# financial report

International Business Machines Corporation
and Subsidiary Companies

# *report of management*

International Business Machines Corporation
and Subsidiary Companies

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

John R. Joyce
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 93, present fairly, in all material respects, the financial position of International Business Machines Corporation and its subsidiaries at December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. 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 auditing standards generally accepted in the United States, 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

PricewaterhouseCoopers LLP
New York, New York
January 19, 2000

## Overview of 1999

IBM's financial performance reflects two very different halves of 1999. The company's performance in the first half was strong. The second half was hit hard by Y2K-related issues, as many of its large customers locked down their systems and technology purchases heading into the Y2K transition. Despite the difficult second half, the overall year was a good one for the company. Revenue, net income and earnings per share were at record levels. The company also had good results on a full-year basis in the strategic growth areas of services, software and original equipment manufacturer (OEM) technology.

The company reported revenue of $87.5 billion and net income of $7.7 billion which yielded $4.12 per diluted common share. The results include an after-tax benefit of $750 million, or $.40 per diluted common share, for a gain from the sale of the company's Global Network to AT&T, charges for actions intended to improve the long-term competitiveness of the company, a change in personal computer depreciable lives and charges for acquired in-process research and development related to acquisitions.

The company ended 1999 with cash and cash equivalents and marketable securities of $5.8 billion, after funding investments of approximately $20 billion in capital expenditures, research and development, strategic acquisitions and repurchases of common stock. The company's debt ratios were well below 1998 levels. The non-global financing debt-to-capital ratio was 9 percent, and the Global Financing business leverage was 5.5 to 1.

## Challenges

The company believes that it has passed the most critical stage of Y2K. However, because it expects the lockdowns to be lifted at different times by different customers during the early part of 2000, the company will feel the lingering effects of Y2K.

Consistent with the fundamental strategy that it put in place several years ago, the company is well positioned to help its customers build integrated e-business solutions. Services, software and OEM technology that are required for this demanding e-business environment will drive the growth in IBM's revenue and earnings.

In addition, the company is aggressively pursuing expanding markets. By increasing sales and distribution through ibm.com, the company will continue to build itself into a leading e-business company.

## Forward-looking and Cautionary Statements

Certain statements contained in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to be materially different, as discussed more fully elsewhere in this Annual Report and in the company's filings with the Securities and Exchange Commission, including the company's 1999 Form 10-K to be filed on or about March 13, 2000.

## Results of Operations

| (Dollars in millions except per share amounts) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | **$ 87,548** | **$ 81,667** | **$ 78,508** |
| Cost | **55,619** | **50,795** | **47,899** |
| Gross profit | **31,929** | **30,872** | **30,609** |
| Gross profit margin | **36.4%** | **37.8%** | **39.0%** |
| Total expense | **20,172** | **21,832** | **21,582** |
| Income before income taxes | **$ 11,757** | **$ 9,040** | **$ 9,027** |
| Net income | **$ 7,712** | **$ 6,328** | **$ 6,093** |
| Earnings per share of common stock—assuming dilution | **$ 4.12** | **$ 3.29** | **$ 3.00** |
| Earnings per share of common stock—basic | **$ 4.25** | **$ 3.38** | **$ 3.09** |

Revenue in 1999 grew 7.2 percent. Growth in Global Services, personal computers, microelectronics and middleware software products drove the increase, partially offset by lower server revenue.

The following table identifies the company's percentage of revenue by category:

| | 1999 | 1998 | 1997 |
|---|---|---|---|
| Hardware | 42.3% | 43.4% | 46.7% |
| Global Services | 36.7 | 35.4 | 32.1 |
| Software | 14.5 | 14.5 | 14.2 |
| Global Financing | 3.6 | 3.5 | 3.6 |
| Enterprise Investments/Other | 2.9 | 3.2 | 3.4 |
| Total | 100.0% | 100.0% | 100.0% |

The overall gross profit margin of 36.4 percent decreased 1.4 points from 1998, following a 1.2 point decrease in 1998 versus 1997. The company's continued shift in revenue to Global Services primarily drove the decline. Global Services has a lower gross profit margin than the company's server products (S/390, AS/400, RS/6000 and NUMA-Q), which are a declining percentage of total revenue.

Revenue for 1999 from the company's end-user businesses totaled $38.8 billion from the Americas, an increase of 5.2 percent (7 percent increase in constant currency) from 1998. Revenue from Europe/Middle East/Africa was $25.7 billion, up 1.8 percent (6 percent increase in constant currency). Asia Pacific revenue increased 19.4 percent (8 percent increase in constant currency) to $15.2 billion. OEM revenue was $7.8 billion, a 15.3 percent increase (14 percent increase in constant currency) compared with 1998.

Information about the company's operating segments can be found in note Y, "Segment Information," on pages 89 through 93. 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 on pages 64 through 68, which reflect, in all material respects, the company's segment results on an external basis.

Hardware

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | $ 37,041 | $ 35,419 | $ 36,630 |
| Cost | 27,071 | 24,214 | 23,473 |
| Gross profit | $ 9,970 | $ 11,205 | $ 13,157 |
| Gross profit margin | 26.9% | 31.6% | 35.9% |

Hardware revenue increased 4.6 percent from 1998, following a decline of 3.3 percent in 1998 versus 1997. Hardware gross profit dollars declined 11.0 percent from 1998, following a decrease of 14.8 percent in 1998 from 1997.

Technology revenue increased 5.9 percent when compared with 1998, following an increase of 7.3 percent in 1998 versus 1997. Strong growth in OEM technology, primarily custom logic and high-performance static random access memory (SRAM) revenue drove the increase in 1999 revenue. A slower growth rate in hard disk drive (HDD) storage revenue in 1999 versus 1998 reflected pricing pressures and a revenue mix away from high-end products. Lower revenues from storage tape and direct access storage device (DASD) products, as well as lower networking hardware revenue, partially offset those increases. The networking hardware decreases resulted, in part, from the sale of routing and switching intellectual property (IP) to Cisco Systems, Inc.

The company took actions in 1999 in the microelectronics and storage areas that are aimed directly at strengthening the Technology Group over the long term. Those actions are intended to shift the focus of the Technology Group to higher margin businesses and more efficient operations. (See note R, "1999 Actions," on pages 81 and 82 for additional information.)

Strong growth in HDD storage products, storage tape products and growth in custom logic products drove the revenue increase in 1998 versus 1997. Lower revenue from dynamic random access memory (DRAMs) and DASD sales partially offset this revenue growth.

Personal Systems revenue grew 19.7 percent in 1999 from 1998, following a 10.9 percent decline in 1998 versus 1997. Despite continued pricing pressures, personal computer revenue improved in 1999. Supply shortages of flat-panel displays in the second half of 1999 constrained sales of ThinkPads, although overall ThinkPad revenue was good. Netfinity servers demonstrated strong revenue growth, compared with 1998 levels. The company continues to focus on expanding its direct channel customers; improving its indirect channel efficiency; increasing its attention on fast-growing, small- and medium-size businesses; and realizing more opportunity in businesses that are tied to the personal computer, including services, software and financing.

Server revenue declined 17.9 percent in 1999 from 1998, following a decrease of 5.9 percent in 1998 versus 1997. S/390 revenue declined in 1999 as customers completed the task of making Y2K ready the mainframe computers that they use in data centers to run mission critical, highly integrated enterprise-wide applications with large transaction volumes. Once the systems were Y2K tested and ready, customers were not inclined to enhance them because of concerns about affecting their Y2K readiness. AS/400 revenue declined due to a slowdown in sales related to Enterprise Resource Planning (ERP) solutions because of Y2K concerns. RS/6000 revenue declined for SP-2 and entry models, partially offset by the enterprise servers which had strong revenue growth in 1999.

Lower revenue from S/390, AS/400 and RS/6000 drove the 5.9 percent decrease in revenue in 1998 versus 1997. While S/390 revenue declined, total delivery of computing power increased more than 60 percent as measured in MIPS (millions of instructions per second) versus 1997. Product transitions late in 1998 affected the revenue for AS/400 and RS/6000 in 1998 versus 1997.

In January 2000, the Server Group reorganized to become the Enterprise Systems Group and adopted a market-centric alignment to help customers connect and integrate S/390, AS/400, RS/6000, NUMA-Q and Netfinity servers to support a wider variety of applications. The reorganized group will focus on cross-server customer requirements for Web servers, enterprise servers, mid-market servers, and for storage subsystems across all computing environments.

During the year, the company signed major technology contracts with Dell Computer Corporation (for the purchase of personal computer parts from the company over seven years), Acer Incorporated (technology purchase contract over seven years), EMC Corporation (five-year strategic technology and business alliance), Cisco Systems, Inc. (technology purchase over five years) and Nintendo Company, Ltd. (multi-year contract to purchase technology). The total of these contracts could be in excess of $15 billion.

Hardware gross profit dollars decreased 11.0 percent in 1999 from 1998, following a 14.8 percent decrease in 1998 versus 1997. In 1999, the shift in the company's revenue away from servers, pricing pressures associated with HDDs and memory chip prices drove the declines in gross profit dollars from 1998. A lower model mix in the mobile HDDs (in which some customers are meeting their capacity needs with new mid-range products, rather than with the more profitable high-end mobile products) also had a negative effect on gross profit dollars. The decline in gross profit dollars in 1998 was primarily driven by lower margins associated with significant price reductions in Personal Systems products.

Hardware gross profit margin decreases in 1999 versus 1998 and 1998 versus 1997 continued to be driven by the shift in the company's revenue away from servers to lower gross profit products, such as personal computers, OEM chip technology and HDDs, as well as price pressures.

Global Services

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | **$ 32,172** | **$ 28,916** | **$ 25,166** |
| Cost | **23,304** | **21,125** | **18,464** |
| Gross profit | **$ 8,868** | **$ 7,791** | **$ 6,702** |
| Gross profit margin | **27.6%** | **26.9%** | **26.6%** |

Global Services revenue increased 11.3 percent in 1999 from 1998 and 14.9 percent in 1998 over 1997. Revenue growth in 1999 without the effect of the sale of the company's Global Network to AT&T would have been 13 percent. (See note D, "Acquisitions/Divestitures," on pages 72 and 73 for additional information about this sale.)

While maintenance revenues declined 1 percent, reflecting continued price pressures as customers transitioned to new technologies, services revenue excluding maintenance and the effect of the sale of the Global Network grew 17 percent. Strategic Outsourcing Services was a major contributor to this performance. Strategic Outsourcing Services creates business value through long-term strategic partnerships with customers by taking on responsibility for their processes and systems. Business Innovation Services (formerly Systems Integration and Consulting) and Integrated Technology Services (formerly Product Support Services) performance was strong through the first nine months of 1999 but slowed in the fourth quarter due to the effect of Y2K-related customer lockdowns and a slowdown in Y2K services.

Toward the end of the third quarter of 1999, the company started to see a decline in demand for Y2K services and expects the effect of Y2K to linger into 2000 as the need for those services disappears. The company sees growing demand for new services offerings especially in Business Innovation Services, which provides business/industry consulting and end-to-end e-business implementation of offerings like Supply Chain Management, Customer Relationship Management, Enterprise Resource Planning and Business Intelligence. Integrated Technology Services offers customers a single IT partner to manage multi-vendor IT systems complexity in today's e-business environment, including traditional offerings like Product Support Services, Business Recovery Services, Site and Connectivity Services and Systems Management and Networking Services.

e-business spans many of the Global Services offerings and contributed significantly to 1999 performance. 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; distributed learning; and hosted business applications such as network-delivered applications, Web hosting and Web infrastructure outsourcing. The company's total discrete e-business services revenue grew 60 percent to over $3 billion in 1999. Revenue from Web hosting and e-business infrastructure services doubled over 1998 and revenue from supply chain and e-procurement services tripled.

In 1999, the company signed contracts totaling over $38 billion, including 46 deals in excess of $100 million with four of those deals in excess of $1 billion. These deals contributed to a services backlog at December 31, 1999, in excess of $60 billion compared with $51 billion at December 31, 1998. In addition to these contracts, the company signed two extensive strategic alliances with Dell Computer Corporation and Cisco Systems, Inc. The company continued to meet the demand for its services by hiring more than 17,000 employees in 1999 and 18,000 employees in 1998.

Gross profit dollars and gross profit margins improved in 1999 over 1998. Significant productivity improvements more than offset competitive pressures and the negative effect of the changing mix of services and maintenance within the Global Services portfolio.

### Software

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | **$ 12,662** | **$ 11,863** | **$ 11,164** |
| Cost | **2,240** | **2,260** | **2,785** |
| Gross profit | **$ 10,422** | **$ 9,603** | **$ 8,379** |
| Gross profit margin | **82.3%** | **80.9%** | **75.1%** |

Software revenue increased 6.7 percent in 1999 from 1998, following an increase of 6.3 percent from 1997. The company's middleware products (which comprise, for both IBM and non-IBM platforms, data management, transaction processing, Tivoli systems management and Lotus Notes messaging and collaboration) had revenue growth of 12 percent in 1999 and 9 percent in 1998. The company continues to focus on helping customers use its software to transform their businesses into e-businesses, particularly in collaboration with the company's Global Services and channel partners.

The company's middleware products continued their momentum due to the company's ability to integrate; the growing participation on non-IBM platforms and the expanding market coverage as more partnerships were formed with Independent Software Vendors, Web integrators and service providers; and a dedicated sales force of 6,600 people.

Operating systems software revenue declined 4 percent in 1999 and increased 3 percent in 1998 when compared with previous periods. The decline in 1999 was driven by lower revenue in AS/400. The 1998 increase was driven by higher AS/400 operating systems revenue versus 1997.

Software gross profit dollars increased 8.5 percent in 1999 from 1998, following an increase of 14.6 percent in 1998 from 1997. Increased revenue and lower levels of amortization costs associated with previously deferred software development spending drove the improvement, partially offset by higher vendor royalty payments due primarily to increased volumes.

Global Financing

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | **$ 3,137** | $ 2,877 | $ 2,806 |
| Cost | **1,446** | 1,494 | 1,448 |
| Gross profit | **$ 1,691** | $ 1,383 | $ 1,358 |
| Gross profit margin | **53.9%** | 48.1% | 48.4% |

Global Financing revenue increased 9.0 percent in 1999 from 1998, following an increase of 2.5 percent in 1998 versus 1997. Growth in working capital financing, along with continued growth in financing of software and services, drove the revenue increase in 1999. Financing originations increased to approximately $43 billion, with year-to-year growth in working capital financing, along with software and services financing. The revenue increase in 1998 over 1997 was due to improved sales of used equipment and growth in software and services financing, offset by a decline in working capital financing.

Gross profit dollars increased 22.3 percent in 1999 versus 1998, following an increase of 1.8 percent in 1998 over 1997. The increase in 1999 reflects Global Financing's ongoing strategy to increase its use of the company's Global Treasury Centers rather than external banks as a funding source and lower costs of borrowing. The increase in gross profit dollars in 1998 versus 1997 was primarily due to increased revenue and a higher gross profit margin in the U.S. markets.

Enterprise Investments/Other

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Revenue | **$ 2,536** | $ 2,592 | $ 2,742 |
| Cost | **1,558** | 1,702 | 1,729 |
| Gross profit | **$ 978** | $ 890 | $ 1,013 |
| Gross profit margin | **38.6%** | 34.3% | 36.9% |

Enterprise Investments/Other revenue decreased 2.2 percent from 1998, following a decrease of 5.5 percent in 1998 from 1997. The decrease was driven by lower revenue from discontinued product lines, such as automated teller machines (ATMs), partially offset by growth in point-of-sale terminals and computer-aided three-dimensional interactive application (CATIA) software. The decrease in 1998 versus 1997 was primarily a result of lower software revenue, partially offset by higher revenue from point-of-sale terminals.

The gross profit dollars from Enterprise Investments/Other increased 9.9 percent in 1999 versus 1998, following a decrease of 12.1 percent in 1998 versus 1997. The increase in 1999 gross profit dollars and gross profit margin was primarily driven by an improving gross profit margin for point-of-sale terminals and software. The decline in 1998 gross profit dollars and gross profit margin was primarily driven by the lower software revenue versus 1997.

Operating Expenses

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Selling, general and administrative | **$ 14,729** | $ 16,662 | $ 16,634 |
| Percentage of revenue | **16.8%** | 20.4% | 21.2% |
| Research, development and engineering | **$ 5,273** | $ 5,046 | $ 4,877 |
| Percentage of revenue | **6.0%** | 6.2% | 6.2% |

Selling, general and administrative (SG&A) expense declined 11.6 percent in 1999 versus 1998 and was essentially flat in 1998 with 1997. The decrease in 1999 reflects the net pre-tax benefit associated with the sale of the Global Network and the actions taken by the company in 1999 to improve its competitiveness and to strengthen further the company's overall business portfolio. (See note D, "Acquisitions/Divestitures," on pages 72 and 73, and note R, "1999 Actions," on pages 81 and 82 for further information.)

The company continues to manage aggressively its infrastructure expense and its overall portfolio to allow for investment in growth areas of the business. Key ongoing investments include software marketing, major marketing campaigns, and new offerings for small and medium business opportunities, as well as the e-business campaign. These types of expenditures are consistent with the company's ongoing objective of growing revenue while improving the expense-to-revenue ratio over time.

Research, development and engineering expense increased 4.5 percent in 1999 from 1998, following an increase of 3.5 percent in 1998 from 1997. The increase in 1999 reflects additional expenses associated with the acquisition of Sequent Computer Systems, Inc., Mylex Corporation and DASCOM, Inc. Those acquisitions are intended to improve the company's long-term competitiveness in the server, storage and Web-security markets, respectively. (See note D, "Acquisitions / Divestitures," on pages 72 and 73 for further detail about the in-process research and development charge.) In addition, the increases in both 1999 and 1998 reflect the company's continued investments in high-growth opportunities like e-business, Tivoli systems management and Lotus products, as well as the effect of ongoing research, development and engineering expense associated with new acquisitions.

As a result of its ongoing research and development efforts, the company received 2,756 patents in 1999, placing it number one in patents granted in the U.S. for the seventh consecutive year. The application of these technological advances transforms the company's research and development into new products. Examples of these efforts range from new e-business solutions to innovative manufacturing techniques. A patent for performing computer-based online commerce using an intelligent agent will play a major role in future e-business. This patent enables customers to use intelligent software agents to negotiate for services from multiple providers. The intelligent agents take into account both the availability of the requested service, such as airline seats, and the providers' business policies, such as those on cancellations. The agents commit to services with the most flexible policies first, giving the user the greatest possible protection. With respect to manufacturing technologies, the silicon-on-insulator (SOI) chip technology can reduce power consumption and improve chip performance. A new patent in 1999 defines processing improvements that increase the efficiency and reduce the cost of manufacturing SOI chips. This technology 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.

See note Y, "Segment Information," on pages 89 through 93 for additional information about the pre-tax income of each segment, 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 34.4 percent for 1999, compared with the 1998 effective tax rate of 30.0 percent and a 1997 effective tax rate of 32.5 percent. The 4.4 point increase from the 1998 rate is the result of the company's sale of its Global Network business to AT&T and various other actions implemented during 1999. (See note D, "Acquisitions / Divestitures," on pages 72 and 73 and note R, "1999 Actions," on pages 81 and 82 for further detail regarding the tax impacts of these items.) The reduction in the 1998 tax rate versus 1997 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) No. 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.

## Fourth Quarter

For the quarter ended December 31, 1999, the company had revenue of $24.2 billion, a decrease of 3.8 percent from the same period in 1998. Net income in the fourth quarter was $2.1 billion ($1.12 per diluted common share), compared with net income of $2.3 billion ($1.24 per diluted common share) in the fourth quarter of 1998.

Revenue for the fourth quarter of 1999 from the company's end-user businesses totaled $10.4 billion from the Americas, a decrease of 3.7 percent (2 percent decrease in constant currency) compared with the same period last year. Revenue from Europe / Middle East / Africa was $7.2 billion, down 15.0 percent (6 percent decrease in constant currency). Asia Pacific revenue grew 12.3 percent (2 percent increase in constant currency) to $4.4 billion. OEM revenue across all geographies was $2.2 billion, a 12.5 percent increase (12 percent in constant currency) compared with the fourth quarter of 1998.

Hardware revenue declined 10.7 percent (10 percent in constant currency) to $10.2 billion from the 1998 fourth quarter. Y2K-related declines in customer demand were a significant factor behind fourth-quarter revenue decreases in S/390, AS/400, RS/6000 and personal computers. However, within the company's server family, Netfinity PC revenues increased significantly, as did revenues from RS/6000 mid-range servers, including the advanced RS/6000 Model S80. Microelectronics revenues increased substantially, principally due to growth in custom logic shipments. Shipments of the company's new "Shark" disk storage product were strong in the quarter, although overall storage revenues declined largely as a result of ongoing price pressures in HDDs. The overall hardware gross profit margin declined to 26.6 percent from 34.2 percent.

Global Services revenue grew 2.0 percent (4 percent in constant currency) versus the fourth quarter of 1998. Strategic Outsourcing showed good growth versus the fourth quarter of 1998. Networking Services declined year to year due to the sale of the Global Network to AT&T during 1999, while revenue from the other categories of services was flat or declined as a result of the Y2K-related slowdown. The company's services unit signed more than $10 billion in services contracts in the quarter. Revenue from maintenance offerings was essentially flat when compared with the fourth quarter of 1998.

Software revenue totaled $3.6 billion, up 1.7 percent (6 percent in constant currency) over the prior year's final quarter. Middleware—which is critical for e-business—grew 8 percent (13 percent at constant currency), with record fourth quarter shipments of Lotus Notes and Domino groupware products and strong performance in database, transaction processing, and Tivoli system management software. The software gross profit margin improved 1.1 points year over year to 83.4 percent.

Global Financing revenue increased 19.3 percent (22 percent in constant currency) versus the same period of 1998, and Enterprise Investments/Other declined 13.3 percent (10 percent in constant currency) compared with 1998's fourth quarter. The revenue decline in Enterprise Investments/Other resulted from the company's strategy to withdraw from certain businesses, such as ATMs.

The company's overall gross profit margin in the fourth quarter was 36.7 percent, compared with 39.0 percent in the year-earlier period. The decrease was primarily due to a drop in the hardware margin of 7.6 points from the fourth quarter 1998 across S/390 and AS/400 servers, storage and personal computer products. This decrease was partially offset by improved margins for services and software in the fourth quarter of 1999 versus the same period in 1998.

Total fourth-quarter 1999 expense declined 9.3 percent when compared with the fourth quarter of 1998. The decline reflects lower revenue-related expenses due to the slowdown that is included in the fourth quarter results. The quarter also reflected expenses associated with infrastructure reductions in areas such as Sales and Distribution, Personal Systems and Server Group, which offset a gain associated with the sale to Cisco Systems, Inc. of certain IBM intellectual property. The expense-to-revenue ratio in the fourth quarter of 1999 was 24.4 percent, compared with 25.9 percent in the year-earlier period.

The company's tax rate was 30.0 percent in the fourth quarter, compared with 28.9 percent in the fourth quarter of 1998.

The company spent approximately $2.1 billion on common share repurchases in the fourth quarter. The average number of shares outstanding in the fourth quarter of 1999 was 1,793.0 million, compared with 1,839.5 million in the year-earlier period. The average number of shares outstanding for purposes of calculating diluted earnings per share was 1,847.8 million in the fourth quarter of 1999 versus 1,894.3 million in the fourth quarter of 1998.

## Financial Condition

During 1999, the company continued to make significant investments to fund future growth and increase shareholder value, spending $5,806 million for research, development and engineering; $4,346 million for plant and other property, including machines used in strategic outsourcing contracts; $1,613 million for machines on operating leases with customers; $1,542 million for strategic acquisitions; and $7,280 million for the repurchase of the company's common shares. The company had $5,831 million in cash and cash equivalents and marketable securities at December 31, 1999.

The company has access to global funding sources. During 1999, the company issued debt in a variety of geographies to a diverse set of investors, including significant funding in the United States, Japan and Europe. The funding has a wide range of maturities from short-term commercial paper to long-term debt. More information about company debt is provided in note J, "Debt," on page 74.

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, 1999, $8,562 million was unused and available.

The company managed assets of $273 million and $864 million at December 31, 1999 and 1998, respectively, from the securitization of loans, leases and trade receivables. For additional information, see note I, "Sale and Securitization of Receivables," on page 74.

The major rating agencies have continued their review of the company's financial condition. None of the agencies announced a change in rating in 1999. Standard and Poor's rates the company and its rated subsidiaries' senior long-term debt as A+, the commercial paper as A-1 and IBM's preferred stock as A.

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 reflected in the Consolidated Statement of Cash Flows on page 68, are summarized in the following table:

| (Dollars in millions) | 1999 | 1998 | 1997 |
|---|---|---|---|
| Net cash provided from (used in): | | | |
| Operating activities | **$ 10,111** | **$ 9,273** | **$ 8,865** |
| Investing activities | **(1,669)** | **(6,131)** | **(6,155)** |
| 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)** |

### Working Capital

| (Dollars in millions) At December 31: | 1999 | 1998 |
|---|---|---|
| Current assets | **$ 43,155** | **$ 42,360** |
| Current liabilities | **39,578** | **36,827** |
| Working capital | **$ 3,577** | **$ 5,533** |
| Current ratio | **1.09:1** | **1.15:1** |

Current assets increased $795 million, driven primarily by increases of $837 million in accounts receivable, $227 million in prepaid expenses and other current assets and $63 million in cash and cash equivalents and marketable securities, offset by a decrease of $332 million in inventories. The increase in accounts receivable is due to strong global financing activity in the software and services businesses across all geographies. The increase in prepaid expenses and other current assets is due to increases in deferred tax assets from year-end 1998. The increase in cash and cash equivalents and marketable securities resulted primarily from cash generated from operations and the net proceeds from the sale of the company's Global Network, offset by stock repurchases, capital expenditures and strategic acquisitions.

The company ended 1999 with inventories of $4,868 million, the lowest level since 1983, due to continued focus on inventory management process improvements, notably in Personal Systems. These improvements increased the company's inventory turnover to 5.9 in 1999 from 5.3 in 1998.

Current liabilities increased $2,751 million from year-end 1998 with increases of $1,667 million in taxes payable, $325 million in short-term debt and $759 million in other current liabilities. The increase in other current liabilities resulted from increases in accounts payable ($148 million), compensation and benefits ($310 million), and deferred income ($414 million), and a $113 million decrease in other accrued expenses and liabilities. The increase in taxes payable primarily reflects improvements in the company's results associated with the sale of the company's Global Network to AT&T. Short-term debt increased to support the growth of global financing assets. The increase in other current liabilities was primarily related to deferred income, mainly advanced billings for software.