on pages 95 to 100 for the company’s accounting policy for retirement-related benefits.
Significant Accounting Policies

Basis of Presentation
On December 31, 2002, the company sold its hard-disk drive (HDD) business to Hitachi, Ltd. (Hitachi). See note e, "Acquisitions/Divestitures," on pages 78 to 80. The HDD business was part of the company's Technology Group reporting segment. The HDD business was accounted for as a discontinued operation under generally accepted accounting principles (GAAP) and therefore, the HDD results of operations and cash flows have been removed from the company's results of continuing operations and cash flows for all periods presented in this document. The financial results reported as discontinued operations include the external original equipment manufacturer (OEM) HDD business and charges related to HDDs used in the company's elsewhere and Storage products that were reported in the Technology Group segment. The discontinued operations results do not reflect HDD shipments to the company's internal customers.

Use of Estimates
The preparation of Consolidated Financial Statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts that are reported in the Consolidated Financial Statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the company may undertake in the future, actual results may be different from the estimates.

Revenue
The company recognizes revenue when it is realized or realizable and earned. The company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sale price is fixed or determinable and collectibility is reasonably assured. The company reduces revenue for estimated customer returns and other allowances. In addition to the aforementioned general policy, the following are the specific revenue recognition policies for each major category of revenue and for multiple-element arrangements.

Services
The revenue of services contracts generally range from less than one year to ten years. Revenue from time and material services contracts is recognized as the services are provided. Revenue from Strategic Outsourcing Services contracts in which IBM manages the customer’s data center reflects the extent of actual services delivered in the period, based upon objective measures of output in accordance with the terms of the contract.

Revenue from Business Consulting Services (BCS) contracts that require IBM to design, develop, manufacture or modify complex information technology systems to a buyer’s specifications, and to provide services related to the performance of such contracts, is recognized using the percentage of completion (POC) method of accounting. In using the POC method, the company records revenue by reference to the costs incurred to date and the estimated costs remaining to fulfill the contracts.

Provisions for losses on services contracts are recognized during the period in which the loss first becomes apparent. Revenue from maintenance is recognized over the contractual period or as the services are performed.

In some of the company’s services contracts, the company bills the customer prior to performing the services. This situation gives rise to deferred income of $2.6 billion and $3.2 billion as of December 31, 2002 and 2001, respectively. Revenue from these services contracts, the company performs the services prior to billing the customer. This situation gives rise to unbilled accounts receivable of $1.1 billion at both December 31, 2002 and 2001, recorded as Notes and accounts receivable—trade in the Consolidated Statement of Financial Position. In other services contracts, the company may undertake in the future, actual results may be different from the estimates.

Selling, General and Administrative
Selling, general and administrative (SG&A) expense charged to income as incurred. Expenses of promoting and selling products and services are classified as selling expense and include such items as advertising, sales commissions and travel. General and administrative expense includes such items as advertising, sales commissions and travel. Selling, general and administrative expense is charged to income as incurred. Expenses of promoting and selling products and services are classified as selling expense and include such items as advertising, sales commissions and travel.

Other Income
Other (income) and expense items are delivered. See “Multiple-Element Arrangements” below for further information.

FINANCING
Finance income attributable to sales-type leases, direct financing leases and loans is recognized at level rates of return over the term of the leases or loans. Operating lease income is recognized on a straight-line basis over the term of the lease.

MULTIPLE-ELEMENT ARRANGEMENTS
The company enters into transactions that include multiple-element arrangements, which may include any combination of services, hardware, software and/or financing. When some elements are delivered prior to others in an arrangement and all of the following criteria are met, revenue for the delivered element is recognized upon delivery of such item. Otherwise, revenue is deferred until the delivery of the last element.

- Vendor-specific objective evidence (VSOE) of fair value of the undelivered elements.
- The functionality of the delivered elements is not dependent on the undelivered elements.
- Delivery of the delivered element represents the culmination of the earnings process.

VSOE is the price charged by the company to an external customer for the same element when such element is sold separately.

Expenses and Other Income

Selling, General and Administrative
Selling, general and administrative expenses include income from sales of products and services, royalty expenses, financial income attributable to sales-type leases and financing leases and loans, interest expense, a provision for doubtful accounts, workforce accruals for contractually obligated payments to employees terminated in the ongoing course of business, amortization of intangible assets and environmental remediation costs. Certain special actions discussed in note s “2002 Actions” on pages 90 through 92 are also included in SG&A. The cost of internal environmental protection programs that are preventative in nature are expensed as incurred. The company accurses for all known environmental liabilities when it becomes probable that the company will incur cleanup costs and those costs can be reasonably estimated. In addition, estimated environmental costs that are associated with post-closure activities (for example, the removal and restoration of chemical storage facilities and monitoring) are accrued when the decision is made to close a facility.

Capitalized software costs incurred or acquired after technology feasibility are amortized over periods up to 3 years. See “Software Costs” on page 74 for additional information. Other intangible assets are amortized for periods up to 7 years. See “Footnote 37—Software” on pages 97 and 98 for additional information on goodwill.

Retirement-Related Benefits
See note w “Retirement-Related Benefits” on pages 95 to 100 for the company’s accounting policy for retirement-related benefits.
Stock-Based Compensation

The company applies the Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related Interpretations in accounting for its stock-based compensation plans. Accordingly, the company records expense for employee stock compensation plans equal to the excess of the market price of the underlying IBM shares at the date of grant over the exercise price of the stock-related award, if any (known as the intrinsic value). Generally, all employee stock options are issued with the exercise price equal to the market price of the underlying shares at the grant date and therefore, no compensation expense is recorded. In addition, no compensation expense is recorded for purchases under the Employees Stock Purchase Plan (ESPP) in accordance with APB Opinion No. 25. This plan is described on pages 94 and 95. The intrinsic value of restricted stock units and certain other stock-based compensation issued to employees as of the date of grant is amortized to compensation expense over the vesting period. To the extent that there are performance criteria that could result in an employee receiving more or less (including zero) shares than the number of units granted, the unamortized liability is marked to market during the performance period based upon the intrinsic value at the end of each quarter.

The following table summarizes the pro forma operating results of the company had compensation cost for stock options granted and for employee stock purchases under the ESPP (see note 5, “Stock-Based Compensation Plans” on pages 94 and 95) been determined in accordance with the fair value method prescribed by Statement of Financial Accounting Standards (SFAS) No. 123, “Accounting for Stock-Based Compensation.”

<table>
<thead>
<tr>
<th>Stock option plan</th>
<th>Year ended December 31,</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term (years)</td>
<td>$ 4/5</td>
<td>$ 45</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volatility*</td>
<td>40.4%</td>
<td>17.7%</td>
<td>12.0%</td>
<td></td>
</tr>
<tr>
<td>Risk-free interest rate (zero coupon U.S. treasury note)</td>
<td>2.8%</td>
<td>4.4%</td>
<td>5.1%</td>
<td></td>
</tr>
<tr>
<td>Dividend yield</td>
<td>0.7%</td>
<td>0.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted-average fair value per option</td>
<td>$ 2.8</td>
<td>$ 3.42</td>
<td>$ 3.16</td>
<td></td>
</tr>
</tbody>
</table>

* The term was the in-the-money option granted in 2002. Option term is 4 years for non-incentive options and 5 years for in-the-money incentive options for years ended December 31, 2002 and 2000.

Income Taxes

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences between asset and liability amounts that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. Valuation allowances are recognized to reduce the tax benefit of a deferred tax asset to the amount that is more likely than not to be realized. In assessing the likelihood of realization, management considers estimates of future taxable income.

Translation of Non-U.S. Currency Amounts

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. dollars at year-end exchange rates. Income and expense items are translated at weighted-average rates of exchange prevailing during the year. Translation adjustments are recorded in Accumulated gains and (losses) not affecting retained earnings within Stockholders’ equity.

Inventories, Plant, rental machines and other property-net, and other non-monetary assets and liabilities of non-U.S. subsidiaries and branches that operate in U.S. dollars, or whose economic environment is highly inflationary, are translated at approximate exchange rates prevailing when the company acquired the assets or liabilities. All other assets and liabilities are translated at year-end exchange rates. Cost of sales and depreciation are translated at historical exchange rates. All other income and expense items are translated at the weighted-average rates of exchange prevailing during the year. Gains and losses that result from translation are included in net income.

Derivatives

All derivatives are recognized in the Consolidated Statement of Financial Position at fair value and are reported in Prepaid expenses and other current assets, Investments and sundry assets, Other accrued expenses and liabilities or Other liabilities in the Consolidated Statement of Financial Position. Classification of each derivative as current or non-current is based upon whether the maturity of each instrument is less than or greater than 12 months. To qualify for hedge accounting in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS No. 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities,” (SFAS No. 133), the company requires that the instruments are effective in reducing the risk exposure that they are designated to hedge. For instruments that are associated with the hedge of cash flows, hedge effectiveness criteria also require that it be probable that the underlying transaction will occur. Instruments that meet established accounting criteria are formally designated as hedges at the inception of the contract. These criteria demonstrate that the derivative is expected to be highly effective at offsetting changes in fair value or cash flows of the underlying exposure both at inception of the hedging relationship and on an ongoing basis. The assessment for effectiveness is formally documented at hedge inception and reviewed at least quarterly throughout the designated hedge period.

The company applies hedge accounting in accordance with SFAS No. 133, whereby the company designates hedge relationships for inclusion in hedge accounting on the basis of the following four criteria:

1. The derivative is designated as a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (“fair value” hedge); (2) the variability of anticipated cash flows of a forecasted transaction or the cash flows to be received or paid related to the hedge; (3) a recognized asset or liability (“cash flow” hedge); or (4) a hedge of a long-term investment ("net investment" hedge) in a foreign operation. From time to time, however, the company may enter into derivatives that economically hedge certain of its risks, even though hedge accounting does not apply under SFAS No. 133 or is not applied by the company.

In these cases, there generally exists a natural hedging relationship in which changes in fair value of the derivative, which are recognized currently in net income, act as an economic offset to changes in the fair value of the underlying hedged items(s). Changes in the value of a derivative that is designated as a fair value hedge, along with offsetting changes in the fair value of the underlying hedged exposure, are recorded in earnings each period. For hedges of interest rate risk, the fair value adjustments are recorded as adjustments to Interest expense and Cost of Global Financing in the Consolidated Statement of Earnings. For hedges of currency risk associated with recorded assets or liabilities, derivative fair value adjust- ments generally are recognized in Other (income) and expense in the Consolidated Statement of Earnings. Changes in the value of a derivative that is designated as a cash flow hedge are recorded in the Accumulated gains and (losses) not affecting retained earnings or Other liabilities. When hedging is discontinued as a result of the underlying cash flow being effectively hedged, any remaining derivative gain or loss that was deferred in Other comprehensive income (OCI) is recognized in income.

The company applies hedge accounting in accordance with SFAS No. 133, whereby the company designates hedge relationships for inclusion in hedge accounting on the basis of the following four criteria:

1. The derivative is designated as a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (“fair value” hedge); (2) the variability of anticipated cash flows of a forecasted transaction or the cash flows to be received or paid related to the hedge; (3) a recognized asset or liability (“cash flow” hedge); or (4) a hedge of a long-term investment ("net investment" hedge) in a foreign operation. From time to time, however, the company may enter into derivatives that economically hedge certain of its risks, even though hedge accounting does not apply under SFAS No. 133 or is not applied by the company.

In these cases, there generally exists a natural hedging relationship in which changes in fair value of the derivative, which are recognized currently in net income, act as an economic offset to changes in the fair value of the underlying hedged items(s). Changes in the value of a derivative that is designated as a fair value hedge, along with offsetting changes in the fair value of the underlying hedged exposure, are recorded in earnings each period. For hedges of interest rate risk, the fair value adjustments are recorded as adjustments to Interest expense and Cost of Global Financing in the Consolidated Statement of Earnings. For hedges of currency risk associated with recorded assets or liabilities, derivative fair value adjust- ments generally are recognized in Other (income) and expense in the Consolidated Statement of Earnings. Changes in the value of a derivative that is designated as a cash flow hedge are recorded in the Accumulated gains and (losses) not affecting retained earnings or Other liabilities. When hedging is discontinued as a result of the underlying cash flow being effectively hedged, any remaining derivative gain or loss that was deferred in Other comprehensive income (OCI) is recognized in income.
Stock-Based Compensation

The company follows Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related Interpretations in accounting for its stock-based compensation plans. Accordingly, the company records employee stock compensation plan related compensation expense with the exercise price equal to the market price of the underlying IBM shares at the date of grant over the exercise price of the stock-related award, if any (known as the intrinsic value). Generally, all employee stock options are issued with the exercise price equal to the market price of the underlying shares at the date and therefore, no compensation expense is recorded. In addition, no compensation expense is recorded for purchases under the Employee Stock Purchase Plan (ESPP) in accordance with APB Opinion No. 25. This plan is described on pages 94 and 95. The intrinsic value of restricted stock units and certain other stock-based compensation issued to employees as of the date of grant is amortized to compensation expense over the vesting period. To the extent there are performance criteria that could result in an employee receiving more or less (including zero) shares than the number of units granted, the unamortized liability is marked to market during the performance period based upon the intrinsic value at the end of each quarter.

The following table summarizes the pro forma operating results of the company had compensation cost for stock options granted and for employee stock purchases under the ESPP (see note V, “Stock-Based Compensation Plans” on pages 94 and 95) been determined in accordance with the fair value method prescribed by Statement of Financial Accounting Standards (SFAS) No. 123, “Accounting for Stock-Based Compensation.”

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income applicable to common stockholders, as reported</td>
<td>$3,579</td>
<td>$7,713</td>
<td>$8,073</td>
</tr>
<tr>
<td>Add: Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects</td>
<td>$2,376</td>
<td>$6,474</td>
<td>$7,183</td>
</tr>
<tr>
<td>Deduct: Total stock-based employee compensation expense included in reported net income, net of related tax effects</td>
<td>112</td>
<td>104</td>
<td>82</td>
</tr>
<tr>
<td>Pro forma net income</td>
<td>$3,467</td>
<td>$7,713</td>
<td>$8,073</td>
</tr>
<tr>
<td>Earnings per share:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic—as reported</td>
<td>$2.10</td>
<td>$4.45</td>
<td>$4.58</td>
</tr>
<tr>
<td>Basic—pro forma</td>
<td>$2.14</td>
<td>$4.74</td>
<td>$4.07</td>
</tr>
<tr>
<td>Assumptions—dilution—as reported</td>
<td>$2.06</td>
<td>$4.31</td>
<td>$4.44</td>
</tr>
<tr>
<td>Assumptions—dilution—pro forma</td>
<td>$1.39</td>
<td>$3.69</td>
<td>$3.99</td>
</tr>
</tbody>
</table>

The pro forma amounts that are disclosed in accordance with SFAS No. 123 reflect the portion of the estimated fair value of awards that was earned for the years ended December 31, 2002, 2001, and 2000.

The fair value of stock option grants is estimated using the Black-Scholes option-pricing model with the following assumptions:

<table>
<thead>
<tr>
<th>For the Year Ended December 31:</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term (years)*</td>
<td>4.7%</td>
<td>4.7%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Volatility**</td>
<td>40.4%</td>
<td>37.7%</td>
<td>32.0%</td>
</tr>
<tr>
<td>Risk-free interest rate (zero coupon U.S. treasury note)</td>
<td>2.8%</td>
<td>4.4%</td>
<td>5.1%</td>
</tr>
<tr>
<td>Dividend yield</td>
<td>0.7%</td>
<td>0.6%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Weighted-average fair value per option</td>
<td>$2.82</td>
<td>$4.42</td>
<td>$5.16</td>
</tr>
</tbody>
</table>

* Years term to maturity option granted in 2002. Option term is 4 years for tax incentive options for the year ended December 31, 2003. Option term is 4 years for non-incentive options and 1 year for non-tax incentive options for the year ended December 31, 2000 and 2000.
** In determining volatility, the company used the daily price changes of the stock over the respective term for tax incentive option and non-tax incentive option.

Income Taxes

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences between asset and liability amounts that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. Valuation allowances are recognized to reduce the tax assets to the amount that is more likely than not to be realized. In assessing the likelihood of realization, management considers estimates of future taxable income.

Translation of Non-U.S. Currency Amounts

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. dollars at year-end exchange rates. Income and expense items are translated at weighted-average rates of exchange prevailing during the year. Translation adjustments are recorded in Accumulated gains and (losses) not affecting retained earnings within Stockholders’ equity.

Inventories, Plant, rental machines and other property-net, and other non-monetary assets and liabilities of non-U.S. subsidiaries and branches that operate in U.S. dollars, or whose economic environment is highly inflationary, are translated at approximate rates prevailing when the company acquired the assets or liabilities. All other assets and liabilities are translated at year-end exchange rates. Cost of sales and depreciation are translated at historical exchange rates. All other income and expense items are translated at the weighted-average rates of exchange prevailing during the year. Gains and losses that result from translation are included in net income.

Derivatives

All derivatives are recognized in the Consolidated Statement of Financial Position at fair value and are reported in Prepaid expenses and other current assets, Investments and sundry assets, Other accrued expenses and liabilities or Other liabilities in the Consolidated Statement of Financial Position. Classification of each derivative as current or non-current is based upon whether the maturity of each instrument is less than or greater than 12 months. To qualify for hedge accounting in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS No. 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities,” (SFAS No. 133), the company requires that the instruments are effective in reducing the risk exposure that they are designated to hedge. For instruments that are associated with the hedge of cash flows, hedge effectiveness criteria also require that it be probable that the underlying transaction will occur. Instruments that meet established accounting criteria are formally designated as hedges at the inception of the contract. These criteria demonstrate that the derivative is expected to be highly effective at offsetting changes in fair value or cash flows of the underlying exposure both at inception of the hedging relationship and on an ongoing basis. The assessment for effectiveness is formally documented at hedge inception and reviewed at least quarterly throughout the designated hedge period.

The company applies hedge accounting in accordance with SFAS No. 133, whereby the company designates each hedge as a fair value hedge, a cash flow hedge or a net investment hedge. The company is required to select a valuation technique for the hedged item(s) that is consistent with the method used to measure the fair value of the underlying instrument or liability or of an unrecognized firm commitment (“fair value” hedge); (2) the variability of anticipated cash flows of a forecasted transaction or the cash flows to be received or paid related to the hedged item(s) or to a recognized asset or liability (“cash flow” hedge); or (3) a hedge of a long-term investment (“net investment” hedge) in a foreign operation. From time to time, however, the company may enter into derivatives that economically hedge certain of its risks, even though hedge accounting does not apply under SFAS No. 133 or is not applied by the company. In these cases, there generally exists a natural hedging relationship in which changes in fair value of the derivative, which are recognized currently in net income, act as an economic offset to changes in the fair value of the underlying hedged item(s).

Changes in the value of a derivative that is designated as a fair value hedge, along with offsetting changes in the fair value of the underlying hedged exposure, are recorded in earnings each period. For hedges of interest rate risk, the fair value adjustments are recorded as adjustments to Interest expense and Cost of Global Financing in the Consolidated Statement of Earnings. For hedges of currency risk associated with recorded assets or liabilities, derivative fair value adjustments generally are recognized in Other (income) and expense in the Consolidated Statement of Earnings. Changes in the value of a derivative that is designated as a cash flow hedge are recorded in the Accumulated gains and (losses) not affecting retained earnings. When net income is affected by the variability of the underlying cash flow, the applicable offsetting amount of the gain or loss from the derivative that is deferred in Stockholders’ equity is released to net income and reported in Interest expense. Cost, SG&A expense or Other (income) and expense in the Consolidated Statement of Earnings based on the nature of the underlying cash flow hedged. Effectiveness for net investment hedging derivatives is measured on a spot to spot basis.

The effective portion of changes in the fair value of derivatives and other non-derivative risk management instruments designated as net investment hedges are recorded as foreign currency translation adjustments in the Accumulated gains and (losses) not affecting retained earnings section of Stockholders’ equity. Changes in the fair value of the portion of a net investment hedging derivative excluded from the effectiveness assessment are recorded in Interest expense.

When the underlying hedged item ceases to exist, all changes in the fair value of the derivative are included in net income each period until the instrument matures. When the derivative transaction ceases to exist, a hedged asset or liability is no longer adjusted for changes in its fair value except as required under other relevant accounting standards. Derivatives that are not designated as hedges, as well as changes in the value of derivatives that do not offset the underlying hedged item throughout the designated hedge period (collectively, “ineffectiveness”), are recorded in net income each period and generally are reported in Other (income) and expense. See note 1, “Derivatives and Hedging Transactions,” on pages 84 to 86 for a description of the major risk management programs and classes of financial instruments used by the company.

Financial Instruments

In determining fair value of its financial instruments, the company uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. For the majority of financial instruments including most derivatives, long-term investments and long-term debt, standard market conventions and techniques such as discounted cash flow analysis, option pricing models, replacement cost and termination cost are used to determine fair value. Dealer quotes are used for the remaining financial instruments. All methods of assessing fair value result in a general approximation of value, and such value may never actually be realized.
Cash Equivalents
All highly liquid investments with a maturity of three months or less at the date of purchase are carried at fair value and considered to be cash equivalents.

Marketable Securities
Marketable securities included in Current assets represent securities with a maturity of less than one year. The company also has Marketable securities, including non-equity method alliance investments, with a maturity of more than one year. These non-current investments are included in Investments and sundry assets. The company's Marketable securities, including certain non-equity method alliance investments, are considered available for sale and are reported at fair value with changes in unrealized gains and losses, net of applicable taxes, recorded in Accumulated gains and (losses) not affecting retained earnings within Stockholders' equity. Realized gains and losses are calculated based on the specific identification method. Other-than-temporary declines in market value from original cost are charged to Other (income) and expense in the period in which the loss occurs. In determining whether an other-than-temporary decline in the market value has occurred, the company considers the duration and extent to which market value is below original cost. Realized gains and losses and other than temporary declines in market value from original cost are included in Other (income) and expense in the Consolidated Statement of Earnings. All other investment securities not described above or in "Principles of Consolidation" on page 70, primarily non-publicly traded equity securities, are accounted for using the cost method.

Inventories
Raw materials, work in process and finished goods are stated at the lower of average cost or net realizable value.

Allowance for Uncollectible Receivables
Trade
An allowance for uncollectible trade receivables is recorded based on a combination of write-off history, aging analysis, and any specific known troubled accounts.

Financing
Below are the methodologies the company uses to calculate both its specific and its unallocated reserves, which are applied consistently to its different portfolios.

Specific
The company reviews all accounts receivable considered at risk on a quarterly basis. The review primarily consists of an analysis based upon current information available about the customer, such as financial statements, news reports, published credit ratings, the current economic environment, as well as, collateral net of repossession cost, and prior history. For loans that are collateral dependent, impairment is measured using the fair value of the collateral when foreclosure is probable. Using this information, the company determines the expected cash flow for the receivable and calculates a recommended estimate of the potential loss and the probability of loss. For those accounts where the loss is probable, the company records a specific reserve.

Unallocated
The company records an unallocated reserve that is calculated by applying a write-off rate to the total portfolio, excluding accounts that have been specifically reserved. This write-off rate is based upon write-off history and is adjusted to reflect current economic conditions.

Certain receivables that have specific reserves recorded may also be placed on nonaccrual status. Nonaccrual status is for receivables (impaired loans or nonperforming leases) with specific reserves and other accounts for which it is likely that the company will be unable to collect all amounts due according to original terms of the lease or loan agreement. Income recognition is discontinued on these receivables. Receivables may be removed from nonaccrual status, if appropriate, based upon changes in customer circumstances.

Estimated Residual Values of Lease Assets
The recorded residual values of the company's lease assets are estimated at the inception of the lease to be the expected fair market value of the assets at the end of the lease term. In accordance with GAAP, the company reassesses the realizable value of its lease residual values, and any anticipated increases in specific future residual values are not recognized before realization through remarketing efforts. Anticipated decreases in specific future residual values that are considered to be other than temporary are recognized immediately upon identification.

Software Costs
Costs that are related to the conceptual formulation and design of licensed programs are expensed as R&D. Also, for licensed programs, the company capitalizes costs that are incurred to produce the finished product after technological feasibility is established. The annual amortization of the capitalized amounts is performed using the straight-line method, and is applied over periods ranging up to three years. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are expensed in the year incurred.

The company capitalizes certain costs that are incurred to purchase or to create and implement internal-use computer software, which includes software coding, installation, testing and data conversion. Capitalized costs are amortized on a straight-line basis over two years.

Common Stock
Common stock refers to the $.20 par value capital stock as designated in the company's Certificate of Incorporation. Treasury stock is accounted for using the cost method. When treasury stock is reissued, the value is computed and recorded using a weighted-average basis.

Product Warranties
The company estimates its warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products under warranty. Included in the company's warranty accrual are costs for limited warranties and extended warranty coverage. Future costs for warranties applicable to revenue recognized in the current period are charged to cost of revenue. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates.

Earnings Per Share of Common Stock
Earnings per share of common stock—basic is computed by dividing Net income applicable to common stockholders by the weighted-average number of common shares outstanding for the period. Earnings per share of common stock—assuming dilution reflects the maximum potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and would then share in the net income of the company. See note 16, “Earnings Per Share of Common Stock,” on page 93 for additional information.

Accounting Changes
Standards Implemented
In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, “Agriculture Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS No. 143 addresses issues related to the implementation of SFAS No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,” and develops a single accounting model, based on the framework established in SFAS No. 121 for long-lived assets to be disposed of by sale, whether such assets are or are not deemed to be a business. SFAS No. 144 also modifies the accounting and disclosure requirements for discontinued operations. The standard was adopted on January 1, 2002, and did not have a material impact on the company's Consolidated Financial Statements. The discontinued HDD operations are presented in the Consolidated Financial Statements in accordance with the new SFAS No. 149 rules.

In November 2001, the FASB issued Emerging Issues Task Force (EITF) Issue No. 01-14, “Income Statement Characterization of Reimbursements Received for ‘Out of Pocket’ Expenses Incurred.” This guidance requires companies to recognize the recovery of reimbursable expenses such as travel costs on contracts or revenues as travel costs. These costs are not to be netted as a reduction of cost. This guidance was effective January 1, 2002. This guidance did not have a material effect on the company's Consolidated Financial Statements due to the company's billing practices. For instance, outside the United States, almost all of the company's contracts involve fixed billings that are designed to recover all costs, including out-of-pocket costs. Therefore, the “reimbursement” of these costs is already recorded in revenue.

In July 2001, the FASB issued SFAS No. 141, “Business Combinations,” and SFAS No. 142, “Goodwill and Other Intangible Assets.” SFAS No. 141 requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. Under the previous rules, the company used the purchase method of accounting. SFAS No. 141 also redefines the definition of intangible assets acquired in a purchase business combination. As a result, the purchase price allocation of current business combinations may be different than the allocation that would have resulted under the old rules. Business combinations must be accounted for using SFAS No. 141 effective July 1, 2001. SFAS No. 142 eliminates the amortization of goodwill, requires annual impairment testing of goodwill and introduces the concept of indefinite life intangible assets. The company adopted SFAS No. 142 on January 1, 2002. The new rules also prohibit the amortization of goodwill associated with business combinations that closed after June 30, 2001.

Notes to Consolidated Financial Statements

International Business Machines Corporation and Subsidiary Companies

International Business Machines Corporation and Subsidiary Companies
Cash Equivalents

All highly liquid investments with a maturity of three months or less at the date of purchase are carried at fair value and considered to be cash equivalents.

Marketable Securities

Marketable securities included in Current assets represent securities with a maturity of less than one year. The company also has Marketable securities, including certain non-equity method alliance investments, with a maturity of more than one year. These non-current investments are included in Investments and sundry assets. The company’s Marketable securities, including certain non-equity method alliance investments, are considered available for sale and are reported at fair value with changes in unrealized gains and losses, net of applicable taxes, recorded in Accumulated gains and (losses) not affecting retained earnings within Stockholders’ equity. Realized gains and losses are calculated based on the specific identification method. Other-than-temporary declines in market value from original cost are charged to Other (income) and expense in the period in which the loss occurs. In determining whether an other-than-temporary decline in the market value has occurred, the company considers the duration and extent to which market value is below original cost. Realized gains and losses and other than temporary declines in market value from original cost are included in Other (income) and expense in the Consolidated Statement of Earnings. All other investment securities not described above or in “Principles of Consolidation” on page 70, primarily non-publicly traded equity securities, are accounted for using the cost method.

Inventories

Raw materials, work in process and finished goods are stated at the lower of average cost or net realizable value.

Allowance for Uncollectible Receivables

An allowance for uncollectable trade receivables is recorded based on a combination of write-off history, aging analysis, and any specific known troubled accounts.

Software Costs

Costs that are related to the conceptual formulation and design of licensed programs are expensed as R&D. Also, for licensed programs, the company capitalizes costs that are incurred to produce the finished product after technological feasibility is established. The annual amortization of the capitalized amounts is performed using the straight-line method, and is applied over periods ranging up to three years. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are expensed as the costs are incurred.

The company capitalizes certain costs that are incurred to purchase or to create and implement internal-use computer software, which includes software coding, installation, testing and data conversion. Capitalized costs are amortized on a straight-line basis over two years.

Common Stock

Common Stock refers to the $2.00 par value capital stock as designated in the company’s Certificate of Incorporation. Treasury stock is accounted for using the cost method. When treasury stock is resold, the value is computed and recorded using a weighted-average basis.

Product Warranties

The company estimates its warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products under warranty. Included in the company’s warranty accrual are costs for limited warranties and extended warranty coverage. Future costs for warranties applicable to revenue recognized in the current period are charged to cost of revenue. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates.

Earnings Per Share of Common Stock

Earnings per share of common stock—basic is computed by dividing Net income applicable to common stockholders by the weighted-average number of common shares outstanding for the period. Earnings per share of common stock—diluted is calculated by dividing Net income available to common stockholders by the weighted-average number of common shares outstanding plus the potential common shares that are expected to be issued as a result of the exercise of outstanding options, warrants, and other rights.

Accounting Changes

Standards Implemented

In accordance with SFAS No. 141, the unamortized bal-
ance for acquired assembled workforce of $13 million, which
had been recognized as an intangible asset separate from
goodwill, has been reclassified to goodwill effective January 1,
2002. In addition, an initial goodwill impairment test was
required to be performed in 2002 as of January 1, 2002. This
initial test and the company’s first annual goodwill impair-
test, performed as of October 1, 2002, resulted in no
goodwill impairment charges.

The following table presents reported Income from con-
tinuing operations and income adjusted to exclude goodwill
amortization, which is no longer recorded under SFAS No. 142
effective January 1, 2002.

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported income from continuing operations</td>
<td>$5,334</td>
<td>$6,146</td>
<td>$7,674</td>
</tr>
<tr>
<td>Goodwill amortization net of tax effects</td>
<td>—</td>
<td>262</td>
<td>436</td>
</tr>
<tr>
<td>Adjusted income from continuing operations</td>
<td>$5,334</td>
<td>$6,408</td>
<td>$8,510</td>
</tr>
</tbody>
</table>

Basic earnings per share from continuing operations:

| Reported income from continuing operations | $3.13  | $4.69  | $4.44  |
| Goodwill amortization | —     | 0.15   | 0.22   |
| Adjusted basic earnings per share from continuing operations | $3.13  | $4.84  | $4.70  |

Diluted earnings per share from continuing operations:

| Reported income from continuing operations | $1.07  | $4.59  | $4.12  |
| Goodwill amortization | —     | 0.15   | 0.24   |
| Adjusted diluted earnings per share from continuing operations | $1.07  | $4.74  | $4.56  |

Reported net income | $3,579 | $7,723 | $8,095 |
Add: Goodwill amortization net of tax effects | —     | 262    | 436    |
Adjusted net income | $3,579 | $7,985 | $8,529 |

Basic earnings per share:

| Reported net income | $2.10  | $4.45  | $4.58  |
| Goodwill amortization | —     | 0.15   | 0.22   |
| Adjusted basic earnings per share | $2.10  | $4.60  | $4.83  |

Diluted earnings per share:

| Reported net income | $2.06  | $4.31  | $4.44  |
| Goodwill amortization | —     | 0.15   | 0.24   |
| Adjusted diluted earnings per share | $2.06  | $4.50  | $4.68  |

* Does not total due to rounding.

On January 1, 2001, the company adopted SFAS No. 141, as amended. SFAS No. 143 establishes accounting and reporting
standards for derivative instruments. As of January 1, 2001, the adoption of the new standard resulted in a cumula-
tive effect, net-of-tax increase of $219 million to Accumulated gains and (losses) not affecting retained earnings in the
Stockholders’ equity section of the Consolidated Statement of
Financial Position and a cumulative effect net-of-tax charge of $6 million included in Other (income) and expense in the
Consolidated Statement of Earnings.

Effective January 1, 2001, the company adopted SFAS No. 140, “Accounting for Transfers and Servicing of Financial
Assets and Extinguishments of Liabilities—a replacement of SFAS No. 125.” This statement provides accounting and
reporting standards for transfers and servicing of financial assets and extinguishments of liabilities and revises the
accounting standards for securitizations and transfers of financial assets and collateral. The adoption did not have a
material effect on the company’s results of operations and

New Standards to be Implemented

In June 2001, the FASB issued SFAS No. 143, “Accounting for
Asset Retirement Obligations.” SFAS No. 143 provides accounting and reporting guidance for legal obligations associ-
cated with the retirement of long-lived assets that result from
the acquisition, construction or normal operation of a long-lived asset. SFAS No. 143 requires the recording of an
asset and a liability equal to the present value of the estimated
costs associated with the retirement of long-lived assets where a legal or contractual obligation exists. The asset is
required to be depreciated over the life of the related equip-
ment or facility, and the liability is required to be accreted
each year based on a present value interest rate. The standard
is effective for the company on January 1, 2003. The company
has reviewed the provisions of this standard, and its adoption
is not expected to have a material effect on the company’s
Consolidated Financial Statements.

In July 2002, the FASB issued SFAS No. 146, “Accounting for
Costs Associated with Exit or Disposal Activities.” SFAS
No. 146 supersedes EITF No. 94-3, “Liability Recognition
for Certain Employee Termination Benefits and Other Costs
to Exit an Activity (Including Certain Costs Incurred in a
Restructuring),” and requires that a liability for a cost associ-
ated with an exit or disposal activity be recognized when the
liability is incurred. Such liabilities should be recorded at fair
value and updated for any changes in the fair value each
period. A notable change from EITF No. 94-3 involves one-
time employee termination costs whereby the employee to be
terminated is required to render service between the notifica-
tion date and the date the employee will be terminated in order
to receive any termination benefits. For these situations
whereby the required postnotification service period extends
beyond the minimum retention period required by local law,
the fair value of the liability will be recognized ratably over
the service period. This change is effective for new exit or
disposal activities initiated after December 31, 2002. Had SFAS No. 146 been effective for the company’s second quarter and fourth
quarter 2002 actions, a portion of the pre-tax employee ter-
mination costs listed in the table on pages 91 and 92 would
have been amortized over the applicable service periods, until
the respective employees were terminated. The impact of
SFAS No. 146 on the company’s future Consolidated Financial
Statements will depend upon the timing of and facts under-
lying any future one-time workforce reduction actions.

In November 2002, the EITF reached a consensus on Issue
No. 00-21, “Accounting for Revenue Arrangements with Multiple Deliverables.” This Issue provides guidance on
when and how to separate elements of an arrangement that
may involve the delivery or performance of multiple products,
services and rights to use assets into separate units of account-
ing. The guidance in the consensus is effective for revenue
arrangements entered into in fiscal periods beginning after
June 15, 2003. The company will adopt Issue No. 00-21 in
the quarter beginning July 1, 2003. The transition provision
allows either prospective application or a cumulative effect
adjustment upon adoption. The company is currently evalu-
ating the impact of adopting this guidance.

In November 2002, the FASB issued Interpretation No. 45
(FIN 45). “Guarantor’s Accounting and Disclosure Require-
ments for Guarantees, Including Indirect Guarantees of
Indebtedness of Others,” which addresses the disclosures to
be made by a guarantor in its interim and annual financial
statements about its obligations under guarantees. FIN 45 also
requires the recognition of a liability by a guarantor at
the inception of certain guarantees that are entered into or
modified after December 31, 2002.

The company has adopted the disclosure requirements of
FIN 45 (see note A, “Significant Accounting Policies,” on pages
70 through 75, and note o, “Contingencies and Commit-
ments,” on pages 88 and 89) and will apply the recognition
and measurement provisions for all material guarantees
entered into or modified in periods beginning January 1,
2003. The impact of FIN 45 on the company’s future
Consolidated Financial Statements will depend upon whether
the company enters into or modifies any material

guarantee arrangements.

In January 2003, the FASB issued Interpretation No. 46 (FIN
46), “Consolidation of Variable Interest Entities,” which addresses consolidation by business enterprises of vari-
able interest entities that either: (1) do not have sufficient
equity investment at risk to permit the entity to finance its
activities without additional subordinated financial support,
or (2) the equity investors lack an essential characteristic of a
controlling financial interest. FIN 46 requires disclosure of Variable Interest Entities (VIEs) in financial statements issued after January 31, 2003, if it is reasonably possible that as of the transition date: (1) the company
will be the primary beneficiary of an existing VIE that will require consolidation or, (2) the company will hold a
significant variable interest in, or have significant influence
with, an existing VIE. Pursuant to the transitional require-
ments of FIN 46, the company will adopt the consolidation
guidance applicable to existing VIEs as of the reporting period
beginning July 1, 2003. Any VIEs created after January 31,
2003, are immediately subject to the consolidation guidance
in FIN 46.

The company’s program to sell state and local government
receivables, as described in note j, “Sale and Securitization of
Receivables,” on page 92, involves qualifying special purpose
entities, and therefore is not subject to FIN 46.

The company does not have any entities that require
disclosure or new consolidation as a result of adopting the
provisions of FIN 46.
| Notes to Consolidated Financial Statements |

In accordance with SFAS No. 141, the unamortized balance for acquired assembled workforce of $13 million, which had been recognized as an intangible asset separate from goodwill, has been reclassified to goodwill effective January 1, 2002. In addition, an initial goodwill impairment test was required to be performed in 2002 as of January 1, 2002. This initial test and the company’s first annual goodwill impairment test, performed as of October 1, 2002, resulted in no goodwill impairment charges.

On January 1, 2001, the company adopted SFAS No. 141, as amended. SFAS No. 143 establishes accounting and reporting standards for derivative instruments. As of January 1, 2001, the adoption of the new standard resulted in a cumulative effect, net-of-tax increase of $219 million to Accumulated gains and (losses) not affecting retained earnings in the Stockholders’ equity section of the Consolidated Statement of Financial Position and a cumulative effect net-of-tax charge of $6 million included in Other (income) and expense in the Consolidated Statement of Earnings.

Effective January 1, 2001, the company adopted SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of SFAS No. 125.” This statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities and revises the accounting standards for securitizations and transfers of financial assets and collateral. The adoption did not have a material effect on the company’s results of operations and financial position. The standard also requires new disclosures that were not applicable to the company.

New Standards to be Implemented

In June 2001, the FASB issued SFAS No. 143, “Accounting for Asset Retirement Obligations.” SFAS No. 143 provides accounting and reporting guidance for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction or normal operation of a long-lived asset. SFAS No. 143 requires the recording of an asset and a liability equal to the present value of the estimated costs associated with the retirement of long-lived assets where a legal or contractual obligation exists. The asset is required to be depreciated over the life of the related equipment or facility, and the liability is required to be accreted each year based on a present value interest rate. The standard is effective for the company on January 1, 2003. The company has reviewed the provisions of this standard, and its adoption is not expected to have a material effect on the company’s Consolidated Financial Statements.

In July 2002, the FASB issued SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities.” SFAS No. 146 supersedes EITF No. 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring),” and requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Such liabilities should be recorded at fair value and updated for any changes in the fair value each period. A notable change from EITF No. 94-3 involves one-time employee termination costs whereby the employee to be terminated is required to render service between the notification date and the date the employee will be terminated in order to receive any termination benefits. For these situations whereby the required postnotification service period extends beyond the minimum retention period required by local law, the fair value of the liability will be recognized ratably over the service period. This change is effective for new exit or disposal activities initiated after December 31, 2002. Had SFAS No. 146 been effective for the company’s second quarter and fourth quarter 2002 actions, a portion of the pre-tax employee termination costs listed in the table on pages 91 and 92 would have been amortized over the applicable service periods, until the respective employees were terminated. The impact of SFAS No. 146 on the company’s future Consolidated Financial Statements will depend upon the timing of and facts underlying any future one-time workforce reduction actions.

In November 2002, the EITF reached a consensus on Issue No. 00-21, “Accounting for Revenue Arrangements with Multiple Deliverables.” This Issue provides guidance on when and how to separate elements of an arrangement that may involve the delivery or performance of multiple products, services and rights to use assets into separate units of accounting. The guidance in the consensus is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The company will adopt Issue No. 00-21 in the quarter beginning July 1, 2003. The transition provision allows either prospective application or a cumulative effect adjustment upon adoption. The company is currently evaluating the impact of adopting this guidance.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45). “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,” which addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 also requires the recognition of a liability by a guarantor at the inception of certain guarantees that are entered into or modified after December 31, 2002.

The company has adopted the disclosure requirements of FIN 45 (see note 4, “Significant Accounting Policies,” on pages 70 through 75, and note 8, “Contingencies and Commitments,” on pages 88 and 89) and will apply the recognition and measurement provisions for all material guarantees entered into or modified in periods beginning January 1, 2003. The impact of FIN 45 on the company’s future Consolidated Financial Statements will depend upon whether the company enters into or modifies any material guarantee arrangements.

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), “Consolidation of Variable Interest Entities,” which addresses consolidation by business enterprises of variable interest entities that either: (1) do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) the equity investors lack an essential characteristic of a controlling financial interest. FIN 46 requires disclosure of Variable Interest Entities (VIEs) in financial statements issued after January 31, 2003, if it is reasonably possible that as of the transition date: (1) the company will be the primary beneficiary of an existing VIE that will require consolidation or, (2) the company will hold a significant variable interest in, or have significant involvement with, an existing VIE. Pursuant to the transitional requirements of FIN 46, the company will adopt the consolidation guidance applicable to existing VIEs as of the reporting period beginning July 1, 2003. Any VIEs created after January 31, 2003, are immediately subject to the consolidation guidance in FIN 46.

The company’s program to sell state and local government receivables, as described in note 1, “Sale and Securitization of Receivables,” on page 82, involves qualifying special purpose entities, and therefore is not subject to FIN 46.

The company does not have any entities that require disclosure or new consolidation as a result of adopting the provisions of FIN 46.
e. Acquisitions/Divestitures

Acquisitions 2002

In 2002, the company completed 12 acquisitions at an aggregate cost of $1,078 million.

The largest acquisition was PricewaterhouseCoopers Consulting (PwCC). On October 1, 2002, the company purchased PricewaterhouseCoopers’ (PwCC) global business consulting and technology services unit, PwCC, for $3,474 million. The acquisition of PwCC provides the company with new expertise in business strategy, industry-based consulting, process integration and application management. The purchase price above includes an estimated amount of net tangible assets to be transferred of approximately $422 million. The recorded amount of net tangible assets transferred to IBM from PwCC on October 1, 2002, was approximately $454 million higher than the estimate. The amount of recorded net tangible assets transferred will be subject to a review process between both parties under the terms of the agreement. Therefore, although the net tangible assets recorded by IBM include this incremental amount, such amounts may be adjusted, dollar for dollar, in 2003 under the terms of the agreement. Any cash settlement to either party resulting from this process is expected to occur in 2003 and may affect the values assigned to assets acquired and liabilities assumed.

The company paid $2,852 million of the purchase price in cash, $294 million primarily in the form of restricted shares of IBM common stock converted into restricted shares of IBM common stock.

In connection with the acquisition, the company incurred approximately $196 million of pre-tax, one-time compensation costs for certain PwCC partners and employees. This amount relates to restricted stock awards and the compensation element of the convertible notes issued as part of the purchase consideration and was recorded in the fourth quarter of 2002. The portion of this amount recorded as part of SG&A in the Consolidated Statement of Earnings as compensation expense for the convertible notes equals the difference between the fair value and the face value of the notes.

As a result of its acquisition of PwCC, the company recorded a liability of approximately $601 million in the fourth quarter of 2002 to rehance its workforce and to vacate excess leased space. All employees affected by this action were notified as of December 31, 2002. The portion of the liability relating to IBM people and space was approximately $318 million, and substantially all was recorded as part of SG&A in the Consolidated Statement of Earnings. The portion of the liability relating to acquired PwCC workforce and leased space was approximately $283 million and was included as part of the liabilities assumed for purchase accounting and are presented in the following table.

The table below presents the allocation of purchase price related to the 2002 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AMORTIZATION (IN YEARS)</th>
<th>PwCC</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 1,197</td>
<td>$ 264</td>
<td></td>
</tr>
<tr>
<td>Fixed/non-current assets</td>
<td>199</td>
<td>102</td>
<td></td>
</tr>
<tr>
<td>Intangible assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>N/A</td>
<td>2,461</td>
<td>364</td>
</tr>
<tr>
<td>Completed technology</td>
<td>3</td>
<td></td>
<td>66</td>
</tr>
<tr>
<td>Strategic alliances</td>
<td>5</td>
<td>101</td>
<td>—</td>
</tr>
<tr>
<td>Non-contractual</td>
<td>4 to 7</td>
<td>131</td>
<td>—</td>
</tr>
<tr>
<td>Customer relationships</td>
<td>3 to 5</td>
<td>82</td>
<td>6</td>
</tr>
<tr>
<td>Customer contracts/backlog</td>
<td>3 to 5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other identifiable</td>
<td>3 to 5</td>
<td>97</td>
<td>50</td>
</tr>
<tr>
<td>intangible assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets acquired</td>
<td>4,268</td>
<td>812</td>
<td></td>
</tr>
<tr>
<td>Total liabilities assumed</td>
<td>(794)</td>
<td>137</td>
<td></td>
</tr>
<tr>
<td>Net assets acquired</td>
<td>3,474</td>
<td>480</td>
<td></td>
</tr>
<tr>
<td>In-process research and development</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total purchase price</td>
<td>$ 3,474</td>
<td>$ 484</td>
<td></td>
</tr>
</tbody>
</table>

PwCC Acquisition

Almost half of the goodwill was estimated to be generated by the value of the acquired assembled workforce. The acquired assembled workforce is treated as goodwill under SFAS No. 141. The remaining items that generated goodwill are synergies between PwCC and the company created by the combination, and the premium paid by the company for the right to control PwCC. The goodwill has been assigned to the Global Services segment. The company estimates that approximately two-thirds of the goodwill is deductible for tax purposes. The overall weighted-average life of amortizable intangible assets purchased from PwCC is approximately 5 years. The results of operations of PwCC were included in the company’s Consolidated Financial Statements as of October 1, 2002.

Other Acquisitions

As a result of cash paid for the other acquisitions. Six of the acquisitions were for software companies, including Crossworlds Software, Inc., and Access360. The other five acquisitions were strategic outsourcing and business consulting companies. The primary items that generated goodwill are the synergies between the acquired businesses and the company, and the premium paid by the company for the right to control the businesses acquired. Approximately $300 million of the goodwill has been assigned to the Software segment and the balance to the Global Services segment. The goodwill is not deductible for tax purposes. The overall weighted-average life of the intangible assets purchased is approximately three years. The results of operations of the acquired businesses were included in the company’s Consolidated Financial Statements from the respective dates of acquisition.

2001

In 2001, the company completed two acquisitions at a cost of approximately $1,082 million.

The larger acquisition was Informix Corporation’s (Informix) database software business. The company paid approximately $1 billion in cash for the net assets of the business. Under the terms of the acquisition, the company paid $889 million of the purchase price in 2001. The balance was paid in January 2005. The Informix acquisition provided the company with a database software system for data warehousing, business intelligence and transaction-handling systems that are used by more than 100,000 customers. In addition, the acquisition significantly increased the size of the company’s UNIX database business. The company purchased Informix in the third quarter of 2001.

The following table presents the allocation of purchase price related to the 2001 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AMORTIZATION (IN YEARS)</th>
<th>IBM</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 156</td>
<td>$ 77</td>
<td></td>
</tr>
<tr>
<td>Fixed/non-current assets</td>
<td>41</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Intangible assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>591</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Customer lists</td>
<td>5</td>
<td>220</td>
<td></td>
</tr>
<tr>
<td>Completed technology</td>
<td>3</td>
<td>140</td>
<td></td>
</tr>
<tr>
<td>Trademarks</td>
<td>2</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Total assets acquired</td>
<td>1,158</td>
<td>103</td>
<td></td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>(101)</td>
<td>(2)</td>
<td></td>
</tr>
<tr>
<td>Payables/accrued expenses</td>
<td>(15)</td>
<td>(21)</td>
<td></td>
</tr>
<tr>
<td>Total liabilities assumed</td>
<td>(256)</td>
<td>(27)</td>
<td></td>
</tr>
<tr>
<td>Total purchase price</td>
<td>$ 1,102</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

In 2000, the company completed nine acquisitions at a cost of approximately $511 million.

The largest acquisition was LGS Group Inc. (LGS). The company acquired all the outstanding stock of LGS in April 2000 for $190 million. LGS offers services ranging from application development to information technology (IT) consulting. The results of operations of LGS were included in the company’s Consolidated Financial Statements as of April 2000.

The table below presents the allocation of the purchase price related to the 2000 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>LGS</th>
<th>IBM</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible net assets</td>
<td>31</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>159</td>
<td>220</td>
<td></td>
</tr>
<tr>
<td>Other identifiable intangible assets</td>
<td>—</td>
<td>16</td>
<td></td>
</tr>
<tr>
<td>In-process research and development</td>
<td>—</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liabilities related to identifiable intangible assets</td>
<td>—</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Total purchase price</td>
<td>$ 190</td>
<td>321</td>
<td></td>
</tr>
</tbody>
</table>

Notes to Consolidated Financial Statements
The table below presents the allocation of purchase price related to the 2002 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Allocation</th>
<th>Non-current assets</th>
<th>Current assets</th>
<th>Total purchase price</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwCC Acquisition</td>
<td></td>
<td></td>
<td></td>
<td>$3,474</td>
</tr>
</tbody>
</table>

**Notes to Consolidated Financial Statements**

**Acquisitions/Diversifications**

In 2002, the company completed 12 acquisitions at an aggregate cost of $1,978 million.

The largest acquisition was PricewaterhouseCoopers Consulting (PwCC). On October 1, 2002, the company purchased PricewaterhouseCoopers’ (PwCC) global business consulting and technology services unit, PwCC, for $3,874 million. The acquisition of PwCC provides the company with new expertise in business strategy, industry-based consulting, process integration and application management. The purchase price above includes an estimated amount of net tangible assets to be transferred of approximately $482 million. The recorded amount of net tangible assets transferred to IBM from PwCC on October 1, 2002, was approximately $454 million higher than the estimate. The amount of recorded net tangible assets transferred will be subject to a review process between both parties under the terms of the agreement. Therefore, although the net tangible assets recorded by IBM include this incremental amount, such amounts may be adjusted, dollar for dollar, in 2003 under the terms of the agreement. Any cash settlement to either party resulting from this process is estimated to occur in 2003 and may affect the values assigned to assets acquired and liabilities assumed.

The company paid $2,852 million of the purchase price in cash, $294 million primarily in the form of restricted shares of IBM common stock and $321 million in notes convertible into restricted shares of IBM common stock.

In connection with the acquisition, the company incurred approximately $196 million of pre-tax, one-time compensation costs for certain PwCC partners and employees. This amount relates to restricted stock awards and the compensation element of the convertible notes issued as part of the purchase consideration and was recorded in the fourth quarter of 2002.

The portion of this amount recorded as part of SG&A in the Consolidated Statement of Earnings as compensation expense for the convertible notes equals the difference between the fair value and the face value of the notes. The overall weighted-average life of amortizable intangible assets is approximately two-thirds of the goodwill is deductible for tax purposes. The results of operations of the acquired businesses were included in the company’s Consolidated Financial Statements from the respective dates of acquisition.

In 2001, the company completed two acquisitions at a cost of approximately $1,082 million.

The largest acquisition was Informix Corporation’s (Informix) database software business. The company paid approximately $1 billion in cash for the net assets of the business. Under the terms of the acquisition, the company paid $889 million of the purchase price in 2001. The balance was paid in January 2003. The Informix acquisition provided the company with a database software system for data warehousing, business intelligence and transaction-handling systems that are used by more than 100,000 customers. In addition, the acquisition significantly increased the size of the company’s UNIX database business. The company purchased Informix in the third quarter of 2001.

The following table presents the allocation of purchase price related to the 2001 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Allocation</th>
<th>Non-current assets</th>
<th>Current assets</th>
<th>Total purchase price</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwCC Acquisition</td>
<td></td>
<td></td>
<td></td>
<td>$3,474</td>
</tr>
</tbody>
</table>

**Other Acquisitions**

The primary items that generated goodwill are the synergies between the acquired business and the company and the premium paid by the company for the right to control the business acquired. Goodwill of $25 million has been assigned to the Global Services segment. The goodwill is not deductible for tax purposes. The results of operations of the acquired business were included in the company’s Consolidated Financial Statements from the date of acquisition.

In 2000, the company completed nine acquisitions at a cost of approximately $511 million.

The largest acquisition was LGS Group Inc. (LGS). The company acquired all the outstanding stock of LGS in April 2000 for $190 million. LGS offers services ranging from application development to information technology (IT) consulting. The results of operations of LGS were included in the company’s Consolidated Financial Statements as of April 2000.

The table below presents the allocation of the purchase price related to the 2000 acquisitions as of the respective dates of acquisition.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Allocation</th>
<th>Non-current assets</th>
<th>Current assets</th>
<th>Total purchase price</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwCC Acquisition</td>
<td></td>
<td></td>
<td></td>
<td>$3,474</td>
</tr>
</tbody>
</table>
Notes to Consolidated Financial Statements

OVERALL
The company’s acquisitions were accounted for as purchase transactions, and accordingly, the assets and liabilities of the acquired entities were recorded at their estimated fair value at the date of acquisition. The effects of these acquisitions on the company’s Consolidated Financial Statements were not material. Hence, the company has not provided pro forma financial information as if the companies had combined at the beginning of the respective periods presented.

The tangible net assets comprise primarily cash, accounts receivable, land, buildings and leasehold improvements. The identifiable intangible assets comprise primarily patents, trademarks, customer lists, employee agreements and leasehold interests. The identifiable intangible assets have been amortized on a straight-line basis, generally not to exceed seven years. Goodwill from acquisitions that were consummated prior to July 1, 2001, was amortized over five years. The company adopted SFAS No. 142 on January 1, 2002, and ceased amortizing goodwill as of that date. The results of operations of all acquired businesses were included in the company’s Consolidated Financial Statements from the respective dates of acquisition.

Dispositions
On December 31, 2002, the company sold its HDD business to Hitachi. The total gross proceeds of the sale were $2 billion (excluding purchase price adjustments), of which $1.414 million was received by IBM at closing. According to the terms of the agreement, the remaining proceeds will be received one and three years after closing. The remaining proceeds are fixed and are not dependent or variable based on the sold business’ earnings or performance. The company transferred approximately $244 million of cash as part of the HDD business, resulting in a net cash inflow in 2002 related to the HDD transaction of $1.170 billion. IBM has entered into an arms-length five-year supply agreement with Hitachi, effective January 1, 2003, designed to provide the company with a majority of its ongoing inter-segment disk drive requirements for the company’s Server, Storage and Personal Systems products.

The loss on disposal recorded in 2002 was approximately $182 million, net of tax, and was recorded in (Loss)/income from discontinued operations in the Consolidated Statement of Earnings.

See note A, “Significant Accounting Policies,” on pages 70 to 75 for the “Basis of Presentation” for the discontinued operations.

In the second and fourth quarters of 2002, the company announced certain asset and workforce reduction actions, and excess leased space charges related to its discontinued HDD business. The company recorded a charge of approximately $508 million, net of tax, in discontinued operations associated with these announced actions.

Summarized selected financial information for the discontinued operations is as follows:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>FOR THE YEAR ENDED DECEMBER 31:</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$ 1,746</td>
<td>$ 2,769</td>
<td>$ 3,107</td>
<td></td>
</tr>
<tr>
<td>(Loss)/income before income taxes</td>
<td>($2,037)</td>
<td>($407)</td>
<td>$123</td>
<td></td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>(282)</td>
<td>(74)</td>
<td>(96)</td>
<td></td>
</tr>
<tr>
<td>(Loss)/income from discontinued operations</td>
<td>($1,755)</td>
<td>($423)</td>
<td>$219</td>
<td></td>
</tr>
</tbody>
</table>

* A $737 million comprises $175 million recorded as current assets and $562 million recorded as non-current assets.

The following table summarizes the company’s marketable securities, all of which are considered available for sale, and alliance investments.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AT DECEMBER 31:</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities—current:</td>
<td>$ 593</td>
<td>$ 55</td>
<td></td>
</tr>
<tr>
<td>Time deposits and other obligations</td>
<td>$ 472</td>
<td>$ 124</td>
<td></td>
</tr>
<tr>
<td>Non-U.S. government securities and other fixed-term obligations</td>
<td>$ 20</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,144</td>
<td>$ 12,246</td>
<td></td>
</tr>
</tbody>
</table>

Investments
Net investment in sales-type leases is for leases that relate principally to IBM equipment and are generally for terms ranging from two to five years. Net investment in sales-type leases includes unguaranteed residual values of $821 million and $791 million at December 31, 2002 and 2001, respectively, and is reflected net of unearned income at those dates of $1,330 million and $1,428 million, respectively. Scheduled maturities of minimum lease payments outstanding at December 31, 2002, expressed as a percentage of the total, are as follows: for approximately 2003, 51 percent; 2004, 28 percent; 2005, 15 percent; 2006, 4 percent; and 2007 and beyond, 2 percent.

Customer loans receivable are provided by Global Financing to the company’s customers to finance the purchase of the company’s software and services. Global Financing is one of many sources of funding from which customers can choose. Separate contractual relationships on these financing arrangements are generally for terms ranging from one to three years requiring straight-line payments over the term. Each financing contract is priced independently at competitive market rates. The company has a history of enforcing the terms of these separate financing agreements.

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

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AT DECEMBER 31:</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer-related</td>
<td>$ 557</td>
<td>$ (324)</td>
<td>$ 153</td>
</tr>
<tr>
<td>Completed technology</td>
<td>229</td>
<td>(108)</td>
<td>21</td>
</tr>
<tr>
<td>Strategic alliances</td>
<td>118</td>
<td>(15)</td>
<td>103</td>
</tr>
<tr>
<td>Patent applications</td>
<td>109</td>
<td>(80)</td>
<td>29</td>
</tr>
<tr>
<td>Other*</td>
<td>98</td>
<td>(7)</td>
<td>98</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,071</td>
<td>$ (134)</td>
<td>$ 737 **</td>
</tr>
</tbody>
</table>

* Other intangibles are primarily acquired proprietary and nonproprietary business processes, methodologies and systems.
** Of the $37 million written off as current assets and $342 million recorded as non-current assets.

The loss on disposal recorded in 2002 was approximately $244 million as part of the HDD business, resulting in a net cash inflow in 2002 related to the HDD transaction of $1.170 billion. IBM has entered into an arms-length five-year supply agreement with Hitachi, effective January 1, 2003, designed to provide the company with a majority of its ongoing inter-segment disk drive requirements for the company’s Server, Storage and Personal Systems products.

The loss on disposal recorded in 2002 was approximately $182 million, net of tax, and was recorded in (Loss)/income from discontinued operations in the Consolidated Statement of Earnings.

See note A, “Significant Accounting Policies,” on pages 70 to 75 for the “Basis of Presentation” for the discontinued operations.

In the second and fourth quarters of 2002, the company announced certain asset and workforce reduction actions, and excess leased space charges related to its discontinued HDD business. The company recorded a charge of approximately $508 million, net of tax, in discontinued operations associated with these announced actions.
Summarized selected financial information for the discontinued operations is as follows:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>FOR THE YEAR ENDED DECEMBER 31:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002*</td>
</tr>
<tr>
<td>Revenue</td>
<td>$ 1,746</td>
</tr>
<tr>
<td>(Loss)/income before income taxes</td>
<td>$(4,031)</td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>(282)</td>
</tr>
<tr>
<td>(Loss)/income from discontinued operations</td>
<td>$(1,755)</td>
</tr>
</tbody>
</table>

* Adjusted to conform to 2002 presentation.

The following table summarizes the company's marketable securities, all of which are considered available for sale, and alliance investments.

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AT DECEMBER 31:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Marketable securities — current:</td>
<td></td>
</tr>
<tr>
<td>Time deposits and other obligations</td>
<td>$ 591</td>
</tr>
<tr>
<td>Non-U.S. government securities and other fixed-term obligations</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>$ 599</td>
</tr>
</tbody>
</table>

Marketable securities — non-current:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AT DECEMBER 31:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>Time deposits and other obligations</td>
<td>$ 172</td>
</tr>
<tr>
<td>Non-U.S. government securities and other fixed-term obligations</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>$ 192</td>
</tr>
</tbody>
</table>

Non-equity method alliance investments:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>AT DECEMBER 31:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td></td>
<td>$ 249</td>
</tr>
</tbody>
</table>

* Gross unrealized gains (losses) related to marketable securities and alliance investments vary $1 million and $27 million at December 31, 2002 and 2001, respectively. Gross unrealized losses (gains) related to marketable securities and alliance investments were $10 million and $6 million at December 31, 2000 and 2002, respectively. See note H, "Stockholders' Equity Activities," on page 47 and FAS 115 for information on unrealized gains and losses on marketable securities.

I. Goodwill

The changes in the carrying amount of goodwill, by reporting segment, for the year ended December 31, 2002, are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Services</td>
<td>$327</td>
<td>$2,132</td>
<td>$69</td>
<td>$2,926</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Systems</td>
<td>113</td>
<td>26</td>
<td>137</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal and Printing Systems</td>
<td>13</td>
<td>—</td>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technology</td>
<td>102</td>
<td>5</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Software</td>
<td>727</td>
<td>293</td>
<td>1,015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Financing</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Investments</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$1,278</td>
<td>$33</td>
<td>$2,825</td>
<td>$12</td>
<td>$83</td>
<td>$74</td>
</tr>
</tbody>
</table>

*In accordance with SFAS No. 141, “Business Combinations,” the unaudited balance for acquired assembled workforces, which had been recognized as an intangible asset separate from goodwill, has been reclassified to goodwill effective January 1, 2002.

There were no goodwill impairment losses recorded during the period.

II. Sale and Securitization of Receivables

The company periodically sells receivables through the securitization of loans, leases and trade receivables. The company retains servicing rights in the securitized receivables for which it receives a servicing fee. Any gain or loss incurred as a result of such sales is recognized in the period in which the sale occurs.

During 2001, the company entered into an uncommitted trade receivables securitization facility that allows for the ongoing sale of up to $500 million of trade receivables. This securitization facility that allows for the ongoing sale of up to $500 million of trade receivables in 2001. No receivables were sold under either of these programs.

At December 31, 2002 and 2001, the total balance of the state and local receivables securitized and under the company’s management was $101 million and $213 million, respectively. Servicing assets net of servicing liabilities were insignificant.

The investors in the state and local loans receivable securitizations have recourse to the company via a limited guarantee of $69 million at December 31, 2002. At year-end 2002, delinquent amounts from the receivables sold and net credit losses were insignificant.

III. Borrowings

Short-term debt

At December 31, 2002 and 2001, the weighted-average interest rates for commercial paper at December 31, 2002 and 2001 were 1.7 percent and 1.9 percent, respectively. The weighted-average interest rates for short-term loans at December 31, 2002 and 2001, were 2.5 percent and 4.0 percent, respectively.

The weighted-average interest rates for commercial paper at December 31, 2002 and 2001, were 1.7 percent and 1.9 percent, respectively. The weighted-average interest rates for short-term loans at December 31, 2002 and 2001, were 2.5 percent and 4.0 percent, respectively.

Long-Term Debt

At December 31, 2002 and 2001, the company sold $278 million of loans receivable securitizations, including $179 million of trade receivables through this facility in 2001.

The company maintains two global credit facilities totaling $12.9 billion in committed lines, including an $8.0 billion multicurrency facility with a term extending through May 31, 2006, and a $4.0 billion, 164-day facility that expires on May 30, 2003. The company’s other lines of credit, most of which were uncommitted, totaled $7,190 million and $6,860 million at December 31, 2002 and 2001, respectively. Interest rates and other terms of borrowing under these lines of credit vary from country to country, depending on local market conditions.

IV. Lines of Credit

The company maintains two global credit facilities totaling $12.9 billion in committed lines, including an $8.0 billion multicurrency facility with a term extending through May 31, 2006, and a $4.0 billion, 164-day facility that expires on May 30, 2003. The company’s other lines of credit, most of which were uncommitted, totaled $7,190 million and $6,860 million at December 31, 2002 and 2001, respectively. Interest rates and other terms of borrowing under these lines of credit vary from country to country, depending on local market conditions.

V. Summary of the Financial Position

The annual contractual maturities on long-term debt outstanding at December 31, 2002, are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$1,949</td>
</tr>
<tr>
<td>2004</td>
<td>3,613</td>
</tr>
<tr>
<td>2005</td>
<td>1,670</td>
</tr>
<tr>
<td>2006</td>
<td>2,705</td>
</tr>
<tr>
<td>2007</td>
<td>846</td>
</tr>
<tr>
<td>2008 and beyond</td>
<td>9,940</td>
</tr>
</tbody>
</table>

VI. Interest on Debt

Refer to the related discussion on pages 101 through 103 in note 1, “Segment Information,” for the total interest expense of the Global Financing segment. See note 4, “Derivatives and Hedging Transactions,” on pages 84 to 86 for a discussion of the use of currency and interest rate swaps in the company’s debt risk management program.

VII. Notes to Consolidated Financial Statements
The the carrying amount of intangible assets increased by $219 million for the year ended December 31, 2002, primarily due to the acquisition of PwCC, offset by the amortization of existing intangible asset balances and the intangible assets associated with divestitures.

The aggregate amortization expense was $181 million and $100 million for the years ended December 31, 2002 and 2001, respectively.

The future 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 December 31, 2002:

<table>
<thead>
<tr>
<th>Segment</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$1,015</td>
<td>875</td>
<td>727</td>
<td>815</td>
<td>750</td>
</tr>
</tbody>
</table>

1 Goodwill

The changes in the carrying amount of goodwill, by reporting segment, for the year ended December 31, 2002, are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Services</td>
<td>$325</td>
<td>—</td>
<td>$2,352</td>
<td>—</td>
<td>—</td>
<td>$2,927</td>
</tr>
<tr>
<td>Enterprise Systems</td>
<td>111</td>
<td>26</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>137</td>
</tr>
<tr>
<td>Personal and Printing Systems</td>
<td>13</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>13</td>
</tr>
<tr>
<td>Technology</td>
<td>102</td>
<td>5</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>110</td>
</tr>
<tr>
<td>Software</td>
<td>727</td>
<td>2</td>
<td>293</td>
<td>(12)</td>
<td>—</td>
<td>1,015</td>
</tr>
<tr>
<td>Global Financing</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Enterprise Investments</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$1,276</td>
<td>$33</td>
<td>$2,825</td>
<td>$12</td>
<td>$83</td>
<td>$4,115</td>
</tr>
</tbody>
</table>

There were no goodwill impairment losses recorded during the period.

2 Sale and Securitization of Receivables

The company periodically sells receivables through the securitization of loans, leases and trade receivables. The company retains servicing rights in the securitized receivables for which it receives a servicing fee. Any gain or loss incurred as a result of such sales is recognized in the period in which the sale occurs.

During 2001, the company entered into an uncommitted trade receivables securitization facility that allows for the ongoing sale of up to $500 million of trade receivables. This facility was put in place primarily to provide backup liquidity and can be accessed on three days notice. The company sold $633 million of trade receivables through this facility in 2001.

At December 31, 2002 and 2001, the total balance of the state and local receivables securitized and under the company's credit facility was $815 million and $213 million, respectively. Servicing assets net of servicing liabilities were insignificant.

The investors in the state and local loans receivables securitizations have recourse to the company via a limited guarantee of $69 million at December 31, 2002. At year-end 2002, delinquent amounts from the receivables sold and net credit losses were insignificant.

2.1 Borrowings

The weighted-average interest rates for commercial paper at December 31, 2002 and 2001, were 1.7 percent and 1.9 percent, respectively. The weighted-average interest rates for short-term loans at December 31, 2002 and 2001, were 2.5 percent and 4.0 percent, respectively.

<table>
<thead>
<tr>
<th>Short-term debt</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial paper</td>
<td>$1,302</td>
<td>$4,809</td>
</tr>
<tr>
<td>Short-term loans</td>
<td>1,013</td>
<td>1,564</td>
</tr>
<tr>
<td>Total</td>
<td>$2,315</td>
<td>$6,373</td>
</tr>
</tbody>
</table>

Total unused lines of credit were $6,860 million at December 31, 2002 and 2001, respectively. Interest rates and other terms of borrowing under these lines of credit vary from country to country, depending on local market conditions.

The future 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 December 31, 2002:

<table>
<thead>
<tr>
<th>Segment</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$1,015</td>
<td>875</td>
<td>727</td>
<td>815</td>
<td>750</td>
</tr>
</tbody>
</table>


Lines of Credit

The company maintains two global credit facilities totaling $12.0 billion in committed lines, including an $8.0 billion multicurrency facility with a term extending through May 31, 2006, and a $4.0 billion, 164-day facility that expires on May 30, 2003. The company’s other lines of credit, most of which were uncommitted, totalled $7,190 million and $6,860 million at December 31, 2002 and 2001, respectively. Interest rates and other terms of borrowing under these lines of credit vary from country to country, depending on local market conditions.

<table>
<thead>
<tr>
<th>Lines of Credit</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total unused lines of credit</td>
<td>$16,934</td>
<td>$16,121</td>
</tr>
</tbody>
</table>

Annual contractual maturities on long-term debt outstanding at December 31, 2002, are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
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<td>2007</td>
<td>846</td>
</tr>
<tr>
<td>2008 and beyond</td>
<td>9,940</td>
</tr>
</tbody>
</table>

Notes to Consolidated Financial Statements
### Derivatives and Hedging Transactions

The company operates in approximately 35 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 price changes. 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 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 limit the effects of foreign exchange rate fluctuations on financial results.

The company does not use derivatives for trading or speculative purposes, nor is it a party to leveraged derivatives. Further, the company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors, and maintains strict dollar and term limits that correspond to the institution’s credit rating. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, the company has not sustained a material loss from these instruments. In its hedging programs, the company employs the use of forward contracts, futures contracts, interest rate and currency swaps, options, caps, floors or a combination thereof depending upon the underlying exposure.

A brief description of the major hedging programs follows.

#### Debt Risk Management

The company issues debt on the global capital markets, primarily to fund its financing lease and loan portfolio. Access to cost-effective financing can result in interest rate and/or currency mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company primarily uses interest-rate and currency instruments, principally swaps, to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt and anticipated commercial paper issuances to fixed rate (i.e., cash flow hedges). The resulting cost of funds is lower than that which would have been available if debt with matching characteristics was issued directly. The weighted-average remaining maturity of all swaps in the debt risk management program is approximately four years.

#### Long-Term Investments in Foreign Subsidiaries (Net Investment)

A significant portion of the company’s foreign currency denominated debt portfolio is designated as a hedge of net investment 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 currency swaps and foreign exchange forward contracts for this risk management purpose. The currency effects of these hedges (approximately $317 million for the current period, net of tax) are reflected as a loss in the Accumulated gains and (losses) not affecting retained earnings section of the Consolidated Statement of Stockholders’ Equity, thereby offsetting a portion of the translation of the applicable foreign subsidiaries’ net assets.

#### Anticipated Royalties and Cost Transactions

The company’s operations generate significant non-functional currency, third party vendor payments and intercompany payments for royalties, and goods and services among the company’s non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward and option contracts to manage its currency risk. At December 31, 2002, the maximum remaining maturity of these derivative instruments was less than 18 months, commensurate with the underlying anticipated cash flows.

---

#### Risk Management Program

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Fair Value</th>
<th>Cash Flow</th>
<th>Net Hedge Effect</th>
<th>Non-Hedge Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Derivatives:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt risk management</td>
<td>$ 645</td>
<td>$ (7)</td>
<td>$ —</td>
<td>$ 3</td>
</tr>
<tr>
<td>Long-term investments in foreign subsidiaries (“net investments”)</td>
<td>—</td>
<td>—</td>
<td>2</td>
<td>—</td>
</tr>
<tr>
<td>Anticipated royalties and cost transactions</td>
<td>—</td>
<td>(469)</td>
<td>—</td>
<td>(109)</td>
</tr>
<tr>
<td>Subsidiary cash and foreign currency asset/liability management</td>
<td>—</td>
<td>—</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>Equity risk management</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>10</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>643(4)</td>
<td>(476)(5)</td>
<td>2(5)</td>
<td>(90)(5)</td>
</tr>
<tr>
<td><strong>Total derivatives</strong></td>
<td>$ 645</td>
<td>$ (476)</td>
<td>$ (2,472)</td>
<td>$ (90)</td>
</tr>
</tbody>
</table>

* Represents fair value of foreign denominated debt issuance formally designated as a hedge of net investment.

1. Comprises assets of $774 million and liabilities of $111 million.
2. Comprises assets of $2 million and liabilities of $479 million.
3. Comprises assets of $2 million.
5. Comprises assets of $874 million and liabilities of $111 million.
1. Derivatives and Hedging Transactions

The company operates in approximately 35 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 price changes. 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 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 limit the effects of foreign exchange rate fluctuations on financial results.

The company does not use derivatives for trading or speculative purposes, nor is it a party to leveraged derivatives. Further, the company has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors, and maintains strict dollar and term limits that correspond to the institution's credit rating. When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, the company has not sustained a material loss from these instruments.

In its hedging programs, the company employs the use of forward contracts, futures contracts, interest rate and currency swaps, options, caps, floors or a combination thereof depending upon the underlying exposure.

A brief description of the major hedging programs follows.

Debt Risk Management

The company issues debt on the global capital markets, principally to fund its financing lease and loan portfolio. Access to cost-effective financing can result in interest rate and/or currency mismatches with the underlying assets. To manage these mismatches and to reduce overall interest cost, the company primarily uses interest-rate and currency instruments, principally swaps, to convert specific fixed-rate debt issuances into variable-rate debt (i.e., fair value hedges) and to convert specific variable-rate debt and anticipated commercial paper issuances to fixed rate (i.e., cash flow hedges). The resulting cost of funds is lower than that which would have been available if debt with matching characteristics was issued directly. The weighted-average remaining maturity of all swaps in the debt risk management program is approximately four years.

Long-Term Investments in Foreign Subsidiaries (Net Investment)

A significant portion of the company's foreign currency denominated debt portfolio is designated as a hedge of net investment 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 currency swaps and foreign exchange forward contracts for this risk management purpose. The currency effects of these hedges (approximately $317 million for the current period, net of tax) are reflected as a loss in the Accumulated gains and (losses) not affecting stockholders' equity, thereby offsetting a portion of the translation of the applicable foreign subsidiaries' net assets.

Anticipated Royalties and Cost Transactions

The company's operations generate significant non-functional currency, third party vendor payments and intercompany payments for royalties, and goods and services among the company's non-U.S. subsidiaries and with the parent company. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the company selectively employs foreign exchange forward and option contracts to manage its currency risk. At December 31, 2002, the maximum remaining maturity of these derivative instruments was less than 18 months, commensurate with the underlying hedged anticipated cash flows.

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 hedge, on a net basis, the foreign currency exposure of a portion of the company's non-functional currency assets and liabilities. The terms of these forward and swap contracts are generally less than one year. The changes in fair value from these contracts and from the underlying hedged exposures are generally offsetting and are recorded in Other (income) and expense in the Consolidated Statement of Earnings.

Equity Risk Management

The company is exposed to certain equity price changes related to certain obligations to employees. These equity exposures are primarily related to market value movements in certain broad equity market indices and in the company's own stock. Changes in the overall value of this employee compensation obligation are recorded in SG&A expense in the Consolidated Statement of Earnings. Although not designated as accounting hedges, the company utilizes equity derivatives, including equity swaps and futures to economically hedge the equity exposures relating to this employee compensation obligation. To match the exposures relating to this employee compensation obligation, these derivatives are linked to the total return of certain broad equity market indices and/or the total return of the company's common stock. These derivatives are recorded at fair value with gains or losses also reported in SG&A expense in the Consolidated Statement of Earnings.

Other Derivatives

The company holds warrants in connection with certain investments that, although not designated as hedging instruments, are deemed derivatives since they contain net share settlement clauses. During the year, the company recorded the change in the fair value of these warrants in net income. The following tables summarizes the net fair value of the company's derivative and other risk management instruments at December 31, 2002 and 2001 (included in the Consolidated Statement of Financial Position).

<table>
<thead>
<tr>
<th>Derivatives:</th>
<th>Fair Value</th>
<th>Cash Flow</th>
<th>Net Investment</th>
<th>Non-Hedge Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt risk management</td>
<td>$ 613</td>
<td>$ (7)</td>
<td>$ —</td>
<td>$ 3</td>
</tr>
<tr>
<td>Long-term investments in foreign subsidiaries (&quot;net investments&quot;)</td>
<td>—</td>
<td>—</td>
<td>2</td>
<td>—</td>
</tr>
<tr>
<td>Anticipated royalties and cost transactions</td>
<td>—</td>
<td>—</td>
<td>(609)</td>
<td>—</td>
</tr>
<tr>
<td>Subsidiary cash and foreign currency asset/liability management</td>
<td>—</td>
<td>—</td>
<td>(109)</td>
<td>—</td>
</tr>
<tr>
<td>Equity risk management</td>
<td>—</td>
<td>—</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>—</td>
<td>—</td>
<td>10</td>
<td>—</td>
</tr>
<tr>
<td>Total derivatives</td>
<td>631(4)</td>
<td>(476)(5)</td>
<td>2(1)</td>
<td>(96)(6)</td>
</tr>
<tr>
<td>Debt: Long-term investments in foreign subsidiaries (&quot;net investments&quot;)</td>
<td>—</td>
<td>—</td>
<td>(2,474)(7)</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$ 643</td>
<td>$ (476)</td>
<td>$ (2,474)</td>
<td>$ (96)</td>
</tr>
</tbody>
</table>

(4) Represents fair value of foreign denominated debt issuance formally designated as a hedge of net investment.
(5) Comprises assets of $774 million and liabilities of $111 million.
(6) Comprises assets of $9 million and liabilities of $479 million.
(7) Comprises assets of $2 million.
(8) Comprises assets of $25 million and liabilities of $32 million.
Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements

Acumulated Derivative Gains or Losses
As illustrated, the company makes extensive use of cash flow hedges, principally in the anticipated royalties and debt actions risk management program. In connection with the company’s cash flow hedges, it has recorded approximately $361 million of net losses in Accumulated gains and losses not affecting retained earnings as of December 31, 2002, of approximately $322 million is expected to be reclassified to net income within the next year, providing an offsetting economic impact against the underlying anticipated cash flow hedges.

The following table summarizes the activity in the Accumulated gains and losses not affecting retained earnings section of the Consolidated Statement of Stockholders’ Equity related to all derivatives classified as cash flow hedges held by the company during the periods January 1, 2001 (the date of the company’s adoption of SFAS No. 113) through December 31, 2002.

<table>
<thead>
<tr>
<th>Derivatives:</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt risk management</td>
<td>$301</td>
<td>$26</td>
</tr>
<tr>
<td>Long-term investments in foreign subsidiaries (“net investments”)</td>
<td>—</td>
<td>92</td>
</tr>
<tr>
<td>Anticipated royalties and debt transactions</td>
<td>—</td>
<td>175</td>
</tr>
<tr>
<td>Subsidiary cash and foreign currency asset/liability management</td>
<td>—</td>
<td>16</td>
</tr>
<tr>
<td>Equity risk management</td>
<td>—</td>
<td>22</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>—</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total derivatives</strong></td>
<td>301(1)</td>
<td>190(2)</td>
</tr>
</tbody>
</table>

Debt:
Long-term investments in foreign subsidiaries (“net investments”) | —          | —          |

Total $301 $190

Notes to Consolidated Financial Statements

Other Liabilities

1. Other Liabilities

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>As of December 31:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>2001</td>
</tr>
</tbody>
</table>

Deferred taxes $1,410 $1,481
Deferred income 1,079 1,141
Executive compensation accruals 851 868
Restructuring actions 1,024 1,089
Postemployment/ preretirement liability 571 493
Environmental accruals 208 215
Other 766 670
Total $5,951 $5,461

* Redefined to conform with 2002 presentation.

The year’s costs include certain workforce realigning actions to improve productivity and competitive position. The non-current contractually obligated future payments associated with these ongoing activities are reflected in the postemployment/preretirement liability caption in the table above.

In addition, the company executed certain actions prior to 1994, and in 1999 and 2002. The non-current liabilities associated with these actions are reflected in restructuring actions in the table above. The reconciliation of the December 31, 2001 to 2002, balances of the current and non-current liabilities for restructuring actions are presented in the table on page 87. The current liabilities presented in the table are included in Other accrued expenses and liabilities in the Consolidated Statement of Financial Position.

At December 31, 2002, there were no significant gains or losses on derivative transactions or portions thereof that were either ineffectiveness as hedges, excluded from the assessment of hedge effectiveness, or associated with an underlying exposure that did not occur; nor are there any anticipated in the normal course of business.

n Stockholders’ Equity Activity

In the fourth quarter of 2002, in connection with the PwCC acquisition, IBM issued 3,677,213 shares of restricted stock valued at approximately $254 million and recorded an additional $30 million for stock to be issued in future periods as part of the purchase price consideration paid to the PwCC partners. See note 4, “Acquisitions/Divestitures,” on pages 78 to 80, for further information regarding this acquisition and related payments made by the company. Additionally, in the fourth quarter of 2002, in conjunction with the funding of the company’s U.S. pension plan, the company issued an additional 24,037,534 shares of common stock from treasury shares valued at $1,871 million.

Stock Repurchases
From time to time, the Board of Directors authorizes the company to repurchase IBM common stock. The company repurchased 48,481,100 common shares at a cost of $4,212 million and 30,764,098 common shares at a cost of $2,293 million in 2002 and 2001, respectively. In 2002 and 2001, the company issued 979,246 and 1,923,502 treasury shares, respectively, as a result of exercises of stock options by employees of certain recently acquired businesses and by non-U.S. employees. At December 31, 2002, $3,864 million of Board-authorized repurchases remained. The company plans to purchase shares on the open market from time to time, depending on market conditions. The company also repurchased 199,779 common shares at a cost of $18 million and 114,433 common shares at a cost of $11 million in 2002 and 2001, respectively, as part of other stock compensation plans.

In 1993, the Board of Directors authorized the company to repurchase all of its outstanding Series A 7-1/2 percent callable preferred stock. On May 18, 2001, the company announced it would redeem all outstanding shares of its Series A 7-1/2 percent callable preferred stock, represented by outstanding depositary shares (10,184,043 shares). The depositary shares represent ownership of one-fourth of a share of preferred stock. Depositary shares were redeemed as of July 3, 2001, the redemption date, for cash at a redemption price of $25 plus accrued and unpaid dividends to the redemption date for each depositary share. Accordingly, these shares are no longer outstanding. Dividends on preferred stock, represented by the depositary shares, ceased to accrue on the redemption date. The company did not repurchase any shares in 2000.
\textbf{Accumulated Derivative Gains or Losses}

As illustrated, the company makes extensive use of cash flow hedges, principally in the anticipated royalties and cost transactions management program. In connection with the company’s cash flow hedges, it has recorded approximately $631 million of net losses in Accumulated gains and losses (not affecting retained earnings as of December 31, 2002), net of tax, of which approximately $122 million is expected to be reclassified to net income within the next year, providing an offsetting economic impact against the underlying anticipated cash flow hedges. The following table summarizes the activity in the Accumulated gains and losses (not affecting retained earnings) section of the Consolidated Statement of Stockholders’ Equity related to all derivatives classified as cash flow hedges held by the company during the periods January 1, 2001 (the date of the company’s adoption of SFAS No. 113) through December 31, 2002.

\textbf{M. Other Liabilities} ($ in millions)

<table>
<thead>
<tr>
<th>Description</th>
<th>$1,000</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred taxes</td>
<td>1,410</td>
<td>1,481</td>
</tr>
<tr>
<td>Deferred income</td>
<td>1,079</td>
<td>1,145</td>
</tr>
<tr>
<td>Executive compensation accruals</td>
<td>851</td>
<td>868</td>
</tr>
<tr>
<td>Restructuring actions</td>
<td>1,024</td>
<td>1,089</td>
</tr>
<tr>
<td>Postemployment/pretirement liability</td>
<td>373</td>
<td>493</td>
</tr>
<tr>
<td>Environmental accruals</td>
<td>204</td>
<td>211</td>
</tr>
<tr>
<td>Other</td>
<td>766</td>
<td>670</td>
</tr>
<tr>
<td>Total</td>
<td>5,951</td>
<td>5,841</td>
</tr>
</tbody>
</table>

*Redacted to confirm with 2002 presentation.*

Each year the company takes certain workforce reorganization actions to improve productivity and competitive position. The non-current contractually obligated future payments associated with these ongoing activities are reflected in the postemployment/pretirement liability caption in the table above.

In addition, the company executed certain actions prior to 1994, and in 1999 and 2002. The non-current liabilities associated with these actions are reflected in restructuring actions in the table above. The reconciliation of the December 31, 2001 to 2002, balances of the current and non-current liabilities for restructuring actions are presented in the table on page 87. The current liabilities presented in the table are included in Other accrued expenses and claims in the Consolidated Statement of Financial Position.

At December 31, 2002, there were no significant gains or losses on derivative transactions or portions thereof that were either ineffectiveness as hedges, excluded from the assessment of hedge effectiveness, or associated with an underlying exposure that did not occur; nor are there any anticipated in the normal course of business.

\textbf{Stockholders’ Equity Activity}

In the fourth quarter of 2002, in connection with the PwCC acquisition, IBM issued 3,677,213 shares of restricted stock valued at approximately $254 million and recorded an additional $30 million for stock to be issued in future periods as part of the purchase price consideration paid to the PwCC partners. See note 2c, “Acquisitions/Divestitures,” on pages 78 to 80, for further information regarding this acquisition and related payments made by the company. Additionally, in the fourth quarter of 2002, in conjunction with the funding of the company’s U.S. pension plan, the company issued an additional 24,037,358 shares of common stock from treasury shares valued at $1,871 million.

\textbf{Stock Repurchases}

From time to time, the Board of Directors authorizes the company to repurchase IBM common stock. The company repurchased 48,481,100 common shares at a cost of $4,212 million and $30,706,098 common shares at a cost of $2,293 million in 2002 and 2001, respectively. In 2002 and 2001, the company issued 979,246 and 1,923,502 treasury shares, respectively, as a result of exercises of stock options by employees of certain recently acquired businesses and by non-U.S. employees. At December 31, 2002, $3,864 million of Board-authorized repurchases remained. The company plans to purchase shares on the open market from time to time, depending on market conditions. The company also repurchased 199,797 common shares at a cost of $8 million and 114,453 common shares at a cost of $11 million in 2002 and 2001, respectively, as part of other stock compensation plans.

In 1995, the Board of Directors authorized the company to repurchase all of its outstanding Series A-7.125 percent callable preferred stock. On May 18, 2001, the company announced it would redeem all outstanding shares of its Series A-7.125 percent callable preferred stock, represented by the outstanding depositary shares (10,184,043 shares). The depositary shares represent ownership of one-fourth of a share of preferred stock. Depositary shares were redeemed as of July 3, 2001, the redemption date, for cash at a redemption price of $25 plus accrued and unpaid dividends to the redemption date for each depositary share. Accordingly, these shares are no longer outstanding. Dividends on preferred stock, represented by the depositary shares, ceased to accrue on the redemption date. The company did not repurchase any shares in 2000.
Employee Benefits Trust

In 1997, the company created an employee benefits trust to which the company contributed 10 million shares of treasury stock. The company was authorized to instruct the trustee to sell such shares from time to time and to use the proceeds from such sales, and any dividends paid or earnings received thereon, for the partial payment of the company’s obligations under certain of its compensation and benefit plans. The shares held in trust were not considered outstanding for earnings per share purposes until they were committed to be released. The company did not commit any shares for release from the trust during its existence nor were any shares sold from the trust. The trust would have expired in 2007. Due to the fact that the company had not used the trust, nor was it expected to need the trust prior to its expiration, the company dissolved the trust, effective May 31, 2001, and all of the shares (20 million on a split-adjusted basis) were returned to the company as treasury shares. Dissolution of the trust did not affect the company’s obligations related to any of its compensation and employee benefit plans or its ability to settle the obligations. In addition, the dissolution is not expected to have any impact on net income. At this time, the company has not yet met its obligations for the compensation and benefit plans in the same manner as it does today, using cash from operations.

<table>
<thead>
<tr>
<th>Date</th>
<th>Net Unrealized Gains/ (Losses) on Marketable Securities</th>
<th>Foreign Currency Translation Adjustment</th>
<th>Marketable Security Gains/ (Losses)</th>
<th>Net Unrealized Gains/ (Losses) on Available for Sale Securities</th>
<th>Accumulated Changes in Unrealized Gains/ (Losses) on Available for Sale Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2000</td>
<td>$ (13)</td>
<td>$ (73)</td>
<td>$ (218)</td>
<td>$ (78)</td>
<td>$ (169)</td>
</tr>
<tr>
<td>Cumulative effect on January 1, 2001</td>
<td>219</td>
<td>219</td>
<td>219</td>
<td>219</td>
<td>219</td>
</tr>
<tr>
<td>Change for period</td>
<td>72</td>
<td>(510)</td>
<td>(109)</td>
<td>(92)</td>
<td>(678)</td>
</tr>
<tr>
<td>December 31, 2001</td>
<td>296</td>
<td>(612)</td>
<td>(126)</td>
<td>14</td>
<td>(826)</td>
</tr>
<tr>
<td>Change for period</td>
<td>(659)</td>
<td>(850)</td>
<td>(2,765)</td>
<td>(16)</td>
<td>(2,196)</td>
</tr>
</tbody>
</table>

**Contingencies**

The company is subject to a variety of claims and suits that arise from time to time in the ordinary course of its business, including actions with respect to contracts, IP, product liability, employment and environmental matters. The company is a defendant and/or third-party defendant in a number of cases in which claims have been led by current and former employees, independent contractors, estate representatives, offspring and relatives of employees seeking damages for wrongful death and personal injuries allegedly caused by exposure to chemicals in various of the company’s facilities from 1964 to the present.

**Commitments**

The company has applied the disclosure provisions of FASB Interpretation No. 4 (FIN 45), “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,” to its agreements that contain guarantees or indemnification clauses. These disclosure provisions expand those required by FASB Statement 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 other party harmless against losses arising from a breach of representations and covenants related to such matters as title to 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 a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party’s claims. Further, the company’s obligations under these agreements may be limited in terms of time and/or amount, and in some instances, the company may have recourse against third parties for certain payments made by the company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the company’s obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the company under these agreements have not had a material effect on the company’s business, financial condition or results of operations. The company believes that if it were to incur a loss in any of these matters, such loss should 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 $126 million and $218 million at December 31, 2002 and 2001, respectively. These amounts include the limited guarantees associated with the company’s loans receivable securitization program. See note j, “Sale and Securitization of Receivables,” on page 82. The company extended lines of credit, of which the unused amounts were $3,482 million and $4,088 million at December 31, 2002 and 2001, 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 $288 million and $209 million at December 31, 2002 and 2001, respectively. Changes in the company’s warranty liability balance are illustrated in the following table.

<table>
<thead>
<tr>
<th>Date</th>
<th>Balance at January 1</th>
<th>Current period accruals</th>
<th>Accrual adjustments to reflect actual experience</th>
<th>Balance at December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$ 520</td>
<td>863</td>
<td>121</td>
<td>$ 614</td>
</tr>
<tr>
<td>2002</td>
<td>$ 572</td>
<td>823</td>
<td>(2)</td>
<td>$ 520</td>
</tr>
</tbody>
</table>

Accrual adjustments in 2002 principally reflect a significant increase in the failure rates of HDD components in the company’s Server and Storage products as a result of product transition.
**Employee Benefits Trust**

In 1997, the company created an employee benefits trust to which the company contributed 10 million shares of treasury stock. The company was authorized to instruct the trustee to sell such shares from time to time and to use the proceeds from such sales, and any dividends paid or earnings received on such stock, toward the partial payment of the company’s obligations under certain of its compensation and benefit plans. The shares held in trust were not considered outstanding for earnings per share purposes until they were committed to be released. The company did not commit any shares for release from the trust during its existence nor were any shares sold from the trust. The trust would have expired in 2007. Due to the fact that the company had not used the trust, nor was it expected to need the trust prior to its expiration, the company dissolved the trust, effective May 31, 2001, and all of the shares (20 million on a split-adjusted basis) were returned to the company as treasury shares. Dissolution of the trust did not affect the company’s obligations related to any of its compensation and employee benefit plans or its ability to settle the obligations. In addition, the dissolution is not expected to have any impact on net income. At this time, the company is not aware of any circumstances involved in each matter, historically, the company has been successful in defending itself against claims and suits that have been brought against it, and payments made by the company in such claims and suits have not been material to the company. The company will continue to defend itself vigorously in all such matters and believes that if it were to lose in any of these matters, such loss should 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 should not have a material effect on the company’s business, financial condition or results of operations. The company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the company to challenge the other party’s claims. Further, the company’s obligations under these agreements may be limited in terms of time and/or amount, and in some instances, the company may have recourse against third parties for certain payments made by the company. It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the company’s obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the company under these agreements did 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 $126 million and $218 million at December 31, 2002 and 2001, respectively. These amounts include the limited guarantee associated with the company’s loans receivable securitization program. See note 3, “Sale and Securitization of Receivables,” on page 82.

The continuing operations provision for income taxes by geographic operations is as follows:

<table>
<thead>
<tr>
<th>Note</th>
<th>December 31, 2002</th>
<th>December 31, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. operations</td>
<td>$ 934</td>
<td>$ 1,543</td>
</tr>
<tr>
<td>Non-U.S. operations</td>
<td>$ 1,256</td>
<td>$ 1,761</td>
</tr>
<tr>
<td>Total continuing operations provision for income taxes</td>
<td>$ 2,190</td>
<td>$ 3,304</td>
</tr>
</tbody>
</table>

The components of the continuing operations provision for income taxes by taxing jurisdiction are as follows:

<table>
<thead>
<tr>
<th>Note</th>
<th>December 31, 2002</th>
<th>December 31, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. federal:</td>
<td>$ 287</td>
<td>$ 414</td>
</tr>
<tr>
<td>Current</td>
<td>$ 284</td>
<td>$ 767</td>
</tr>
<tr>
<td>Deferred</td>
<td>$ 184</td>
<td>$ 192</td>
</tr>
<tr>
<td>U.S. state and local:</td>
<td>147</td>
<td>147</td>
</tr>
<tr>
<td>Current</td>
<td>$ 187</td>
<td>$ 228</td>
</tr>
<tr>
<td>Deferred</td>
<td>187</td>
<td>228</td>
</tr>
<tr>
<td>Non-U.S.:</td>
<td>$ 1,796</td>
<td>$ 2,133</td>
</tr>
<tr>
<td>Current</td>
<td>$ 239</td>
<td>$ 239</td>
</tr>
<tr>
<td>Deferred</td>
<td>$ 176</td>
<td>$ 288</td>
</tr>
<tr>
<td>Total continuing operations provision for income taxes</td>
<td>$ 2,190</td>
<td>$ 3,304</td>
</tr>
<tr>
<td>Provision for social security, real estate, personal property and other taxes</td>
<td>$ 2,789</td>
<td>$ 2,710</td>
</tr>
<tr>
<td>Total continuing operations provision for taxes</td>
<td>$ 4,979</td>
<td>$ 6,014</td>
</tr>
</tbody>
</table>

Accrual adjustments in 2002 principally reflect a significant increase in the failure rates of HDD components in the company’s Server and Storage products as a result of product transitions.
For tax return purposes, the company has available tax credit carryforwards of approximately $2,234 million, of which $1,316 million have an indefinite carryforward period and the remainder begin to expire in 2005. The company also has state and local, and foreign tax loss carryforwards, the tax effect of which is $543 million. Most of these carryforwards are available for five years or have an indefinite carryforward period.

Undistributed earnings of non-U.S. subsidiaries included in consolidated retained earnings were $16,631 million at December 31, 2002, and $16,891 million at December 31, 2001. These earnings, which reflect full provisions for non-U.S. income taxes, are indefinitely reinvested in non-U.S. operations or will be remitted substantially free of additional tax.

Advertising and Promotional Expense
Advertising and promotional expense, which includes media, agency and promotional expense, was $1,797 million, $1,651 million and $1,742 million in 2002, 2001 and 2000, respectively, and is recorded in SG&A expense.

Research, Development and Engineering
R&D expense was $8,750 million in 2002, $8,986 million in 2001 and $7,084 million in 2000.

The company incurred expense of $8,247 million in 2002, $8,321 million in 2001 and $8,101 million in 2000 for basic scientific research and the application of scientific advances to the development of new and improved products and their uses. Of these amounts, software-related expense was $1,974 million, $1,926 million and $1,955 million in 2002, 2001 and 2000, respectively. Included in the expense for 2002 and 2000 were charges for acquired in-process R&D of $4 million and $9 million, respectively.

Expense for product-related engineering was $503 million in 2002, $495 million in 2001 and $472 million in 2000.

Second Quarter Actions
During the second quarter of 2002, the company executed several actions in its Microelectronics Division. The Microelectronics Division is within the company’s Technology Group segment. These actions were the result of the company’s announced intentions to refocus and direct its microelectronics business to the high-end foundry, application-specific integrated circuit and standard products, while creating a technology services business. A major part of the actions related to a significant reduction in the company’s manufacturing capacity for aluminum technology.

In addition, the company rebalanced both its workforce and its leased space resources primarily in response to the recent decline in corporate spending on technology services.

For the year ending December 31: 2002 2001 2000
Statutory rate 35% 35% 35%
Foreign tax differential (7) (6) (6)
State and local 1 1 1
Valuation allowance related items — (1) (1)
Other — (2) (2)
Effective rate 29% 29% 31%

The table following summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Microelectronics:</th>
<th>Pre-tax charges</th>
<th>Write-off of assets</th>
<th>Microelectronics in Q2 &amp; Q3, 2002</th>
<th>Payments</th>
<th>Other adjustments</th>
<th>Liabilities as of Dec. 31, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery:</td>
<td>$423</td>
<td>$121</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>$338</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-cancelable purchase commitments:</td>
<td>60</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td>$31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>$32</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee terminations:</td>
<td>45</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td>$44</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>$1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vacant space:</td>
<td>11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of Endicott facility:</td>
<td>223</td>
<td>221</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>User rights:</td>
<td>10</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Global Services and Other:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee terminations:</td>
<td>722</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td>679</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>$515</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vacant space:</td>
<td>180</td>
<td>291</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current:</td>
<td>$571</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>94</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current:</td>
<td>94</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total:</td>
<td>1,727</td>
<td>$2,626</td>
<td>$1,101</td>
<td>$651</td>
<td>4</td>
<td>$4,470</td>
</tr>
</tbody>
</table>

* Recast to reflect adoption of SFAS 2002 presentation.

The valuation allowance at December 31, 2002, principally applies to certain state and local, and foreign tax loss carryforwards that, in the opinion of management, are more likely than not to expire before the company can use them.

A reconciliation of the company’s continuing operations effective tax rate to the statutory U.S. federal tax rate is as follows:

(a) This amount was recorded in SG&A expense and primarily represents the abandonment and loss on sale of certain capital assets during the second quarter of 2002.
(b) This amount comprises costs incurred to remove abandoned capital assets and the remaining lease payments for leased equipment that was abandoned in the second quarter of 2002. The company expects to pay the remaining costs by June 30, 2003. The remaining lease payments will continue through 2005. These amounts were recorded in SG&A expense.
(c) The company is subject to certain noncancelable purchase commitments. As a result of the decision to significantly reduce aluminum capacity, the company no longer has a need for certain materials subject to these agreements. The required future payments for materials no longer needed under these contracts are expected to be paid over two years. This amount was recorded in SG&A expense.
(d) The workforce reductions represent 1,400 people of which approximately 94 percent left the business as of December 31, 2002. These amounts were recorded in SG&A expense. The non-current portion of the liability 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 dies.
(e) The space accruals are for ongoing obligations to pay rent for vacant space that could not be sublet or space that was sublet at rates below than the committed lease arrangement. The length of these obligations varies by lease with the longest extending through 2006. These charges were recorded in Other (income) and expense in the Consolidated Statement of Earnings.
(f) As part of the company’s strategic decisions in its Microelectronics business to exit the manufacture and sale of certain products and component technologies, the company signed an agreement in the second quarter of 2002 to sell its interconnect products operations in Endicott to Endicott Interconnect Technologies, Inc. (EIT). As a result of this transaction, the company incurred a $223 million loss on sale in the second quarter of 2002, primarily relating to land, buildings, machinery and equipment. This loss was recorded in Other (income) and expense in the Consolidated Statement of Earnings. This transaction closed in
For tax return purposes, the company has available tax credit carryforwards of approximately $2,234 million, of which $1,316 million have an indefinite carryforward period and the remainder begin to expire in 2005. The company also has state and local, and foreign tax loss carryforwards, the tax effect of which is $543 million. Most of these carryforwards are available for five years or have an indefinite carryforward period.

Undistributed earnings of non-U.S. subsidiaries included in consolidated retained earnings were $16,631 million at December 31, 2002, and $16,831 million at December 31, 2001. These earnings, which reflect full provision for non-U.S. income taxes, are indefinitely reinvested in non-U.S. operations or will be remitted substantially free of additional tax.

9 Advertising and Promotional Expense

Advertising and promotional expense, which includes media, agency and promotional expense, was $1,171 million, $1,651 million and $1,742 million in 2002, 2001 and 2000, respectively, and is recorded in SG&A expense.

R Research, Development and Engineering

RD&E expense was $4,750 million in 2002, $4,986 million in 2001, and $5,084 million in 2000. The company incurred expense of $4,247 million in 2002, $4,321 million in 2001 and $4,301 million in 2000 for basic scientific research and the application of scientific advances to the development of new and improved products and their uses.

The significant components of activities that gave rise to deferred tax assets and liabilities that are recorded in the Consolidated Statement of Financial Position were as follows:

<table>
<thead>
<tr>
<th>Deferred Tax Assets</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement benefits</td>
<td>$ 3,587</td>
<td>$ 2,589</td>
</tr>
<tr>
<td>Capitalized research and development</td>
<td>2,251</td>
<td>747</td>
</tr>
<tr>
<td>Alternative minimum tax credits</td>
<td>1,516</td>
<td>1,322</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>1,049</td>
<td>1,122</td>
</tr>
<tr>
<td>Deferred income</td>
<td>995</td>
<td>694</td>
</tr>
</tbody>
</table>

Other charges of assets 2nd qtr. 2002 payments adjustments $3,829
895
51

<table>
<thead>
<tr>
<th>Deferred Tax Liabilities</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement benefits</td>
<td>$ 9,904</td>
<td>$ 3,829</td>
</tr>
<tr>
<td>Sales-type leases</td>
<td>1,088</td>
<td>1,814</td>
</tr>
<tr>
<td>Depreciation</td>
<td>329</td>
<td>422</td>
</tr>
<tr>
<td>Other</td>
<td>1,401</td>
<td>1,472</td>
</tr>
<tr>
<td>Gross deferred tax liabilities</td>
<td>$ 8,752</td>
<td>$ 7,744</td>
</tr>
</tbody>
</table>

The valuation allowance at December 31, 2002, principally applies to certain state and local, and foreign tax loss carryforwards that, in the opinion of management, are more likely than not to expire before the company can use them.

A reconciliation of the company’s continuing operations effective tax rate to the statutory U.S. federal tax rate is as follows:

<table>
<thead>
<tr>
<th>For the Year Ending December 31:</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory rate</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>Foreign tax differential</td>
<td>(7)</td>
<td>(6)</td>
<td>(6)</td>
</tr>
<tr>
<td>Effective rate</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

The table following summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Pre-tax Charge</th>
<th>Write-off of Assets</th>
<th>Recognized in 2nd qtr. 2002</th>
<th>Payments</th>
<th>Other Adjustments</th>
<th>Liability as of Dec. 31, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery:</td>
<td>$ 423</td>
<td>$ 321</td>
<td>$ 670=</td>
<td>$ 38</td>
<td>$ 13</td>
</tr>
<tr>
<td>Non-current</td>
<td>335**</td>
<td>—</td>
<td>(16)</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Non-cancelable purchase commitments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>315=</td>
<td>—</td>
<td>15</td>
<td>4</td>
<td>24</td>
</tr>
<tr>
<td>Non-current</td>
<td>215**=</td>
<td>—</td>
<td>(12)</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Employee terminations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>45</td>
<td>44=</td>
<td>(5)</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td></td>
<td>14**</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Vacant space:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>5**</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td>6**=</td>
<td>—</td>
<td>(1)</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Sale of Endicott facility</td>
<td>223</td>
<td>221=</td>
<td>27=</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Sale of certain operations</td>
<td>63</td>
<td>13=</td>
<td>10**</td>
<td>9</td>
<td>1</td>
</tr>
</tbody>
</table>

Total: $ 1,727 $ 626 $ 1,101 $ 635 $ 4 $ 470

* Recorded to Acquisities payable and accruals in the Consolidated Statement of Financial Position.
** Recorded to Other liabilities in the Consolidated Statement of Financial Position.

Principal represents currency translation adjustments and reclassification of non-current to current. In addition, net adjustments of $30 million were made in the fourth quarter of 2000 and $23 million in the third quarter of 2001 to reduce previously recorded liabilities. These adjustments, along with a net $10 million credit for assets previously written off, were for differences between the estimated and actual proceeds on the disposition of certain assets and changes in the estimated cost of employee terminations.

The required future payments for materials no longer required that are subject to lease agreements that extend beyond the contract termination date, or that are required to make payments to terminate these obligations, are included in liabilities as of December 31, 2002. The company incurred a $223 million loss on the sale of non-U.S. assets and $30 million of losses on the disposition of certain assets in 2002.

The table following summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Pre-tax Charge</th>
<th>Write-off of Assets</th>
<th>Recognized in 2nd qtr. 2002</th>
<th>Payments</th>
<th>Other Adjustments</th>
<th>Liability as of Dec. 31, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery:</td>
<td>$ 423</td>
<td>$ 321</td>
<td>$ 670=</td>
<td>$ 38</td>
<td>$ 13</td>
</tr>
<tr>
<td>Non-current</td>
<td>335**</td>
<td>—</td>
<td>(16)</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Non-cancelable purchase commitments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>315=</td>
<td>—</td>
<td>15</td>
<td>4</td>
<td>24</td>
</tr>
<tr>
<td>Non-current</td>
<td>215**=</td>
<td>—</td>
<td>(12)</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Employee terminations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>45</td>
<td>44=</td>
<td>(5)</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td></td>
<td>14**</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Vacant space:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>5**</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td>6**=</td>
<td>—</td>
<td>(1)</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Sale of Endicott facility</td>
<td>223</td>
<td>221=</td>
<td>27=</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Sale of certain operations</td>
<td>63</td>
<td>13=</td>
<td>10**</td>
<td>9</td>
<td>1</td>
</tr>
</tbody>
</table>

Total: $ 1,727 $ 626 $ 1,101 $ 635 $ 4 $ 470

* Recorded to Acquisities payable and accruals in the Consolidated Statement of Financial Position.
** Recorded to Other liabilities in the Consolidated Statement of Financial Position.

Principal represents currency translation adjustments and reclassification of non-current to current. In addition, net adjustments of $30 million were made in the fourth quarter of 2000 and $23 million in the third quarter of 2001 to reduce previously recorded liabilities. These adjustments, along with a net $10 million credit for assets previously written off, were for differences between the estimated and actual proceeds on the disposition of certain assets and changes in the estimated cost of employee terminations.

The required future payments for materials no longer required that are subject to lease agreements that extend beyond the contract termination date, or that are required to make payments to terminate these obligations, are included in liabilities as of December 31, 2002. The company incurred a $223 million loss on the sale of non-U.S. assets and $30 million of losses on the disposition of certain assets in 2002.

The table following summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Pre-tax Charge</th>
<th>Write-off of Assets</th>
<th>Recognized in 2nd qtr. 2002</th>
<th>Payments</th>
<th>Other Adjustments</th>
<th>Liability as of Dec. 31, 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery:</td>
<td>$ 423</td>
<td>$ 321</td>
<td>$ 670=</td>
<td>$ 38</td>
<td>$ 13</td>
</tr>
<tr>
<td>Non-current</td>
<td>335**</td>
<td>—</td>
<td>(16)</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>Non-cancelable purchase commitments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>315=</td>
<td>—</td>
<td>15</td>
<td>4</td>
<td>24</td>
</tr>
<tr>
<td>Non-current</td>
<td>215**=</td>
<td>—</td>
<td>(12)</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Employee terminations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>45</td>
<td>44=</td>
<td>(5)</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td></td>
<td>14**</td>
<td>—</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Vacant space:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>5**</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Non-current</td>
<td>6**=</td>
<td>—</td>
<td>(1)</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Sale of Endicott facility</td>
<td>223</td>
<td>221=</td>
<td>27=</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Sale of certain operations</td>
<td>63</td>
<td>13=</td>
<td>10**</td>
<td>9</td>
<td>1</td>
</tr>
</tbody>
</table>

Total: $ 1,727 $ 626 $ 1,101 $ 635 $ 4 $ 470

* Recorded to Acquisities payable and accruals in the Consolidated Statement of Financial Position.
** Recorded to Other liabilities in the Consolidated Statement of Financial Position.

Principal represents currency translation adjustments and reclassification of non-current to current. In addition, net adjustments of $30 million were made in the fourth quarter of 2000 and $23 million in the third quarter of 2001 to reduce previously recorded liabilities. These adjustments, along with a net $10 million credit for assets previously written off, were for differences between the estimated and actual proceeds on the disposition of certain assets and changes in the estimated cost of employee terminations.
Specifically, the company rebalanced both its workforce and its leased space resources. The following table summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Fourth Quarter Actions</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Records in the Consolidated Statement of Earnings</td>
<td>Records in the Consolidated Financial Statements</td>
</tr>
<tr>
<td></td>
<td>Total Obligation</td>
<td>Earned or Liable in 4th QTR.</td>
</tr>
<tr>
<td>Workforce:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$23,541</td>
<td>—</td>
</tr>
<tr>
<td>Non-current</td>
<td>570</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$24,111</td>
<td>—</td>
</tr>
<tr>
<td>Vacant space:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>175</td>
<td>4</td>
</tr>
<tr>
<td>Non-current</td>
<td>6</td>
<td>62</td>
</tr>
<tr>
<td>Total</td>
<td>175</td>
<td>68</td>
</tr>
</tbody>
</table>

Notes:
- Principle represents average tenancy adjustments.

The majority of the workforce reductions relate to the company's Global Services business. The workforce reductions represent 3,541 people who are expected to leave the company by the end of the first quarter of 2003 ($105 million in the table above). These charges were included in SG&A expense in the Consolidated Statement of Earnings. The workforce reductions also affected 1,203 acquired individuals in the Global Services business and the downturn in corporate technology spending on services. The length of these obligations varies by lease with the longest extending through 2009. These charges were recorded in Other (income) and expense in the Consolidated Statement of Earnings.

Stock options to purchase 111,713,072 common shares in 2002, 67,956,737 common shares in 2001 and 34,633,349 common shares in 2000 were outstanding, but not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive. Net income applicable to common stockholders excludes preferred stock dividends of $10 million in 2001 and $20 million in 2000.

### Rental Expense and Lease Commitments

Rental expense from continuing operations, including amounts charged to inventories and fixed assets, and excluding amounts previously reserved, was $1,377 million in 2002, $1,324 million in 2001 and $1,315 million in 2000. The table below depicts gross minimum rental commitments from continuing operations under noncancelable leases, amounts related to vacant space associated with infrastructure reductions and restructuring actions taken through 1991, and in 1999 and 2002 (previously reserved), and sublease income commitments. These amounts reflect activities primarily related to office space as well as manufacturing equipment.
the fourth quarter of 2002. The company entered into a limited supply agreement with RFH for future products, and it will also lease back, at fair market value rental rates, approximately one-third of the Endicott campus’ square footage for operations outside the interconnect O&M business.

d) As part of the strategic realignment of the company’s Microelectronics business, the company reached an agreement to sell certain assets and liabilities comprising its Mylex business to LSI Logic Corporation and the company sold part of its wireless phone chipset operations to TriQuint Semiconductor, Inc. in June 2002. The Mylex transaction was completed in August 2002. The loss of $74 million for the Mylex transaction and the realized gain of $11 million for the chipset sale were recorded in Other (income) and expense in the Consolidated Statement of Earnings.

Fourth Quarter Actions

During the fourth quarter of 2002, the company executed several actions related to the company’s acquisition of PwCC. Specifically, the company rebalanced both its workforce and its leased space resources. The following table summarizes the significant components of these actions:

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Charges/Benefits (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workforce:</td>
<td>$305(n) $— $248 $400</td>
</tr>
<tr>
<td>Current:</td>
<td>$— $296 $16 $278</td>
</tr>
<tr>
<td>Non-current:</td>
<td>$575 $— $575 $575</td>
</tr>
<tr>
<td>Vacant space:</td>
<td>$175</td>
</tr>
<tr>
<td>Current:</td>
<td>4 $6 $62 $68</td>
</tr>
<tr>
<td>Non-current:</td>
<td>7 $17 $86 $86</td>
</tr>
<tr>
<td>Total</td>
<td>$322 $4 $318 $438</td>
</tr>
</tbody>
</table>

* Principally represents severance and relocation expenses.

The majority of the workforce reductions relate to the company’s Global Services business. The workforce reductions represent 14,213 people of which approximately 94 percent left the company as of December 31, 2002. See (d) on page 91 for information on the non-current portion of the liability. The majority of the workforce reductions represent 14,213 people of which approximately 94 percent left the company as of December 31, 2002. See (d) on page 91 for information on the non-current portion of the liability.

e) The majority of the workforce reductions relate to the company’s Global Services business. The workforce reductions represent 14,213 people of which approximately 94 percent left the company as of December 31, 2002. See (d) on page 91 for information on the non-current portion of the liability.

(f) The space accruals are for ongoing obligations to pay rent for vacant space that could not be sublet or space that was sublet at rates lower than the committed lease arrangements. This space relates primarily to workforce dynamics in the Global Services business and the downturn in corporate technology spending on services. The length of these leases varies by lease with the longest extending through 2009. These charges were recorded in Other (income) and expense in the Consolidated Statement of Earnings.

(g) As part of the strategic realignment of the company’s Microelectronics business, the company reached an agreement to sell certain assets and liabilities comprising its Mylex business to LSI Logic Corporation and the company sold part of its wireless phone chipset operations to TriQuint Semiconductor, Inc. in June 2002. The Mylex transaction was completed in August 2002. The loss of $74 million for the Mylex transaction and the realized gain of $11 million for the chipset sale were recorded in Other (income) and expense in the Consolidated Statement of Earnings.

Stock options to purchase 111,713,072 common shares in 2002, 67,396,737 common shares in 2001 and 34,633,343 common shares in 2000 were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the common shares and, therefore, the effect would have been anti-dilutive. Net income applicable to common stockholders excludes preferred stock dividends of $10 million in 2001 and $20 million in 2000.

Rental Expense and Lease Commitments

Rental expense from continuing operations, including amounts charged to inventories and fixed assets, and excluding amounts previously reserved, was $1,377 million in 2002, $1,324 million in 2001 and $1,315 million in 2000. The table below depicts gross minimum rental commitments from continuing operations under noncancelable leases, amounts related to vacant space associated with infrastructure reductions and restructuring actions taken through 1991, and in 1999 and 2002 (previously reserved), and sublease income commitments. These amounts reflect activities primarily related to office space as well as manufacturing equipment.

### Table: Rental Expense and Lease Commitments

<table>
<thead>
<tr>
<th>Year Ended December 31</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$2,10</td>
<td>$4,41</td>
<td>$4,58</td>
</tr>
<tr>
<td>Basic</td>
<td>$—</td>
<td>$—</td>
<td>$—</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(1,03)</td>
<td>(0,24)</td>
<td>0,12</td>
</tr>
<tr>
<td>Total</td>
<td>$2,10</td>
<td>$4,41</td>
<td>$4,58</td>
</tr>
</tbody>
</table>

* Represents short-term or option contracts sold by the company on a limited basis through private placements with independent third parties to reduce the cost of the share buy-back program. The put option contracts that were exercised permitted net share settlement at the company’s option and did not result in a gain or loss on the option liability. The Consolidated Statement of Financial Position as of December 31, 2002, did not include any option obligations outstanding.

** Does not include the $90 million of restructuring related to vacant space.
Stock-Based Compensation Plans

The following is a description of the terms of the company's stock-based compensation plans:

Incentive Plans

Incentive awards are to be provided to employees and directors under the terms of the company's plans (the Plans). Employee awards are administered by the Executive Compensation and Management Resources Committee of the Board of Directors. The Committee determines the type and terms of the awards to be granted, including vesting provisions.

Awards under the Plans may include stock options, stock appreciation rights, restricted stock, cash or stock awards, or any combination thereof. The original amount of shares authorized to be issued under the Plans was 411.3 million. There were 183.1 million and 194.4 million unused shares available to be granted under the Plans as of December 31, 2002 and 2001, respectively. Awards under the Plans resulted in compensation expense of $189 million, $170 million and $134 million in 2002, 2001 and 2000, respectively.

**Stock Option Grants**

Stock options are granted to employees and directors at an exercise price equal to the fair market value of the company's stock at the date of grant. Generally, options vest 25 percent per year, are fully vested four years from the grant date and have a term of ten years. The following tables summarize option activity under the Plans during 2002, 2001 and 2000:

The shares under option at December 31, 2002, were in the following exercise price ranges:

- **$12-$20**: 2,099,313
- **$21-$30**: 74,701,940
- **$31-$40**: 68,564,327
- **$41 and over**: 49,571,920

IBM Employees Stock Purchase Plan

The ESPP enables substantially all regular employees to purchase full or fractional shares of IBM common stock through payroll deductions of up to 10 percent of eligible compensation. Effective July 1, 2000, the ESPP was amended whereby the share price paid by an employee changed from 85 percent of the average market price on the last business day of each pay period, to the lesser of 85 percent of the average market price on the first business day of such offering period or 85 percent of the average market price on the last business day of each pay period. This change did not have a material impact on the company's financial condition. The current plan provides semi-annual offerings over the five-year period commencing July 1, 2000. ESPP participants are restricted from purchasing more than $25,000 of common stock in one calendar year or 1,000 shares in an offering period. Approximately 4.6 million, 16.5 million and 26.1 million restricted unvested shares were available for purchase under the ESPP at December 31, 2002, 2001 and 2000, respectively. The

company intends to request stockholder approval of a new ESPP in April 2003. If approved, shares may be issued under that plan and employee participation would be subject to the terms and conditions of that plan.

Pro Forma Disclosure

See “Stock-Based Compensation” on page 72, in note A, “Significant Accounting Policies,” for the pro forma disclosure of net income and earnings per share required under SFAS No. 123.

Retirement-Related Benefits

IBM offers defined benefit pension plans, defined contribution pension plans and nonpension postretirement plans, primarily consisting of retiree medical benefits. These benefits form an important part of the company's total compensation and benefits program that is designed to attract and retain highly skilled and talented employees. The following table provides the total retirement-related benefit plans' impact on income before income taxes.

<table>
<thead>
<tr>
<th>(\text{period (in millions)})</th>
<th>(\text{2002})</th>
<th>(\text{2001})</th>
<th>(\text{2000})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total retirement-related plans—income</td>
<td>$154</td>
<td>$156</td>
<td>$17</td>
</tr>
<tr>
<td>Nonpension postretirement benefits—cost</td>
<td>$62</td>
<td>$66</td>
<td>$66</td>
</tr>
<tr>
<td>composite</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Components</td>
<td>(\text{2002})</td>
<td>(\text{2001})</td>
<td>(\text{2000})</td>
</tr>
<tr>
<td>Defined benefit pension plans—income</td>
<td>$478</td>
<td>$612</td>
<td>$46</td>
</tr>
<tr>
<td>Nonpension postretirement benefits—cost</td>
<td>$36</td>
<td>$37</td>
<td>$37</td>
</tr>
<tr>
<td>Total</td>
<td>$514</td>
<td>$649</td>
<td>$53</td>
</tr>
</tbody>
</table>

Accounting Policy

**Defined Benefit Pension and Nonpension Postretirement Benefit Plans**

The company accounts for its defined benefit pension plans and its nonpension postretirement benefit plans using actuarial models required by SFAS No. 75, “Employers’ Accounting for Pensions,” and SFAS No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions,” respectively. These models use an attribution approach that generally spreads individual events over the service lives of the employees in the plan. Examples of “events” are plan amendments and changes in actuarial assumptions such as discount rate, rate of compensation increases and mortality. See the next paragraph for information on the expected long-term rate of return on plan assets. The principle underlying the required attribution approach is that employees render service over their service lives on a relatively smooth basis and therefore, the income statement effects of pensions or nonpension postretirement benefit plans are earned in, and should follow, the same pattern.

One of the principal components of the net periodic pension income (cost) calculation is the expected long-term rate of return on plan assets. The required use of expected long-term rate of return on plan assets may result in recognized pension income that is greater or less than the actual returns of those plan assets in any given year. Over time, however, the expected long-term rates are designed to approximate the actual long-term returns and therefore result in a pattern of income and expense recognition that more closely matches the pattern of the services provided by the employees. Differences between actual and expected returns are recognized in the calculation of net periodic pension income (cost)/over five years for the company in providing for the accountings.

The company uses long-term historical actual return information, the expected mix of investments that comprise plan assets, and future estimates of long-term investment returns to develop its expected return on plan assets. The discount rate assumptions used for pension and nonpension postretirement benefit plans are intended to reflect the prevailing rates available on high-quality, fixed-income debt instruments. The rate of compensation increase is another significant assumption used in the actuarial model for pension accounting and is determined by the company, based upon its long-term plans for such increases. For retiree medical plan accounting, the company reviews external data and its own historical trends for health care costs to determine the health care cost trend rates. As required by SFAS No. 87, for instances in which pension plan assets are less than the accumulated benefit obligation (ABO) as of the end of the reporting period (defined as an unfunded ABO position), a minimum liability equal to the excess of the ABO over plan assets. See “Other Comprehensive Income” above for information on the expected long-term rate of return on plan assets. The minimum liability is a charge to equity, net of tax. In addition, any prepaid pension asset in excess of unrecognized prior service cost must be recovered through a net-of-tax charge to equity. The charge to equity is included in the Accumulated gains (losses) not affecting retained earnings section of the Stockholders’ equity in the Consolidated Statement of Financial Position.
Includes amounts for discontinued operations costs of $77 million, $56 million and $62 million for 2002, 2001 and 2000, respectively.

Stock-Option Grants

Stock options are granted to employees and directors at an exercise price equal to the fair market value of the company's stock at the date of grant. Generally, options vest 25 percent per year, are fully vested four years from the grant date and have a term of ten years. The following tables summarize option activity under the Plans during 2002, 2001 and 2000:

The shares under option at December 31, 2002, were in the following exercise price ranges:

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IBM offers defined benefit pension plans, defined contribution pension plans and nonpension postretirement plans, primarily consisting of retiree medical benefits. These benefits form an important part of the company's total compensation and benefits program that is designed to attract and retain highly skilled and talented employees. The following table provides the total retirement-related benefit plans' impact on income before income taxes.

Notes to Consolidated Financial Statements
 DEFINED CONTRIBUTION PENSION PLANS
The company records pension expense for defined contribution plans when the employee renders service to the company, essentially coinciding with the cash contributions to plans.

Defined Benefit and Defined Contribution Plans
The company and its subsidiaries have defined benefit and defined contribution pension plans that cover substantially all regular employees, and supplemental retirement plans that cover certain executives.

U.S. PLANS
IBM Personal Pension Plan
IBM provides U.S. regular, full-time and part-time employees with noncontributory defined benefit pension benefits (the IBM Personal Pension Plan, “PPP”). The PPP comprises a tax qualified plan and a non-qualified plan. The qualified plan is funded by company contributions to an irrevocable trust fund, which is held for the sole benefit of participants.
Effective January 1, 2001, the company increased pension benefits to certain recipients who retired before January 1, 1997. The increases ranged from 2.5 percent to 25 percent, and were based on the year of retirement and the pension benefit then being received. This improvement resulted in an additional cost of $100 million in 2001 as compared to 2000.
The number of individuals receiving benefits from the PPP at December 31, 2002 and 2001, was 136,365 and 131,071, respectively. The pre-tax net periodic pension income for the non-qualified plan for the years ended December 31, 2002, 2001 and 2000, was $(917) million, $(1,086) million and $(971) million, respectively. The pre-tax net periodic pension income for the qualified plan for the years ended December 31, 2002, 2001 and 2000, was $(917) million, $(1,086) million and $(971) million, respectively. The pre-tax net periodic pension income for the non-qualified plan was $106 million, $138 million, and $123 million for the years ended December 31, 2002, 2001, and 2000, respectively. The costs of the non-qualified plan are reflected in Cost of other defined benefit plans on page 97.

IBM provides U.S. regular, full-time and part-time employees with noncontributory defined benefit pension benefits (the IBM Personal Pension Plan, “PPP”). The PPP comprises a tax qualified plan and a non-qualified plan. The qualified plan is funded by company contributions to an irrevocable trust fund, which is held for the sole benefit of participants.
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Non-U.S. Plans
Most subsidiaries and branches outside the United States have defined benefit and/or defined contribution retirement plans that cover substantially all regular employees, under which the company deposits funds under various fiduciary-type arrangements, purchases annuities under group contracts or provides reserves. Benefits under the defined benefit plans are typically based either on years of service and the employee’s compensation, generally during a fixed number of years immediately before retirement, or on annual credits. The range of assumptions that are used for the non-U.S. defined benefit plans reflect the different economic environments within various countries. The total non-U.S. retirement plan income of these plans for the years ended December 31, 2002, 2001 and 2000, was $46 million, $209 million and $198 million, respectively.

Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements
Notes to Consolidated Financial Statements

**Defined Contribution Pension Plans**

The company records pension expense for defined contribution plans when the employee renders service to the company, essentially coinciding with the cash contributions to plans.

**Defined Benefit and Defined Contribution Plans**

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IBM Personal Pension Plan
IBM provides U.S. regular, full-time and part-time employees with noncontributory defined benefit pension benefits (the IBM Personal Pension Plan, “PPP”). The PPP comprises a tax qualified plan and a non-qualified plan. The qualified plan is funded by company contributions to an irrevocable trust fund, which is held for the sole benefit of participants.

The company also has a non-qualified U.S. Supplemental Executive Retirement Plan (SERP). The SERP, which is unfunded, provides defined benefit pension benefits in addition to the PPP to eligible executives based on average earnings, years of service and age at retirement. Effective July 1, 1999, the company adopted the SERP (which replaced the previous Supplemental Executive Retirement Plan). Some participants of the prior SERP will still be eligible for benefits under that plan, but will not be eligible for the new plan. The total cost of this plan for the years ended December 31, 2002, 2001 and 2000, was $(917) million, $(1,086) million and $(971) million, respectively. These amounts are reflected in Cost of defined contribution plans on page 97. At December 31, 2002 and 2001, the benefit obligation was $10 million and $166 million, respectively, and the amounts included in Retirement and nonpension postretirement benefit obligations in the Consolidated Statement of Financial Position at December 31, 2002 and 2001, were liabilities of $165 million and $151 million, respectively.

**Non-U.S. Plans**

Most subsidiaries and branches outside the United States have defined benefit and/or defined contribution retirement plans that cover substantially all regular employees, under which the company deposits funds under various fiduciary-type arrangements, purchases annuities under group contracts or provides reserves. Benefits under the defined benefit plans are typically based either on years of service and the employee’s compensation, generally during a fixed number of years immediately before retirement, or on annual credits. The range of assumptions that are used for the non-U.S. defined benefit plans reflect different economic environments within various countries. The total non-U.S. retirement plan income of these plans for the years ended December 31, 2002, 2001 and 2000, was $46 million, $209 million and $198 million, respectively.

---

**Notes to Consolidated Financial Statements**

### Defined Contribution Pension Plans

<table>
<thead>
<tr>
<th>(Income)/Cost of Pension Plans</th>
<th>U.S. Plan</th>
<th>Non-U.S. Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Service cost</strong></td>
<td>$ 650</td>
<td>$ 647</td>
</tr>
<tr>
<td>Interest cost</td>
<td>2,591</td>
<td>2,560</td>
</tr>
<tr>
<td>Expected return on plan assets</td>
<td>(4,121)</td>
<td>(4,202)</td>
</tr>
<tr>
<td>Amortization of transition assets</td>
<td>144</td>
<td>141</td>
</tr>
<tr>
<td>Amortization of prior service cost</td>
<td>61</td>
<td>52</td>
</tr>
<tr>
<td>Recognized actuarial losses/(gains)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Divestitures/settlement losses/(gains)</td>
<td>46</td>
<td>—</td>
</tr>
<tr>
<td><strong>Net periodic pension income — U.S. Plan and material non-U.S. Plans</strong></td>
<td>(197)**</td>
<td>(1,086)**</td>
</tr>
<tr>
<td>Cost of other defined benefit plans</td>
<td>124</td>
<td>144</td>
</tr>
<tr>
<td><strong>Total net periodic pension income for all defined benefit plans</strong></td>
<td>(791)</td>
<td>(945)</td>
</tr>
<tr>
<td><strong>Cost of defined contribution plans</strong></td>
<td>315</td>
<td>313</td>
</tr>
<tr>
<td>Total retirement plan income recognized in the Consolidated Statement of Earnings</td>
<td>(470)</td>
<td>(832)</td>
</tr>
</tbody>
</table>

* Redefined to conform with 2002 presentation.
** Represents the qualified portion of the PPP.

See beginning of note w, “Retirement-Related Benefits,” on page 95 for the company’s total retirement-related benefits (income)/cost.
Changes in the discount rate assumptions and rate of compensation increase assumptions since 2000 have not had a material impact on the company's Consolidated Financial Statements. The changes in the expected long-term return on plan assets assumption in the U.S. and non-U.S. for 2002 reduced the 2002 income from retirement-related plans by approximately $175 million as compared to 2001.

**Funded Status for Defined Benefit Pension Plans**

It is the company's practice to fund amounts for pensions sufficient to meet the minimum requirements set forth in applicable employee benefits laws and local tax laws. From time to time, the company contributes additional amounts as it deems appropriate. The assets of the various plans include corporate equities, government securities, corporate debt securities, and real estate. In the fourth quarter of 2002, the company voluntarily fully funded the qualified portion of the PPP, as measured by its ABO, through a total contribution of $9,631 million. The contribution comprised $2,092 million in cash and $7,539 million, or 29,037,154 shares, of IBM stock.

In contrast, the company's plan assets were less than the ABO in certain non-U.S. countries, and the company did not contribute funds up to the ABO level. As a result and consistent with the accounting rules for these "unfunded" positions as described on page 58, the company recorded an additional mandatory minimum liability of $2,676 million and a reduction to stockholders' equity of $2,765 million as of December 31, 2002. This accounting transaction does not impact 2003 retirement-related plans income.

The company's Benefit Obligation (BO) for its significant plans is disclosed at the top of page 98. BO is calculated similarly to ABO except for the fact that BO includes an estimate for future salary increases. SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," requires that companies disclose the aggregate BO and plan assets of all plans in which the BO exceeds plan assets. Similar disclosure is required for all plans in which the ABO exceeds plan assets. The aggregate BO and plan assets are also disclosed for plans in which the plans exceed the BO. The following table excludes the U.S. plans due to the fact that these plans' BO and plan assets, if any, appear either in the narrative on page 96 or the table on page 98.

The total cost of the company's nonpension postretirement benefits for the years ended December 31, 2002, 2001 and 2000, were $353 million, $404 million and $401 million, respectively. The company has a defined benefit postretirement plan that provides medical, dental and life insurance for U.S. retirees and eligible dependents. The total cost of this plan for the years ended December 31, 2002, 2001 and 2000, was $124 million, $376 million and $174 million, respectively. The changes in the benefit obligation and plan assets for this plan are presented on page 100. Effective July 1, 1999, the company established a "Future Health Account" (FHA) for employees who were more than five years away from retirement eligibility. Employees who were within five years of retirement eligibility were covered under the company's prior retiree health benefits arrangements. Under either the FHA or the preexisting plan, there is a maximum cost to the company for retiree health benefits. For employees who retired before January 1, 1992, that maximum became effective in 2001. For all other employees, the maximum is effective upon retirement.

Certain of the company's non-U.S. subsidiaries have similar plans for retirees. However, most of the retirees outside the United States are covered by government-sponsored and administered programs. The total cost of these plans for the years ended December 31, 2002, 2001 and 2000, was $29 million, $28 million and $27 million, respectively. At December 31, 2002 and 2001, other liabilities in the Consolidated Statement of Financial Position include non-U.S. postretirement benefit liabilities of $211 million and $280 million, respectively.

The net periodic postretirement benefit cost for the U.S. plan for the years ended December 31 include the following components:

### Notes to Consolidated Financial Statements

<table>
<thead>
<tr>
<th>Plan Components</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost</td>
<td>$49</td>
<td>$65</td>
</tr>
<tr>
<td>Interest cost</td>
<td>421</td>
<td>417</td>
</tr>
<tr>
<td>Amortization of prior service costs</td>
<td>(147)</td>
<td>(146)</td>
</tr>
<tr>
<td>Recognized actuarial losses</td>
<td>30</td>
<td>22</td>
</tr>
<tr>
<td>Divestiture</td>
<td>(29)</td>
<td></td>
</tr>
<tr>
<td>Net periodic post-retirement benefit cost</td>
<td>$324</td>
<td>$376</td>
</tr>
</tbody>
</table>

| Plans with BO in excess of plan assets | $20,212 | $13,132 | $14,757 | $10,929 |
| Plans with ABO in excess of plan assets | $15,978 | $10,086 | $5,305 | $2,636 |
| Plans with assets in excess of BO | $5,487 | $7,505 | $7,044 | $10,602 |

*Redescribed to conform with 2002 presentation.

The net periodic benefit obligation for the years ended December 31, 2002, 2001 and 2000, were $353 million, $404 million and $401 million, respectively. The company has a defined benefit postretirement plan that provides medical, dental and life insurance for U.S. retirees and eligible dependents. The total cost of this plan for the years ended December 31, 2002, 2001 and 2000, was $124 million, $376 million and $174 million, respectively. The changes in the benefit obligation and plan assets for this plan are presented on page 100. Effective July 1, 1999, the company established a "Future Health Account" (FHA) for employees who were more than five years away from retirement eligibility. Employees who were within five years of retirement eligibility were covered under the company's prior retiree health benefits arrangements. Under either the FHA or the preexisting plan, there is a maximum cost to the company for retiree health benefits. For employees who retired before January 1, 1992, that maximum became effective in 2001. For all other employees, the maximum is effective upon retirement.

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| Plans with assets in excess of BO | $5,487 | $7,505 | $7,044 | $10,602 |

*Redescribed to conform with 2002 presentation.
The changes in the benefit obligations and plan assets of the qualified portion of the PPP and the significant non-U.S. qualified portion for 2002 and 2001 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>2002 (dollars in millions)</th>
<th>2001 (dollars in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in benefit obligation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit obligation at beginning of year</td>
<td>$37,762</td>
<td>$36,620</td>
</tr>
<tr>
<td>Service cost</td>
<td>650</td>
<td>647</td>
</tr>
<tr>
<td>Interest cost</td>
<td>2,020</td>
<td>2,020</td>
</tr>
<tr>
<td>Plan participants’ contributions</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Acquisitions/divestitures</td>
<td>32</td>
<td>(29)</td>
</tr>
<tr>
<td>Amendments</td>
<td>18</td>
<td>99</td>
</tr>
<tr>
<td>Actuarial losses</td>
<td>47</td>
<td>460</td>
</tr>
<tr>
<td>Benefits paid from trust</td>
<td>(2,743)</td>
<td>(2,743)</td>
</tr>
<tr>
<td>Direct benefit payments</td>
<td>(2,211)</td>
<td>(2,211)</td>
</tr>
<tr>
<td>Foreign exchange impact</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Plan curtailments/settlements/termination benefits</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Benefit obligation at beginning of year</td>
<td>$38,537</td>
<td>$37,762</td>
</tr>
<tr>
<td>Change in plan assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value of plan assets at beginning of year</td>
<td>$39,565</td>
<td>$44,594</td>
</tr>
<tr>
<td>Actual return on plan assets</td>
<td>(3,801)</td>
<td>(2,405)</td>
</tr>
<tr>
<td>Employer contribution</td>
<td>9,063</td>
<td>225</td>
</tr>
<tr>
<td>Acquisitions/divestitures</td>
<td>—</td>
<td>(29)</td>
</tr>
<tr>
<td>Plan participants’ contributions</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Benefits paid from trust</td>
<td>(2,743)</td>
<td>(2,743)</td>
</tr>
<tr>
<td>Foreign exchange impact</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Settlements</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Fair value of plan assets at end of year</td>
<td>$37,187</td>
<td>$39,565</td>
</tr>
<tr>
<td>Gain on plan assets in excess of benefit obligation</td>
<td>(1,373)</td>
<td>1,803</td>
</tr>
<tr>
<td>Unrecognized net actuarial losses</td>
<td>12,187</td>
<td>4,218</td>
</tr>
<tr>
<td>Unrecognized prior service costs</td>
<td>584</td>
<td>641</td>
</tr>
<tr>
<td>Unrecognized net transition asset</td>
<td>(126)</td>
<td>(160)</td>
</tr>
<tr>
<td>Net prepaid pension asset recognized</td>
<td>$11,182</td>
<td>$6,102</td>
</tr>
<tr>
<td>Amounts recognized in the Consolidated Statement of Financial Position captions include:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid pension assets</td>
<td>$11,182</td>
<td>$6,102</td>
</tr>
<tr>
<td>Intangible asset</td>
<td>54</td>
<td>18</td>
</tr>
<tr>
<td>Total prepaid pension assets</td>
<td>$11,236</td>
<td>$6,118</td>
</tr>
<tr>
<td>Retirement and nonpension postretirement benefit obligation</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Accumulated gains and (losses) not affecting retained earnings</td>
<td>(5,865)</td>
<td>(2,669)</td>
</tr>
<tr>
<td>Deferred tax assets (investments and sundry assets)</td>
<td>1,843</td>
<td>274</td>
</tr>
<tr>
<td>Net amount recognized</td>
<td>$11,182</td>
<td>$6,102</td>
</tr>
<tr>
<td>Accumulated benefit obligation</td>
<td>$36,738</td>
<td>$35,134</td>
</tr>
<tr>
<td>Gain on plan assets</td>
<td>$24,386</td>
<td>$24,082</td>
</tr>
</tbody>
</table>

Changes in the discount rate assumptions and rate of compensation increase assumptions as compared to 2001:

- Discount rate: 6.75% to 6.25%
- Expected long-term return on plan assets: 9.5% to 10.0%
- Rate of compensation increase: 4.0% to 6.0%

Other liabilities in the Consolidated Statement of Financial Position include non-U.S. post-retirement benefit liabilities of $212 million and $280 million, respectively.

Notes to Consolidated Financial Statements
### Segment Information

IBM uses advanced IT to provide customer solutions. The company operates primarily in a single industry using several segments that create value by offering a variety of solutions that include, either singularly or in some combination, technologies, systems, products, services, software and financing.

Organizational changes have occurred throughout the Company since 1998. The Company's segments as of December 31, 2002, and the years then ended, have been reclassified to reflect the organizational changes and the results of continuing operations of the segments consistent with the Company's management system. These changes will not be reflective of the results of continuing operations of the segments consistent with the Company's management system. These changes are not necessarily a depiction that is in conformity with GAAP; e.g., employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments on headcount. Different amounts could result if actuarial assumptions that are unique to the 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. The results for 2000 have been reclassified to reflect the organizational changes and product transfers made in 2001.

The Group's segments are the Global Services, System, Technology Group, Software and Integrated Solutions. The unallocated corporate amounts arising from certain acquisitions, indirect infrastructure reductions, the company's use of shared-resources concepts to realize economies of scale and efficient use of resources. Thus, a considerable amount of expense is shared by all of the company's segments. This expense represents sales coverage, marketing and support functions such as Accounting, Treasury, Procurement, Legal, Human Resources, and Billing and Collections. Where practical, shared expenses are allocated based on measurable drivers of expense, e.g., headcount. When a clear and measurable driver cannot be identified, shared expenses are allocated on a financial basis that is consistent with the company's management systems. For example, image advertising is allocated based on the gross profit of the segments. The allocated unimportant corporate amounts arising from certain acquisitions, indirect infrastructure reductions, and unallocated tax activity from continuing operations and the unallocated corporate expense pool are recorded in net income but are not allocated to the segments.

The following tables reflect the results of continuing operations of the segments consistent with the Company's management system. These results are not necessarily a depiction that is in conformity with GAAP, e.g., employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments on headcount. Different amounts could result if actuarial assumptions that are unique to the 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. The results for 2000 have been reclassified to reflect the organizational changes and product transfers made in 2001.

### Notes to Consolidated Financial Statements

The health care cost trend rate has an insignificant effect on plan costs and obligations and a one-percentage-point change in the assumed health care cost trend rate would have the following effects as of December 31, 2002:

<table>
<thead>
<tr>
<th>Effect on total service and interest cost</th>
<th>Effect on postretirement benefit obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5 (1%)</td>
<td>$32 (18%)</td>
</tr>
</tbody>
</table>

Table: Segment Revenues

<table>
<thead>
<tr>
<th>Segment</th>
<th>2002 Revenue</th>
<th>2001 Revenue</th>
<th>2000 Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Services</td>
<td>$6,266</td>
<td>$6,140</td>
<td>$5,987</td>
</tr>
<tr>
<td>System Group</td>
<td>$26,333</td>
<td>$27,123</td>
<td>$27,647</td>
</tr>
<tr>
<td>Technology Group</td>
<td>$11,089</td>
<td>$12,055</td>
<td>$13,920</td>
</tr>
<tr>
<td>Software</td>
<td>$12,055</td>
<td>$13,920</td>
<td>$14,453</td>
</tr>
<tr>
<td>Integrated</td>
<td>$15,098</td>
<td>$19,922</td>
<td>$21,350</td>
</tr>
<tr>
<td>Solutions</td>
<td>$5,184</td>
<td>$6,600</td>
<td>$7,643</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$49,996</td>
<td>$57,603</td>
<td>$64,453</td>
</tr>
</tbody>
</table>

Table: Segment Pre-tax income

<table>
<thead>
<tr>
<th>Segment</th>
<th>2002 Pre-tax Income</th>
<th>2001 Pre-tax Income</th>
<th>2000 Pre-tax Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Services</td>
<td>$8,203</td>
<td>$8,283</td>
<td>$8,129</td>
</tr>
<tr>
<td>System Group</td>
<td>$23,123</td>
<td>$24,981</td>
<td>$25,195</td>
</tr>
<tr>
<td>Technology Group</td>
<td>$3,156</td>
<td>$3,500</td>
<td>$4,243</td>
</tr>
<tr>
<td>Software</td>
<td>$3,500</td>
<td>$4,243</td>
<td>$5,798</td>
</tr>
<tr>
<td>Integrated</td>
<td>$12,111</td>
<td>$13,123</td>
<td>$14,350</td>
</tr>
<tr>
<td>Solutions</td>
<td>$1,122</td>
<td>$1,369</td>
<td>$1,944</td>
</tr>
<tr>
<td>Total Pre-tax</td>
<td>$38,996</td>
<td>$42,432</td>
<td>$46,996</td>
</tr>
</tbody>
</table>

Table: Benefit Obligation at Beginning of Year

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Systems Group</td>
<td>$3,657</td>
<td>$1,561</td>
<td>$578</td>
</tr>
<tr>
<td>Technology</td>
<td>$3,556</td>
<td>$955</td>
<td>(293)</td>
</tr>
<tr>
<td>Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$8,436</td>
<td>$6,443</td>
<td>$3,575</td>
</tr>
</tbody>
</table>

Table: Fair Value of Plan Assets at End of Year

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
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<td>$1,122</td>
</tr>
<tr>
<td>Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$57,603</td>
<td>$18,896</td>
<td>$13,920</td>
</tr>
</tbody>
</table>

### Notes to Consolidated Financial Statements

The changes in the benefit obligation and plan assets of the plans for 2002 and 2001 are as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Systems Group</td>
<td>$3,657</td>
<td>$1,561</td>
<td>$578</td>
</tr>
<tr>
<td>Technology</td>
<td>$3,556</td>
<td>$955</td>
<td>(293)</td>
</tr>
<tr>
<td>Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$8,436</td>
<td>$6,443</td>
<td>$3,575</td>
</tr>
</tbody>
</table>

### Notes to Consolidated Financial Statements

The plan assets primarily comprise short-term fixed-income investments. The benefit obligation was determined by applying the terms of medical, dental and life insurance plans, including the effects of established maximums on covered costs, together with relevant actuarial assumptions. These actuarial assumptions include a projected health care cost trend rate of 10 percent. The projected health care cost trend rate assumption is projected to be 10 percent in 2001, and is assumed to decrease gradually to 4.5 percent by 2008 and remain constant thereafter.

### Notes to Consolidated Financial Statements

The related costs of shared services are allocated to the segments on a financial basis that is consistent with the company’s management systems. This expense represents sales coverage, marketing and support functions such as Accounting, Treasury, Procurement, Legal, Human Resources, and Billing and Collections. Where practical, shared expenses are allocated based on measurable drivers of expense, e.g., headcount. When a clear and measurable driver cannot be identified, shared expenses are allocated on a financial basis that is consistent with the company’s management systems. For example, image advertising is allocated based on the gross profit of the segments. The unimportant corporate amounts arising from certain acquisitions, indirect infrastructure reductions, and unimportant tax activity from continuing operations and the unimportant corporate expense pool are recorded in net income but are not allocated to the segments.

### Notes to Consolidated Financial Statements

The following tables reflect the results of continuing operations of the segments consistent with the Company’s management system. These results are not necessarily a depiction that is in conformity with GAAP, e.g., employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments on headcount. Different amounts could result if actuarial assumptions that are unique to the 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. The results for 2000 have been reclassified to reflect the organizational changes and product transfers made in 2001.

### Notes to Consolidated Financial Statements

The Group’s segments are the Global Services, System, Technology Group, Software and Integrated Solutions. The unallocated corporate amounts arising from certain acquisitions, indirect infrastructure reductions, the company’s use of shared-resources concepts to realize economies of scale and efficient use of resources. Thus, a considerable amount of expense is shared by all of the company’s segments. This expense represents sales coverage, marketing and support functions such as Accounting, Treasury, Procurement, Legal, Human Resources, and Billing and Collections. Where practical, shared expenses are allocated based on measurable drivers of expense, e.g., headcount. When a clear and measurable driver cannot be identified, shared expenses are allocated on a financial basis that is consistent with the company’s management systems. For example, image advertising is allocated based on the gross profit of the segments. The unimportant corporate amounts arising from certain acquisitions, indirect infrastructure reductions, and unimportant tax activity from continuing operations and the unimportant corporate expense pool are recorded in net income but are not allocated to the segments.
The changes in the benefit obligation and plan assets of the company for 2002 and 2001 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Benefit obligation at beginning of year</th>
<th>Plan assets at beginning of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$148,464</td>
<td>(20,900)</td>
</tr>
<tr>
<td>2002</td>
<td>$156,266</td>
<td>(39,316)</td>
</tr>
</tbody>
</table>

Change in benefit obligation:
- Increase  $8,802
- Decrease (8,416)
- Net increase $386

Change in plan assets:
- Increase $471
- Decrease (415)
- Net increase $56

Segment Information

IBM uses advanced IT to provide customer solutions. The company operates primarily in a single industry using several segments that create value by offering a variety of solutions that include, either individually or in some combination, technology, systems, products, services, software and financing.

Organizationally, the company's major operations comprise a Global Services segment; three hardware product segments— Systems Group, Personal Systems Group and Technology Group; a Software segment; a Global Financing segment; and an Enterprise Investments segment. The segments are determined based on several factors, including customer base, homogeneous products, technology and delivery claims.

Information about each segment's business and the products and services that generate each segment's revenue is located in the “Description of Business” sections of the Management Discussion on pages 44 through 50 and page 60.

In the first quarter of 2001, the company reorganized the Personal Systems segment and renamed it the Personal and Printing Systems segment. In accordance with the organizational change, the company transferred the Printing Division from the Technology segment to the Personal and Printing Systems segment. At the same time, the Xerxes servers were transferred to the Enterprise Systems segment from the Personal Systems segment.

In 2003, the company reclassified all of its hardware segments without changing the organization of these segments. The Enterprise Systems segment was renamed the Systems Group segment, the Personal and Printing Systems segment was renamed the Personal Systems Group segment and the Technology Group segment was renamed the Technology Group segment.

Due to the sale of the HDD business as described in note c, “Acquisitions/Divestitures,” on pages 78 to 80 and consistent with the “Basis of Presentation” discussed in note a, “Significant Accounting Policies,” on page 70, the income statement and cash flow statement information for the Technology Group segment has been reclassified to exclude or separate the results of the discontinued HDD business.

Segment revenue and pre-tax income include transactions between the segments that are intended to reflect an arm’s-length transfer price. Specifically, semiconductors are sourced internally from the Technology Group segment for use in the manufacture of the Systems Group and Personal Systems Group segments and for use in the Hardware and Software segments. In addition, hardware and software that are used by the Global Services segment in outsourcing engagements are mostly sourced internally from the Systems Group, Personal Systems Group and Software segments. For the internal use of IT services, the Global Services segment recovers cost, as well as a reasonable fee, reflecting the arm’s-length value of providing the services. The Global Services segment enters into arm’s-length leases at prices equivalent to market rates with the Global Financing segment to facilitate the acquisition of equipment used in services engagements. Generally, all internal transaction prices are reviewed and reset annually if appropriate.

The company uses shared-resources concepts to realize economies of scale and efficient use of resources. Thus, a considerable amount of expense is shared by all of the company's segments. This expense represents sales coverage, marketing and support functions such as Accounting, Treasury, Procurement, Legal, Human Resources, and Billing and Collections. Where practical, shared expenses are allocated on a measurable driver of expense, e.g., headcount. When a clear and measurable driver cannot be identified, shared expenses are allocated on a financial basis, that is consistent with the company's management system; e.g., image advertising is allocated based on the gross profit of the segments. The unallocated corporate amounts arising from certain acquisitions, indirect infrastructure reductions, certain IP income, miscellaneous tax items, HDD internal activity from continuing operations and the unallocated corporate expense pool are recorded in net income but are not allocated to the segments.

The following tables reflect the results of continuing operations of the segments consistent with the company's management system. These results are not necessarily a depiction that is in conformity with GAAP, e.g., employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments on headcount. Different amounts could result if actuarial assumptions that are unique to the 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. The results for 2000 have been reclassified to reflect the organizational changes and product transfers made in 2001.

<table>
<thead>
<tr>
<th>Segment Information</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hardware</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-tax income/(loss)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue year-to-year change</td>
<td>4.8%</td>
<td>(7.9)%</td>
</tr>
<tr>
<td>Pre-tax income year-to-year change</td>
<td>28.4%</td>
<td>(13.7)%</td>
</tr>
<tr>
<td>Pre-tax income margin</td>
<td>9.7%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Global Services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue</td>
<td>9.7%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Pre-tax income/(loss)</td>
<td>3.8%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Revenue year-to-year change</td>
<td>10.1%</td>
<td>(8.6)%</td>
</tr>
<tr>
<td>Pre-tax income year-to-year change</td>
<td>6.8%</td>
<td>(4.7)%</td>
</tr>
<tr>
<td>Pre-tax income margin</td>
<td>3.7%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Software</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue</td>
<td>2.4%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Pre-tax income/(loss)</td>
<td>2.8%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Revenue year-to-year change</td>
<td>7.9%</td>
<td>(8.6)%</td>
</tr>
<tr>
<td>Pre-tax income year-to-year change</td>
<td>5.3%</td>
<td>(4.7)%</td>
</tr>
<tr>
<td>Pre-tax income margin</td>
<td>2.8%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Global Financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue</td>
<td>4.2%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Pre-tax income/(loss)</td>
<td>3.8%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Revenue year-to-year change</td>
<td>6.5%</td>
<td>(7.9)%</td>
</tr>
<tr>
<td>Pre-tax income year-to-year change</td>
<td>5.3%</td>
<td>(4.7)%</td>
</tr>
<tr>
<td>Pre-tax income margin</td>
<td>3.8%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Enterprise Investments</td>
<td>1.8%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total revenue</td>
<td>8.1%</td>
<td>8.1%</td>
</tr>
<tr>
<td>Pre-tax income/(loss)</td>
<td>5.1%</td>
<td>5.1%</td>
</tr>
<tr>
<td>Revenue year-to-year change</td>
<td>6.5%</td>
<td>(7.9)%</td>
</tr>
<tr>
<td>Pre-tax income year-to-year change</td>
<td>5.3%</td>
<td>(4.7)%</td>
</tr>
<tr>
<td>Pre-tax income margin</td>
<td>3.8%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

The the changes in the benefit obligation and plan assets of the company for 2002 and 2001 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Benefit obligation at beginning of year</th>
<th>Plan assets at beginning of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$148,464</td>
<td>(20,900)</td>
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<tr>
<td>2002</td>
<td>$156,266</td>
<td>(39,316)</td>
</tr>
</tbody>
</table>

Change in benefit obligation:
- Increase  $8,802
- Decrease (8,416)
- Net increase $386

Change in plan assets:
- Increase $471
- Decrease (415)
- Net increase $56

Notes to Consolidated Financial Statements
Notes to Consolidated Financial Statements

Reconciliations to IBM as Reported

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reportable segments</td>
<td>$87,986</td>
<td>$99,996</td>
<td>$92,017</td>
</tr>
<tr>
<td>Other revenue and adjustments</td>
<td>(103)</td>
<td>(227)</td>
<td>(6)</td>
</tr>
<tr>
<td>Elimination of internal revenue</td>
<td>(6,697)</td>
<td>(6,702)</td>
<td>(6,920)</td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$81,186</td>
<td>$81,067</td>
<td>$85,089</td>
</tr>
</tbody>
</table>

Pre-tax Income:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total reportable segments</td>
<td>$9,436</td>
<td>$11,009</td>
<td>$10,908</td>
</tr>
<tr>
<td>Elimination of internal transactions</td>
<td>(164)</td>
<td>108</td>
<td>62</td>
</tr>
<tr>
<td>Unallocated corporate amounts</td>
<td>(748)</td>
<td>113</td>
<td>441</td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$7,524</td>
<td>$11,430</td>
<td>$11,411</td>
</tr>
</tbody>
</table>

Immaterial Items

Investment in Equity Alliances and Equity Alliances Gains/(Losses)

The investments in equity alliances and the resulting gains and (losses) from these investments that are attributable to the segments do not have a material effect on the financial position or the financial results of the segments.

Segment Assets and Other Items

The Global Services assets primarily are accounts receivable, maintenance inventory, and plant, property and equipment including those associated with the segment's outsourcing business. The assets of the Hardware segments primarily are inventory and plant, property and equipment. The Software segment assets are mainly plant, property and equipment, and investment in capitalized software. The assets of the Global Financing segment are primarily financing receivables and fixed assets under operating leases.

To accomplish the efficient use of the company's space and equipment, it is necessary for several segments to share plant, property and equipment assets. Where assets are shared, landlord ownership of the assets is assigned to one segment and is not allocated to each user segment. This is consistent with the company's management system and is reflected accordingly in the schedule on page 101. In those cases, there will not be a precise correlation between segment pre-tax income and segment assets.

Similarly, the depreciation amounts reported by each segment are based on the assigned landlord ownership and may not be consistent with the amounts that are included in the segments' pre-tax income. The amounts that are included in pre-tax income reflect occupancy charges from the landlord segment and are not specifically identified by the management reporting system. Capital expenditures that are reported by each segment also are in line with the landlord ownership basis of asset assignment.

The Global Financing segment amounts on page 103 for Interest income and Cost of Global Financing interest expense reflect the interest income and interest expense associated with the Global Financing business, including the intercompany financing activities discussed on page 60 as well as the income from the investment in cash and marketable securities. The explanation of the difference between Cost of Global Financing and Interest expense for segment presentation versus presentation in the Consolidated Statement of Earnings is included on page 63 of the Management Discussion.

Reconciliations to IBM as Reported

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reconciliations to IBM as reported:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reportable segments</td>
<td>$63,824</td>
<td>$64,720</td>
<td>$69,263</td>
</tr>
<tr>
<td>Elimination of internal transactions</td>
<td>(5,061)</td>
<td>(4,884)</td>
<td>(5,308)</td>
</tr>
<tr>
<td>Unallocated amounts:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and marketable securities</td>
<td>4,568</td>
<td>5,111</td>
<td>2,268</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>3,553</td>
<td>2,810</td>
<td>3,145</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>6,631</td>
<td>6,525</td>
<td>5,496</td>
</tr>
<tr>
<td>Plant, other property and equipment</td>
<td>3,219</td>
<td>3,260</td>
<td>3,798</td>
</tr>
<tr>
<td>Pension assets</td>
<td>15,996</td>
<td>11,398</td>
<td>8,872</td>
</tr>
<tr>
<td>Other</td>
<td>3,734</td>
<td>3,062</td>
<td>2,868</td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$90,412</td>
<td>$90,361</td>
<td>$90,412</td>
</tr>
</tbody>
</table>

Notes to Consolidated Financial Statements

Management System Segment View

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Global Services</th>
<th>Systems Group</th>
<th>Technology Group</th>
<th>Software</th>
<th>Global Financing</th>
<th>Enterprise Investments</th>
<th>Total Segments</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>$14,462</td>
<td>$3,124</td>
<td>$1,776</td>
<td>$5,771</td>
<td>$3,361</td>
<td>$35,242</td>
<td>$88</td>
</tr>
<tr>
<td>Depreciation/amortization</td>
<td>1,213</td>
<td>335</td>
<td>116</td>
<td>1,167</td>
<td>809</td>
<td>2,413</td>
<td></td>
</tr>
<tr>
<td>Capital expenditures/ investment in software:</td>
<td>1,294</td>
<td>307</td>
<td>96</td>
<td>1,165</td>
<td>687</td>
<td>2,561</td>
<td>6</td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$10,340</td>
<td>$3,208</td>
<td>$1,904</td>
<td>$9,136</td>
<td>$3,356</td>
<td>$36,670</td>
<td>$106</td>
</tr>
</tbody>
</table>

2001:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Global Services</th>
<th>Systems Group</th>
<th>Technology Group</th>
<th>Software</th>
<th>Global Financing</th>
<th>Enterprise Investments</th>
<th>Total Segments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$10,140</td>
<td>$3,208</td>
<td>$1,904</td>
<td>$9,136</td>
<td>$3,356</td>
<td>$36,670</td>
<td>$106</td>
</tr>
<tr>
<td>Depreciation/amortization</td>
<td>1,219</td>
<td>308</td>
<td>111</td>
<td>676</td>
<td>782</td>
<td>2,476</td>
<td>8</td>
</tr>
<tr>
<td>Capital expenditures/ investment in software:</td>
<td>1,519</td>
<td>390</td>
<td>128</td>
<td>1,495</td>
<td>839</td>
<td>3,143</td>
<td>7</td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$9,042</td>
<td>$3,451</td>
<td>$2,448</td>
<td>$9,136</td>
<td>$2,488</td>
<td>$40,822</td>
<td>$246</td>
</tr>
</tbody>
</table>

2000:

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>Global Services</th>
<th>Systems Group</th>
<th>Technology Group</th>
<th>Software</th>
<th>Global Financing</th>
<th>Enterprise Investments</th>
<th>Total Segments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$10,492</td>
<td>$3,451</td>
<td>$2,448</td>
<td>$9,136</td>
<td>$2,488</td>
<td>$40,822</td>
<td>$246</td>
</tr>
<tr>
<td>Depreciation/amortization</td>
<td>1,243</td>
<td>425</td>
<td>154</td>
<td>649</td>
<td>665</td>
<td>2,696</td>
<td>12</td>
</tr>
<tr>
<td>Capital expenditures/ investment in software:</td>
<td>1,311</td>
<td>325</td>
<td>180</td>
<td>1,326</td>
<td>770</td>
<td>2,898</td>
<td>9</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$9,186</td>
<td>$3,051</td>
<td>$3,051</td>
<td>$3,051</td>
<td>$3,051</td>
<td>$32,761</td>
<td>$32,761</td>
</tr>
</tbody>
</table>

Notes to Consolidated Financial Statements

Reconciliations to IBM as Reported

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reportable segments</td>
<td>$63,824</td>
<td>$64,720</td>
<td>$69,263</td>
</tr>
<tr>
<td>Elimination of internal transactions</td>
<td>(5,061)</td>
<td>(4,884)</td>
<td>(5,308)</td>
</tr>
<tr>
<td>Unallocated amounts:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and marketable securities</td>
<td>4,568</td>
<td>5,111</td>
<td>2,268</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>3,553</td>
<td>2,810</td>
<td>3,145</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>6,631</td>
<td>6,525</td>
<td>5,496</td>
</tr>
<tr>
<td>Plant, other property and equipment</td>
<td>3,219</td>
<td>3,260</td>
<td>3,798</td>
</tr>
<tr>
<td>Pension assets</td>
<td>15,996</td>
<td>11,398</td>
<td>8,872</td>
</tr>
<tr>
<td>Other</td>
<td>3,734</td>
<td>3,062</td>
<td>2,868</td>
</tr>
<tr>
<td><strong>Total IBM consolidated</strong></td>
<td>$90,412</td>
<td>$90,361</td>
<td>$90,412</td>
</tr>
</tbody>
</table>

* Redrafted to conform with 2001 presentation.
Notes to Consolidated Financial Statements

Reconciliations to IBM as Reported

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reportable segments</td>
<td>$87,986</td>
<td>$89,996</td>
<td>$92,013</td>
</tr>
<tr>
<td>Other revenue and adjustments</td>
<td>(103)</td>
<td>(227)</td>
<td>(6)</td>
</tr>
<tr>
<td>Elimination of internal revenue</td>
<td>(6,697)</td>
<td>(6,702)</td>
<td>(6,920)</td>
</tr>
<tr>
<td>Total IBM consolidated</td>
<td>$81,386</td>
<td>$83,067</td>
<td>$85,089</td>
</tr>
<tr>
<td>Profit Income:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total reportable segments</td>
<td>$8,446</td>
<td>$11,009</td>
<td>$10,908</td>
</tr>
<tr>
<td>Elimination of internal transactions</td>
<td>(164)</td>
<td>108</td>
<td>62</td>
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<tr>
<td>Unallocated corporate amounts</td>
<td>(748)</td>
<td>113</td>
<td>441</td>
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<tr>
<td>Total IBM consolidated</td>
<td>$7,524</td>
<td>$11,430</td>
<td>$11,411</td>
</tr>
</tbody>
</table>

Immaterial Items

Investment in Equity Alliances and Equity Alliances Gains/(Losses)

The investments in equity alliances and the resulting gains and (losses) from those investments that are attributable to the segments do not have a material effect on the financial position or the financial results of the segments.

Segment Assets and Other Items

The Global Services assets primarily are accounts receivable, maintenance inventory, and plant, property and equipment including those associated with the segment's outsourcing business. The assets of the Hardware segments primarily are inventory and plant, property and equipment. The Software segment assets mainly are plant, property and equipment, and investment in capitalized software. The assets of the Global Financing segment are primarily financing receivables and fixed assets under operating leases.

To accomplish the efficient use of the company's space and equipment, it usually is necessary for several segments to share plant, property and equipment assets. Where assets are shared, landlord ownership of the assets is assigned to one segment and is not allocated to each user segment. This is consistent with the company's management system and is reflected accordingly in the schedule on page 101. In those cases, there will not be a precise correlation between segment pre-tax income and segment assets.

Similarly, the depreciation amounts reported by each segment are based on the assigned landlord ownership and may not be consistent with the amounts that are included in the segments' pre-tax income. The amounts that are included in pre-tax income reflect occupancy charges from the landlord segment and are not specifically identified by the management reporting system. Capital expenditures that are reported by each segment also are in line with the landlord ownership basis of asset assignment.

The Global Financing segment amounts on page 103 for 2001 indicate the interest income and Cost of Global Financing interest expense reflect the interest income and interest expense associated with the Global Financing business, including the intercompany financing activities discussed on page 60 as well as the income from the investment in cash and marketable securities. The explanation of the difference between Cost of Global Financing and Interest expense for segment presentation versus presentation in the Consolidated Statement of Earnings is included on page 63 of the Management Discussion.

Reconciliations to IBM as Reported

<table>
<thead>
<tr>
<th>(dollars in millions)</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total reportable segments</td>
<td>$63,824</td>
<td>$64,720</td>
<td>$69,263</td>
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<td>Unallocated amounts:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Cash and marketable securities</td>
<td>$4,568</td>
<td>$5,111</td>
<td>$2,698</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>$3,553</td>
<td>$2,810</td>
<td>$3,145</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>$6,631</td>
<td>$6,623</td>
<td>$5,498</td>
</tr>
<tr>
<td>Plant, other property and equipment</td>
<td>$3,239</td>
<td>$3,260</td>
<td>$3,798</td>
</tr>
<tr>
<td>Pension assets</td>
<td>$15,996</td>
<td>$11,398</td>
<td>$8,872</td>
</tr>
<tr>
<td>Other</td>
<td>$3,734</td>
<td>$3,062</td>
<td>$2,868</td>
</tr>
<tr>
<td>Total IBM consolidated</td>
<td>$90,484</td>
<td>$90,363</td>
<td>$90,412</td>
</tr>
</tbody>
</table>

* Recast to conform with 2002 presentation.

Notes to Consolidated Financial Statements
Revenue by Classes of Similar Products or Services

For the Personal Systems Group, Software and Global Financing segments, the segment data on page 101 represents the revenue contributions from the products that are contained in the segments and that are basically similar in nature. The following table provides external revenue for similar classes of products within the Technology Group, Systems Group, Global Services and Enterprise Investments segments. The Technology Group segment’s OEM hardware comprises revenue primarily from the sale of semiconductors and display devices. Technology services comprise the Technology Group’s existing circuit design business for its OEM customers and the new component design services, strategic outsourcing of customer’s design team work, and technology and manufacturing consulting services associated with the new Engineering and Technology Services Division. The Systems Group segment’s storage comprises revenue from the Enterprise Storage Server, other disk storage products and tape subsystems. Enterprise Investments software revenue is primarily from product life-cycle management products. The following table on the right is presented on a continuing operations basis.

Major Customers

No single customer represents 10 percent or more of the company’s total revenue.

Geographic Information

(a) Revenue is attributed to countries based on location of customer and are for continuing operations.

“**” Indicates all revenue is from external customers.

Notes to Consolidated Financial Statements

Subsequent Events

On January 21, 2003, the company filed with the Securities and Exchange Commission a shelf registration to periodically sell up to $20 billion in debt securities, preferred and capital stock, depositary shares and warrants. The company may sell securities in one or more separate offerings with the size, price and terms to be determined at the time of sale. The net proceeds from the sale of the securities will be used for general corporate purposes, which may include debt repayment, investments in or extensions of credit to its subsidiaries, redemption of any preferred stock the company may issue, or financing of possible acquisitions or business expansion. The net proceeds may be invested temporarily or applied to repay short-term debt until they are used for their stated purpose.

Consistent with the company’s strategy to concentrate borrowing at the IBM level, this shelf registration eliminates the need for a shelf registration associated with its U.S. financing subsidiary, IBM Credit Corporation (ICC). The ICC shelf will be terminated shortly after the effective date of the new IBM shelf.

On February 21, 2003, the company purchased the outstanding stock of Rational Software Corp. (Rational) for approximately $2.1 billion in cash. Rational provides open, standards-based software development tools and systems. The Rational acquisition provides the company with the ability to offer a complete software development environment for customers. The company intends to merge Rational’s business operations and employees into the IBM Software Group as a new division and brand. The results of operations of Rational will be included in the company’s Consolidated Financial Statements as of February 21, 2003.

The company has not completed the allocation of the purchase price related to the Rational acquisition as it is in the process of identifying and determining the fair value of all assets acquired and liabilities assumed.

Five-Year Comparison of Selected Financial Data

(dollars in millions except per share amounts)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$81,186</td>
<td>$83,067</td>
<td>$85,089</td>
<td>$83,341</td>
<td>$77,548</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>5,134</td>
<td>8,146</td>
<td>7,874</td>
<td>7,319</td>
<td>5,469</td>
</tr>
<tr>
<td>(Loss)/income from discontinued operations</td>
<td>(1.75)</td>
<td>(4.43)</td>
<td>(2.19)</td>
<td>(3.53)</td>
<td>(0.859)</td>
</tr>
<tr>
<td>Net income</td>
<td>3,379</td>
<td>7,723</td>
<td>8,093</td>
<td>7,172</td>
<td>6,328</td>
</tr>
<tr>
<td>Earnings/(loss) per share of common stock:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>3.07</td>
<td>4.59</td>
<td>4.12</td>
<td>3.91</td>
<td>2.84</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(1.01)</td>
<td>(0.24)</td>
<td>0.12</td>
<td>0.19</td>
<td>0.45</td>
</tr>
<tr>
<td>Total</td>
<td>2.06</td>
<td>4.35</td>
<td>4.44</td>
<td>3.92</td>
<td>2.39</td>
</tr>
<tr>
<td>Basic:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>3.13</td>
<td>4.69</td>
<td>4.45</td>
<td>4.06</td>
<td>2.92</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(1.03)</td>
<td>(0.24)</td>
<td>0.12</td>
<td>0.20</td>
<td>0.46</td>
</tr>
<tr>
<td>Total</td>
<td>2.10</td>
<td>4.45</td>
<td>4.18**</td>
<td>4.27**</td>
<td>3.38</td>
</tr>
<tr>
<td>Cash dividends paid on common stock</td>
<td>1,005</td>
<td>916</td>
<td>909</td>
<td>859</td>
<td>814</td>
</tr>
<tr>
<td>Per share of common stock</td>
<td>0.59</td>
<td>0.55</td>
<td>0.51</td>
<td>0.47</td>
<td>0.43</td>
</tr>
<tr>
<td>Investment in plant, rental machines and other property</td>
<td>5,022</td>
<td>5,660</td>
<td>5,616</td>
<td>5,959</td>
<td>6,520</td>
</tr>
<tr>
<td>Return on stockholders’ equity</td>
<td>15.5%**</td>
<td>31.3%**</td>
<td>40.0%**</td>
<td>39.1%**</td>
<td>32.7%**</td>
</tr>
</tbody>
</table>

AT END OF YEAR:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$96,494</td>
<td>$90,303**</td>
<td>$90,442**</td>
<td>$89,571**</td>
<td>$88,160**</td>
</tr>
<tr>
<td>Net investment in plant, rental machines and other property</td>
<td>14,440</td>
<td>16,504</td>
<td>16,714</td>
<td>17,590</td>
<td>19,631</td>
</tr>
<tr>
<td>Working capital</td>
<td>7,182</td>
<td>7,342</td>
<td>7,474</td>
<td>8,177</td>
<td>8,513</td>
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<tr>
<td>Total debt</td>
<td>26,017</td>
<td>27,181</td>
<td>28,576</td>
<td>28,134</td>
<td>29,413</td>
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<tr>
<td>Stockholders’ equity</td>
<td>22,782</td>
<td>23,448**</td>
<td>20,550**</td>
<td>20,426**</td>
<td>19,383**</td>
</tr>
</tbody>
</table>

* Does not relate to the redemption.

** Reclassified to conform with 2002 presentation.
Revenue by Classes of Similar Products or Services
For the Personal Systems Group, Software and Global Financing segments, the segment data on page 101 represents the revenue contributions from the products that are contained in the segments and that are basically similar in nature. The following table provides external revenue for similar classes of products within the Technology Group, Systems Group, Global Services and Enterprise Investments segments. The Technology Group segment's OEM hardware comprises revenue primarily from the sale of semiconductor and display devices. Technology services comprise the Technology Group's existing circuit design business for its OEM customers and the new component design services, strategic outsourcing of customer's design team work, and technology and manufacturing consulting services associated with the new Engineering and Technology Services Division. The Systems Group segment's storage comprises revenue from the Enterprise Storage Server, other disk storage products and tape subsystems. Enterprise Investments software revenue is primarily from product life-cycle management products. The following table on the right is presented on a continuing operations basis.

Major Customers
No single customer represents 10 percent or more of the company's total revenue.

Geographic Information

<table>
<thead>
<tr>
<th>Location</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$37,759</td>
<td>$34,231</td>
<td>$37,733</td>
</tr>
<tr>
<td>Japan</td>
<td>$16,993</td>
<td>$17,632</td>
<td>$13,122</td>
</tr>
<tr>
<td>Other countries</td>
<td>$18,828</td>
<td>$20,121</td>
<td>$12,109</td>
</tr>
<tr>
<td>Total</td>
<td>$62,186</td>
<td>$58,184</td>
<td>$53,964</td>
</tr>
</tbody>
</table>

\( \* \) Revenue is attributed to countries based on location of customer and are for continuing operations.

\( ** \) Includes all non-current assets except non-current financial instruments and deferred tax assets.

\( *** \) Redefined to conform with 2002 presentation.

\( **** \) Does not total due to rounding.

\( ***** \) Net proceeds may be invested temporarily or applied to repay borrowings at the IBM level, this shelf registration eliminates the need for a shelf registration associated with its U.S.

\( ***** \) Financing subsidiary, IBM Credit Corporation (ICC). The ICC shelf will be terminated shortly after the effective date of the new IBM shelf.

\( ***** \) On January 21, 2003, the company filed with the Securities and Exchange Commission a shelf registration to periodically sell up to $20 billion in debt securities, preferred and capital stock, depositary shares and warrants. The company may sell securities in one or more separate offerings with the size, price and terms to be determined at the time of sale. The net proceeds from the sale of the securities will be used for general corporate purposes, which may include debt repayment, investments in or extensions of credit to its subsidiaries, redemption of any preferred stock the company may issue, or financing of possible acquisitions or business expansion. The net proceeds may be invested temporarily or applied to repay short-term debt until they are used for their stated purpose.

Consistent with the company's strategy to concentrate borrowing at the IBM level, this shelf registration eliminates the need for a shelf registration associated with its U.S.

\( ***** \) Technology Group:

<table>
<thead>
<tr>
<th>Subsidiary Companies</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM</td>
<td>$3,612</td>
<td>$4,605</td>
<td>$4,900</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>323</td>
<td>444</td>
<td>284</td>
</tr>
<tr>
<td>IBM</td>
<td>$150,047</td>
<td>$10,947</td>
<td>$11,497</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>2,581</td>
<td>2,755</td>
<td>2,519</td>
</tr>
<tr>
<td>IBM</td>
<td>18</td>
<td>41</td>
<td>158</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>$11,290</td>
<td>$29,953</td>
<td>$28,036</td>
</tr>
<tr>
<td>IBM</td>
<td>5,070</td>
<td>5,003</td>
<td>5,166</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>$916</td>
<td>$913</td>
<td>$1,077</td>
</tr>
<tr>
<td>IBM</td>
<td>$95</td>
<td>$181</td>
<td>238</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>11</td>
<td>24</td>
<td>54</td>
</tr>
</tbody>
</table>

\( \* \) Redefined to conform with 2002 presentation.

\( **** \) \( ***** \)

\( ***** \)

Subsequent Events
On January 21, 2003, the company purchased the outstanding stock of Rational Software Corp. (Rational) for approximately $2.1 billion in cash. Rational provides open, industry standard tools, best practices and services for developing business applications and building software products and systems. The Rational acquisition provides the company with the ability to offer a complete software development environment for customers. The company intends to merge Rational’s business operations and employees into the IBM Software Group as a new division and brand. The results of operations of Rational will be included in the company’s Consolidated Financial Statements as of February 21, 2003. The company has not completed the allocation of the purchase price related to the Rational acquisition as it is in the process of identifying and determining the fair value of all assets acquired and liabilities assumed.
The company executed special actions in the second and fourth quarter of 2002 recording charges of $1,727 million and $322 million, respectively. See note S, 0.13 0.14 0.14 0.14 0.55
*(0.02) (0.03) (0.07) (0.13) (0.24)
0.75 0.26 1.00 1.12 3.13
+ 0.14 0.15 0.15 0.15 0.59
1.02 1.20 0.99 1.49 4.69
0.60
0.03 0.76
(0.05) (0.22) (0.22) (0.52) (1.01)
0.73 0.25 0.99 1.11 3.07
quarter quarter quarter quarter year
0.69* 0.03 0.78* 0.60* 2.10

Earnings (loss) per share of common stock:
Assuming dilution:
Continuing operations
0.75 0.26 1.00 1.12 3.13
Continued operations
(0.05) (0.23) (0.23) (0.53) (1.03)*
Total
0.08
Basic:
Continuing operations
0.75 0.26 1.00 1.12 3.13
Discontinued operations
(0.05) (0.23) (0.23) (0.53) (1.03)*
Total
0.08

Dividends per share of common stock
0.14 0.15 0.15 0.15 0.59

Stock prices**
High $120.39 $104.00 $82.85 $89.46
Low 90.76 66.10 57.99 54.01

2002:
Revenue $18,030 $19,651 $19,821 $23,684 $81,186
Gross profit 6,500 7,270 7,323 9,191 30,284
Income from continuing operations 1,284 444* 1,094 1,911* 3,134
Loss from discontinued operations (92) (389) (381) (893) (1,755)
Net income 1,192 56 1,313 1,018 1,579
Earnings (loss) per share of common stock:
Assuming dilution:
Continuing operations 0.73 (0.05) 0.99 1.11 3.07*
Discontinued operations (0.05) (0.23) (0.23) (0.53) (1.03)*
Total 0.68 0.03 0.76* 0.60* 2.06

Total:
Revenue $20,309 $20,834 $19,783 $22,141 $30,284
Gross profit 7,515 7,987 7,414 8,933 31,889
Income from continuing operations 1,777 2,091 1,713 2,565 8,146
Loss from discontinued operations (27) (46) (118) (232) (423)
Net income 1,750 2,045 1,595 2,333 7,723
Earnings (loss) per share of common stock:
Assuming dilution:
Continuing operations 1.00 1.17 0.97 1.46 4.29*
Discontinued operations (0.02) (0.03) (0.07) (0.13) (0.24)*
Total 0.98 1.15* 0.90 1.33 4.31*

Basic:
Continuing operations 1.02 (0.20) 0.99 1.49 4.69*
Discontinued operations (0.02) (0.03) (0.07) (0.14) (0.24)*
Total 1.00 1.17 0.92 1.51 4.47*

Stock prices**
High $118.64 $119.90 $115.40 $124.70 $301.04
Low 87.35 90.76 87.49 91.34

166 INTERNATIONAL BUSINESS MACHINES CORPORATION AND SUBSIDIARY COMPANIES
107 INTERNATIONAL BUSINESS MACHINES CORPORATION AND SUBSIDIARY COMPANIES

Note: The annual report is printed on recycled paper and is recyclable.
Selected Quarterly Data

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<thead>
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<th>2002</th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>FIRST</td>
<td>SECOND</td>
<td>THIRD</td>
<td>FOURTH</td>
<td>FULL</td>
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<tr>
<td>Revenue</td>
<td>$18,030</td>
<td>$19,651</td>
<td>$19,821</td>
<td>$23,684</td>
<td>$81,186</td>
</tr>
<tr>
<td>Gross profit</td>
<td>6,580</td>
<td>7,270</td>
<td>7,323</td>
<td>9,191</td>
<td>30,284</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>1,284</td>
<td>445</td>
<td>1,094</td>
<td>1,911</td>
<td>3,134</td>
</tr>
<tr>
<td>Loss from discontinued operations</td>
<td>(92)</td>
<td>(389)</td>
<td>(184)</td>
<td>(893)</td>
<td>(1,755)</td>
</tr>
<tr>
<td>Net income</td>
<td>1,192</td>
<td>56</td>
<td>1,133</td>
<td>1,018</td>
<td>1,579</td>
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<tr>
<td>Earnings/(loss) per share of common stock</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Assuming dilution:</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>0.73</td>
<td>0.21</td>
<td>0.99</td>
<td>1.11</td>
<td>3.07</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(0.05)</td>
<td>(0.22)</td>
<td>(0.22)</td>
<td>(0.52)</td>
<td>(1.03)</td>
</tr>
<tr>
<td>Total</td>
<td>0.68</td>
<td>0.03</td>
<td>0.76</td>
<td>0.59</td>
<td>2.06</td>
</tr>
<tr>
<td>Basic:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>0.75</td>
<td>0.26</td>
<td>1.00</td>
<td>1.12</td>
<td>3.13</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(0.05)</td>
<td>(0.23)</td>
<td>(0.23)</td>
<td>(0.53)</td>
<td>(1.03)</td>
</tr>
<tr>
<td>Total</td>
<td>0.69*</td>
<td>0.03</td>
<td>0.78*</td>
<td>0.60*</td>
<td>2.10</td>
</tr>
</tbody>
</table>

Stock prices**

<p>| | | | | | |</p>
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</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>$126.39</td>
<td>$104.00</td>
<td>$82.85</td>
<td>$89.46</td>
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<tr>
<td></td>
<td>Low</td>
<td>98.76</td>
<td>66.10</td>
<td>87.99</td>
<td>54.01</td>
</tr>
</tbody>
</table>

* The company executed special actions in the second and fourth quarter of 2002 recording charges of $1,727 million and $322 million, respectively. See note S, "Discontinued operations," for details.

** Dividends per share of common stock:

<p>| | | | | | |</p>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>$4.35</td>
<td>$4.35</td>
<td>$4.35</td>
<td>$4.35</td>
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<tr>
<td></td>
<td>Low</td>
<td>$4.35</td>
<td>$4.35</td>
<td>$4.35</td>
<td>$4.35</td>
</tr>
</tbody>
</table>

IBM Stock

IBM common stock is listed on the New York Stock Exchange and on other exchanges in the United States and around the world.

Annual Meeting

The IBM Annual Meeting of Stockholders will be held on Tuesday, April 29, 2003, at 10 a.m. at the Kansas City Convention Center, 201 West 14th Street, Kansas City, Missouri.

Stockholder Communications

Stockholders in the United States and Canada can get quarterly financial results, listen to a summary of the Annual Meeting and hear voting results from the meeting by calling (800) IBM-7800. Callers can also request printed copies of the information via e-mail or fax. Stockholders residing outside the United States, Canada and Puerto Rico should call (402) 573-9861.

Literature for IBM Stockholders

The following literature on IBM is available without charge from: EquiServe Trust Company, N.A. P.O. Box 43072 Providence, Rhode Island 02940-1072 (888) IBM-6700 Investors residing outside the United States, Canada and Puerto Rico should call (402) 573-2727.

The Form 10-K Annual Report and Form 10-Q Quarterly Reports to the SEC provide additional information on IBM's business. The 10-K report is released in March, 10-Q reports are released in May, August and November.

An audio cassette recording of the 2002 Annual Report will be available starting November 1. An audio cassette recording of the 2001 Annual Report will be available starting November 1.

A “Blueprint, IBM Corporate Citizenship” reports on IBM’s community relations program around the world and IBM’s commitment to education.

“IBM Environment and End-Being: Progress Report” reports on IBM’s health and safety, environmental and energy programs.

“Vitalizing Diversity: An Ongoing Commitment” communicates to the company’s entire community of employees, customers, stockholders, vendors, suppliers, business partners and employer applicants the importance IBM places on the diversity of the company’s workplace.

General Information

For answers to general questions about IBM from within the continental United States, call (888) IBM-4YOU. From outside the United States, call (404) 216-1214.

Corporate Offices

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* The IBM Annual Report is printed on recycled paper and is recyclable.

** The stock prices reflect the high and low prices for IBM’s common stock on the New York Stock Exchange composite tape for the last two years.
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President and Chief Executive Officer
Elli Lilly and Company

Alex Trotman
Chairman of the Board
Imperial Chemical Industries PLC

Charles M. Vott
President
Massachusetts Institute of Technology

* retiring effective April 29, 2003
Seven days at IBM