Investments

The company's investments for plant, rental machines and other property were $5,959 million for 1999, a decrease of $561 million from 1998. The company continues to invest significantly in its rapidly growing services business, primarily 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 $464 million of software costs during 1999, an increase of $214 million from the 1998 period. The increase resulted primarily from the adoption by the company as of January 1, 1999, of the American Institute of Certified Public Accountants Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The SOP requires the capitalization of internal use computer software if certain criteria are met. The company amortizes the capitalized costs over two years. Amortization of capitalized software costs (both internal use and licensed programs) was $426 million in 1999, a decline of $91 million from 1998.

Investments and sundry assets were $26,087 million at the end of 1999, an increase of $2,577 million from 1998, primarily the result of increases in prepaid pension assets, customer loan receivables-not yet due, and alliance investments, which include investments in high-growth-potential technology companies. See note G, "Investments and Sundry Assets," on page 73 for additional information.

Debt and Equity

(Dollars in millions)	1999	1998
Non-global financing debt	**$ 1,555**	**$ 1,659**
Global financing debt	**26,799**	**27,754**
Total debt	**$ 28,354**	**$ 29,413**
Stockholders' equity	**$ 20,511**	**$ 19,433**
Debt/capitalization	**58.0%**	**60.2%**
EBITDA/Interest expense	**9x**	**8x**
Non-global financing:		
Debt/capitalization	**9.0%**	**9.9%**
EBITDA/Interest expense	**19x**	**15x**
Global financing debt/equity	**5.5:1**	**6.5:1**

Because a financing business has a different capital structure than a technology business, the company's debt and key financial ratios are calculated on both a global financing and non-global financing basis.

Total debt decreased $1,059 million from year-end 1998 as debt supporting the growth of global financing assets decreased $955 million and non-global financing debt decreased $104 million.

Stockholders' equity increased $1,078 million to $20,511 million at December 31, 1999, primarily due to the increase in retained earnings and accumulated gains and losses not affecting retained earnings, partially offset by the company's ongoing stock repurchase program. (See note N, "Stockholders' Equity Activity," on pages 78 and 79.)

The ratio of 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 19x and 15x in 1999 and 1998, respectively. EBITDA is a useful indicator of the company's ability to service its debt.

Currency Rate Fluctuations

Changes in the relative values of non-U.S. currencies to the U.S. dollar affect the company's results. At December 31, 1999, currency changes resulted in assets and liabilities denominated in local currencies being translated into fewer dollars than at year-end 1998. The currency rate changes had minimal effect on 1999 revenue growth, but had an unfavorable effect on 1998 and 1997 revenue growth of approximately 2 percent and 5 percent, respectively.

In high-inflation environments, translation adjustments are reflected in period income, as required by SFAS No. 52, "Foreign Currency Translation." Generally, the company limits currency risk in these countries by linking prices and contracts to U.S. dollars, financing operations locally and entering into 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 of currency and hedging appears in note L, "Financial Instruments," on pages 75 through 77.

Market Risk

In the normal course of business, the financial position of the company routinely is subject 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 all of these risks and has established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, the company does not anticipate any material losses from these risks.

The company's debt in support of the global financing business and the geographic breadth of the company's operations contain an element of market risk from changes in interest and currency rates. The company manages this risk, in part, through the use of a variety of financial instruments including derivatives, as explained in note L, "Financial Instruments," on pages 75 through 77.

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

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

To perform sensitivity analysis, the company assesses the risk of loss in fair values from the effect 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 affected by the changes in rates that are attributable to the market risk that is being measured. The company selected the discount rates that it used for the present value computations based on market interest and foreign currency exchange rates in effect at December 31, 1999 and 1998. The differences in this comparison are the hypothetical gains or losses associated with each type of risk.

Information provided by the sensitivity analysis does not necessarily represent the actual changes in fair value that the company would incur under normal market conditions because, due to practical limitations, all variables other than the specific market risk factor are held constant. In addition, the results of the model are constrained by the fact that certain items are specifically excluded from the analysis, while the financial instruments that relate 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, the reported changes in the values of some financial instruments that affect 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, 1999, and December 31, 1998, are as follows:

Interest Rate Risk: As of December 31, 1999, 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 $164 million as compared with a decrease of $322 million 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 $145 million as compared with an increase of $282 million as of December 31, 1998. 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 primarily are driven by changes in the company's debt maturity and interest rate profile and amount. In 1999 versus 1998, the reported decline in interest rate sensitivity primarily is due to the effect of increased activity in receive fixed/pay floating interest rate swaps.

Foreign Currency Exchange Rate Risk: As of December 31, 1999, a 10 percent decrease or increase 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 $1,319 million or an increase in the fair value of the company's financial instruments of $1,340 million, respectively, compared with a decrease of $597 million or an increase of $855 million, respectively, as of December 31, 1998. 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 primarily is driven by an increase in the overall level of net foreign investment hedging activity as well as by an increase in the use of foreign currency forwards in lieu of foreign currency options to hedge the company's various foreign currency exposures in accordance with the company's established risk management practices. As the effect of offsetting changes in the fair market value of the company's net foreign investments are not included in the sensitivity model, the results of the analysis do not indicate 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 consistently have 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, 1997, 1998 and 1999. The following table excludes approximately $34 million of estimated residual value associated with non-information technology equipment.

	Total			Run Out of 1999 Balance			
(Dollars in millions)	1997	1998	1999	2000	2001	2002	2003 and beyond
Sales-type leases	$ 563	$ 685	$ 737	$ 209	$ 301	$ 198	$ 29
Operating leases	701	731	609	319	197	87	6
Total residual value	$ 1,264	$ 1,416	$ 1,346	$ 528	$ 498	$ 285	$ 35

Employees and Related Workforce

	1999	1998	1997	Percentage Changes 1999-98	Percentage Changes 1998-97
IBM/wholly owned subsidiaries	**307,401**	**291,067**	**269,465**	**5.6**	**8.0**
Less than wholly owned subsidiaries	**17,176**	**21,704**	**20,751**	**(20.9)**	**4.6**
Complementary	**29,800**	**36,900**	**43,000**	**(19.2)**	**(14.2)**

IBM employees, including wholly owned subsidiaries, increased by more than 16,000 in 1999. The growth areas of the company, Global Services and the Software Group, continue to drive the increase; Global Services hired approximately 17,000 in 1999. Acquisitions also contributed to the increase. The company also continues to reduce its infrastructure and to withdraw from certain businesses, thereby offsetting some of the growth. For example, during 1999, IBM sold its Global Network to AT&T, resulting in the loss of about 5,300 employees.

The decrease in employees in the less than wholly owned subsidiaries over the last year reflects a number of entities that were converted to a wholly owned status, such as Global Services in India and MiCRUS in the U.S., or divested during the year. Partially offsetting the decrease was continued growth in Global Services, notably in Australia, and in a number of subsidiaries in China.

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 issues raised by the transition to the Year 2000 presented a pervasive and unprecedented global challenge to IBM, its customers, partners, suppliers and employees, as well as to governments, communities and individuals. The company believes that the overall uneventful arrival of the Year 2000 is testimony to the hard work and investment of organizations and individuals around the world.

With respect to the company's own operations, it prepared more than one million critical items for the transition, including PCs and servers, application software, and manufacturing tools and instruments. In addition, 2,500 suppliers, 750 business partners and 200 subsidiaries were assessed for risk mitigation planning purposes. The company estimates that it will have spent approximately $500 million over a multi-year period in these efforts, including conversion, testing and contingency planning.

Over the past five years, the company undertook numerous initiatives to help customers prepare for the Year 2000 including contacting customers around the world to help promote awareness of Year 2000 issues; developing a range of service offerings and tools to help customers assess, develop and execute plans to make their systems Year 2000 ready; and making the company's own current hardware and software offerings Year 2000 ready. To illustrate the extent of the company's efforts, more than one million customers used the company's technical support Year 2000 Web site; and the company's Global Services organization processed more than one billion lines of customer code. Further, the company found that a large number of its enterprise customers locked down their information technology systems and postponed technology purchases heading into the Year 2000 transition, which adversely affected the company's business performance during the second half of 1999. See the Results of Operations and Financial Condition sections within the Management Discussion for further information.

In the near term, the company recognizes the need to maintain its vigilance in the event Y2K issues do arise. 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 potential claims brought against it.

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	1999	1998	1997
Revenue:				
Hardware		$ 37,041	$ 35,419	$ 36,630
Global Services		32,172	28,916	25,166
Software		12,662	11,863	11,164
Global Financing		3,137	2,877	2,806
Enterprise Investments/Other		2,536	2,592	2,742
Total revenue		87,548	81,667	78,508
Cost:				
Hardware		27,071	24,214	23,473
Global Services		23,304	21,125	18,464
Software		2,240	2,260	2,785
Global Financing		1,446	1,494	1,448
Enterprise Investments/Other		1,558	1,702	1,729
Total cost		55,619	50,795	47,899
Gross profit		31,929	30,872	30,609
Operating expenses:				
Selling, general and administrative	Q	14,729	16,662	16,634
Research, development and engineering	S	5,273	5,046	4,877
Total operating expenses		20,002	21,708	21,511
Operating income		11,927	9,164	9,098
Other income, principally interest		557	589	657
Interest expense	K	727	713	728
Income before income taxes		11,757	9,040	9,027
Provision for income taxes	P	4,045	2,712	2,934
Net income		7,712	6,328	6,093
Preferred stock dividends		20	20	20
Net income applicable to common stockholders		$ 7,692	$ 6,308	$ 6,073
Earnings per share of common stock:				
Assuming dilution	T	$ 4.12	$ 3.29*	$ 3.00*
Basic	T	$ 4.25	$ 3.38*	$ 3.09*

Average number of common shares outstanding:
Assuming dilution: 1999–1,871,073,912; 1998–1,920,130,470*; 1997–2,021,869,884*
Basic: 1999–1,808,538,346; 1998–1,869,005,570*; 1997–1,966,572,722*

* Adjusted to reflect a two-for-one stock split effective May 10, 1999.
The accompanying notes on pages 69 through 93 are an integral part of the financial statements.

consolidated statement of financial position

International Business Machines Corporation
and Subsidiary Companies

(Dollars in millions except per share amounts)

At December 31:	Notes	1999	1998
Assets			
Current assets:			
Cash and cash equivalents		$ 5,043	$ 5,375
Marketable securities	L	788	393
Notes and accounts receivable—trade, net of allowances		20,039	18,958
Sales-type leases receivable		6,220	6,510
Other accounts receivable		1,359	1,313
Inventories	E	4,868	5,200
Prepaid expenses and other current assets		4,838	4,611
Total current assets		43,155	42,360
Plant, rental machines and other property	F	39,616	44,870
Less: Accumulated depreciation		22,026	25,239
Plant, rental machines and other property—net		17,590	19,631
Software		663	599
Investments and sundry assets	G	26,087	23,510
Total assets		$ 87,495	$ 86,100
Liabilities and Stockholders' Equity			
Current liabilities:			
Taxes	P	$ 4,792	$ 3,125
Short-term debt	J & L	14,230	13,905
Accounts payable		6,400	6,252
Compensation and benefits		3,840	3,530
Deferred income		4,529	4,115
Other accrued expenses and liabilities		5,787	5,900
Total current liabilities		39,578	36,827
Long-term debt	J & L	14,124	15,508
Other liabilities	M	11,928	12,818
Deferred income taxes	P	1,354	1,514
Total liabilities		66,984	66,667
Contingencies	O		
Stockholders' equity:	N		
Preferred stock, par value $.01 per share		247	247
Shares authorized: 150,000,000			
Shares issued and outstanding (1999 and 1998–2,546,011)			
Common stock, par value $.20* per share	C	11,762	10,121
Shares authorized: 4,687,500,000*			
Shares issued (1999–1,876,665,245; 1998–1,853,738,104*)			
Retained earnings		16,878	10,141
Treasury stock, at cost (shares: 1999–72,449,015; 1998–1,924,293*)		(7,375)	(133)
Employee benefits trust (shares: 1999–20,000,000; 1998–20,000,000*)		(2,162)	(1,854)
Accumulated gains and losses not affecting retained earnings		1,161	911
Total stockholders' equity		20,511	19,433
Total liabilities and stockholders' equity		$ 87,495	$ 86,100

* Adjusted to reflect a two-for-one stock split effective May 10, 1999.

The accompanying notes on pages 69 through 93 are an integral part of the financial statements.

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
1997*							
Stockholders' equity, January 1, 1997	$ 253	$ 7,752	$ 11,189	$ (135)	$ —	$ 2,569	$ 21,628
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 (137,554,672** shares)		(565)	(5,455)				(6,020)
Preferred stock purchased and retired (13,450 shares)	(1)						(1)
Common stock issued under employee plans (39,303,206** shares)		985	(2)				983
Purchases (8,254,336** shares) and sales (10,764,558** shares) of treasury stock under employee plans—net			(32)	49			17
Employee benefits trust (20,000,000** shares)					(860)		(860)
Tax effect—stock transactions		429					429
Stockholders' equity, December 31, 1997	$ 252	$ 8,601	$ 11,010	$ (86)	$ (860)	$ 899	$ 19,816
1998*							
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 (113,993,636** shares)		(556)	(6,291)				(6,847)
Preferred stock purchased and retired (51,250 shares)	(5)						(5)
Common stock issued under employee plans (29,701,038** shares)		709	(1)				708
Purchases (9,100,678** shares) and sales (9,024,296** 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

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
1999							
Stockholders' equity, December 31, 1998	$ 247	$ 10,121	$ 10,141	$ (133)	$ (1,854)	$ 911	$ 19,433
Net income plus gains and losses not affecting retained earnings:							
Net income			7,712				$ 7,712
Gains and losses not affecting retained earnings (net of tax):							
Foreign currency translation adjustments (net of tax expense of $180)						(546)	(546)
Net unrealized gains on marketable securities (net of tax expense of $456)						796	796
Total gains and losses not affecting retained earnings							250
Subtotal: Net income plus gains and losses not affecting retained earnings							$ 7,962
Cash dividends declared—common stock			(859)				(859)
Cash dividends declared—preferred stock			(20)				(20)
Treasury shares purchased, not retired (70,711,971 shares)				(7,192)			(7,192)
Common stock issued under employee plans (22,927,141 shares)		741	(1)				740
Purchases (6,418,975 shares) and sales (6,606,223 shares) of treasury stock under employee plans—net			(95)	(50)			(145)
Fair value adjustment of employee benefits trust		318			(308)		10
Increase due to shares issued by subsidiary		37					37
Tax effect—stock transactions		545					545
Stockholders' equity, December 31, 1999	$ 247	$ 11,762	$ 16,878	$ (7,375)	$ (2,162)	$ 1,161	$ 20,511

* Reclassified to conform with 1999 presentation.
**Adjusted to reflect a two-for-one stock split effective May 10, 1999.
The accompanying notes on pages 69 through 93 are an integral part of the financial statements.

consolidated statement of cash flows

International Business Machines Corporation
and Subsidiary Companies

(Dollars in millions)

At December 31:	1999	1998*	1997*
Cash flow from operating activities:			
Net income	$ 7,712	$ 6,328	$ 6,093
Adjustments to reconcile net income to cash provided from operating activities:			
Depreciation	6,159	4,475	4,018
Amortization of software	426	517	983
Deferred income taxes	(713)	(606)	358
Gain on disposition of fixed and other assets	(4,791)	(261)	(273)
Other changes that (used) provided cash:			
Receivables	(1,677)	(2,736)	(3,727)
Inventories	301	73	432
Other assets	(130)	219	(378)
Accounts payable	(3)	362	699
Other liabilities	2,827	902	660
Net cash provided from operating activities	10,111	9,273	8,865
Cash flow from investing activities:			
Payments for plant, rental machines and other property	(5,959)	(6,520)	(6,793)
Proceeds from disposition of plant, rental machines and other property	1,207	905	1,130
Investment in software	(464)	(250)	(314)
Purchases of marketable securities and other investments	(3,949)	(4,211)	(1,617)
Proceeds from marketable securities and other investments	2,616	3,945	1,439
Proceeds from sale of the Global Network	4,880	—	—
Net cash used in investing activities	(1,669)	(6,131)	(6,155)
Cash flow from financing activities:			
Proceeds from new debt	6,133	7,567	9,142
Short-term borrowings less than 90 days—net	276	499	(668)
Payments to settle debt	(7,510)	(5,942)	(4,530)
Preferred stock transactions—net	—	(5)	(1)
Common stock transactions—net	(6,645)	(6,278)	(6,250)
Cash dividends paid	(879)	(834)	(783)
Net cash used in financing activities	(8,625)	(4,993)	(3,090)
Effect of exchange rate changes on cash and cash equivalents	(149)	120	(201)
Net change in cash and cash equivalents	(332)	(1,731)	(581)
Cash and cash equivalents at January 1	5,375	7,106	7,687
Cash and cash equivalents at December 31	$ 5,043	$ 5,375	$ 7,106
Supplemental data:			
Cash paid during the year for:			
Income taxes	$ 1,904	$ 1,929	$ 2,472
Interest	$ 1,574	$ 1,605	$ 1,475

* Reclassified to conform with 1999 presentation.
The accompanying notes on pages 69 through 93 are an integral part of the financial statements.

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 in general 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 that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the company may undertake in the future, actual results may be different from the estimates.

Revenue

The company recognizes revenue when it is realized or realizable and earned. The company reduces revenue for estimated customer returns, allowances and anticipated price actions. The following are the specific revenue recognition policies for each major category of 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 that are provided during the period compared with the total estimated services to be 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 is recorded as unbilled receivables and is included in trade accounts receivable. Billings in excess of revenue that is 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 at the inception of the license term, provided the company has vendor-specific objective evidence of the fair value of each element of the software offering and the software has been delivered. Revenue is deferred if vendor-specific objective evidence does not exist for each contract element, or if there are uncertainties about the timing of delivery of specific contract elements. The revenue that is deferred for any contract element is recognized when all of the revenue recognition criteria have been met for that element. 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.

Income Taxes

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences between assets and liabilities that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. In accordance with Statement of Financial Accounting Standards (SFAS) No. 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 the company acquired the assets or liabilities. All other assets and liabilities are translated at year-end exchange rates. Cost of sales and depreciation are translated at historical exchange rates. All other income and expense items are translated at the 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 to manage currency exchange rate and interest rate risk. To qualify for hedge accounting, the company requires that the derivative instruments that are used for risk management purposes effectively reduce the risk exposure that they are designed to hedge. For instruments that are associated with the hedge of an anticipated transaction, hedge effectiveness criteria also require that it be probable that the underlying transaction will occur. Instruments that meet these hedging criteria are formally designated as hedges at the inception of the contract. When the terms of an underlying hedged item or transaction are modified, or when the underlying hedged item ceases to exist, all changes in the fair value of the risk management instrument are recognized in income each period until the instrument matures. Those risk management instruments that do not meet the hedging criteria are accounted for at fair value, and changes in fair value are recognized immediately in net income. Refer to note L, "Financial Instruments," on pages 75 through 77 for descriptions of the major classes of derivative financial instruments used by the company, including the specific methods that the company uses to account for them.

In determining the fair value of its derivative and non-derivative financial instruments, the company uses a variety of methods and assumptions that are based on market conditions and risks existing at each balance sheet date. For the majority of financial instruments including most derivatives, long-term investments and long-term debt, standard market conventions and techniques such as estimated discounted value of future cash flows, option pricing models, replacement cost and termination cost are used to determine fair value. Quoted market prices or dealer quotes for the same or similar instruments are used for the remaining financial instruments.

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 in current assets represent securities with a maturity of less than one year. The company's policy is to invest in primarily high-grade marketable securities. 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 that is used internally, subject to an operating lease or as part of strategic outsourcing 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 generally are 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 that are related to the conceptual formulation and design of licensed programs are expensed as research and development. Also, for licensed programs, the company capitalizes costs to produce the finished product that are incurred after technological feasibility is established. 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 three years. The company performs periodic reviews to ensure that unamortized program costs remain recoverable from future revenue. The company charges costs to support or service licensed programs against income as they are incurred.

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

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 that result from amendments to the plans are amortized over the average remaining service period of the employees expected to receive benefits. Unrecognized net gains and losses that exceed ten percent of the greater of the projected benefit obligation or the market-related value of plan assets are amortized to service cost over the average remaining service life of employees expected to receive benefits. See note W, "Retirement Plans," on pages 86 through 88 and note X, "Nonpension Postretirement Benefits," on pages 88 and 89 for further discussion.