



startup

because you can.

One of the wonderful things about starting any new venture is the freedom. To have big ideas, breathe life into them, and build them. From scratch. That freedom is appealing, but exists – practically speaking – for relatively few.

Until now.

Because whether you're two friends tinkering in a garage, or you work inside one of the most venerable enterprises on earth, the rise of a globally connected world offers a truly rare opportunity: the chance to start something totally new.

This is what we believe at IBM. And it is the core idea we are taking to customers (and pursuing ourselves): how to seize this unique moment and rethink what you do, reconceive what you offer and, along the way, reinvent who you are.



Louis V. Gerstner, Jr.
Chairman and Chief Executive Officer

Dear fellow investor,

Last year my message to you was one of continuity. We were making our strategic vision of a networked world real, in the marketplace and in the laboratory. We were intensifying execution across all our businesses to produce marketplace wins and consistent revenue growth. I said that we planned to stay the course.

We did that in 1998, and the results were strong. Our market value – probably the most important measure of progress to investors – grew \$69 billion. (It has grown by \$146 billion since our major restructuring in 1993.) Last year, IBM's share price rose 76 percent. As 1999 began, our Board of Directors approved the second IBM stock split in two years.

There were good reasons for this growth in investor confidence in IBM. For the fourth straight year, we reported record revenue – \$81.7 billion. Our earnings rose to \$6.3 billion. We set a new record in earnings per share. Customer satisfaction improved measurably. After making substantial investments – \$5.6 billion in research and development, \$6.5 billion on capital expenditures, and \$700 million to acquire companies that strengthened

our portfolio of businesses – we still had substantial cash on hand to return to shareholders via dividends and our ongoing stock buyback program (another \$6.9 billion of IBM shares in 1998). Even then, we finished the year with \$5.8 billion in cash.

We had our difficulties, too. Some were external – the economic distress in Asia and Latin America, soft memory chip prices and a PC price war. Some were of our own making – wrestling with important product transitions in our server line, for example. But overall, in the marketplace and inside the company, IBM remains on track.

You might expect, then, that my message for 1999 would be the same – continuity and staying the course. But continuity is not my message to you this year.

No year is easy to predict, but 1999 promises to be unique for our industry and for IBM. Like every year, we see significant opportunities combined with a truckload of uncertainties. This year, those uncertainties include continuing softness in Asia and Latin America, the impact of the Euro conversion and, of course, the much publicized Year 2000 problem (more on Y2K later).

What makes 1999 different, though, is that a historic shift – something IBM began talking about three years ago – is taking hold, and it’s reshaping everything: how we work, how we shop, how we interact with our governments, how we learn, what we do at home. Every day it becomes more certain that the Internet will take its place alongside the other great transformational technologies that first challenged, and then fundamentally changed, the way things are done in the world.

One school of thought says a new mass medium has been born when it’s used by 50 million people. Radio took nearly 40 years to hit that threshold. TV took 13 years. Cable TV, 10 years. The Internet did it in less than five. As I write this, more than 140 million people are online. Today the Net is largely a U.S. phenomenon, but that won’t last long. Already seven countries other than the United States have about 10 percent of their populations using the Web. In China, which is really just now joining the world economy, Web growth is astonishing.

Figuring out what all those people were going to do when they were linked by the Web has kept the gurus in overdrive. We used to hear a lot about the Information Superhighway, with the Web playing the role of local library. Next, you heard about the Wired World, in which people sent e-mails and then relaxed in chat rooms. All of that has happened, but it isn’t where the real action is.

From the beginning, IBM’s position has been consistent. Since 1995 we have been saying that the Net is about mainstream business, not browsing – about conducting real commerce, not

merely accessing content. At the time IBM articulated this “vision,” it sounded downright uncool. And the gurus said so.

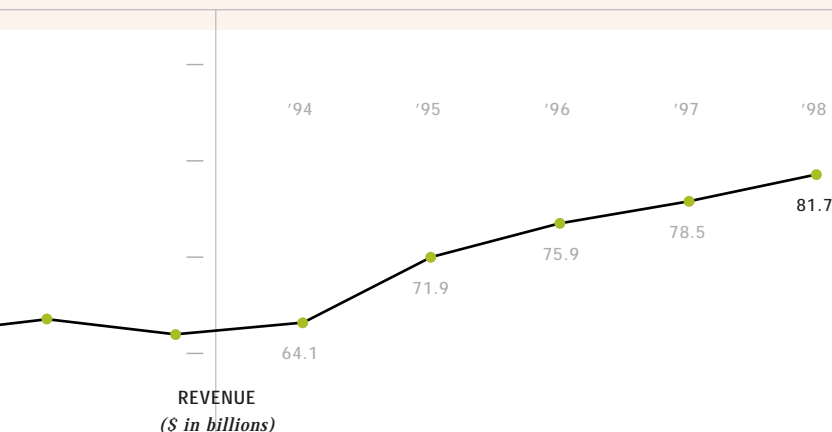
Well, today this position is feeling a lot less lonely. In fact, it’s getting pretty crowded, as the prevailing opinion swings our way and people talk about this transformation in terms of a “networked society” and a “networked economy.”

At IBM we call this “e-business,” and it represents an enormous opportunity. We expect the overall information technology industry to grow at an annual rate of 10 percent, to \$1.6 trillion by 2002. Of that, the e-business segment will grow to \$600 billion, and it will grow twice as fast as the industry overall. (We intend to capture a good chunk of that new business.)

I said that 1999 is going to be unique. Here’s why: With this fundamental change just beginning, I believe that the next two years are going to witness a sweeping shakeup. In just about all businesses – including information technology, but also banking and retailing and health care, and in the noncommercial world, too – we will see new leaders emerge, and we will see some old, longtime leaders sink. Competitors will spring up out of nowhere – competitors called “something.com.”

Savvy businesspeople know this and are intensely focused on what to do. IBM holds daylong seminars on the new world of e-business for CEOs and CIOs from every part of the world. Of late there have been no empty seats. In the pages of this Annual Report, you will read what we tell these customers about e-business and what it takes to succeed in the evolving networked world. We’ll also tell you why we think IBM is uniquely qualified, structured, situated and ready not only to benefit from all this change, but to emerge stronger than ever.

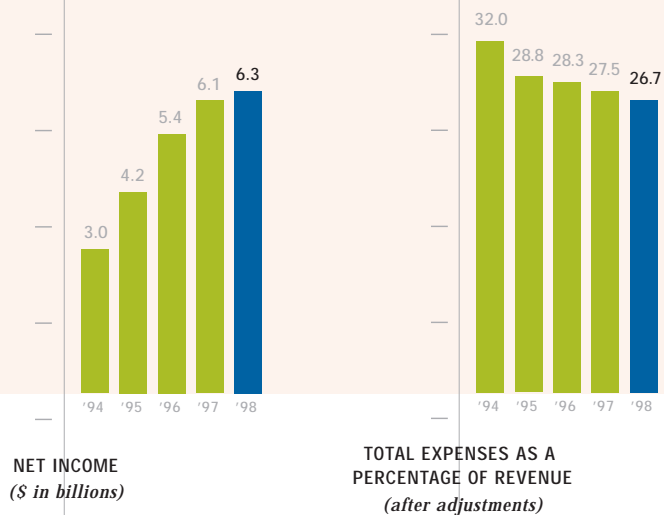
As we stand on the brink of the 21st century, with the mass media full of millennial retrospectives and predictions, there’s a strong temptation to make grand pronouncements. I’m going to try to resist that temptation. However, at our CEO/CIO

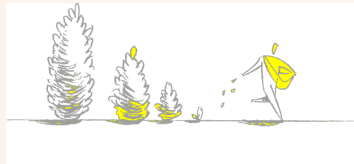


FINANCIAL HIGHLIGHTS International Business Machines Corporation and Subsidiary Companies

(Dollars in millions except per share amounts)

| | 1998 | 1997 |
|---|-----------|-----------|
| For the year: | | |
| Revenue | \$ 81,667 | \$ 78,508 |
| Income before income taxes | \$ 9,040 | \$ 9,027 |
| Income taxes | \$ 2,712 | \$ 2,934 |
| Net income | \$ 6,328 | \$ 6,093 |
| Earnings per share of common stock—basic | \$ 6.75 | \$ 6.18 |
| Earnings per share of common stock—assuming dilution | \$ 6.57 | \$ 6.01 |
| Cash dividends paid on common stock | \$ 814 | \$ 763 |
| Per share of common stock | \$.86 | \$.775 |
| Investment in plant, rental machines and other property | \$ 6,520 | \$ 6,793 |
| Average number of common shares outstanding (in millions) | | |
| Basic | 935 | 983 |
| Assuming dilution | 960 | 1,011 |
| At year end: | | |
| Total assets | \$ 86,100 | \$ 81,499 |
| Net investment in plant, rental machines and other property | \$ 19,631 | \$ 18,347 |
| Working capital | \$ 5,533 | \$ 6,911 |
| Total debt | \$ 29,413 | \$ 26,926 |
| Stockholders' equity | \$ 19,433 | \$ 19,816 |
| Number of employees in IBM/wholly owned subsidiaries | 291,067 | 269,465 |
| Number of common stock holders | 616,800 | 623,537 |





NEW PRODUCTS Nearly half of 1998's \$35.4 billion in hardware revenue was generated by products introduced in the past 12 months.

meetings and whenever I meet with customers, I am asked where IBM stands on a wide variety of technology issues. I'd like to cover a few of these, because I believe they are the ones on which the new leaders will be focusing more and more over the next two years. At IBM, we are.

- ***The Internet isn't just creating new businesses. It's creating new business models.***

Businesses and institutions are finding that the Net is the most potent tool they've ever had to build competitive advantage. I don't mean just online retailing, which has been getting a lot of attention lately. Many of the most impactful e-business solutions we are building with our customers are aimed at transforming less glamorous but extremely important processes like supply chain management, customer service and support, and distribution.

But the important point is that e-business is not simply a matter of adding another distribution channel or introducing some new efficiencies. It is driving customers to do business in a fundamentally different way.

This feverish search for new business models is having another interesting effect. It's creating a breeding ground for a new generation of startup companies. This may not be surprising. What has been unexpected is that every business and institution now has a chance to rethink what it does.

IBM is in a strong position to help. In our solutions business we have amassed thousands of experts who understand the inner

workings of 26 major industries, from banking to entertainment to education. In working with thousands of customers, we come to understand which issues are common from industry to industry – and we can leverage that knowledge for our customers very quickly.

- ***The greatest competitive advantage in the information technology industry is no longer technology.***

Without question, strength in basic and applied research remains essential in our industry – not only to achieve the breakthroughs that make new products possible, but also because they give the discoverer a unique ability to foresee, and shape, the future.

However, technology changes much too quickly now for any company to build a sustainable competitive advantage on that basis alone. Someone is always inventing some software code or device that is a little faster or cheaper. More and more, the winning edge comes from *how you help customers use technology* – to steal a march on their competitors, to implement entirely new business models. That means creating integrated solutions that draw on the full range of products and, increasingly, services. And it means connecting the dots between what you learn in the lab and what you learn in the marketplace.

We understood this when we decided six years ago to keep IBM together. And we've seen it borne out most clearly where all the pieces of information technology come together – in

STOCK PERFORMANCE 1998
End-of-week closing prices



information technology services. With its huge current demand, solid fundamentals underlying future demand and lack of a dominant competitor, I/T services has all the earmarks of a classic growth business.

I believe that IBM is well positioned to win a disproportionate share of that growth. IBM Global Services has grown in just eight years from a \$4 billion to a \$24 billion business, with better than 20 percent annual growth. And its market leadership is increasing, because the 126,000 IBMers who work in services can draw on all the technology and human assets of IBM, including an R&D community with a strong record of innovation (they just marked their sixth straight year of U.S. patent leadership).

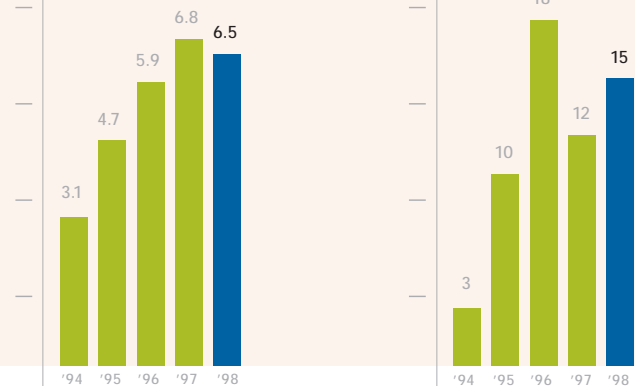
- **The PC era is over.**

This is not to say that PCs are going to die off, any more than mainframes vanished when the IBM PC debuted in 1981. Indeed, IBM's own PC business was an important turnaround story in 1998. But the PC's reign as the driver of customer buying decisions and the primary platform for application development is over. In all those respects, it has been supplanted by the network.

You experience this every time you go online to buy a book or trade stock. Where is the transaction executed? Where is the data managed and stored? Where does the processing take place? A teeny part is handled by your PC. Most of the work is done behind the scenes, in the network, by bigger computer systems.

Businesses deploying network applications have to handle an exponential increase in the volume of interactions and transactions, and they need to do something useful with the tidal wave of information generated from those interactions. Both needs are driving the rediscovery of enterprise computing – that is, industrial-strength servers and the software that runs on them.

As the Net takes over much of the work previously performed by PCs, we're seeing another interesting development: a proliferation of new personal computing devices – personal digital assistants, Web-enabled TVs, screenphones, smart cards and a host of products we have yet to imagine. One market research firm predicts that sales of non-PC Internet devices will surpass PCs within five years. This explosion of “information appliances” will bring computing to millions of new users – perhaps a billion people – faster and more affordably than the PC could ever have taken us.



CAPITAL INVESTMENTS
(*\$ in billions*)

NUMBER OF ACQUISITIONS

All of this is very good news for IBM – the company that, in many ways, invented enterprise computing. In recent years we've invested heavily to reinvent our server and enterprise software lines. Middleware products like Tivoli systems management, Lotus Notes and Domino, and DB2 Universal Database have been standout performers. The advent of non-PC devices is also benefiting our OEM (original equipment manufacturer) business, where we sell IBM components like chips and disk drives to other technology companies, many of them our competitors. It's a business that's already growing at double-digit rates.

- ***We're only at the beginning – more is coming.***

Two more things actually – and they're both extensions of the network computing revolution.

First, the basic components of computing – processors, memory, storage, networking – are becoming so small, powerful and inexpensive that soon computing will be embedded in all kinds of everyday things that don't look at all like computing devices: cars, roads, machine tools, vending machines, houses.

When all these are connected to the Net, they will make possible a new class of applications, invisible to end users but vitally important to businesses and institutions. Imagine this: Automakers will be able to gather real-time information about the performance of their cars. Soft drink companies can tie together their vending machines to learn what's selling (and not selling), at what prices, in what regions, at what temperatures. Imagine not just a billion connected people, but a trillion connected devices. We call this Pervasive Computing.

The second major development looks like the polar opposite of Pervasive Computing, but it's really just the flip side. A new class of heavyweight computing systems is emerging that will make possible new ways to gain insight – and *foresight* – from

both the enormous, underutilized stores of data that organizations already possess, and the sea of information that pervasive computing devices will generate. We call this capability Deep Computing – named after our chess-playing supercomputer Deep Blue, which combined ultrafast processing power with sophisticated analytical software.

In Deep Computing, we're already applying what we learned from Deep Blue to real-world initiatives that were previously inconceivable, like modeling pharmacological agents, simulating weather patterns for more accurate forecasting, and mining databases in retail or insurance for patterns and insights. What the future holds – solutions in everything from genomics to financial markets to disease control – is almost impossible to fathom today. But we're out there pushing the edges and learning.

- ***The Year 2000 problem is important, and it's being addressed. But a lot of work remains to be done – fast.***

While no one knows for sure what will happen, we believe the largest companies, institutions and government agencies will be ready, particularly those in technologically advanced nations. They got an early start fixing their systems, and they are using this year to test extensively. Less certain is how smaller businesses and emerging nations will fare. They've got to pick up the pace.

To help our customers worldwide, we have deployed thousands of IBMers and mobilized thousands of our business partners. Most of our client teams are working through specific plans with their customers. We will deploy even more IBMers to the extent we can (we've already asked our people to alter vacation plans). And internally, we are working just as hard to ensure that IBM's own essential operations are ready.

* * *



PATENT LEADERSHIP In 1998, for the sixth consecutive year, IBM was awarded the most U.S. patents, shattering the previous record (our own) by more than 40 percent. We received **2,658** U.S. patents in 1998, 934 more than in 1997, and we eclipsed the next closest company by 38 percent.



e-IBM IBM itself is turning into one of the world's largest e-businesses. In 1998, we sold more than **\$3 billion** of products and services over the Internet.

As I look at the information technology industry today – its economic fundamentals, its technological underpinnings and even its emotional tonality – I see an industry that looks, operates and trades more like a business at the beginning of a growth cycle than one reaching maturity.

Perhaps even more remarkably, I see the same qualities in IBM.

The thing that most surprises and delights me about our company is not how we've reinvented our internal processes from the ground up. Nor how we're relentlessly improving execution and teamwork. Nor even that we're practicing what we preach, making encouraging strides toward becoming the world's premier e-business – in everything from procurement, where Net-based purchasing should save IBM nearly a quarter of a billion dollars in 1999; to e-commerce, where our online sales in December reached \$38 million a day; to using distance learning to improve IBMers' skills.

As important as all that is, the thing that most persuades me that we are at a key inflection point in IBM's history is simply what it actually feels like to be here today.

Given what we have accomplished over the past six years, it would have been natural for IBMers to indulge themselves in well-deserved pride at having turned the ship around, or comfort in resuming a familiar role and stature. When I came to IBM in 1993, frankly, my fondest wish was for the company to return to its former position of leadership.

More and more, however, my colleagues are preoccupied not with our achievements of the recent past, but with the vast prospects opening before us. Not that we're taking anything for granted – like confusing a bull market with personal and institutional success. But it's as if, on our journey back up to a familiar plateau, we shot right past it and kept on going.

This is something I never dreamed of six years ago. Spurred by the extraordinary adventure of building a networked world, this large and storied enterprise now believes that its best years lie ahead of it – that its past, and that of the information technology industry as a whole, were just a preamble. As we move into 1999, with all its near-term momentum and all its external uncertainties, what we are most acutely aware of is the trajectory of this underlying shift, of a company and an industry that feel as though they are just getting started.

And of one more thing: a group of people who can't quite believe their good fortune. To be at this place, and at this time. Count me among them.

Louis V. Gerstner, Jr.
Chairman and Chief Executive Officer

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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 control, 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. 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 our internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters.



Louis V. Gerstner, Jr.
Chairman of the Board and
Chief Executive Officer



Douglas L. Maine
Senior Vice President and
Chief Financial Officer

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

In our opinion, the accompanying consolidated financial statements, appearing on pages 64 through 89, present fairly, in all material respects, the financial position of International Business Machines Corporation and its subsidiaries at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards, 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 provide a reasonable basis for the opinion expressed above.



PricewaterhouseCoopers LLP
1301 Avenue of the Americas
New York, NY 10019
January 21, 1999

Overview

IBM's financial results for 1998 demonstrated the value and strength of the company's portfolio of businesses. The company achieved good results despite a number of challenges throughout the year: weakness in Asia, ongoing softness in memory chip prices, continued pricing pressures across many of its product lines, product transitions in the Server segment and weakness in Latin America during the second half of the year. Despite all of these factors, the company achieved overall strong performance, especially from its Global Services segment, Software segment and hard disk drive (HDD) products of the Technology segment. The AS/400 product line, when viewed on a combined software and hardware basis, had good year-over-year performance. On a geographic basis, good results within North America and Europe were somewhat offset by weakness in Asia and Latin America.

The company's financial results showed improved revenue growth and a more balanced performance between gross profit and expense in the second half of the year versus the first half of 1998. This improved performance led to a diluted earnings per share growth of about 17 percent in the second half of the year, versus a decline of about 1 percent in the first half of the year when compared to the same periods of 1997.

The company reported revenue of \$81.7 billion—a record for the fourth consecutive year; while net income of \$6.3 billion yielded a record \$6.57 earnings per share of common stock—assuming dilution. The company funded investments of approximately \$20 billion in capital expenditures, research and development, strategic acquisitions and repurchases of common stock.

Challenges

While good progress was made in 1998, there are a number of uncertainties facing the company in 1999: the continued weak economies in Asia and Latin America, continued price pressure in the information technology industry, particularly within the fiercely competitive Personal Systems segment and the microelectronics unit of the Technology segment, and how the "Year 2000 issue" will affect customer purchases. The company's focus in 1999 will be to increase revenue with particular emphasis on addressing customers' needs to build integrated e-business solutions through the use of the company's hardware, services, software and technology. In addition, the company plans to continue to invest judiciously, reduce infrastructure and optimize the deployment of the company's employees and resources to maintain or improve its pre-tax profits.

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 differ materially, 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 1998 Form 10-K to be filed on or about March 26, 1999.

Results of Operations

(Dollars in millions except per share amounts)

| | 1998 | 1997 | 1996 |
|-----------------------|-----------|-----------|-----------|
| Revenue | \$ 81,667 | \$ 78,508 | \$ 75,947 |
| Cost | 50,795 | 47,899 | 45,408 |
| Gross profit | 30,872 | 30,609 | 30,539 |
| Gross profit margin | 37.8% | 39.0% | 40.2% |
| Total expense | 21,832 | 21,582 | 21,952 |
| Income before | | | |
| income taxes | \$ 9,040 | \$ 9,027 | \$ 8,587 |
| Net income | \$ 6,328 | \$ 6,093 | \$ 5,429 |
| Earnings per share of | | | |
| common stock—basic | \$ 6.75 | \$ 6.18 | \$ 5.12 |
| Earnings per share of | | | |
| common stock— | | | |
| assuming dilution | \$ 6.57 | \$ 6.01 | \$ 5.01 |

Revenue in 1998 grew 4.0 percent as reported and 6.2 percent when currency impacts are removed. This increase was primarily driven by growth in the Global Services segment, HDD storage products of the Technology segment, and middleware software offerings including those from Tivoli Systems, Inc. (Tivoli) of the Software segment.

The following table provides the company's percentage of revenue by segment and illustrates the continuing shift toward a greater percentage of the company's revenue being derived from the Global Services and Software segments.

| | 1998 | 1997 | 1996 |
|--------------------------|--------|--------|--------|
| Hardware segments | 43.4% | 46.7% | 48.2% |
| Global Services segment | 35.4 | 32.1 | 29.4 |
| Software segment | 14.5 | 14.2 | 15.0 |
| Global Financing segment | 3.5 | 3.6 | 4.0 |
| Enterprise Investments | | | |
| segment/Other | 3.2 | 3.4 | 3.4 |
| Total | 100.0% | 100.0% | 100.0% |

The overall gross profit margin at 37.8 percent decreased 1.2 points from 1997, following a 1.2 point decrease in 1997 versus 1996. The declines were primarily the result of the company's continued shift to global services in 1998 and 1997. The Global Services segment has a lower gross profit margin than the company's Server segment (S/390, AS/400 and RS/6000), which has been declining as a percentage of total revenue over the past three years.

The 1998 revenue from the United States was \$35.3 billion, an increase of 8.1 percent from 1997. Revenue from Europe/Middle East/Africa was \$26.0 billion, up 8.6 percent (up about 9 percent in constant currency). Asia Pacific revenue fell 9.4 percent (down about 1 percent in constant currency) to \$13.8 billion, while revenue from Latin America was \$3.3 billion, a decline of 9.2 percent (down about 7 percent in constant currency) versus 1997. Revenue from Canada was \$3.3 billion, an increase of 6.8 percent (up about 14 percent in constant currency) compared to 1997.

Information about the company's operating segments can be found in note Y, "Segment Information," on pages 84 through 89. This note provides additional information, including a description of the products and services of each segment, as well as financial data pertaining to each segment.

The following discussion is based on the Consolidated Financial Statements found on pages 64 through 68, which reflect, in all material respects, the company's segment results on an external basis.

Hardware Segments

| (Dollars in millions) | 1998 | 1997 | 1996 |
|-----------------------|-----------|-----------|-----------|
| Revenue | \$ 35,419 | \$ 36,630 | \$ 36,634 |
| Cost | 24,214 | 23,473 | 22,888 |
| Gross profit | \$ 11,205 | \$ 13,157 | \$ 13,746 |
| Gross profit margin | 31.6% | 35.9% | 37.5% |

Revenue from Hardware segments decreased 3.3 percent (down about 2 percent in constant currency) from 1997, after being essentially flat in 1997 versus 1996. Gross profit dollars from Hardware segments declined 14.8 percent from 1997, following a decrease of 4.3 percent in 1997 from 1996.

Technology segment revenue increased 7.3 percent in 1998 versus 1997, following an increase of 8.2 percent in 1997 compared to 1996. The increases were driven by continued strong growth in HDD storage products, which are primarily sold to Original Equipment Manufacturers (OEMs) for use in their product offerings, storage tape products, and growth in custom logic products. These increases were partially offset by

lower dynamic random access memory (DRAM) revenue due to the continued industry-wide pricing pressures and lower revenue from high-end storage products. The company continues to evaluate various alternatives to mitigate the impact of memory price pressures on the results of the company. These alternatives include, among other actions, realigning alliance structures, rebalancing sources of supply and redirecting product focus.

Server segment revenue decreased 5.9 percent in 1998 from 1997, following a decrease of 7.7 percent in 1997 versus 1996. The declines were driven by lower revenue from S/390, AS/400 and RS/6000. While S/390 revenue declined, total delivery of computing power increased over 60 percent as measured in MIPS (millions of instructions per second) versus last year. AS/400 and RS/6000 were impacted by the effect of product transitions late in 1998, as well as anticipation by customers of early 1999 product announcements.

Personal Systems segment revenue declined 10.9 percent in 1998 from 1997, following an increase of 3.3 percent in 1997 versus 1996. The decline in 1998 versus 1997 was driven by lower revenue from both commercial and consumer personal computers. Although Personal Systems segment revenue declined for the full year, the second half of 1998 showed improved performance when compared to the first half of the year. The increase in revenue in 1997 over 1996 was driven by higher commercial personal computer revenue and increased general-purpose display revenue.

The decrease in the 1998 Hardware segments' gross profit dollars was driven primarily by lower margins associated with Personal Systems segment products. This was a result of severe price reductions, partially offset by cost improvements. In addition, gross profit dollars for the Technology segment were lower due to the year-to-year price reductions in DRAMs. The decrease in gross profit margin over the periods continues to be driven by the shift in the company's revenue to lower gross profit products, such as personal computers, OEM semiconductors and HDDs, as well as price pressures. The overall Hardware segments' gross profit dollars and margin continue to be adversely impacted by pricing pressures across most products.

Global Services Segment

| (Dollars in millions) | 1998 | 1997 | 1996 |
|-----------------------|-----------|-----------|-----------|
| Revenue | \$ 28,916 | \$ 25,166 | \$ 22,310 |
| Cost | 21,125 | 18,464 | 16,270 |
| Gross profit | \$ 7,791 | \$ 6,702 | \$ 6,040 |
| Gross profit margin | 26.9% | 26.6% | 27.1% |

The Global Services segment revenue increased 14.9 percent in 1998 (up about 18 percent in constant currency) from 1997 and 12.8 percent in 1997 over 1996. The increases were driven by all major categories of services. Strategic outsourcing was a major contributor to the growth. Strategic outsourcing is the management of all or part of our customer's business processes, technology operations, network operations and data. The company's IT consulting and systems integration offerings also had strong growth. Systems integration services assist companies to bridge the gap between current capabilities and future business requirements by modifying their existing applications and integrating new ones.

Another category of service offerings which demonstrated significant growth in 1998 was product support services. These services identify systems-related requirements and determine more efficient solutions. The major offering categories in this area are hardware and software support, business recovery services, systems management and networking services, and site and connectivity services.

E-business spans many of the Global Services segment offerings already mentioned and played a key role in its 1998 growth. The company's e-business services offerings include: e-business strategy and planning; e-commerce services for Web selling, e-payments, e-procurement, security and privacy; e-business enablement services involving applications, information use and messaging; learning services such as distributed learning; and hosted business applications such as network-delivered applications, Web hosting and Web infrastructure outsourcing.

In 1998, the company signed services contracts worth \$33 billion, increasing the backlog to \$51 billion. The company continued to meet the growing demand for its services by hiring about 18,000 employees in 1998 and over 15,000 employees in each of 1997 and 1996.

Revenue and profitability increases in these services categories were partially offset by lower revenue associated with maintenance offerings. The maintenance portion of the Global Services segment continues to be affected by price reductions on maintenance offerings. The focus on stabilizing maintenance revenues led to identification of many new opportunities in this business. While maintenance gross profit dollars are declining as a result of lower revenue, the decrease was partially offset by cost efficiencies achieved in 1998. These productivity improvements have sustained the gross profit margin despite competitive pressures and overall declining revenue. The effect of lower maintenance revenues was to reduce the overall Global Services profit margins, but this impact was more than offset by increases in services profitability and the sustained margins of the maintenance business.

Software Segment

| (Dollars in millions) | 1998 | 1997 | 1996 |
|-----------------------|-----------|-----------|-----------|
| Revenue | \$ 11,863 | \$ 11,164 | \$ 11,426 |
| Cost | 2,260 | 2,785 | 2,946 |
| Gross profit | \$ 9,603 | \$ 8,379 | \$ 8,480 |
| Gross profit margin | 80.9% | 75.1% | 74.2% |

Software segment revenue increased 6.3 percent in 1998 (up about 9 percent in constant currency) from 1997, following a decline of 2.3 percent from 1996. The revenue increase in 1998 was driven by growth in the company's middleware products consisting of data management, transaction processing, Tivoli systems management, and messaging and collaboration. In addition, operating systems software grew slightly year over year primarily as a result of strong AS/400 revenue. The decrease in 1997 versus 1996 of 2.3 percent was a result of lower operating system revenue associated with S/390 products. This decrease was partially offset by increased revenue for middleware products, especially systems management software from Tivoli.

Software segment gross profit dollars increased 14.6 percent in 1998 from 1997, following a decrease of 1.2 percent in 1997 from 1996. The improvement in gross profit dollars was the result of less amortization cost of previously deferred development spending. This is the result of more software spending being expensed in the period incurred, and less being capitalized in relation to historical levels. In 1997, this improvement was more than offset by the decline in revenue versus 1996.

Global Financing Segment

| (Dollars in millions) | 1998 | 1997 | 1996 |
|-----------------------|----------|----------|----------|
| Revenue | \$ 2,877 | \$ 2,806 | \$ 3,054 |
| Cost | 1,494 | 1,448 | 1,481 |
| Gross profit | \$ 1,383 | \$ 1,358 | \$ 1,573 |
| Gross profit margin | 48.1% | 48.4% | 51.5% |

Global Financing segment revenue increased 2.5 percent in 1998 (up about 5 percent in constant currency) from 1997, following a decrease of 8.1 percent in 1997 versus 1996. The revenue increase in 1998 over 1997 was due to improved used equipment sales and growth in software and services financing, offset by a decline in working capital financing and decreased interest income. The revenue decline in 1997 versus 1996 was attributable to lower used equipment sales and decreases in both working capital financing and interest income.

Gross profit dollars increased 1.8 percent in 1998 versus 1997, following a decrease of 13.7 percent in 1997 from 1996. The increase in 1998 versus 1997 was primarily due to increased revenue and a higher gross profit margin in the U.S. markets. The decrease in 1997 versus 1996 reflects a trend towards financing a greater volume of low-end products and faster

growth in the more competitive U.S. markets. See note Y, "Segment Information," on pages 84 through 89 for more detailed information on the Global Financing segment.

| Enterprise Investments Segment/Other | | | |
|--------------------------------------|-----------------|-----------------|-----------------|
| (Dollars in millions) | 1998 | 1997 | 1996 |
| Revenue | \$ 2,592 | \$ 2,742 | \$ 2,523 |
| Cost | 1,702 | 1,729 | 1,823 |
| Gross profit | \$ 890 | \$ 1,013 | \$ 700 |
| Gross profit margin | 34.3% | 36.9% | 27.7% |

Information, including a description of the company's Enterprise Investment segment, can be found in note Y, "Segment Information," on pages 84 through 89.

The revenue from the Enterprise Investments segment/Other decreased 5.5 percent (down about 3 percent in constant currency) from 1997, following an increase of 8.7 percent in 1997 from 1996. The decrease was primarily a result of lower software revenue, partially offset by higher revenue from point-of-sale terminals. The increase in 1997 versus 1996 was driven by higher software and point-of-sale terminal revenue. The gross profit dollars from the Enterprise Investments segment/Other decreased 12.1 percent in 1998 versus 1997, following an increase of 44.7 percent in 1997 versus 1996. The decline in 1998 gross profit dollars was primarily driven by the lower software revenue versus 1997, while the increase in 1997 versus 1996 was due to lower software costs.

| Operating Expenses | | | |
|---------------------------------------|------------------|------------------|------------------|
| (Dollars in millions) | 1998 | 1997 | 1996 |
| Selling, general and administrative | \$ 16,662 | \$ 16,634 | \$ 16,854 |
| Percentage of revenue | 20.4% | 21.2% | 22.2% |
| Research, development and engineering | \$ 5,046 | \$ 4,877 | \$ 5,089 |
| Percentage of revenue | 6.2% | 6.2% | 6.7% |

Selling, general and administrative (SG&A) expense was essentially flat in 1998 versus 1997 and declined 1.3 percent in 1997 from 1996. The company continued its focus on reducing infrastructure costs with particular emphasis on expenses not related to revenue, e.g., non-customer travel and contracted services, while reallocating its resources to allow for investment in growth segments of the business. These actions yielded a 0.8 percentage point improvement in the expense-to-revenue ratio in 1998 and a 1.0 percentage point improvement in 1997.

The company continues to focus on productivity, expense controls and prioritization of spending in order to improve its expense-to-revenue level.

Research, development and engineering expense increased 3.5 percent in 1998 from 1997, following a decrease of 4.2 percent

in 1997 from 1996. The increase reflects the company's continued investments in high-growth opportunities like e-business, Java, Tivoli systems management and HDD products, as well as the impact of additional expenses associated with new acquisitions. The decline in 1997 versus 1996 was a result of \$435 million of purchased in-process research and development being recorded in 1996 for the Tivoli and Object Technology International, Inc. acquisitions.

The company's ongoing research and development efforts have resulted in the company being granted 2,658 patents in 1998, placing it number one in patents granted in the U.S. for the sixth consecutive year. The application of these technological advances has enabled the company to transform this research and development into new products. Examples of these efforts are numerous patents directly related to two major chip breakthroughs announced last year, silicon germanium and silicon-on-insulator. Both technologies will be crucial in the industry's development of a new class of "pervasive computing" devices, handheld and embedded products such as smart phones and internet appliances that business professionals and consumers will rely on for easy access to e-business data and services. In addition, the use of copper in place of aluminum in the making of integrated circuits was introduced into new products in 1998.

On a constant currency basis, SG&A expense increased approximately 2.1 percent in 1998 versus 1997, and Research, development and engineering expense increased approximately 3.9 percent.

See note Y, "Segment Information," on pages 84 through 89 for additional information regarding each segment's pre-tax income, as well as the methodologies employed by the company to allocate shared expenses to the segments.

Provision for Income Taxes

The provision for income taxes resulted in an effective tax rate of 30 percent for 1998, as compared to the 1997 effective tax rate of 33 percent and a 1996 effective tax rate of 37 percent. Adjusting for purchased in-process research and development which had no corresponding tax effect, the 1996 effective tax rate would have been 35 percent. The reduction in the 1998 and 1997 tax rate reflects the company's continued expansion into markets with lower effective tax rates.

The company accounts for income taxes under Statement of Financial Accounting Standards (SFAS) 109, "Accounting for Income Taxes," which provides that a valuation allowance should be recognized to reduce the deferred tax asset to the amount that is more likely than not to be realized. In assessing the likelihood of realization, management considered estimates of future taxable income, which are based primarily on recent financial performance.

Fourth Quarter

For the quarter ended December 31, 1998, the company had revenue of \$25.1 billion, an increase of 5.9 percent (up about 5 percent in constant currency) over the same period of 1997. Net income in the fourth quarter was \$2.3 billion (\$2.47 per common share—assuming dilution), compared with net income of \$2.1 billion (\$2.11 per common share—assuming dilution) in the fourth quarter of 1997.

Fourth quarter revenue from the United States was \$10.3 billion, an increase of 8.0 percent from the same period of 1997. Revenue from Europe/Middle East/Africa was \$8.7 billion, up 12.5 percent. Revenue from Canada was \$996 million, up 8.3 percent. Asia Pacific revenue fell 3.4 percent to \$4.2 billion, while revenue from Latin America fell 21.7 percent to \$929 million.

Excluding the effects of currency translation, Europe/Middle East/Africa grew 9 percent, Canada increased 12 percent, Asia Pacific declined 6 percent and Latin America declined 19 percent versus the fourth quarter of 1997.

The Hardware segments revenue was essentially flat with the year-ago period at \$11.4 billion. Declines were driven by the Server segment, due to lower S/390, AS/400 and RS/6000 revenue in 1998 versus 1997. Shipments of S/390 computing power increased by approximately 60 percent, as measured in MIPS, though S/390 revenue declined. These decreases were offset by higher revenue from the Technology and Personal Systems segments. The Technology segment increases were driven by higher HDD revenue. The Personal Systems segment increases were due to higher commercial personal computer revenue, partially offset by lower consumer personal computer revenue.

Global Services segment revenue grew 14.1 percent versus the fourth quarter of 1997. Global Services revenue grew by more than \$1 billion compared to last year's fourth quarter, and the company's services unit signed more than \$9 billion in new services contracts in the quarter. Maintenance offerings revenue continued to decline when compared to the fourth quarter of 1997.

Software segment revenue increased 9.1 percent versus the fourth quarter of 1997. The increase was driven primarily by strength in database, transaction processing and Tivoli systems management products.

Global Financing segment revenue increased 2.5 percent versus the fourth quarter of 1997, and the Enterprise Investments segment/Other revenue increased 5.6 percent compared with 1997's fourth quarter.

The company's overall gross profit margin in the fourth quarter was 39.0 percent, compared to 40.1 percent in the year-earlier period.

Total fourth-quarter 1998 expenses were essentially flat year over year. The expense-to-revenue ratio in the fourth quarter of 1998 was 25.9 percent compared to 27.4 percent in the year-earlier period.

The company's tax rate was 28.9 percent in the fourth quarter, compared to 30.5 percent in the fourth quarter of 1997. The 1998 fourth quarter tax rate reflects the net effect of the company's transfer of certain intellectual property rights to several subsidiaries and the related valuation allowance impacts. See note Q, "Taxes," on pages 77 and 78 for additional information.

The company spent approximately \$1.6 billion on share repurchases in the fourth quarter. The average number of shares outstanding in the fourth quarter of 1998 was 919.8 million, compared to 964.8 million in the year-earlier period. The average number of shares outstanding for purposes of calculating diluted earnings was 947.2 million in the fourth quarter of 1998 versus 990.7 million in the fourth quarter of 1997.

Financial Condition

The company continued to make significant investments during 1998 to fund future growth and increase shareholder value, expending \$5.6 billion for research, development and engineering, \$4.8 billion for plant and other property, including machines used in managed operations services offerings, \$1.7 billion for machines on operating leases with customers, \$0.7 billion for strategic acquisitions and \$6.9 billion for the repurchase of the company's common shares. The company had \$5.8 billion in cash, cash equivalents and marketable securities on hand at December 31, 1998.

The company has access to global funding sources. During 1998, the company issued debt in a variety of geographies to a diverse set of investors. Significant funding was issued in the United States, Japan and Europe. Funding was obtained across the range of debt maturities, from short-term commercial paper to long-term debt. More information about company debt is provided in note K, "Debt," on page 73.

In December 1993, the company entered into a \$10 billion committed global credit facility to enhance the liquidity of funds. This facility was amended in February 1997, and extended to February 2002. As of December 31, 1998, \$8.8 billion was unused and available.

The company had an outstanding balance at December 31, 1998 and 1997, of \$0.9 billion in assets under management from the securitization of loans, leases and trade receivables. For additional information see note J, "Sale and Securitization of Receivables," on page 73.

The major rating agencies have continued their review of the company's financial condition. In February 1998, Standard and

Poor's upgraded its credit ratings for the company and its rated subsidiaries' senior long-term debt to A+ from A, and on IBM's preferred stock to A from A-. They also affirmed the commercial paper rating at A-1.

Moody's Investors Service rates the senior long-term debt of the company and its rated subsidiaries as A1, the commercial paper as Prime-1, and the company's preferred stock as "a1."

Fitch Investors Service rates the company and its rated subsidiaries' senior long-term debt as AA-, commercial paper as F-1+, and preferred stock as A+.

Duff & Phelps rates the company and its rated subsidiaries' senior long-term debt as A+, commercial paper as Duff 1, and the company's preferred stock as A.

Cash Flows

The company's cash flows from operating, investing and financing activities, as prescribed by generally accepted accounting principles and reflected in the Consolidated Statement of Cash Flows on page 68, are summarized in the following table:

| (Dollars in millions) | 1998 | 1997 | 1996 |
|--|------------|----------|-----------|
| Net cash provided from (used in): | | | |
| Operating activities | \$ 9,273 | \$ 8,865 | \$ 10,275 |
| Investing activities | (6,131) | (6,155) | (5,723) |
| Financing activities | (4,993) | (3,090) | (3,952) |
| Effect of exchange rate changes on cash and cash equivalents | 120 | (201) | (172) |
| Net change in cash and cash equivalents | \$ (1,731) | \$ (581) | \$ 428 |

WORKING CAPITAL

| (Dollars in millions) | 1998 | 1997 |
|-----------------------|-----------|-----------|
| At December 31: | | |
| Current assets | \$ 42,360 | \$ 40,418 |
| Current liabilities | 36,827 | 33,507 |
| Working capital | \$ 5,533 | \$ 6,911 |
| Current ratio | 1.15:1 | 1.21:1 |

Current assets increased \$1.9 billion, driven primarily by increases in accounts receivable relative to strong year-end global financing volumes and in prepaid expenses due to increases in net deferred tax assets. The company ended 1998 with inventories of \$5.2 billion, near last year's levels which were the lowest since 1983, due to continued focus on inventory management process improvements, notably in the Personal Systems segment. These improvements have enabled the company's inventory turn rate to increase from 4.9 in 1997 to 5.3 in 1998.

Current liabilities increased \$3.3 billion from year-end 1997 with increases of \$0.7 billion in taxes payable, \$0.7 billion in short-term debt and \$1.9 billion in other current liabilities (increases in accounts payable (\$1.0 billion), compensation and benefits (\$0.5 billion), and deferred income (\$0.7 billion), and a \$0.3 billion decrease in other accrued expenses and liabilities). The increase in taxes payable primarily reflects improvements in the company's operating results in certain geographies. Short-term debt essentially increased to support the growth of global financing assets. The increase in other current liabilities was primarily attributable to the effect of currency rate translation (\$1.0 billion) on non-U.S. balances, and by considerable year-end business activity relative to deferred income, mainly advanced billings for software.

Investments

The company's investments for plant, rental machines and other property were \$6.5 billion for 1998, a decrease of \$0.3 billion from 1997. The company continues to invest significantly in its rapidly growing services business, principally in the management of customers' information technology, and in manufacturing capacity for HDDs and microelectronics.

In addition to software development expenses included in Research, development and engineering, the company capitalized \$0.3 billion of software costs during both 1998 and 1997. Amortization of capitalized software costs amounted to \$0.5 billion for 1998, a decrease of \$0.5 billion from 1997. This decrease in the level of costs amortized is a result of more software spending being expensed in the period incurred, and less being capitalized in relation to historical levels.

Investments and sundry assets were \$23.5 billion at the end of 1998, an increase of \$1.6 billion from 1997, primarily the result of increases in prepaid pension assets and non-current customer loan receivables. See note H, "Investments and Sundry Assets," on page 72 for additional information.

DEBT AND EQUITY

| (Dollars in millions) | 1998 | 1997 |
|------------------------------|-----------|-----------|
| Non-global financing debt | \$ 1,659 | \$ 3,102 |
| Global financing debt | 27,754 | 23,824 |
| Total debt | \$ 29,413 | \$ 26,926 |
| Stockholders' equity | \$ 19,433 | \$ 19,816 |
| Debt/capitalization | 60.2% | 57.6% |
| EBITDA/interest expense | 8x | 8x |
| Non-global financing: | | |
| Debt/capitalization | 9.9% | 16.1% |
| EBITDA/interest expense | 15x | 14x |
| Global financing debt/equity | 6.5:1 | 6.5:1 |

Total debt increased \$2.5 billion from year-end 1997, driven by an increase of \$3.9 billion in debt to support the growth in global financing assets, offset by a \$1.4 billion decrease in debt not related to the Global Financing segment.

Stockholders' equity declined \$0.4 billion to \$19.4 billion at December 31, 1998. The company's ongoing stock repurchasing program (see note O, "Stockholders' Equity Activity," on pages 76 and 77) basically offset the \$6.3 billion of net income for the year.

Non-global financing earnings before interest and taxes plus depreciation and amortization (EBITDA) to non-global financing interest expense, adjusted for future gross minimum rental commitments, was 15x and 14x in 1998 and 1997, respectively. While the company does not calculate EBITDA on a segment basis, it is a useful indicator of the company's ability to service its debt.

Currency Rate Fluctuations

The company's results are affected by changes in the relative values of non-U.S. currencies to the U.S. dollar. At December 31, 1998, currency changes resulted in assets and liabilities denominated in local currencies being translated into more dollars. The currency rate changes also resulted in an unfavorable impact on revenue of approximately 2 percent, 5 percent and 3 percent, respectively, in 1998, 1997 and 1996.

In high-inflation environments, translation adjustments are reflected in period income, as required by SFAS 52, "Foreign Currency Translation." Generally, the company limits currency risk in these countries by linking prices and contracts to U.S. dollars, by financing operations locally and through foreign currency hedge contracts.

The company uses a variety of financial hedging instruments to limit specific currency risks related to global financing transactions and the repatriation of dividends and royalties. Further discussion on currency and hedging appears in note M, "Financial Instruments," on pages 74 and 75.

Market Risk

In the normal course of business, the financial position of the company is routinely subjected to a variety of risks. In addition to the market risk associated with interest rate and currency movements on outstanding debt and non-U.S. dollar denominated assets and liabilities, other examples of risk include collectibility of accounts receivable and recoverability of residual values on leased assets.

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 in these areas.

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 M, "Financial Instruments," on pages 74 and 75.

For purposes of specific risk analysis, the company uses sensitivity analysis to determine the impact that market risk exposures may have on the fair values of the company's debt and other financial instruments.

The financial instruments included in the sensitivity analysis consist of 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. Interest rate swaps, interest rate options, foreign currency swaps, forward contracts and foreign currency option contracts constitute the company's portfolio of derivative financial instruments.

To perform sensitivity analysis, the company assesses the risk of loss in fair values from the impact of 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 impacted by the changes in rates 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, 1998 and 1997. The differences in this comparison are the hypothetical gains or losses associated with each type of risk.

Information provided by the model used does not necessarily represent the actual changes in fair value that the company would incur under normal market conditions because, of necessity, all variables other than the specific market risk factor are held constant. In addition, the model is 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 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, 1998 and December 31, 1997, are as follows:

Interest Rate Risk: As of December 31, 1998, a 10 percent decrease in the levels of interest rates with all other variables held constant would result in a decrease in the fair value of the company's financial instruments of \$396 million, as compared to \$369 million as of December 31, 1997. Conversely, as of December 31, 1998, 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 \$354 million, as compared to \$341 million as of December 31, 1997. 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 and interest rate profile and amount. In 1998 versus 1997, the reported change in interest rate sensitivity is primarily due to an overall increase in the amount of debt outstanding.

Foreign Currency Exchange Rate Risk: As of December 31, 1998, a 10 percent movement in the levels of foreign currency exchange rates against the U.S. dollar with all other variables held constant would result in a decrease in the fair value of the company's financial instruments of \$1,317 million or an increase in the fair value of the company's financial instruments of \$1,535 million, as compared to a decrease of \$809 million or increase of \$981 million as of December 31, 1997. The change in the relative sensitivity of the fair market value of the company's financial instrument portfolio to the level of foreign currency exchange rates is primarily driven by an increase in the use of foreign currency swaps and other finan-

cial instruments designed to hedge the company's net foreign investments in accordance with the company's established risk management practices. As the impact of offsetting changes in the fair market value of the company's net foreign investments is not included in the sensitivity model, these results are not indicative of an increase in the company's actual exposure to foreign currency exchange rate risk.

Financing Risks

Global financing is an integral part of the company's total worldwide offerings. Inherent in global financing are certain risks, including credit, interest rate, currency and residual value. The company manages credit risk through comprehensive credit evaluations and pricing practices. To manage the risks associated with an uncertain interest rate environment, the company pursues a funding strategy of substantially matching the terms of its debt with the terms of its assets. Currency risks are managed by denominating liabilities in the same currency as the assets.

Residual value risk is managed by developing projections of future equipment values at lease inception, reevaluating these projections periodically, and effectively deploying remarketing capabilities to recover residual values and potentially earn a profit. Remarketing efforts have consistently generated profits. The following table depicts an approximation of the unguaranteed residual value maturities for the company's sales-type leases, as well as a projection of the remaining net book value of machines on operating leases at the end of the lease terms as of December 31, 1996, 1997 and 1998. The following table excludes approximately \$52 million of estimated residual value associated with non-information technology equipment.

| (Dollars in millions) | Total | | | Run Out of 1998 Balance | | | |
|-----------------------------|---------------|-----------------|-----------------|-------------------------|---------------|---------------|-----------------|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 and beyond |
| Sales-type leases | \$ 471 | \$ 563 | \$ 685 | \$ 167 | \$ 261 | \$ 226 | \$ 31 |
| Operating leases | 480 | 701 | 731 | 291 | 285 | 139 | 16 |
| Total residual value | \$ 951 | \$ 1,264 | \$ 1,416 | \$ 458 | \$ 546 | \$ 365 | \$ 47 |

Divestitures/Acquisitions

In December 1998, the company and AT&T announced that AT&T will acquire IBM's Global Network business for \$5 billion in cash. In addition, the two companies have agreed to enter into outsourcing contracts with each other. The company will outsource a significant portion of its global networking needs to AT&T. AT&T will outsource certain applications processing and data center management operations to the company. About 5,000 IBM employees will join AT&T as part of the acquisition and more than 2,000 AT&T employees will be offered positions with the company.

The company believes that this transaction, in its entirety, will not have a significant impact on the company's 1999 ongoing operational results. The company and AT&T expect the acquisition to conclude in the various geographies throughout 1999, following clearance by U.S. regulatory authorities and certain regulatory authorities outside the U.S.

The company awarded AT&T Solutions a contract valued at \$5 billion over five years for a significant portion of the company's own global networking needs, making it the single

largest networking outsourcing contract ever awarded. In addition, AT&T and the Global Services unit have reached an agreement for services valued at about \$4 billion over the next 10 years. As part of the agreement, the company will manage AT&T's applications processing (including billing, service-order processing, scheduling of installation and maintenance) for customers of AT&T's business long-distance services. In addition, the company will assume management of AT&T data processing centers, which operate corporate information systems such as accounts payable and receivable and employee payroll and benefits.

In January 1998, the company acquired Software Artistry, Inc., a leading provider of both consolidated service desk and customer relationship management solutions for distributed enterprise environments. In March 1998, the company acquired CommQuest Technologies, Inc., a company that designs and markets advanced semiconductors for wireless communications applications, such as cellular phones and satellite communications.

On April 16, 1997, the company purchased a majority interest in NetObjects, a leading provider of website development tools for designers and intranet developers. In September 1997, the company acquired the 30 percent equity interest held by Sears in Advantis, the U.S. network services arm of the IBM Global Network. Advantis is now 100 percent owned by the company. In December 1997, the company acquired Eastman Kodak's share of Technology Service Solutions (TSS), which was formed in 1994 by the company and Eastman Kodak. TSS is now a wholly owned subsidiary of the company, offering comprehensive services solutions to its customers. In December 1997, the company acquired Unison Software, Inc., a leading developer of workload management software.

On March 1, 1996, the company acquired all outstanding shares of Tivoli for approximately \$800 million (\$716 million in net cash). The company engaged a nationally recognized, independent appraisal firm to express an opinion on the fair market value of the assets of the acquisition to serve as a basis for allocation of the purchase price to the various classes of assets. The company recorded \$280 million of goodwill, \$103 million of other assets and expensed \$417 million of purchased in-process research and development as a result of the appraisal.

In 1996, the acquisition of Object Technology International, Inc. for approximately \$50 million resulted in a valuation of purchased in-process research and development amounting to \$18 million, bringing the total amount of purchased in-process research and development in 1996, included in Research, development and engineering expense in the Consolidated Statement of Earnings, to \$435 million.

Employees

| | 1998 | 1997 | 1996 | Percentage Changes | |
|-------------------------------------|----------------|----------------|----------------|--------------------|---------------|
| | | | | 1998-97 | 1997-96 |
| IBM/wholly owned subsidiaries | 291,067 | 269,465 | 240,615 | 8.0 | 12.0 |
| Less than wholly owned subsidiaries | 21,704 | 20,751 | 28,033 | 4.6 | (26.0) |
| Complementary | 36,900 | 43,000 | 37,000 | (14.2) | 16.2 |

As of December 31, 1998, employees of the company and its wholly owned subsidiaries increased 21,602 over 1997, of which approximately 18,000 were in the Global Services segment. Increases were also significant in the Tivoli organization, as well as in the storage business, due to the addition of new manufacturing capacity in the company's emerging markets.

The increase in employees in the less than wholly owned subsidiaries over last year reflects continued growth in the company's Global Services segment, notably Australia and India. Entities in emerging geographic markets such as China increased as well. Partially offsetting the increase was a number of less than wholly owned subsidiaries that were divested during the year or converted to a wholly owned status.

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.

Year 2000

The "Year 2000 issue" arises because many computer hardware and software systems use only two digits to represent the year. As a result, these systems and programs may not process dates beyond 1999, which may cause errors in information or systems failures. Assessments of the potential effects of the Year 2000 issues vary markedly among different companies, governments, consultants, economists and commentators, and it is not possible to predict what the actual impact may be. Given this uncertainty, the company recognizes the need to remain vigilant and is continuing its analysis, assessment, conversion and contingency planning for the various Year 2000 issues, across its business.

With respect to its internal systems, the potential Year 2000 impacts extend beyond the company's information technology systems to its manufacturing and development systems and physical facilities. The company has been addressing these issues using the same five-part methodology it recommends to its customers: (1) assessment and strategy; (2) detailed analysis and planning; (3) implementation; (4) maintaining readiness of converted systems; and (5) project office management. The company has completed most conversion and testing efforts, with extended system integration testing and contingency planning projects scheduled throughout 1999. The company estimates that at the conclusion of its various Year 2000 efforts, including conversion, testing and contingency planning, it will have spent a total of approximately \$575 million over a multi-year period. Although the company believes its efforts will be successful, any failure or delay could result in the disruption of business and in the company incurring substantial expense. To minimize any such potential impact, the company has initiated a global contingency planning effort designed to support critical business operations.

As part of its ordinary course product development efforts, the company's current product and service offerings have been designed by it to be Year 2000 ready. The Year 2000 readiness of the company's customers varies, and the company continues actively to encourage its customers to prepare their own systems, making available a broad array of product, service and educational offerings to assist them (see the IBM Year 2000 Home Page at <http://www.ibm.com/IBM/year2000/>). Efforts by customers to address Year 2000 issues may absorb

a substantial part of their information technology budgets in the near term, and customers may either delay or accelerate the deployment and implementation of new applications and systems. While this behavior may increase demand for certain of the company's products and services, including its Year 2000 offerings, it could also soften demand for other offerings or change customer buying practices from past trends. These events could affect the company's revenues or change its revenue patterns.

The company is also continuing its assessment of the Year 2000 readiness of its key suppliers in an effort to establish that the company has adequate resources for required supplies and components. With respect to third-party products the company may remarket or provide with the company's offerings (such as third-party software pre-loaded on the company's personal computers), the company relies on its business partners and other third parties to be responsible for the Year 2000 readiness of their offerings. A failure of the company's suppliers, business partners and other third parties to address adequately their Year 2000 readiness could affect the company's business. As part of its contingency planning efforts, the company is identifying alternate sources or strategies where necessary if significant exposures are identified.

Further, some commentators believe that a significant amount of litigation will arise from Year 2000 issues. The company continues to believe that it has good defenses to any such claims brought against it.

Finally, the Year 2000 presents a number of other risks and uncertainties that could affect the company, including utilities and telecommunications failures, competition for personnel skilled in the resolution of Year 2000 issues, and the nature of government responses to Year 2000 issues, among others. While the company continues to believe that the Year 2000 matters discussed above will not have a material impact on its business, financial condition or results of operations, it remains uncertain whether or to what extent the company may be affected.

The Year 2000 statements set forth above are designated as "Year 2000 Readiness Disclosures" pursuant to the Year 2000 Information and Readiness Disclosure Act (P.L. 105-271).

CONSOLIDATED STATEMENT OF EARNINGS International Business Machines Corporation and Subsidiary Companies

(Dollars in millions except per share amounts)

| For the year ended December 31: | Notes | 1998 | 1997* | 1996* |
|---|-------|-----------------|-----------------|-----------------|
| Revenue: | | | | |
| Hardware segments | | \$ 35,419 | \$ 36,630 | \$ 36,634 |
| Global Services segment | | 28,916 | 25,166 | 22,310 |
| Software segment | | 11,863 | 11,164 | 11,426 |
| Global Financing segment | | 2,877 | 2,806 | 3,054 |
| Enterprise Investments segment /Other | | 2,592 | 2,742 | 2,523 |
| Total revenue | | 81,667 | 78,508 | 75,947 |
| Cost: | | | | |
| Hardware segments | | 24,214 | 23,473 | 22,888 |
| Global Services segment | | 21,125 | 18,464 | 16,270 |
| Software segment | | 2,260 | 2,785 | 2,946 |
| Global Financing segment | | 1,494 | 1,448 | 1,481 |
| Enterprise Investments segment /Other | | 1,702 | 1,729 | 1,823 |
| Total cost | | 50,795 | 47,899 | 45,408 |
| Gross profit | | 30,872 | 30,609 | 30,539 |
| Operating expenses: | | | | |
| Selling, general and administrative | R | 16,662 | 16,634 | 16,854 |
| Research, development and engineering | S | 5,046 | 4,877 | 5,089 |
| Total operating expenses | | 21,708 | 21,511 | 21,943 |
| Operating income | | 9,164 | 9,098 | 8,596 |
| Other income, principally interest | | 589 | 657 | 707 |
| Interest expense | L | 713 | 728 | 716 |
| Income before income taxes | | 9,040 | 9,027 | 8,587 |
| Provision for income taxes | Q | 2,712 | 2,934 | 3,158 |
| Net income | | 6,328 | 6,093 | 5,429 |
| Preferred stock dividends | | 20 | 20 | 20 |
| Net income applicable to common shareholders | | \$ 6,308 | \$ 6,073 | \$ 5,409 |
| Earnings per share of common stock—basic | T | \$ 6.75 | \$ 6.18 | \$ 5.12 |
| Earnings per share of common stock—assuming dilution | T | \$ 6.57 | \$ 6.01 | \$ 5.01 |

Average number of common shares outstanding:

Basic: 1998–934,502,785; 1997–983,286,361; 1996–1,056,704,188

Assuming dilution: 1998–960,065,235; 1997–1,010,934,942; 1996–1,079,708,904

* Reclassified to conform to 1998 presentation.

The notes on pages 69 through 89 of the 1998 IBM Annual Report are an integral part of this statement.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION International Business Machines Corporation and Subsidiary Companies

(Dollars in millions)

| At December 31: | Notes | 1998 | 1997* |
|--|-------|------------------|------------------|
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | | \$ 5,375 | \$ 7,106 |
| Marketable securities | M | 393 | 447 |
| Notes and accounts receivable—trade, net of allowances | | 18,958 | 16,850 |
| Sales-type leases receivable | | 6,510 | 5,720 |
| Other accounts receivable | | 1,313 | 1,256 |
| Inventories | F | 5,200 | 5,139 |
| Prepaid expenses and other current assets | | 4,611 | 3,900 |
| Total current assets | | 42,360 | 40,418 |
| Plant, rental machines and other property | G | 44,870 | 42,133 |
| Less: Accumulated depreciation | | 25,239 | 23,786 |
| Plant, rental machines and other property—net | | 19,631 | 18,347 |
| Software, less accumulated amortization (1998—\$12,516; 1997—\$12,610) | | 599 | 819 |
| Investments and sundry assets | H | 23,510 | 21,915 |
| Total assets | | \$ 86,100 | \$ 81,499 |
| Liabilities and Stockholders' Equity | | | |
| Current liabilities: | | | |
| Taxes | Q | \$ 3,125 | \$ 2,381 |
| Short-term debt | K & M | 13,905 | 13,230 |
| Accounts payable | | 6,252 | 5,215 |
| Compensation and benefits | | 3,530 | 3,043 |
| Deferred income | | 4,115 | 3,445 |
| Other accrued expenses and liabilities | | 5,900 | 6,193 |
| Total current liabilities | | 36,827 | 33,507 |
| Long-term debt | K & M | 15,508 | 13,696 |
| Other liabilities | N | 12,818 | 12,993 |
| Deferred income taxes | Q | 1,514 | 1,487 |
| Total liabilities | | 66,667 | 61,683 |
| Contingencies | P | | |
| Stockholders' equity: | O | | |
| Preferred stock, par value \$.01 per share | | 247 | 252 |
| Shares authorized: 150,000,000 | | | |
| Shares issued (1998—2,546,011; 1997—2,597,261) | | | |
| Common stock, par value \$.50 per share | | 10,121 | 8,601 |
| Shares authorized: 1,875,000,000 | | | |
| Shares issued (1998—926,869,052; 1997—969,015,351) | | | |
| Retained earnings | | 10,141 | 11,010 |
| Treasury stock, at cost (shares: 1998—962,146; 1997—923,955) | | (133) | (86) |
| Employee benefits trust (shares: 1998—10,000,000; 1997—10,000,000) | | (1,854) | (860) |
| Accumulated gains and losses not affecting retained earnings | | 911 | 899 |
| Total stockholders' equity | | 19,433 | 19,816 |
| Total liabilities and stockholders' equity | | \$ 86,100 | \$ 81,499 |

* Reclassified to conform to 1998 presentation.

The notes on pages 69 through 89 of the 1998 IBM Annual Report are an integral part of this statement.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY International Business Machines Corporation and Subsidiary Companies

| (Dollars in millions) | Preferred Stock | Common Stock | Retained Earnings | Treasury Stock | Employee Benefits Trust | Accumulated Gains and Losses Not Affecting Retained Earnings | Total |
|--|-----------------|--------------|-------------------|----------------|-------------------------|--|-----------|
| 1996* | | | | | | | |
| Stockholders' equity, January 1, 1996 | \$ 253 | \$ 7,488 | \$ 11,630 | \$ (41) | \$ — | \$ 3,093 | \$ 22,423 |
| Net income plus gains and losses not affecting retained earnings: | | | | | | | |
| Net income | | | 5,429 | | | | \$ 5,429 |
| Gains and losses not affecting retained earnings (net of tax): | | | | | | | |
| Foreign currency translation adjustments (net of tax expense of \$19) | | | | | | (635) | (635) |
| Net unrealized gains on marketable securities (net of tax expense of \$71) | | | | | | 111 | 111 |
| Total gains and losses not affecting retained earnings | | | | | | | (524) |
| Subtotal: Net income plus gains and losses not affecting retained earnings | | | | | | | \$ 4,905 |
| Cash dividends declared—common stock | | | (686) | | | | (686) |
| Cash dividends declared—preferred stock | | | (20) | | | | (20) |
| Common stock purchased and retired (97,951,400 shares) | | (710) | (5,046) | | | | (5,756) |
| Common stock issued under employee plans (19,694,458 shares) | | 811 | (13) | | | | 798 |
| Purchases (8,914,332 shares) and sales (7,584,432 shares) of treasury stock under employee plans—net | | | (105) | (94) | | | (199) |
| Tax effect—stock transactions | | 163 | | | | | 163 |
| Stockholders' equity, December 31, 1996 | 253 | 7,752 | 11,189 | (135) | — | 2,569 | 21,628 |
| 1997* | | | | | | | |
| Net income plus gains and losses not affecting retained earnings: | | | | | | | |
| Net income | | | 6,093 | | | | \$ 6,093 |
| Gains and losses not affecting retained earnings (net of tax): | | | | | | | |
| Foreign currency translation adjustments (net of tax expense of \$24) | | | | | | (1,610) | (1,610) |
| Net unrealized losses on marketable securities (net of tax benefit of \$37) | | | | | | (60) | (60) |
| Total gains and losses not affecting retained earnings | | | | | | | (1,670) |
| Subtotal: Net income plus gains and losses not affecting retained earnings | | | | | | | \$ 4,423 |
| Cash dividends declared—common stock | | | (763) | | | | (763) |
| Cash dividends declared—preferred stock | | | (20) | | | | (20) |
| Common stock purchased and retired (68,777,336 shares) | | (565) | (5,455) | | | | (6,020) |
| Preferred stock purchased and retired (13,450 shares) | (1) | | | | | | (1) |
| Common stock issued under employee plans (19,651,603 shares) | | 985 | (2) | | | | 983 |
| Purchases (3,850,643 shares) and sales (5,105,754 shares) of treasury stock under employee plans—net | | | (32) | 49 | | | 17 |
| Employee benefits trust (10,000,000 shares) | | | | | (860) | | (860) |
| Tax effect—stock transactions | | 429 | | | | | 429 |
| Stockholders' equity, December 31, 1997 | \$ 252 | \$ 8,601 | \$ 11,010 | \$ (86) | \$ (860) | \$ 899 | \$ 19,816 |

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY International Business Machines Corporation and Subsidiary Companies

| (Dollars in millions) | Preferred Stock | Common Stock | Retained Earnings | Treasury Stock | Employee Benefits Trust | Accumulated Gains and Losses Not Affecting Retained Earnings | Total |
|--|-----------------|------------------|-------------------|-----------------|-------------------------|--|------------------|
| 1998 | | | | | | | |
| Stockholders' equity, December 31, 1997 | \$ 252 | \$ 8,601 | \$ 11,010 | \$ (86) | \$ (860) | \$ 899 | \$ 19,816 |
| Net income plus gains and losses not affecting retained earnings: | | | | | | | |
| Net income | | | 6,328 | | | | \$ 6,328 |
| Gains and losses not affecting retained earnings (net of tax): | | | | | | | |
| Foreign currency translation adjustments (net of tax benefit of \$45) | | | | | | 69 | 69 |
| Net unrealized losses on marketable securities (net of tax benefit of \$36) | | | | | | (57) | (57) |
| Total gains and losses not affecting retained earnings | | | | | | | 12 |
| Subtotal: Net income plus gains and losses not affecting retained earnings | | | | | | | \$ 6,340 |
| Cash dividends declared—common stock | | | (814) | | | | (814) |
| Cash dividends declared—preferred stock | | | (20) | | | | (20) |
| Common stock purchased and retired (56,996,818 shares) | | (556) | (6,291) | | | | (6,847) |
| Preferred stock purchased and retired (51,250 shares) | (5) | | | | | | (5) |
| Common stock issued under employee plans (14,850,519 shares) | | 709 | (1) | | | | 708 |
| Purchases (4,163,057 shares) and sales (4,124,866 shares) of treasury stock under employee plans—net | | | (71) | (47) | | | (118) |
| Fair value adjustment of employee benefits trust | | 1,002 | | | (994) | | 8 |
| Tax effect—stock transactions | | 365 | | | | | 365 |
| Stockholders' equity, December 31, 1998 | \$ 247 | \$ 10,121 | \$ 10,141 | \$ (133) | \$ (1,854) | \$ 911 | \$ 19,433 |

* Reclassified to conform to 1998 presentation.

The notes on pages 69 through 89 of the 1998 IBM Annual Report are an integral part of this statement.

CONSOLIDATED STATEMENT OF CASH FLOWS International Business Machines Corporation and Subsidiary Companies

(Dollars in millions)

| For the year ended December 31: | 1998 | 1997 | 1996* |
|---|-----------------|-----------------|-----------------|
| Cash flow from operating activities: | | | |
| Net income | \$ 6,328 | \$ 6,093 | \$ 5,429 |
| Adjustments to reconcile net income to cash provided from operating activities: | | | |
| Depreciation | 4,475 | 4,018 | 3,676 |
| Amortization of software | 517 | 983 | 1,336 |
| Effect of restructuring charges | (355) | (445) | (1,491) |
| Deferred income taxes | (606) | 358 | 11 |
| Gain on disposition of fixed and other assets | (261) | (273) | (300) |
| Other changes that (used) provided cash: | | | |
| Receivables | (2,736) | (3,727) | (650) |
| Inventories | 73 | 432 | 196 |
| Other assets | 880 | (1,087) | (545) |
| Accounts payable | 362 | 699 | 319 |
| Other liabilities | 596 | 1,814 | 2,294 |
| Net cash provided from operating activities | 9,273 | 8,865 | 10,275 |
| Cash flow from investing activities: | | | |
| Payments for plant, rental machines and other property | (6,520) | (6,793) | (5,883) |
| Proceeds from disposition of plant, rental machines and other property | 905 | 1,130 | 1,314 |
| Acquisition of Tivoli Systems, Inc. | — | — | (716) |
| Investment in software | (250) | (314) | (295) |
| Purchases of marketable securities and other investments | (4,211) | (1,617) | (1,613) |
| Proceeds from marketable securities and other investments | 3,945 | 1,439 | 1,470 |
| Net cash used in investing activities | (6,131) | (6,155) | (5,723) |
| Cash flow from financing activities: | | | |
| Proceeds from new debt | 7,567 | 9,142 | 7,670 |
| Short-term borrowings less than 90 days—net | 499 | (668) | (919) |
| Payments to settle debt | (5,942) | (4,530) | (4,992) |
| Preferred stock transactions—net | (5) | (1) | — |
| Common stock transactions—net | (6,278) | (6,250) | (5,005) |
| Cash dividends paid | (834) | (783) | (706) |
| Net cash used in financing activities | (4,993) | (3,090) | (3,952) |
| Effect of exchange rate changes on cash and cash equivalents | 120 | (201) | (172) |
| Net change in cash and cash equivalents | (1,731) | (581) | 428 |
| Cash and cash equivalents at January 1 | 7,106 | 7,687 | 7,259 |
| Cash and cash equivalents at December 31 | \$ 5,375 | \$ 7,106 | \$ 7,687 |
| Supplemental data: | | | |
| Cash paid during the year for: | | | |
| Income taxes | \$ 1,929 | \$ 2,472 | \$ 2,229 |
| Interest | \$ 1,605 | \$ 1,475 | \$ 1,563 |

* Reclassified to conform to 1998 presentation.

The notes on pages 69 through 89 of the 1998 IBM Annual Report are an integral part of this statement.

A Significant Accounting Policies**Principles of Consolidation**

The consolidated financial statements include the accounts of International Business Machines Corporation and its controlled subsidiary companies, which are majority owned. Investments in business entities in which IBM 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.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions the company may undertake in the future, actual results ultimately may differ from the estimates.

Revenue**HARDWARE**

Revenue from hardware sales or sales-type leases is recognized when the product is shipped. Revenue from rentals and operating leases is recognized monthly as the fees accrue.

SERVICES

Revenue from time and material service contracts is recognized as the services are provided. Revenue from fixed price long-term service contracts is recognized over the contract term based on the percentage of services provided during the period compared to the total estimated services provided over the entire contract. Losses on fixed price 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. Revenue in excess of billings on service contracts are recorded as unbilled receivables and included in trade accounts receivable. Billings in excess of revenue recognized on service contracts are recorded as deferred income until the above revenue recognition criteria are met.

SOFTWARE

Revenue from one-time charge licensed software is recognized when the program is shipped, provided the company has vendor-specific objective evidence of the fair value of each element of the software offering. A deferral is recorded for post-contract customer support and any other future deliverables included within the contract arrangement. This deferral is earned over the support period or as contract elements are delivered. Revenue from monthly software licenses is recognized as license fees accrue.

FINANCING

Revenue from financing is recognized at level rates of return over the term of the lease or receivable.

Revenue for all categories is reduced for estimated customer returns, allowances and anticipated price actions.

Income Taxes

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the impact of temporary differences between assets and liabilities recognized for financial reporting purposes and such amounts recognized for income tax purposes. In accordance with Statement of Financial Accounting Standards (SFAS) 109, "Accounting for Income Taxes," these deferred taxes are measured by applying currently enacted tax laws.

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 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 and plant, rental machines 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 acquired. All other assets and liabilities are translated at year-end exchange rates. Inventories charged to cost of sales and depreciation are translated at historical exchange rates. All other income and expense items are translated at average rates of exchange prevailing during the year. Gains and losses that result from translation are included in net income.

Financial Instruments

In the normal course of business, the company uses a variety of derivative financial instruments for the purpose of currency exchange rate and interest rate risk management. In order to qualify for hedge accounting, the company requires that the derivative instruments used for risk management purposes effectively reduce the risk exposure that they are designed to hedge. For instruments associated with the hedge of anticipated transactions, hedge effectiveness criteria also require that the occurrence of the underlying transactions be probable. Instruments meeting these hedging criteria are formally designated as hedges at the inception of the contract. Those risk management instruments not meeting these criteria and considered ineffective as hedges are accounted for at fair

value with changes in fair value recognized immediately in net income. Refer to note M, "Financial Instruments," on pages 74 and 75 for descriptions of the major classes of derivative financial instruments used by the company, including the specific methods used to account for them.

In assessing the fair value of its financial instruments, both derivative and non-derivative, the company uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. Quoted market prices or dealer quotes for the same or similar instruments are used for the majority of marketable securities, long-term investments and long-term debt. Other techniques, such as option pricing models, estimated discounted value of future cash flows, replacement cost and termination cost, are used to determine fair value for the remaining financial instruments. These values represent a general approximation of possible value and may never actually be realized.

Cash Equivalents

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

Marketable Securities

Marketable securities included within current assets represent highly liquid securities with a maturity less than one year. The company's marketable securities 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.

Inventories

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

Depreciation

Plant, rental machines (computer equipment used internally or as part of managed operations contracts) 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 are generally as follows: buildings, 50 years; building equipment, 20 years; land improvements, 20 years; plant, laboratory and office equipment, 2 to 15 years; and computer equipment, 1.5 to 5 years.

Software

Costs related to the conceptual formulation and design of licensed programs are expensed as research and development. Costs incurred subsequent to establishment of technological feasibility to produce the finished product are capitalized. The annual amortization of the capitalized amounts is the greater of the amount computed based on the estimated revenue distribution over the products' revenue-producing lives, or the straight-line method, and is applied over periods ranging up to four years. Periodic reviews are performed to ensure that unamortized program costs remain recoverable from future revenue. Costs to support or service licensed programs are charged against income as incurred, or when related revenue is recognized, whichever occurs first.

Retirement Plans and Nonpension Postretirement Benefits

Current service costs of retirement plans and postretirement healthcare and life insurance benefits are accrued in the period. Prior service costs resulting from amendments to the plans are amortized over the average remaining service period of employees expected to receive benefits. Assuming thresholds established in SFAS 87, "Employers' Accounting for Pensions," are met, unrecognized net gains and losses are amortized to service cost over the average remaining service life of employees expected to receive benefits. See note W, "Retirement Plans," on page 81 through 83 and note X, "Nonpension Postretirement Benefits," on pages 83 and 84 for further discussion.

Goodwill

Goodwill is charged to net income on a straight-line basis over the periods estimated to be benefited, generally not exceeding five years. Reviews to evaluate recoverability of this goodwill are conducted periodically.

Common Stock

Common stock refers to the \$.50 par value capital stock as designated in the company's Certificate of Incorporation.

Earnings Per Share of Common Stock

Earnings per share of common stock is computed by dividing net income after deduction of preferred stock dividends by the weighted-average number of common shares outstanding for the period. Earnings per common share of stock—assuming dilution reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock which would then share in the net income of the company. See note T, "Earnings Per Share of Common Stock," on page 79 for further discussion.

B Accounting Changes**Standards Implemented**

The company implemented new accounting standards in 1998, 1997 and 1996. None of these standards had a material effect on the financial position or results of operations of the company.

Beginning with the first quarter of 1998, the company adopted SFAS 130, "Reporting Comprehensive Income," which established standards for reporting and displaying comprehensive income and its components. The disclosures required by SFAS 130 are presented in the Accumulated gains and losses not affecting retained earnings section in the Consolidated Statement of Stockholders' Equity on pages 66 and 67 and in note O, "Stockholders' Equity Activity," on pages 76 and 77.

Effective December 31, 1998, the company adopted SFAS 131, "Disclosures About Segments of an Enterprise and Related Information," which establishes standards for reporting operating segments and disclosures about products and services, geographic areas and major customers. See note Y, "Segment Information," on pages 84 through 89 for further information.

Effective December 31, 1998, the company adopted SFAS 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," which established expanded disclosures for defined benefit pension and postretirement benefit plans. See note W, "Retirement Plans," on pages 81 through 83 and note X, "Nonpension Postretirement Benefits" on pages 83 and 84 for the required disclosures.

On January 1, 1998, the company adopted the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, "Software Revenue Recognition." This SOP provides guidance on revenue recognition for software transactions. It requires deferral of some or all of the revenue related to a specific contract depending on the existence of vendor-specific objective evidence and the ability to allocate the total fee to all elements within the contract. The portion of the fee allocated to an element is recognized as revenue when all of the revenue recognition criteria have been met for that element.

In December 1997, the company implemented SFAS 128, "Earnings Per Share" (EPS). This standard prescribes the methods for calculating basic and diluted EPS and requires dual presentation of these amounts on the face of the earnings statement. No restatement of EPS, for either basic or diluted, was required for amounts reported previously in the company's filings with the U.S. Securities and Exchange Commission.

Effective January 1, 1997, the company implemented SFAS 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." This standard provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. The company was generally in compliance with this standard prior to adoption.

In 1996, the company adopted SOP 96-1, "Environmental Remediation Liabilities." This SOP provides guidance on the recognition, measurement, display and disclosure of environmental remediation liabilities. See note N, "Other Liabilities and Environmental," on page 76 for further information. The company was generally in compliance with this standard prior to adoption.

In 1996, the company implemented the disclosure-only provisions of SFAS 123, "Accounting for Stock-Based Compensation." See note V, "Stock-Based Compensation Plans," on pages 79 through 81 for further information.

New Standards to be Implemented

In June 1998, the Financial Accounting Standards Board issued SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards for derivative instruments. It requires an entity to recognize all derivatives as either assets or liabilities in the Statement of Financial Position and measure those instruments at fair value. Additionally, the fair value adjustments will impact either stockholders' equity or net income depending on whether the derivative instrument qualifies as a hedge and, if so, the nature of the hedging activity. The company will adopt this new standard as of January 1, 2000. Management does not expect the adoption to have a material impact on the company's results of operations, however, the impact on the company's financial position is dependent upon the fair values of the company's derivatives and related financial instruments at the date of adoption.

During 1998, the American Institute of Certified Public Accountants issued SOP 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The statement requires the capitalization of internal use computer software costs if certain criteria are met. The capitalized software costs will be amortized on a straight-line basis over the useful life of the software. The company will adopt the statement as of January 1, 1999. The adoption of the statement is not expected to have a material impact on the company's financial statements.

C Subsequent Events

Stock Split

On January 26, 1999, the IBM Board of Directors declared a two-for-one common stock split, subject to the approval of stockholders of an increase in the number of common shares authorized from 1,875 million to 4,687.5 million. The record date for the split will be on May 10, 1999, with distribution of the split shares expected to follow on May 26, 1999. Earnings per share calculations included in this report have not been restated to reflect this proposed stock split.

Debt Offering

On February 1, 1999, the company issued \$600 million of 5 3/8% notes due February 1, 2009. The net proceeds from the issuance of this debt will be used for general corporate purposes.

D Divestitures

In December 1998, IBM and AT&T announced that AT&T will acquire IBM's Global Network business for \$5 billion in cash. In addition, the two companies have agreed to enter into outsourcing contracts with each other. This subject is discussed further on pages 61 and 62 under the section entitled "Divestitures/Acquisitions" in the Management Discussion.

E Common Stock Split

On April 29, 1997, the stockholders of the company approved amendments to the Certificate of Incorporation to increase the number of authorized shares of common stock from 750 million to 1,875 million, which was required to effect a two-for-one stock split approved by the company's Board of Directors on January 28, 1997. In addition, the amendments served to reduce the par value of the common stock from \$1.25 to \$.50 per share. Stockholders of record at the close of business on May 9, 1997, received one additional share for each share held. All share and per share data prior to the second quarter of 1997 presented in the Consolidated Financial Statements and footnotes of this Annual Report reflect the two-for-one stock split.

F Inventories

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|-----------------------------------|-----------------|-----------------|
| Finished goods | \$ 1,088 | \$ 1,090 |
| Work in process and raw materials | 4,112 | 4,049 |
| Total | \$ 5,200 | \$ 5,139 |

G Plant, Rental Machines and Other Property

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|--|------------------|------------------|
| Land and land improvements | \$ 1,091 | \$ 1,117 |
| Buildings | 11,088 | 11,208 |
| Plant, laboratory and office equipment | 27,025 | 25,015 |
| | 39,204 | 37,340 |
| Less: Accumulated depreciation | 22,463 | 21,680 |
| | 16,741 | 15,660 |
| Rental machines | 5,666 | 4,793 |
| Less: Accumulated depreciation | 2,776 | 2,106 |
| | 2,890 | 2,687 |
| Total | \$ 19,631 | \$ 18,347 |

H Investments and Sundry Assets

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|--|------------------|------------------|
| Net investment in sales-type leases* | \$ 14,384 | \$ 13,733 |
| Less: Current portion—net | 6,510 | 5,720 |
| | 7,874 | 8,013 |
| Deferred taxes | 2,921 | 3,163 |
| Prepaid pension assets | 4,836 | 3,828 |
| Customer loan receivables— not yet due | 3,499 | 2,741 |
| Installment payment receivables | 1,087 | 977 |
| Alliance investments: | | |
| Equity method | 420 | 484 |
| Other | 138 | 236 |
| Goodwill, less accumulated amortization (1998, \$2,111; 1997, \$1,717) | 945 | 950 |
| Marketable securities—non-current | 281 | 295 |
| Other investments and sundry assets | 1,509 | 1,228 |
| Total | \$ 23,510 | \$ 21,915 |

* These leases relate principally to IBM equipment and are generally for terms ranging from three to five years. Net investment in sales-type leases includes unguaranteed residual values of approximately \$685 million and \$563 million at December 31, 1998 and 1997, respectively, and is reflected net of unearned income at those dates of approximately \$1,600 million for both years. Scheduled maturities of minimum lease payments outstanding at December 31, 1998, expressed as a percentage of the total, are approximately as follows: 1999, 48 percent; 2000, 31 percent; 2001, 15 percent; 2002, 5 percent; and 2003 and beyond, 1 percent.

I Lines of Credit

The company maintains a \$10.0 billion committed global credit facility. Unused committed lines of credit from this global facility amounted to \$8.8 billion and \$9.2 billion at December 31, 1998 and 1997, respectively. The company's other committed and uncommitted lines of credit amounted to \$5.2 billion at December 31, 1998 and 1997. The unused portion of those lines amounted to \$4.3 billion and \$3.9 billion at December 31, 1998 and 1997, respectively. Total unused lines of credit at December 31, 1998 and 1997, amounted to \$13.1 billion. Interest rates on borrowings vary from country to country depending on local market conditions.

J Sale and Securitization of Receivables

At year-end 1998 and 1997, the company had a net balance of \$0.9 billion in assets under management from the securitization of loans, leases and trade receivables. The company received total cash proceeds of approximately \$2.4 billion and \$3.0 billion in 1998 and 1997, respectively, from the sale and securitization of these receivables and assets. No material gain or loss resulted from these transactions. Recourse amounts associated with the aforementioned sale and securitization activities are expected to be minimal, and adequate reserves are in place to cover potential losses.

K Debt

Short-term debt

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|------------------------------------|------------------|------------------|
| Commercial paper | \$ 4,885 | \$ 4,583 |
| Short-term loans | 6,370 | 5,699 |
| Long-term debt: Current maturities | 2,650 | 2,948 |
| Total | \$ 13,905 | \$ 13,230 |

The weighted-average interest rates for commercial paper at December 31, 1998 and 1997, were approximately 5.7 percent and 5.8 percent, respectively. The weighted-average interest rates for short-term loans at December 31, 1998 and 1997, were approximately 5.3 percent and 5.5 percent, respectively.

Long-term debt

(Dollars in millions)

| At December 31: | Maturities | 1998 | 1997* |
|---|------------|------------------|------------------|
| U.S. Dollars: | | | |
| Debentures: | | | |
| 6.22% | 2027 | \$ 500 | \$ 500 |
| 6.5% | 2028 | 700 | — |
| 7.0% | 2025 | 600 | 600 |
| 7.0% | 2045 | 150 | 150 |
| 7.125% | 2096 | 850 | 850 |
| 7.5% | 2013 | 550 | 550 |
| 8.375% | 2019 | 750 | 750 |
| Notes: 6.7% average | 2000-2013 | 2,695 | 2,674 |
| Medium-term note | | | |
| program: 5.8% average | 1999-2013 | 4,885 | 4,472 |
| Other: 6.5% average | 1999-2012 | 1,514 | 1,319 |
| | | 13,194 | 11,865 |
| Other currencies | | | |
| (average interest rate at December 31, 1998, in parentheses): | | | |
| Japanese yen (3.1%) | 1999-2014 | 3,866 | 3,944 |
| Canadian dollars (5.7%) | 1999-2003 | 672 | 407 |
| German marks (4.9%) | 1999-2002 | 120 | 111 |
| Swiss francs (2.5%) | 2001 | 91 | 85 |
| U.K. pounds (7.9%) | 1999-2004 | 25 | 28 |
| Other (11.9%) | 1999-2026 | 221 | 235 |
| | | 18,189 | 16,675 |
| Less: Net unamortized discount | | | |
| | | 31 | 31 |
| | | 18,158 | 16,644 |
| Less: Current maturities | | | |
| | | 2,650 | 2,948 |
| Total | | \$ 15,508 | \$ 13,696 |

Annual maturities in millions of dollars on long-term debt outstanding at December 31, 1998, are as follows: 1999, \$2,650; 2000, \$5,120; 2001, \$1,491; 2002, \$1,676; 2003, \$1,116; 2004 and beyond, \$6,136.

* Reclassified to conform to 1998 presentation.

L Interest on Debt

Interest paid and accrued on borrowings of the company and its subsidiaries amounted to \$1,585 million in 1998, \$1,596 million in 1997 and \$1,565 million in 1996. Of these amounts, \$28 million in 1998, \$32 million in 1997 and \$31 million in 1996 were capitalized. The remainder was charged to the cost of rentals and financing in the amounts of \$844 million in 1998, \$836 million in 1997 and \$818 million in 1996, or interest expense in the amounts of \$713 million in 1998, \$728 million in 1997 and \$716 million in 1996. The decrease in total interest expense in 1998 versus 1997 was due primarily to lower average interest rates, partially offset by higher levels of debt. The increase in total interest expense in 1997 versus 1996 was primarily due to higher levels of debt, partially offset by lower interest rates. The average interest rate for total debt was 5.7 percent, 6.4 percent and 7.0 percent in 1998, 1997 and 1996, respectively. These rates include the results of currency and interest rate swaps applied to the debt described in note K, "Debt," on page 73.

M Financial Instruments

The company maintains portfolios of financial instruments both on- and off-balance sheet.

Financial Instruments On-Balance Sheet (excluding derivatives)

Financial assets with carrying values approximating fair value include cash and cash equivalents, marketable securities, notes and other accounts receivable and other investments. Financial liabilities with carrying values approximating fair value include accounts payable and other accrued expenses and liabilities, and short-term and long-term debt.

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

MARKETABLE SECURITIES AND OTHER INVESTMENTS

| (Dollars in millions) | Carrying Value | |
|---|----------------|---------------|
| | 1998 | 1997 |
| At December 31: | | |
| Current marketable securities: | | |
| U.S. government securities | \$ 15 | \$ 93 |
| Time deposits and other bank obligations | 335 | 181 |
| Non-U.S. government securities and other fixed-term obligations | 43 | 173 |
| Total | \$ 393 | \$ 447 |
| Marketable securities—non-current:* | | |
| U.S. government securities | \$ — | \$ 54 |
| Time deposits and other bank obligations | 271 | 183 |
| Non-U.S. government securities and other fixed-term obligations | 10 | 58 |
| Total | \$ 281 | \$ 295 |
| Other investments:* | | |
| Alliance investments—Other | \$ 138 | \$ 236 |

* Included within Investments and sundry assets on the Consolidated Statement of Financial Position (See note H on page 72).

Financial Instruments Off-Balance Sheet (excluding derivatives)

IBM has guaranteed certain loans and financial commitments of affiliates. The approximate amount of these financial guarantees were \$1,158 million and \$861 million at December 31, 1998 and 1997, respectively. Additionally, the company is responsible for fulfilling financial commitments associated with certain contracts to which it is a party. These commitments, which in the aggregate were approximately \$1,600 million and \$600 million at December 31, 1998 and 1997, respectively, are not expected to have a material adverse effect on the company's financial position or results of operations.

The company's dealers had unused lines of credit available from IBM for working capital financing of approximately \$3.6 billion and \$2.1 billion at December 31, 1998 and 1997, respectively.

Derivative Financial Instruments

The company has used derivative instruments as an element of its risk management strategy for many years. Although derivatives entail a risk of nonperformance by counterparties, the company manages this risk by establishing explicit dollar and term limitations that correspond to the credit rating of each carefully selected counterparty. The company has not sustained a material loss from these instruments nor does it anticipate any material adverse effect on its results of operations or financial position in the future.

The following table summarizes the notional value, carrying value and fair value of the company's derivative financial instruments on- and off-balance sheet. The notional value at

December 31 provides an indication of the extent of the company's involvement in such instruments at that time, but does not represent exposure to market risk.

| (Dollars in millions) | At December 31, 1998 | | | At December 31, 1997 | | |
|--------------------------------------|----------------------|-----------------|------------------|----------------------|----------------|----------------|
| | Notional Value | Carrying Value | Fair Value | Notional Value | Carrying Value | Fair Value |
| Interest rate and currency contracts | \$ 31,484 | \$ (485) | \$ (427) | \$ 24,774 | \$ 29 | \$ 84 |
| Option contracts | 9,021 | 67 | 45 | 14,211 | 41 | 193 |
| Total | \$ 40,505 | \$ (418) | \$ (382)* | \$ 38,985 | \$ 70 | \$ 277* |

Bracketed amounts are liabilities.

* The estimated fair value of derivatives both on- and off-balance sheet at December 31, 1998 and 1997, consists of assets of \$486 million and \$581 million and liabilities of \$868 million and \$304 million, respectively.

A significant portion of the company's derivative transactions relates to the matching of liabilities to assets associated with both its global financing business and its non-global financing business. The company issues debt, using the most efficient capital markets and products, which may result in a currency or interest rate mismatch with the underlying assets. Interest rate swaps or currency swaps are then used to match the interest rates and currencies of its debt to the related assets. These swap contracts principally mature within five years. Interest and currency rate differentials accruing under these interest rate and currency swap contracts are recognized over the life of the contracts in interest expense.

The company uses internal regional centers to manage the cash of its subsidiaries. These regional centers principally use currency swaps to convert cash flows in a cost-effective manner, predominantly for the company's European subsidiaries. The terms of the swaps are generally less than one year. The effects of these contracts are recognized over the life of the contract in interest expense.

The company also utilizes currency swaps and other foreign currency contracts in order to hedge the foreign currency exposures of certain of the company's net investments in foreign subsidiaries. The currency effects of these hedges are reflected in the Accumulated gains and losses not affecting retained earnings section of Stockholders' equity, offsetting a portion of the translation of net assets.

When the terms of an underlying instrument are modified, or if it ceases to exist, all changes in fair value of the swap contract are recognized in income each period until it matures.

Additionally, the company uses derivatives to limit its exposure to loss resulting from fluctuations in foreign currency exchange rates on anticipated cash transactions among foreign subsidiaries and the parent company. The company receives significant intracompany royalties and net payments for goods and services from its non-U.S. subsidiaries. In anticipation of these foreign currency flows, and given the volatility of the currency markets, the company selectively employs foreign currency options to manage the currency risk. The terms of these instruments are generally less than one year.

For purchased options that hedge qualifying anticipated transactions, gains and losses are deferred and recognized in net income in the same period that the underlying transaction occurs, expires or is otherwise terminated. At December 31, 1998 and 1997, there were no material deferred gains or losses. The premiums associated with entering into these option contracts are generally amortized over the life of the options and are not material to the company's results. Unamortized premiums are included in prepaid assets. For purchased options that hedge anticipated transactions which do not qualify for hedge accounting, gains and losses are recorded in net income as they occur on a mark-to-market basis. All written options are marked to market monthly and are not material to the company's results.

The company also enters into transactions to moderate the impact that an appreciation of the dollar relative to other currencies would have on the translation of foreign earnings. These transactions do not qualify as hedges for accounting purposes, and their foreign exchange gains and losses are recorded in net income as they occur.

N Other Liabilities and Environmental

Other liabilities consists principally of accruals for nonpension postretirement benefits for U.S. employees (\$6.6 billion) and nonpension postretirement benefits, indemnity and retirement plan reserves for non-U.S. employees (\$1.4 billion). More detailed discussion of these liabilities appears in note X, "Nonpension Postretirement Benefits," on pages 83 and 84, and note W, "Retirement Plans," on pages 81 through 83.

Also included are non-current liabilities associated with infrastructure reduction and restructuring actions taken in 1993 and prior. As a result, amounts representing postemployment preretirement accruals in the amount of \$793 million and \$681 million (net of sublease receipts) for accruals for leased space that the company has vacated are included.

The company employs extensive internal environmental protection programs that are primarily preventative in nature. The cost of these ongoing programs is recorded as incurred.

The company continues to participate in environmental assessments and cleanups at a number of locations, including operating facilities, previously owned facilities and Superfund sites. The company accrues for all known environmental liabilities for remediation costs when a cleanup program becomes probable and costs can be reasonably estimated. In addition, estimated environmental costs associated with post-closure activities, such as the removal and restoration of chemical storage facilities and monitoring, are accrued when the decision is made to close a facility. The total amounts accrued, which do not reflect any insurance recoveries, were \$238 million and \$243 million at December 31, 1998 and 1997, respectively.

The amounts accrued do not cover sites that are in the preliminary stages of investigation where neither the company's percentage of responsibility nor the extent of cleanup required has been identified. Estimated environmental costs are not expected to materially impact the financial position or results of the company's operations in future periods. However, environmental cleanup periods are protracted in length, and environmental costs in future periods are subject to changes in environmental remediation regulations.

O Stockholders' Equity Activity

Stock Repurchases

The Board of Directors from time to time has authorized the company to repurchase IBM common stock. The company repurchased 57,384,100 common shares at a cost of \$6.9 billion and 81,505,200 common shares at a cost of \$7.1 billion in 1998 and 1997, respectively. The repurchases resulted in a reduction of \$28,498,409 and \$34,388,668 in the stated capital (par value) associated with common stock in 1998 and 1997, respectively. In 1997, 10 million repurchased shares were used to establish the Employee Benefits Trust (see below). In 1998 and 1997, 387,282 and 2,727,864 shares, respectively, were issued as a result of acquisitions. The rest of the repurchased shares were retired and restored to the status of authorized but unissued shares. At December 31, 1998, approximately \$2.8 billion of Board authorization for repurchases remained. The company plans to purchase shares on the open market from time to time, depending on market conditions.

In 1995, the IBM Board of Directors authorized the company to purchase all of its outstanding Series A 7 1/2 percent preferred stock. During 1998 and 1997, the company repurchased 51,250 shares at a cost of \$5.5 million and 13,450 shares at a cost of \$1.4 million, respectively. This resulted in a \$512.50 and \$134.50 (\$.01 par value per share) reduction in the stated capital associated with preferred stock as of December 31, 1998 and 1997, respectively. The repurchased shares were retired and restored to the status of authorized but unissued shares. The company plans to purchase remaining shares on the open market and in private transactions from time to time, depending on market conditions.

Employee Benefits Trust

Effective November 1, 1997, the company created an employee benefits trust to which the company contributed 10 million shares of treasury stock. The company is authorized to instruct the trustee to sell shares from time to time and to use proceeds from such sales, and any dividends paid on such contributed stock, toward the partial satisfaction of the company's future obligations under certain of its compensation and benefits plans, including its retiree medical plans. The shares held in trust are not considered outstanding for earnings per share purposes until they are committed to be released. The shares will be voted by the trustee in accordance with its fiduciary duties. As of December 31, 1998 and 1997, no shares have been committed to be released.

At December 31, 1998, the company adjusted its valuation of the employee benefits trust to fair value. This adjustment solely impacted line items within stockholders' equity and did not affect total stockholders' equity or net income.

Accumulated Gains and Losses Not Affecting Retained Earnings

| (Dollars in millions) | Foreign Currency Items (Net of Tax) | Net Unrealized Gains (Losses) on Marketable Securities (Net of Tax) | Total Gains and Losses Not Affecting Retained Earnings (Net of Tax) |
|------------------------------------|--|--|--|
| Beginning balance, January 1, 1996 | \$ 3,036 | \$ 57 | \$ 3,093 |
| Change for period | (635) | 111 | (524) |
| Ending balance, December 31, 1996 | 2,401 | 168 | 2,569 |
| Change for period | (1,610) | (60) | (1,670) |
| Ending balance, December 31, 1997 | 791 | 108 | 899 |
| Change for period | 69 | (57) | 12 |
| Ending balance, December 31, 1998 | \$ 860 | \$ 51 | \$ 911 |

**NET CHANGE IN UNREALIZED GAINS (LOSSES) ON
MARKETABLE SECURITIES (NET OF TAX)**

| (Dollars in millions) | 1998 |
|---------------------------------------|---------|
| For the year ended December 31: | |
| Unrealized gains | |
| arising during the period, net of tax | \$ 99 |
| Less gains included in net income | |
| for the period, net of tax | 156 |
| Net decrease in unrealized gains | |
| on marketable securities, net of tax | \$ (57) |

P Contingencies

The company is subject to a variety of claims and suits that arise from time to time out of the ordinary course of its business, including actions with respect to contracts, intellectual property, product liability and environmental matters. The company does not believe that any such current action will have a material impact on the company's business, financial condition or results of operations.

On February 25, 1993, a class action complaint was filed against the company in the United States District Court for the Southern District of New York alleging, among other matters, that the company disseminated false and misleading statements concerning its financial condition and dividends during certain periods of 1992. On February 3, 1997, Judge Rakoff issued an order granting the company's motion for summary judgment in this case in its entirety. Plaintiffs filed an appeal and on November 17, 1998, the Second Circuit Court of Appeals upheld Judge Rakoff's decision for the company.

Q Taxes

| (Dollars in millions) | 1998 | 1997 | 1996 |
|---------------------------------|----------|----------|----------|
| For the year ended December 31: | | | |
| Income before income taxes: | | | |
| U.S. operations | \$ 2,960 | \$ 3,193 | \$ 3,025 |
| Non-U.S. operations | 6,080 | 5,834 | 5,562 |
| | \$ 9,040 | \$ 9,027 | \$ 8,587 |

The provision for income taxes by geographic operations is as follows:

| | | | |
|----------------------------------|----------|----------|----------|
| U.S. operations | \$ 991 | \$ 974 | \$ 1,137 |
| Non-U.S. operations | 1,721 | 1,960 | 2,021 |
| Total provision for income taxes | \$ 2,712 | \$ 2,934 | \$ 3,158 |

The components of the provision for income taxes by taxing jurisdiction are as follows:

| | | | |
|---|----------|----------|----------|
| U.S. federal: | | | |
| Current | \$ 1,117 | \$ 163 | \$ 727 |
| Deferred | (475) | 349 | 83 |
| | 642 | 512 | 810 |
| U.S. state and local: | | | |
| Current | 139 | 83 | 158 |
| Deferred | (260) | (87) | (353) |
| | (121) | (4) | (195) |
| Non-U.S.: | | | |
| Current | 2,062 | 2,330 | 2,262 |
| Deferred | 129 | 96 | 281 |
| | 2,191 | 2,426 | 2,543 |
| Total provision for income taxes | 2,712 | 2,934 | 3,158 |
| Provision for social security, real estate, personal property and other taxes | 2,859 | 2,774 | 2,584 |
| Total provision for taxes | \$ 5,571 | \$ 5,708 | \$ 5,742 |

The effect of tax law changes on deferred tax assets and liabilities did not have a significant impact on the company's effective tax rate.

The significant components of activities that gave rise to deferred tax assets and liabilities included on the balance sheet were as follows:

DEFERRED TAX ASSETS

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|---|-----------|-----------|
| Employee benefits | \$ 3,909 | \$ 3,707 |
| Bad debt, inventory and warranty reserves | 1,249 | 1,027 |
| Alternative minimum tax credits | 1,169 | 1,092 |
| Capitalized research and development | 913 | 1,196 |
| Restructuring charges | 863 | 1,163 |
| Deferred income | 686 | 893 |
| General business credits | 555 | 492 |
| Equity alliances | 387 | 378 |
| Foreign tax loss carryforwards | 304 | 202 |
| State and local tax loss carryforwards | 212 | 203 |
| Depreciation | 201 | 132 |
| Intracompany sales and services | 182 | 235 |
| Other | 2,614 | 2,507 |
| Gross deferred tax assets | 13,244 | 13,227 |
| Less: Valuation allowance | 488 | 2,163 |
| Net deferred tax assets | \$ 12,756 | \$ 11,064 |

DEFERRED TAX LIABILITIES

(Dollars in millions)

| At December 31: | 1998 | 1997 |
|--------------------------------|----------|----------|
| Sales-type leases | \$ 3,433 | \$ 3,147 |
| Retirement benefits | 2,775 | 2,147 |
| Depreciation | 1,505 | 1,556 |
| Software costs deferred | 287 | 420 |
| Other | 1,841 | 1,413 |
| Gross deferred tax liabilities | \$ 9,841 | \$ 8,683 |

As part of implementing its global strategies involving the relocation of certain of its manufacturing operations, the company transferred certain intellectual property rights to several non-U.S. subsidiaries in December 1998. Since these strategies, including this transfer, result in the anticipated utilization of U.S. federal tax credit carryforwards, the company reduced the valuation allowance from that previously required. The valuation allowance at December 31, 1998, 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 utilize them.

A reconciliation of the company's effective tax rate to the statutory U.S. federal tax rate is as follows:

| For the year ended December 31: | 1998 | 1997 | 1996 |
|--|------|------|------|
| Statutory rate | 35% | 35% | 35% |
| Foreign tax differential | (6) | (3) | 2 |
| State and local | 1 | 1 | 1 |
| U.S. valuation allowance related items | (1) | — | (6) |
| Other | 1 | — | 5 |
| Effective rate | 30% | 33% | 37% |

For tax return purposes, the company has available tax credit carryforwards of approximately \$2,067 million, of which \$1,169 million have an indefinite carryforward period, \$184 million expire in 1999 and the remainder thereafter. The company also has state and local and foreign tax loss carryforwards, the tax effect of which is \$516 million. Most of these carryforwards are available for 10 years or have an indefinite carryforward period.

Undistributed earnings of non-U.S. subsidiaries included in consolidated retained earnings amounted to \$13,165 million at December 31, 1998, \$12,511 million at December 31, 1997, and \$12,111 million at December 31, 1996. 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.

R Selling and Advertising

Selling and advertising expense is charged against income as incurred. Advertising expense, which includes media, agency and promotional expenses, amounted to \$1,681 million, \$1,708 million and \$1,569 million in 1998, 1997 and 1996, respectively.

S Research, Development and Engineering

Research, development and engineering expense amounted to \$5,046 million in 1998, \$4,877 million in 1997 and \$5,089 million in 1996. Expenditures for product-related engineering included in these amounts were \$580 million, \$570 million and \$720 million in 1998, 1997 and 1996, respectively.

Expenditures of \$4,466 million in 1998, \$4,307 million in 1997 and \$4,369 million in 1996 were made for research and development activities covering 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 activities were \$2,086 million, \$2,016 million and \$2,161 million in 1998, 1997 and 1996, respectively. Included in the 1996 expenditures is \$435 million of purchased in-process research and development expense relating to the Tivoli and Object Technology International, Inc. acquisitions.

T Earnings Per Share of Common Stock

The following table sets forth the computation of basic and diluted earnings per share.

| For the year ended December 31: | 1998 | 1997 | 1996 |
|--|--------------------|----------------------|----------------------|
| Number of shares on which basic earnings per share is calculated: | | | |
| Average outstanding during year | 934,502,785 | 983,286,361 | 1,056,704,188 |
| Add—Incremental shares under stock compensation plans | 25,562,450 | 27,648,581 | 23,004,716 |
| Number of shares on which diluted earnings per share is calculated | 960,065,235 | 1,010,934,942 | 1,079,708,904 |
| Net income (millions) | \$ 6,328 | \$ 6,093 | \$ 5,429 |
| Less—Preferred stock dividends (millions) | 20 | 20 | 20 |
| Net income on which basic and diluted earnings per share are calculated (millions) | \$ 6,308 | \$ 6,073 | \$ 5,409 |
| Basic earnings per share | \$ 6.75 | \$ 6.18 | \$ 5.12 |
| Diluted earnings per share | \$ 6.57 | \$ 6.01 | \$ 5.01 |

Stock options to purchase 2,062,365 shares in 1998, 165,833 shares in 1997 and 784,141 shares in 1996 were outstanding, but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares, and therefore, the

effect would be antidilutive. In addition, 2,565,519 restricted stock units in 1998 relating to the company's Long-Term Performance Plan were not included in the computation of diluted earnings as their effect would be antidilutive.

U Rental Expense and Lease Commitments

Rental expense, including amounts charged to inventories and fixed assets and excluding amounts previously reserved, was \$1,431 million in 1998, \$1,280 million in 1997 and \$1,210 million in 1996. The table below depicts gross minimum rental commitments under noncancelable leases, amounts related to vacant space that the company has reserved and sublease income commitments. These amounts generally reflect activities related to office space and manufacturing equipment.

| (Dollars in millions) | 1999 | 2000 | 2001 | 2002 | 2003 | Beyond 2003 |
|-----------------------------|-----------------|-----------------|-----------------|---------------|---------------|-----------------|
| Gross rental commitments | \$ 1,398 | \$ 1,242 | \$ 1,085 | \$ 877 | \$ 623 | \$ 1,417 |
| Vacant space | 205 | 188 | 150 | 98 | 59 | 222 |
| Sublease income commitments | 165 | 140 | 122 | 64 | 35 | 66 |

V Stock-Based Compensation Plans

The company applies Accounting Principles Board (APB) Opinion No. 25 and related Interpretations in accounting for its stock-based compensation plans. A description of the terms of the company's stock-based compensation plans follows:

Long-Term Performance Plan

Incentive awards are provided to officers and other key employees under the terms of the IBM 1997 Long-Term Performance Plan, which was approved by stockholders in April 1997, and its predecessor plan, the 1994 Long-Term Performance Plan ("the Plans"). The Plans 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 may include stock options, stock appreciation rights, restricted stock, cash or stock awards, or any combination thereof. The number of shares that may be issued under the IBM 1997 Long-Term Performance Plan for awards is 50.3 million, which was 5 percent of the outstanding common stock on February 10, 1997. There were 34.3 million and 46.4 million unused shares available for granting under the IBM 1997 Long-Term Performance Plan as of December 31, 1998 and 1997, respectively, and approximately 2.0 and 9.0 million shares available for granting under the 1994 Long-Term Performance Plan at December 31, 1998 and 1997, respectively.

These awards, which are expressed in terms of shares, are adjusted to fair value at the end of each period and the change in value is included in net income. Awards under the Plans resulted in compensation expense of \$322.4 million, \$214.1 million and \$203.9 million in 1998, 1997 and 1996, respectively.

Stock Option Grants

Stock options granted under the Plans allow the purchase of the company's common stock at 100 percent of the market price on the date of grant and generally expire 10 years from the date of grant. The following tables summarize option activity of the Plans during 1998, 1997 and 1996:

| | 1998 | | 1997 | | 1996 | |
|----------------------------|--------------------------|----------------------------|--------------------------|----------------------------|--------------------------|----------------------------|
| | Wtd. Avg. Exercise Price | No. of Shares under Option | Wtd. Avg. Exercise Price | No. of Shares under Option | Wtd. Avg. Exercise Price | No. of Shares under Option |
| Balance at January 1 | \$ 54 | 61,728,361 | \$ 44 | 61,435,322 | \$ 39 | 68,565,806 |
| Options granted | 107 | 20,587,675 | 71 | 21,471,228 | 63 | 15,359,058 |
| Options exercised | 44 | (14,816,738) | 42 | (19,630,005) | 36 | (19,302,622) |
| Options terminated | 71 | (1,777,373) | 56 | (1,548,184) | 61 | (3,186,920) |
| Balance at December 31 | \$ 72 | 65,721,925 | \$ 54 | 61,728,361 | \$ 44 | 61,435,322 |
| Exercisable at December 31 | \$ 44 | 23,095,818 | \$ 38 | 26,619,548 | \$ 41 | 30,603,845 |

The shares under option at December 31, 1998, were in the following exercise price ranges:

| Exercise Price Range | Options Outstanding | | | Options Currently Exercisable | |
|----------------------|---------------------|--------------------------|---------------------------------------|-------------------------------|--------------------------|
| | No. of Options | Wtd. Avg. Exercise Price | Wtd. Avg. Contractual Life (in years) | No. of Options | Wtd. Avg. Exercise Price |
| \$21 – 50 | 16,708,124 | \$ 32 | 5 | 15,137,952 | \$ 32 |
| \$51 – 80 | 26,369,118 | 68 | 7 | 7,463,820 | 66 |
| \$81 – 110 | 20,024,496 | 103 | 9 | 491,047 | 103 |
| \$111 and over | 2,620,187 | 138 | 10 | 2,999 | 112 |
| | 65,721,925 | \$ 72 | | 23,095,818 | \$ 44 |

IBM Employees Stock Purchase Plan

The IBM Employees Stock Purchase Plan (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. The price an employee pays is 85 percent of the average market price on the last day of an applicable pay period.

During 1998, 1997 and 1996, employees purchased 3,993,372, 4,676,980 and 6,461,856 shares, all of which were treasury shares, for which \$415 million, \$354 million and \$324 million were paid to the company, respectively.

There were approximately 31.5 million, 35.5 million and 40.2 million reserved unissued shares available for purchase under the ESPP, as previously approved by stockholders, at December 31, 1998, 1997 and 1996, respectively.

Pro Forma Disclosure

In applying APB Opinion No. 25, no expense was recognized for stock options granted under the Plan or for employee stock purchases under the ESPP. SFAS 123 requires that a fair market value of all awards of stock-based compensation be determined using standard techniques and that pro forma net income and earnings per share be disclosed as if the resulting stock-based compensation amounts were recorded in the Consolidated Statement of Earnings. The table below depicts the effects of SFAS 123.

| (Dollars in millions except per share amounts) | 1998 | | 1997 | | 1996 | |
|--|-------------|-----------|-------------|-----------|-------------|-----------|
| | As reported | Pro forma | As reported | Pro forma | As reported | Pro forma |
| Net income applicable to common shareholders | \$ 6,308 | \$ 5,985 | \$ 6,073 | \$ 5,866 | \$ 5,409 | \$ 5,267 |
| Earnings per share of common stock—basic | \$ 6.75 | \$ 6.40 | \$ 6.18 | \$ 5.97 | \$ 5.12 | \$ 4.98 |
| Earnings per share of common stock—assuming dilution | \$ 6.57 | \$ 6.24 | \$ 6.01 | \$ 5.82 | \$ 5.01 | \$ 4.89 |

The pro forma amounts, for purposes of SFAS 123, reflect the portion of the estimated fair value of awards earned in 1998, 1997 and 1996. The aggregate fair value of awards granted is earned ratably over the vesting or service period and is greater than that included in the pro forma amounts.

The company used the Black-Scholes model to value the stock options granted in 1998, 1997 and 1996. The weighted-average assumptions used to estimate the value of the options included in the pro forma amounts, and the weighted-average estimated fair value of an option granted are as follows:

| | 1998 | 1997 | 1996 |
|--|-------|-------|-------|
| Term (years)* | 5/6 | 5/6 | 5/6 |
| Volatility** | 26.4% | 23.0% | 22.0% |
| Risk-free interest rate (zero coupon U.S. treasury note) | 5.1% | 6.2% | 6.0% |
| Dividend yield | 0.8% | 1.0% | 1.2% |
| Weighted-average fair value of options | \$ 36 | \$ 25 | \$ 20 |

* Option term is based on tax incentive options (5 years) and non-tax incentive options (6 years).
 **To determine volatility, the company measured the daily price changes of the stock over the most recent 5 and 6 year periods.

W Retirement Plans

The company and its subsidiaries have defined benefit and defined contribution retirement plans covering substantially all regular employees, and a supplemental retirement plan that covers certain executives.

The changes in the benefit obligations and plan assets of the U.S. and material non-U.S. defined benefit plans for 1998 and 1997 were as follows:

| (Dollars in millions) | U.S. Plan | | Non-U.S. Plans | |
|---|-----------|-----------|----------------|-----------|
| | 1998 | 1997* | 1998 | 1997* |
| Change in benefit obligation: | | | | |
| Benefit obligation at beginning of year | \$ 33,161 | \$ 29,729 | \$ 18,846 | \$ 19,883 |
| Service cost | 532 | 397 | 399 | 366 |
| Interest cost | 2,261 | 2,215 | 1,213 | 1,182 |
| Plan participants' contributions | — | — | 29 | 33 |
| Acquisitions/divestitures, net | 22 | (2) | — | 129 |
| Amendments | — | 14 | 2 | — |
| Actuarial losses | 2,729 | 2,805 | 1,331 | 431 |
| Benefits paid from trust | (2,144) | (1,997) | (683) | (623) |
| Direct benefit payments | — | — | (254) | (281) |
| Foreign exchange impact | — | — | 1,155 | (2,186) |
| Plan curtailments/settlements/termination benefits | — | — | 10 | (88) |
| Benefit obligation at end of year | 36,561 | 33,161 | 22,048 | 18,846 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year | 38,475 | 34,281 | 21,841 | 21,039 |
| Actual return on plan assets | 5,240 | 6,193 | 2,400 | 3,454 |
| Employer contribution | — | — | 452 | 192 |
| Acquisitions/divestitures, net | 22 | (2) | — | 129 |
| Plan participants' contributions | — | — | 29 | 33 |
| Benefits paid from trust | (2,144) | (1,997) | (683) | (623) |
| Foreign exchange impact | — | — | 1,283 | (2,263) |
| Settlements | — | — | (28) | (120) |
| Fair value of plan assets at end of year | 41,593 | 38,475 | 25,294 | 21,841 |
| Fair value of plan assets in excess | | | | |
| of benefit obligation | 5,032 | 5,314 | 3,246 | 2,995 |
| Unrecognized net actuarial gains | (1,289) | (1,901) | (2,342) | (2,897) |
| Unrecognized prior service costs | 174 | 190 | 181 | 194 |
| Unrecognized net transition asset | (771) | (911) | (78) | (83) |
| Adjustment to recognize minimum liability | — | — | (87) | (3) |
| Prepaid pension asset recognized | | | | |
| in the Consolidated Statement of Financial Position | \$ 3,146 | \$ 2,692 | \$ 920 | \$ 206 |

* Reclassified to conform to 1998 presentation.

U.S. Plan: U.S. regular, full-time and part-time employees are covered by a noncontributory plan that is funded by company contributions to an irrevocable trust fund, which is held for the sole benefit of employees. Under a new formula, which is being phased in over five years, retirement benefits will be determined based on points accumulated for each year worked and final average compensation period. To preserve benefits of employees close to retirement, service and earnings credit will continue to accrue under the prior formula through the year 2000, and upon retirement, these employees will receive the benefit from either the new or prior formulas, whichever is higher. Benefits become vested upon the completion of five years of service. The number of individuals receiving benefits at December 31, 1998 and 1997, was 116,685 and 108,415, respectively.

Non-U.S. Plans: Most subsidiaries and branches outside the U.S. have retirement plans covering substantially all regular employees, under which funds are deposited under various

fiduciary-type arrangements, annuities are purchased under group contracts or reserves are provided. Retirement benefits are based on years of service and the employee's compensation, generally during a fixed number of years immediately prior to retirement. The ranges of assumptions used for the non-U.S. plans reflect the different economic environments within various countries.

U.S. Supplemental Executive Retirement Plan: The company also has a non-qualified U.S. Supplemental Executive Retirement Plan (SERP). The SERP, which is unfunded, provides eligible executives defined pension benefits outside the IBM Retirement Plan, based on average earnings, years of service and age at retirement. At December 31, 1998 and 1997, the projected benefit obligation was \$178 million and \$128 million, respectively, and the amounts included in the Consolidated Statement of Financial Position were pension liabilities of \$81 million and \$56 million, respectively.

WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:

| | U.S. Plan | | | Non-U.S. Plan | | |
|--------------------------------|-----------|------|-------|---------------|------------|-------------|
| | 1998 | 1997 | 1996 | 1998 | 1997 | 1996 |
| Discount rate | 6.5% | 7.0% | 7.75% | 4.5 – 7.5% | 4.5 – 7.5% | 4.5 – 8.5% |
| Expected return on plan assets | 9.5% | 9.5% | 9.25% | 6.5 – 10.0% | 6.0 – 9.5% | 6.5 – 10.0% |
| Rate of compensation increase | 5.0% | 5.0% | 5.0% | 2.7 – 6.1% | 2.6 – 6.1% | 2.3 – 6.5% |

The cost of the defined benefit plans for 1998, 1997 and 1996 was as follows:

| (Dollars in millions) | U.S. Plan | | | Non-U.S. Plan | | |
|---|-----------|----------|----------|---------------|---------|---------|
| | 1998 | 1997* | 1996* | 1998 | 1997* | 1996* |
| Service cost | \$ 532 | \$ 397 | \$ 412 | \$ 399 | \$ 366 | \$ 384 |
| Interest cost | 2,261 | 2,215 | 2,125 | 1,213 | 1,182 | 1,302 |
| Expected return on plan assets | (3,123) | (2,907) | (2,701) | (1,739) | (1,457) | (1,485) |
| Net amortization | (124) | (125) | (121) | 21 | 15 | 27 |
| Settlement losses/(gains) | — | — | — | 10 | (63) | (102) |
| Net periodic pension cost (benefit)—U.S. Plan and material non-U.S. Plans | \$ (454) | \$ (420) | \$ (285) | \$ (96) | \$ 43 | \$ 126 |
| Total net periodic pension cost (benefit) for all non-U.S. plans | | | | \$ (42) | \$ 50 | \$ 148 |

* Reclassified to conform to 1998 presentation.

| | | | | | | |
|---|--------|--------|--------|-------|-------|-------|
| Cost of defined contribution plans | \$ 258 | \$ 236 | \$ 209 | \$ 90 | \$ 64 | \$ 29 |
| Cost of complementary defined benefits | \$ 34 | \$ 33 | \$ 27 | | | |
| Cost of U.S. supplemental executive retirement plan | \$ 25 | \$ 20 | \$ 19 | | | |

Net periodic pension cost is determined using the Projected Unit Credit actuarial method.

The effects on the company's results of operations and financial position from changes in the estimates and assumptions used in computing pension and prepaid pension assets or pension liability is mitigated by the delayed recognition provisions of SFAS 87, with the exception of the effects of settlement gains, curtailment losses and early terminations, which are recognized immediately. The 0.5% decrease in the discount rate in 1998 resulted in an actuarial loss of \$2,144 million for the U.S. plan. The 0.75% decrease in the discount rate in 1997 resulted in an actuarial loss of \$2,723 million for the U.S. plan.

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 with regard to local tax laws. Additional amounts are contributed from time to time when deemed appropriate by the company. Liabilities for amounts in excess of these funding levels are accrued and reported in the company's Consolidated Statement of Financial Position. The assets of the various plans include corporate equities, government securities, corporate debt securities and real estate.

At December 31, 1998, the material non-U.S. defined benefit plans in which the plan assets exceeded the benefit obligation had obligations of \$18,217 million and assets of \$21,736 million. The material non-U.S. defined benefit plans in which the benefit obligation exceeded the fair value of plan assets had obligations of \$3,831 million and assets of \$3,558 million.

At December 31, 1997, the material non-U.S. defined benefit plans in which the plan assets exceeded the benefit obligation had obligations of \$18,322 million and assets of \$21,391 million. The material non-U.S. defined benefit plans in which the benefit obligation exceeded the fair value of plan assets had obligations of \$524 million and assets of \$450 million.

X Nonpension Postretirement Benefits

The company and its U.S. subsidiaries have defined benefit postretirement plans that provide medical, dental and life insurance for retirees and eligible dependents. Plan cost maximums for those who retired prior to January 1, 1992, will take effect beginning with the year 2001. Plan cost maximums for all other employees take effect upon retirement.

The changes in the benefit obligation and plan assets of the U.S. plans for 1998 and 1997 are as follows:

| (Dollars in millions) | 1998 | 1997* |
|---|--------------|--------------|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | \$ 6,384 | \$ 6,453 |
| Service cost | 42 | 32 |
| Interest cost | 427 | 455 |
| Amendments | (26) | (290) |
| Actuarial gains | (146) | (234) |
| Actuarial losses | 272 | 435 |
| Benefits paid from trust | (486) | (455) |
| Direct benefit payments | (10) | (12) |
| Benefit obligation at end of year | 6,457 | 6,384 |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | 120 | 559 |
| Actual return on plan assets | 10 | 16 |
| Employer contributions | 479 | — |
| Benefits paid, net of employee contributions | (486) | (455) |
| Fair value of plan assets at end of year | 123 | 120 |
| Benefit obligation in excess of plan assets | | |
| | (6,334) | (6,264) |
| Unrecognized net actuarial losses | 700 | 578 |
| Unrecognized prior service cost | (965) | (1,073) |
| Accrued postretirement benefit liability recognized in the Consolidated Statement of Financial Position | | |
| | \$ (6,599) | \$ (6,759) |

* Reclassified to conform to 1998 presentation.

The benefit obligation was determined by application of 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 included a projected healthcare cost trend rate of 6 percent.

The net periodic postretirement benefit cost for the U.S. plan for the years ended December 31 included the following components:

| (Dollars in millions) | 1998 | 1997 | 1996 |
|--|--------|--------|--------|
| Service cost | \$ 42 | \$ 32 | \$ 43 |
| Interest cost | 427 | 455 | 478 |
| Expected return on plan assets | (5) | (15) | (68) |
| Net amortization and deferral | (133) | (119) | (87) |
| Net periodic postretirement benefit cost | \$ 331 | \$ 353 | \$ 366 |

WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:

| | | | |
|--------------------------------|------|------|-------|
| Discount rate | 6.5% | 7.0% | 7.75% |
| Expected return on plan assets | 5.0% | 5.0% | 9.25% |

The assets of the plan are comprised of short-term fixed income investments. 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 obligations and cost of these programs are not significant to the company.

A one percentage-point change in the assumed healthcare cost trend rate would have the following effects as of December 31, 1998:

| (Dollars in millions) | One Percentage Point Increase | One Percentage Point Decrease |
|---|-------------------------------|-------------------------------|
| Effect on total service and interest cost | \$ 4 | \$ (6) |
| Effect on postretirement benefit obligation | \$ 87 | \$ (122) |

Y Segment Information

IBM is in the business of providing customer solutions through the use of advanced information technology. The company operates primarily in a single industry utilizing 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.

Organizationally, the company's major operations consist of three hardware product segments—Technology, Personal Systems and Server; a Global Services segment; a Software segment; a Global Financing segment and a series of Enterprise Investments. The product segments are determined based on several factors including customer base, homogeneity of products, technology, delivery channels and other factors.

The Technology segment produces peripheral equipment for use in general purpose computer systems including storage and networking devices, advanced function printers and display devices. In addition, the segment provides components such as semiconductors and hard disk drives for use in the company's products and for sale to original equipment manufacturers (OEM). Major business units include Storage Systems, Microelectronics, Printer Systems and Networking Hardware.

The Personal Systems segment produces general purpose computer systems, including some system and consumer software, that operate applications for use by one user at a time (personal computer clients), or as servers, and display devices. Major brands include the Aptiva home PC's, IntelliStation workstations, Netfinity servers, PC 300 commercial desktop and ThinkPad mobile systems. Consumer software brands include Crayola, Edmark and World Book Multimedia Encyclopedia. These products are sold primarily through reseller and retail channels.

The Server segment produces powerful multi-purpose computer systems that operate many open-network based applications and are used primarily by multiple users at the same time. They perform high-volume transaction processing and serve data to personal systems and other end-user devices. The servers are the engines behind the bulk of electronic business transactions, including e-commerce. Major brands include S/390, AS/400 and RS/6000. The segment's products are sold directly by the company and through business partner relationships.

The Global Services segment is the world's largest and most versatile information technology services provider, supporting computer hardware and software products, and providing professional services to help customers of all sizes realize the full value of information technology (IT). The segment provides its customers with services that include business and IT consulting, business transformational services like an ERP solution, e-business services and full scope services like strategic outsourcing or Total Systems Management services. The Global Services segment is uniquely suited to integrate the full range of the company's capabilities, including hardware, software and research.

The Software segment delivers operating systems for the company's servers and middleware for IBM and non-IBM platforms. Middleware includes application development, data management, networking, systems management, transaction processing, and messaging and collaboration. In addition to its own development, product and marketing effort, the segment supports more than 29,000 independent software vendors to ensure that the company's software and hardware offerings are included in those partners' solutions.

The Global Financing segment provides and facilitates a broad array of financing services for the company, its customers and its business partners. The primary focus is to leverage its financial structuring, portfolio management and partnering skills to expand the company's customer and partner base.

Enterprise Investments segment provides a spectrum of initiatives in information technology solutions, supporting the hardware, software and services segments of the company. The segment develops unique products designed to meet specific marketplace requirements and to complement the company's overall portfolio of products.

Segment revenue and pre-tax income include transactions between the segments which are intended to reflect an arm's-length transfer at the best price available for comparable external customers. Specifically, semiconductors and disk drives are sourced internally from the Technology segment for use in the manufacture of the Server segment and Personal Systems segment products. Technology, hardware and software used by the Global Services segment in outsourcing

engagements are sourced internally from the Technology, Server, Personal Systems and Software segments. For the internal use of information technology 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 outsourcing engagements. All internal transaction prices are reviewed and reset annually if appropriate.

The company extensively utilizes shared-staff concepts in order to realize economies of scale and efficient use of resources. As such, a significant 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., Human Resources costs are allocated on headcount while account coverage expenses are allocated on a revenue mix that reflects the company's sales commission plan. When a clear and measurable driver cannot be identified, shared expenses are allocated based on a financial basis consistent with the company's management system, e.g., image advertising is allocated based on the gross profit of the segments. The unallocated corporate expenses primarily relate to expense arising from certain acquisitions, indirect infrastructure reductions and currency exchange gains and losses recorded in net income which are not allocated to the segments.

The following tables reflect the results of the segments consistent with the company's management system. These results are not necessarily a depiction that is in conformity with generally accepted accounting principles, e.g., employee retirement plan costs are developed using actuarial assumptions on a country-by-country basis and allocated to the segments on headcount. A different result could be arrived at for any segment if actuarial assumptions unique to each segment were used. Performance measurement is based on income before income taxes (pre-tax income). These results are used, in part, by management, both in evaluating the performance of, and in allocating resources to, each of the segments.

MANAGEMENT SYSTEM SEGMENT VIEW

| (Dollars in millions) | Hardware Segments | | | Global Services | Software | Global Financing | Enterprise Investments | Total Segments |
|------------------------------------|-------------------|------------------|-----------|-----------------|-----------|------------------|------------------------|----------------|
| | Technology | Personal Systems | Server | | | | | |
| 1998: | | | | | | | | |
| External revenue | \$ 11,890 | \$ 12,776 | \$ 10,624 | \$ 28,916 | \$ 11,863 | \$ 2,979 | \$ 2,468 | \$ 81,516 |
| Internal revenue | 4,578 | 29 | 445 | 2,747 | 749 | 792 | 56 | 9,396 |
| Total revenue | \$ 16,468 | \$ 12,805 | \$ 11,069 | \$ 31,663 | \$ 12,612 | \$ 3,771 | \$ 2,524 | \$ 90,912 |
| Pre-tax income | \$ 955 | \$ (992) | \$ 2,842 | \$ 3,757 | \$ 2,588 | \$ 1,165 | \$ (616) | \$ 9,699 |
| Revenue year-to-year change | (4.4)% | (10.8)% | (6.0)% | 13.5% | 6.6% | 5.8% | 0.6% | 2.0% |
| Pre-tax income year-to-year change | (47.1)% | (516.1)% | (1.9)% | 30.0% | 27.2% | 3.0% | 32.3% | 0.1% |
| Pre-tax income margin | 5.8% | (7.7)% | 25.7% | 11.9% | 20.5% | 30.9% | (24.4)% | 10.7% |
| 1997: | | | | | | | | |
| External revenue | \$ 11,083 | \$ 14,337 | \$ 11,286 | \$ 25,166 | \$ 11,164 | \$ 2,935 | \$ 2,438 | \$ 78,409 |
| Internal revenue | 6,147 | 20 | 491 | 2,737 | 671 | 628 | 70 | 10,764 |
| Total revenue | \$ 17,230 | \$ 14,357 | \$ 11,777 | \$ 27,903 | \$ 11,835 | \$ 3,563 | \$ 2,508 | \$ 89,173 |
| Pre-tax income | \$ 1,806 | \$ (161) | \$ 2,896 | \$ 2,890 | \$ 2,034 | \$ 1,131 | \$ (910) | \$ 9,686 |
| Revenue year-to-year change | 0.3% | 3.3% | (6.9)% | 12.6% | (1.5)% | (3.3)% | 5.0% | 3.0% |
| Pre-tax income year-to-year change | 17.7% | (312.8)% | (12.1)% | 14.3% | (17.5)% | (10.2)% | (17.4)% | (5.7)% |
| Pre-tax income margin | 10.5% | (1.1)% | 24.6% | 10.4% | 17.2% | 31.7% | (36.3)% | 10.9% |
| 1996: | | | | | | | | |
| External revenue | \$ 10,244 | \$ 13,876 | \$ 12,230 | \$ 22,310 | \$ 11,426 | \$ 3,224 | \$ 2,294 | \$ 75,604 |
| Internal revenue | 6,942 | 23 | 423 | 2,460 | 593 | 462 | 95 | 10,998 |
| Total revenue | \$ 17,186 | \$ 13,899 | \$ 12,653 | \$ 24,770 | \$ 12,019 | \$ 3,686 | \$ 2,389 | \$ 86,602 |
| Pre-tax income | \$ 1,535 | \$ (39) | \$ 3,293 | \$ 2,529 | \$ 2,466 | \$ 1,260 | \$ (775) | \$ 10,269 |
| Pre-tax income margin | 8.9% | (0.3)% | 26.0% | 10.2% | 20.5% | 34.2% | (32.4)% | 11.9% |

Reconciliations to IBM as Reported

| (Dollars in millions) | 1998 | 1997 | 1996 |
|--------------------------------------|------------------|------------------|------------------|
| REVENUE: | | | |
| Total reportable segments | \$ 90,912 | \$ 89,173 | \$ 86,602 |
| Other revenues | 151 | 99 | 343 |
| Elimination of internal revenue | (9,396) | (10,764) | (10,998) |
| Total IBM Consolidated | \$ 81,667 | \$ 78,508 | \$ 75,947 |
| PRE-TAX INCOME: | | | |
| Total reportable segments | \$ 9,699 | \$ 9,686 | \$ 10,269 |
| Elimination of internal transactions | (162) | (377) | (251) |
| Unallocated corporate expenses | (497) | (282) | (996) |
| Purchased research and development | — | — | (435) |
| Total IBM Consolidated | \$ 9,040 | \$ 9,027 | \$ 8,587 |

Major Customers

No single customer represents 10% or more of the company's total revenue.

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 attributable to the segments are minimal and do not have a material impact on the financial results of the segments.

Segment Assets and Other Items

The assets of the hardware segments primarily include inventory and plant, property and equipment. The software segment assets mainly include inventory, plant, property and equipment, and investment in deferred software development. The Global Services segment assets primarily include maintenance inventory and plant, property and equipment associated with its strategic outsourcing business. Details regarding the Global Financing segment assets can be found on page 89.

To accomplish the efficient use of space and equipment, it becomes necessary, in most instances, 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 not allocated to each user segment. This is consistent with the company's management system and is reflected as such in the schedule on page 88. In such cases, there will not be a precise compatibility between segment pre-tax income and segment assets.

Similarly, the depreciation amounts reported by segment are deployed on a landlord ownership basis and may not be consistent with the actual amounts included in the segments' pre-tax income. Such amounts included in pre-tax income reflect occupancy charges from the landlord segment and are not specifically identified by the management reporting system.

Capital expenditures reported by segment are also in line with the landlord ownership basis of asset assignment.

The Global Financing segment amounts on page 88 for interest income and interest expense reflect the interest income and expense associated with the financing business as well as the investment in cash and marketable securities. The remaining amounts of interest income and interest expense are not allocated discretely to the other segments, but are included as part of an indirect expense allocation.

MANAGEMENT SYSTEM SEGMENT VIEW

| (Dollars in millions) | Hardware Segments | | | Global Services | Software | Global Financing | Enterprise Investments | Total Segments |
|--|-------------------|------------------|----------|-----------------|----------|------------------|------------------------|----------------|
| | Technology | Personal Systems | Server | | | | | |
| 1998: | | | | | | | | |
| Assets | \$ 11,251 | \$ 1,464 | \$ 2,106 | \$ 2,236 | \$ 2,577 | \$ 40,109 | \$ 363 | \$ 60,106 |
| Depreciation/amortization | 1,207 | 121 | 178 | 322 | 681 | 2,768 | 15 | 5,292 |
| Capital expenditures/ investment-software | 2,044 | 156 | 288 | 358 | 424 | 3,438 | 19 | 6,727 |
| Interest income | — | — | — | — | — | 2,725 | — | 2,725 |
| Interest expense | — | — | — | — | — | 1,252 | — | 1,252 |
| 1997: | | | | | | | | |
| Assets | \$ 10,060 | \$ 1,629 | \$ 2,191 | \$ 1,914 | \$ 2,642 | \$ 35,444 | \$ 362 | \$ 54,242 |
| Depreciation/amortization | 1,092 | 112 | 167 | 315 | 1,132 | 2,170 | 10 | 4,998 |
| Capital expenditures/ investment-software | 2,028 | 195 | 235 | 361 | 515 | 3,615 | 16 | 6,965 |
| Interest income | — | — | — | — | — | 2,639 | — | 2,639 |
| Interest expense | — | — | — | — | — | 1,175 | — | 1,175 |
| 1996: | | | | | | | | |
| Assets | \$ 9,435 | \$ 2,666 | \$ 2,322 | \$ 2,067 | \$ 2,813 | \$ 31,793 | \$ 295 | \$ 51,391 |
| Depreciation/amortization | 1,030 | 141 | 201 | 283 | 1,496 | 1,761 | 11 | 4,923 |
| Capital expenditures/ investment-software | 1,805 | 162 | 171 | 359 | 453 | 3,086 | 11 | 6,047 |
| Interest income | — | — | — | — | — | 2,752 | — | 2,752 |
| Interest expense | — | — | — | — | — | 1,166 | — | 1,166 |

Reconciliations to IBM as Reported

| (Dollars in millions) | 1998 | 1997 | 1996 |
|--------------------------------------|------------------|------------------|------------------|
| ASSETS: | | | |
| Total reportable segments | \$ 60,106 | \$ 54,242 | \$ 51,391 |
| Elimination of internal transactions | (7,519) | (6,287) | (5,192) |
| Unallocated amounts: | | | |
| Cash and marketable securities | 4,295 | 6,062 | 6,601 |
| Notes and accounts receivable | 7,715 | 7,441 | 7,962 |
| Deferred tax assets | 5,376 | 4,746 | 4,683 |
| Plant, other property and equipment | 7,706 | 7,564 | 7,505 |
| Pension assets | 4,836 | 3,828 | 3,323 |
| Other | 3,585 | 3,903 | 4,859 |
| Total IBM Consolidated | \$ 86,100 | \$ 81,499 | \$ 81,132 |

In addition to the previous information for the company's business segments, the following information is provided to enhance the understanding of the Global Financing segment. This data summarizes the Global Financing segment's financial statements for 1998, 1997 and 1996, respectively.

STATEMENT OF FINANCIAL POSITION

(Dollars in millions)

| At December 31: | 1998 | 1997 | 1996 |
|---|------------------|------------------|------------------|
| Assets: | | | |
| Cash and cash equivalents | \$ 1,032 | \$ 998 | \$ 1,433 |
| Net investment in capital leases | 14,456 | 13,831 | 13,430 |
| Working capital financing receivables | 5,798 | 4,928 | 4,030 |
| Loans receivable | 8,682 | 6,951 | 6,428 |
| Inventories | 119 | 111 | 98 |
| Equipment on operating leases and other property, net of accumulated depreciation | 5,663 | 5,168 | 3,988 |
| Other assets | 4,359 | 3,457 | 2,386 |
| Total assets | \$ 40,109 | \$ 35,444 | \$ 31,793 |
| Liabilities and stockholders' equity: | | | |
| Taxes, accrued expenses and other liabilities | \$ 8,077 | \$ 7,969 | \$ 7,915 |
| Debt | 27,754 | 23,824 | 20,627 |
| Total liabilities | 35,831 | 31,793 | 28,542 |
| Stockholders' equity/ invested capital | 4,278 | 3,651 | 3,251 |
| Total liabilities and stockholders' equity | \$ 40,109 | \$ 35,444 | \$ 31,793 |

NET INCOME

(Dollars in millions)

| For the year ended December 31: | 1998 | 1997 | 1996 |
|---------------------------------|---------------|---------------|---------------|
| Net income before income taxes | \$ 1,165 | \$ 1,131 | \$ 1,260 |
| Provision for income taxes | 432 | 429 | 531 |
| Net income | \$ 733 | \$ 702 | \$ 729 |
| Return on equity | 19.1% | 20.3% | 22.7% |

Geographic Information

(Dollars in millions)

| | Revenue* | | | Long-lived Assets** | | |
|--------------------------|------------------|------------------|------------------|---------------------|------------------|------------------|
| | 1998 | 1997 | 1996 | 1998 | 1997 | 1996 |
| United States | \$ 35,303 | \$ 32,663 | \$ 29,395 | \$ 18,450 | \$ 17,802 | \$ 16,910 |
| Japan | 8,567 | 9,765 | 10,181 | 4,310 | 3,635 | 3,765 |
| Other non-U.S. countries | 37,797 | 36,080 | 36,371 | 12,343 | 11,621 | 11,648 |
| Total | \$ 81,667 | \$ 78,508 | \$ 75,947 | \$ 35,103 | \$ 33,058 | \$ 32,323 |

* Revenues are attributed to countries based on location of customer.

**Includes all non-current assets except non-current financial instruments and deferred tax assets.

CASH FLOWS

(Dollars in millions)

| For the year ended December 31: | 1998 | 1997 | 1996 |
|--|-----------------|---------------|-----------------|
| Net cash provided from operating activities | \$ 4,441 | \$ 3,919 | \$ 5,314 |
| Net cash used in investing activities | (7,296) | (8,435) | (5,544) |
| Net cash provided from financing activities | 2,856 | 4,102 | 872 |
| Effect of exchange rate changes on cash and cash equivalents | 33 | (21) | (17) |
| Net change in cash and cash equivalents | 34 | (435) | 625 |
| Cash and cash equivalents at January 1 | 998 | 1,433 | 808 |
| Cash and cash equivalents at December 31 | \$ 1,032 | \$ 998 | \$ 1,433 |

Revenue by Classes of Similar Products or Services

For the Personal Systems, Server, Software and Global Financing segments, the segment data on page 86 represents the revenue contributions from the products contained in the segments which are basically similar in nature. In the Technology and Global Services segments the table below provides external revenue for similar classes of products within those segments. OEM hardware consists primarily of revenue from the sale of HDD storage files and semiconductors. Storage consists of externally attached direct access storage devices and tape storage devices. Other technology consists primarily of advanced function printers and networking devices.

| (Dollars in millions) | Consolidated | | |
|-------------------------|--------------|----------|----------|
| | 1998 | 1997 | 1996 |
| Technology: | | | |
| OEM | \$ 6,756 | \$ 5,560 | \$ 4,123 |
| Storage | 2,439 | 2,644 | 2,716 |
| Other technology | 2,695 | 2,879 | 3,405 |
| Global Services: | | | |
| Services | 23,730 | 19,534 | 16,218 |
| Maintenance | 5,186 | 5,632 | 6,092 |

Five-Year Comparison of Selected Financial Data

(Dollars in millions except per share amounts)

| For the year: | 1998 | 1997 | 1996 | 1995 | 1994 |
|--|-----------|-----------|-----------|-----------|-----------|
| Revenue | \$ 81,667 | \$ 78,508 | \$ 75,947 | \$ 71,940 | \$ 64,052 |
| Net income | 6,328 | 6,093 | 5,429 | 4,178 | 3,021 |
| Per share of common stock—basic | 6.75 | 6.18 | 5.12 | 3.61 | 2.51 |
| Per share of common stock—assuming dilution | 6.57 | 6.01 | 5.01 | 3.53 | 2.48 |
| Cash dividends paid on common stock | 814 | 763 | 686 | 572 | 585 |
| Per share of common stock | .86 | .775 | .65 | .50 | .50 |
| Investment in plant, rental machines and other property | 6,520 | 6,793 | 5,883 | 4,744 | 3,078 |
| Return on stockholders' equity | 32.6% | 29.7% | 24.8% | 18.5% | 14.3% |
| At end of year: | | | | | |
| Total assets | \$ 86,100 | \$ 81,499 | \$ 81,132 | \$ 80,292 | \$ 81,091 |
| Net investment in plant, rental machines and other property | 19,631 | 18,347 | 17,407 | 16,579 | 16,664 |
| Working capital | 5,533 | 6,911 | 6,695 | 9,043 | 12,112 |
| Total debt | 29,413 | 26,926 | 22,829 | 21,629 | 22,118 |
| Stockholders' equity | 19,433 | 19,816 | 21,628 | 22,423 | 23,413 |

Selected Quarterly Data

(Dollars in millions except per share amounts and stock prices)

| | Revenue | Gross Profit | Net Income | Per Share Common Stock | | | Stock Prices** | |
|----------------|------------------|------------------|-----------------|------------------------|----------------------------|----------------|----------------|----------|
| | | | | Earnings-Basic | Earnings-Assuming Dilution | Dividends | High | Low |
| 1998 | | | | | | | | |
| First quarter | \$ 17,618 | \$ 6,450 | \$ 1,036 | \$ 1.08 | \$ 1.06 | \$.20 | \$ 108.38 | \$ 95.63 |
| Second quarter | 18,823 | 7,146 | 1,452 | 1.54 | 1.50 | .22 | 129.31 | 103.31 |
| Third quarter | 20,095 | 7,467 | 1,494 | 1.60 | 1.56 | .22 | 138.13 | 110.75 |
| Fourth quarter | 25,131 | 9,809 | 2,346 | 2.55 | 2.47 | .22 | 189.94 | 116.81 |
| Total | \$ 81,667 | \$ 30,872 | \$ 6,328 | \$ 6.75* | \$ 6.57* | \$.86 | | |
| 1997 | | | | | | | | |
| First quarter | \$ 17,308 | \$ 6,592 | \$ 1,195 | \$ 1.19 | \$ 1.16 | \$.175 | \$ 85.06 | \$ 65.00 |
| Second quarter | 18,872 | 7,401 | 1,446 | 1.46 | 1.43 | .200 | 93.75 | 63.56 |
| Third quarter | 18,605 | 7,098 | 1,359 | 1.38 | 1.35 | .200 | 109.44 | 90.13 |
| Fourth quarter | 23,723 | 9,518 | 2,093 | 2.16 | 2.11 | .200 | 113.50 | 88.63 |
| Total | \$ 78,508 | \$ 30,609 | \$ 6,093 | \$ 6.18* | \$ 6.01* | \$.775 | | |

* The sum of the quarters' earnings per share does not equal the year-to-date earnings per share due to changes in average share calculations. This is in accordance with prescribed reporting requirements.

** 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.

STOCKHOLDER INFORMATION

IBM Stockholder Services

Stockholders with questions about their accounts should contact:
First Chicago Trust Company, a division of EquiServe
Mail Suite 4688
P.O. Box 2530
Jersey City, New Jersey 07303-2530
(888) IBM-6700

Investors residing outside the United States, Canada and Puerto Rico should call (201) 324-0405.

Stockholders can also reach First Chicago Trust Company via the Internet at: ibmfct@em.fcncbd.com

Hearing-impaired stockholders with access to a telecommunications device (TDD) can communicate directly with First Chicago Trust Company by calling (201) 222-4489.

IBM on the Internet

Topics featured in this Annual Report can be found via the IBM home page on the Internet (<http://www.ibm.com>). Financial results, news on IBM products, services and other activities can also be found via that address. Stockholders of record can receive online account information and answers to frequently asked questions regarding stockholder accounts via the Internet (<http://www.ibm.com/investor>).

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Annual Meeting

The IBM Annual Meeting of Stockholders will be held on Tuesday, April 27, 1999, at 10 a.m. (EST) at the James L. Knight Center at the Miami Convention Center in Miami, Florida.

IBM Stock

IBM common stock is listed on the New York Stock Exchange, on other exchanges in the United States and around the world.

Stockholder Communications

Stockholders in the United States and Canada can get quarterly financial results, listen to a summary of Mr. Gerstner's Annual Meeting remarks and hear voting results from the meeting by calling (800) IBM-7800. Callers can also request printed copies of the information via mail or fax. Stockholders residing outside the United States, Canada and Puerto Rico should call (402) 573-9861.

Investors with other requests may write to:

IBM Stockholder Relations
IBM Corporation
New Orchard Road
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Literature for IBM Stockholders

The following literature on IBM is available without charge from First Chicago Trust Company, a division of EquiServe
Mail Suite 4688
P.O. Box 2530
Jersey City, New Jersey 07303-2530
(201) 324-0405

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 is issued in April; 10-Q reports are released in May, August and November.

An audio cassette recording of the 1998 Annual Report is available for sight-impaired stockholders.

IBM Credit Corporation's Annual Report is available in April.

"Progress Report: Environment and Well-Being" reports on IBM's environmental, safety and energy programs.

"Valuing Diversity: An Ongoing Commitment" communicates to the company's entire community of employees, customers, stockholders, vendors, suppliers, business partners and employment applicants the importance IBM places on the diversity of the company's workplace and marketplace.

General Information

For answers to general questions about IBM from within the continental United States, call (800) IBM-4YOU. From outside the United States, call (770) 863-1234.

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