

DEAR FELLOW INVESTOR,

This is my last annual letter to you.

By the time you read this, Sam Palmisano will be our new Chief Executive Officer, the eighth in IBM's history. He will be responsible for shaping our strategic direction, as well as leading our operations. For a discussion of IBM's performance in 2001, I invite you to read Sam's first letter to shareholders, starting on page 45.

I want to use this occasion to offer a perspective on what lies ahead for our industry. To many observers today, its future is unclear, following perhaps the worst year in its history. A lot of people chalk that up to the recession and the "dot-com bubble." They seem to believe that when the economies of the world recover, life in the information technology industry will get back to normal.

In my view, nothing could be further from the truth.



CHAIRMAN'S LETTER	1
FINANCIAL CHARTS	6
SIXTEEN DECISIONS THAT <i>transformed</i> IBM	9
SEVEN SHIFTS THAT <i>will transform</i> THE FUTURE	42
CEO'S LETTER	45
FINANCIAL HIGHLIGHTS	48
FINANCIAL REPORT	53
STOCKHOLDER INFORMATION	107
BOARD OF DIRECTORS AND SENIOR MANAGEMENT	108

A massive shift is under way in our industry. You may think I mean the transition to a networked world. After all, IBM was one of the first to recognize this change and the impact it would have. And make no mistake, we are experiencing an explosion of technological innovation that will lead to permanent changes in business, government, education, health care and every other area of human endeavor—as every significant institution, every product and service, as well as billions of people, become permanently “connected.”

But that's not the shift I'm talking about. The revolution I'm describing is that customers are finally driving the direction of the information technology industry.

Technologists Talking to Technologists

The first 30 years of this industry's history consisted of the technology inventors inside I/T companies talking to the technology implementers inside businesses and institutions. For most of that era, the applications of the technology were fairly limited—focused on the automation of back-office processes like accounting and payroll, or desktop applications such as word processing and e-mail.

Then, starting in the early 1990s, businesspeople began to understand the importance of information technology to everything they wanted to do. It's gotten to the point where it's almost impossible to distinguish between the business strategy and the I/T strategy of any successful enterprise. Approximately half of the investments that customers make in I/T are now driven by line-of-business managers, not chief information officers. This is a remarkable shift in just five or six years. Not that CIOs

have become unimportant. They now sit at the table where technology is translated into business value. And their traditional bailiwick of infrastructure, too, has been transformed by the networked world. But there's no question that business strategy now sets the technology agenda, not the other way around.

Prior to joining IBM, my career as a management consultant and executive took me inside the inner workings of many industries. So I was surprised, on entering this one, to learn that the computer industry had been able to get away with inventing new things and just “throwing them over the wall,” leaving customers to figure out how to integrate and apply them. That wasn't easy for those customers, for a lot of reasons. One was the absence of common standards. The industry model was designed around a variety of proprietary architectures (which, to be candid, technology providers were using to control customers).

This came as quite a shock to me, since all my prior experience had taught me that you either give the customer what he or she wants, or the customer walks. Well, guess what? Customers have finally put on their walking shoes. They've made it emphatically clear to this industry that they will no longer cede control to the makers of the technology.

That means customers are demanding integration, and refusing to accept piece parts that aren't designed and delivered to work together. It means they are demanding solutions, not “speeds and feeds.” And it means they insist that the technology adapt itself to the needs of their business and help them gain some tangible competitive advantage—to squeeze cost from

their supply chains, to create lasting relationships with customers, to empower their key constituencies (internal and external) with tools and knowledge.

A Tale of Two Revolutions

So the past decade hasn't seen just one major shift, it's seen two. For IBM, this was good news. Even in the depths of our decline, in 1993, it was obvious that no other company had both the technical expertise to win product battles against competitors *and* the business knowledge to become a trusted partner for its customers. Contrary to the conventional wisdom of pundits, analysts, the media (and, of course, our rivals), IBM still had a *raison d'être*.

Of course, we had to unlock both capabilities, and, in fact, make them feed each other. That goal—creating a business model that uniquely combines technical and business innovation, a company with one foot in the lab and one in the boardroom—underpins the new IBM we set out to build.

Thus, the big decision we made early on—to reverse the then-current plan to break up the company and commit instead to making all of IBM's parts work together—was a fairly easy one. It didn't involve a lot of research or market analysis. The real question in my mind was not “Should IBM exist?” but rather, “Can we become what this new era demands?” Put another way: Could we aspire to lead again? I can't think of many companies, in any industry, that have led two eras. But I can tell you now that, even in the dark days, we began believing that we could defy history.

Of course, that's like deciding to climb Mount Everest. You still have to climb the mountain! And we weren't

starting our trek from an elevated base camp, or even from sea level. This annual report captures a sense of the sheer range of what was involved to pull it off.

Through it all, our guiding light came down to two words: customer focus. It has proved both galvanizing and clarifying, serving as the criterion for reexamining a whole lot of dogma, and for resolving many of our seemingly intractable internal debates.

Was it okay for IBM Global Services to recommend competitors' hardware or software? Should the IBM software business develop solutions for Sun or HP servers? How about letting our hardware units support Oracle or Microsoft products? In every case, the answer was: We'll do what customers want.

Once we started really listening to customers, it's striking how many aspects of our business improved—and not just on the market-facing side, but also in procurement, with our suppliers and even in technology, where the quality and quantity of our output have benefited enormously from exposure to the marketplace.

This is important. The relationship between business and technology isn't one-way. Technology itself isn't some force of nature that we simply direct or use. It, too, is the product of human intentionality and choice. So yes, we apply technology to solve customer problems. And we also apply marketplace knowledge to help shape our research agenda—whether it's the direction of the economy, or growth opportunities, or emerging forms of governance and education, or demographic and social trends, or discoveries in other fields such as life sciences.

A decade ago, the two were disconnected—and one of them was running amok. Technology was being pursued for

its own sake, and was either buried in labs (in the case of IBM), or generating premature visions of business triumph (in the “build it and they will come” fantasies of the dot-com paper billionaires and “new economy” moguls).

We needed to reassert a proper balance. And that led, in IBM, to a handful of strategic bets on the future drivers of our industry. I would highlight four.

1. THE NEW INDUSTRY MODEL: *Innovate or Integrate*

To survive, you have to do one or the other really well. To lead, you have to do both.

The vertical integration of the technology industry in the '60s and '70s had given way by the early 1990s to a dizzying array of “pure play” companies (specialists in PCs, databases, application software and the like). This explosion of entrepreneurial and technical creativity was, on the one hand, a testament to our industry's enduring power. It's a well that will never run dry.

Businesses, however, desperately needed someone to help them make sense of this chaos. Hence, the emergence over the past several years of technology integrators—and the rush of traditional professional services companies into e-business consulting.

As I/T moves out of the back office and into the executive suite, value and growth in our industry are driven less than they used to be by technical innovation or product excellence, as necessary as those remain. What matters most today is the ability to integrate technology into the lifeblood of business. The people who help customers apply technology to transform their businesses have increasing influence over everything from architecture and standards to hardware and software choices and partners.

2. THE NEW BUSINESS MODEL: *Services-Led*

A lot of people now understand the lead role played by I/T services. However, building up the requisite skill base, not to mention an appropriately sophisticated management system, is nontrivial. You can't buy your way into it, or just go out and hire a lot of smart people. You need a certain scale and range of disciplines. Also, you can't just layer one kind of expertise on top of another. This isn't just filling up two beakers, one labeled “customer” and the other labeled “technology.” It takes years and a lot of knowledge to be able to mix those elements properly.

Plus, services is rapidly expanding and evolving in some surprising ways. It now encompasses not just labor-intensive consulting, but also the utility-like delivery of computing—from applications, to processing, to storage. We see the beginnings of this trend in Web hosting and our own “e-business on demand” offerings, where customers don't buy computers, but acquire computing services over the Net, on a pay-for-use basis. To play here, as well as in the globally booming strategic outsourcing arena, you have to be willing and able to use your balance sheet to support growth.

IBM, of course, had deep experience in I/T services. But in our old business model, it was buried inside a revenue stream dependent on selling hardware. We had to extract our service operations and turn them into a profit center in their own right. That involved a lot of trial and error. But today, IBM Global Services has evolved into the world's largest and most innovative consultancy, systems integrator and strategic outsourcing leader.

3. THE NEW COMPUTING MODEL: *Infrastructure Plus Ubiquity*

It became clear to some of us in the mid-'90s that the PC-driven, client/server computing model had run its course, and was being replaced by network-based, distributed computing. This meant that, on one end of the scale, the workload was moving back to the infrastructure—to industrial-strength servers, storage, databases and transaction-management systems. On the client end, it has spawned a proliferation of network-connected devices of all kinds: PDAs, cell phones, videogame systems, set-top boxes and beyond—to the whole pervasive-computing world of embedded components in everything from household appliances, to medical devices, to cars. And tying it all together was an emerging category of software with a wonderfully descriptive name, which hardly anybody had heard of five years ago—middleware.

It stood to reason that, in a distributed model, profitability would be distributed, too. So we zeroed in on three sweet spots of the new computing “stack”: enterprise systems, integrating middleware, and the specialized, high-value components (such as custom chips) that turn every sort of device into a computer.

This is anything but a “portfolio” approach. We're not just hedging our bets, and we're certainly not trying to be all things to all people. Our choices have been about both what businesses to pursue aggressively, and what ones to exit (such as enterprise application software and networking hardware).

- In enterprise systems, we retooled our storage family and entirely revamped and consolidated our server lines. And, let the record note, we didn't accept another piece of conventional wisdom—we didn't give up on the

mainframe. Like IBM, it's back—transformed, more powerful, and doing quite nicely.

- In software, through acquisition and internal development, we built the biggest middleware business in the world. That's fortunate, because middleware—which helps customers integrate their applications and processes—has emerged as the fastest-growing sector of the software industry. As a development platform, it's becoming more important than operating systems. And that, in turn, has helped IBM Software to become more deeply integrated into the wider software industry than ever before, much better positioned to share in its future growth.

- In component technology, what began as a search for a new revenue stream to support our R&D expenses turned into a significant growth engine in its own right—our OEM, or original equipment manufacturer, business. Yes, that part of IBM has been hit by the general downturn in technology purchasing. But we remain confident in the long-term future of the business, which is based on exactly the kinds of specialized components for which demand will be greatest in a post-PC world.

Of course, we are no longer alone in drawing this new computing model. But while pretty much everyone now agrees on the outlines, there is much disagreement about the approach. Basically, it comes down to whether you believe in interoperability and common standards or not. We have certainly placed our bet.

4. THE NEW MARKETPLACE MODEL: *An Open Playing Field*

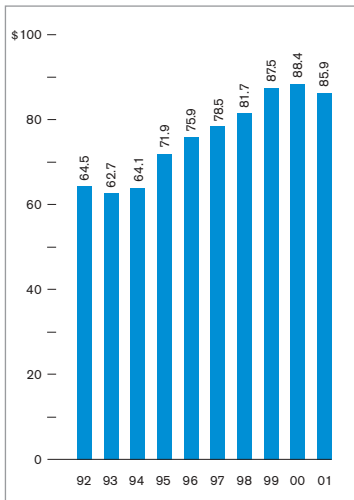
A lot of companies—including many of our leading competitors—still don't acknowledge or fully understand that common standards are essential in a networked



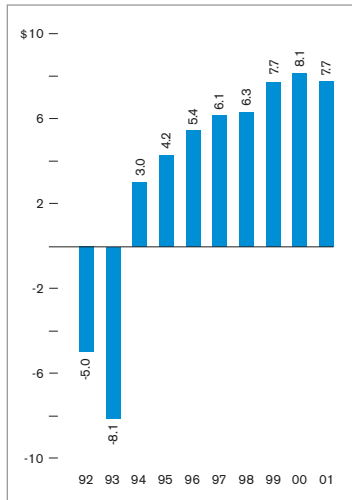
SAMUEL J. PALMISANO
President and Chief Executive Officer

JOHN M. THOMPSON
Vice Chairman of the Board

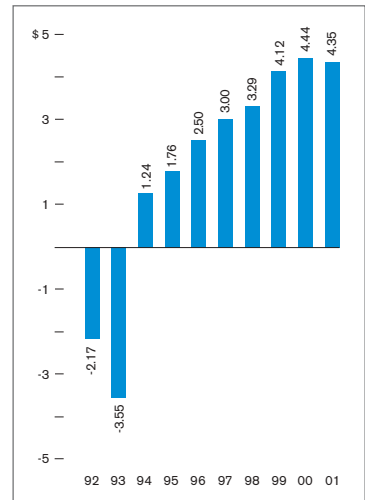
LOUIS V. GERSTNER, JR.
Chairman of the Board



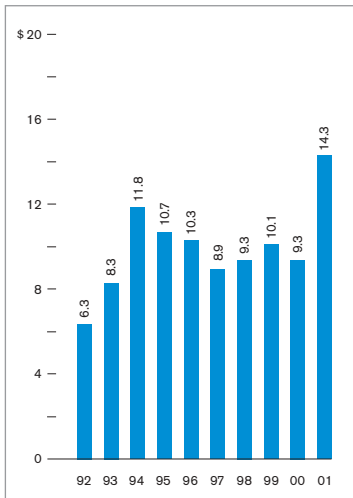
REVENUE
(\$ in billions)



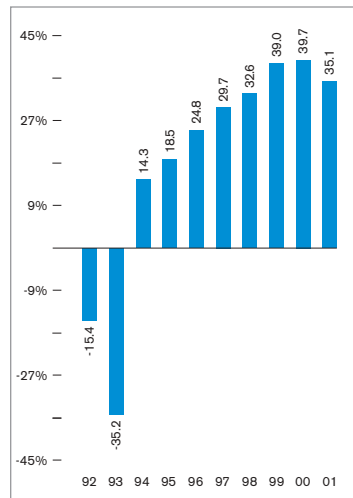
NET INCOME
(\$ in billions)



EARNINGS PER SHARE - DILUTED



CASH FLOW FROM OPERATIONS
(\$ in billions)



RETURN ON STOCKHOLDERS' EQUITY

world, and that no one will ever again control customers through proprietary technology.

We can certainly appreciate their struggle. We've had to turn a company that long ago made its fortune from proprietary technologies into one that saw the benefits of openness. Maybe it's precisely because we were so acutely aware of the siren call of proprietary control that we have learned to resist it. But one thing is apparent: In a customer-driven world, open architectures and common standards are inevitable.

Today, we are focusing all our technical expertise and marketing energy—previously devoted to creating and marketing self-sufficient systems—toward reimagining and rebuilding them for open platforms. We now share our emerging software products with the developer community; license our technology and patents; and champion common standards at all levels, from Linux, to Java, to Web services. Most important of all was the work we undertook to open up our technical architectures. Absolutely every piece of IBM hardware and software today is a fundamentally different beast (and a more socialized one) than it was ten years ago.

We know what it's like to be on the wrong side of history. The future won't be kind to those who ignore this lesson.

* * *

Put these models together, and you see a changed competitive landscape with very new dynamics. There will be a different lineup of winners and losers. And at the head of the pack, we will see the emergence of a new type of enterprise with a whole new type of corporate culture. We've been building such a company for nearly a decade: big but fast; entrepreneurial and disciplined; at once

scientific and market-driven; able to create intellectual capital on a worldwide scale, and to deliver it to a customer of one. This new breed continually learns, changes and renews itself. It is tough and focused—but open to new ideas. It abhors bureaucracy, dissembling and politicking. It rewards results. Above all, it covets talent and passion for everything it does.

It's hard work—the hardest any business can undertake, in my view—but we're making good progress. From a changed approach to hiring and performance-based compensation; to groundbreaking work on distance learning; to providing the tools, opportunities and flexibility for employees to control their own work/life balance; we are creating not just the theory, but also the practice—and the mindset—of a true e-business.

This is a very different place from the one I joined nine years ago, in many ways that are obvious, even to the casual observer—and in some that aren't, even to the observant insider. It is smarter, more unified and much, much faster. Instead of consistently resisting change, more IBMers now lead it. Our employee population is as skilled and comfortable collaborating online—across geographies, functions, roles—as any I've seen. And we are even learning to make a virtue of our size and complexity, becoming more adept at working the matrix to get things done.

Farewell

Nine years! As must be obvious by now, I am not exactly ready for retirement. And I would love nothing better than to help drive, and learn from, all that I see happening in the laboratories of IBM and the work we're doing with

CHAIRMAN'S LETTER

customers—everything from “smart dust” to e-sourcing, from global e-learning to e-government, from life sciences to grid computing. What a world is hurtling toward us!

However, a decade or so is long enough to be the leader of a large, complex company like IBM. To win in this industry, you've got to get out in front of the big shifts that come along about every ten years. You need fresh thinking and the courage to lead wrenching change. With e-business, we caught the wave early. We bet the company on the networked world, and that will serve IBM well for years. But I'm sure that Sam will face, during his long and illustrious career, another major shift. When it comes, I hope he throws out everything Gerstner ever did. Adjusting to the market's evolution is why IBM is now succeeding—just as an inability to do so was once IBM's fundamental failure.

We see fascinating hints already of the company IBM will become. I am confident that, with Sam Palmisano's leadership, the best is yet to come. As Chairman of the Board for the remainder of this year, I will continue to be involved in any way that Sam desires. But my time as IBM's leader is over. It has been an enormously exhilarating run, and I have learned more, much more, than I ever expected.

I don't comfortably express my deepest feelings in public. So let me just say, to all my colleagues, all our loyal customers, all our invaluable partners, and to my friend and worthy successor—thank you.

Thanks to the IBM customers who rooted for us to come back from the brink.

Thanks to our shareholders, who took the time to understand what was happening in IBM against the backdrop of industry change.

Thanks to a smart, committed board of directors, who provided wisdom, guidance and support for an agenda full of risk-taking change.

Thanks to the many IBM executives who gave me a chance, who helped me learn and supported me in the early days—when they could very easily have been antibodies resisting this invader from outside.

And, thanks—320,000 thanks—to all my colleagues in this magnificent company. No matter what the challenge—from IBM's own near-death experience, to Y2K, to dot-com mania, to recession, to 9/11—IBM employees blessed all of us with their grit, their passion, their compassion and their class.

I'm proud to have served and worked with all of you. I'm grateful for all that you've taught me, and for sharing with me the business opportunity of a lifetime.

And now—go get 'em.

A handwritten signature in blue ink, reading "Lou Gerstner". The signature is fluid and cursive, with a large initial "L" and "G".

Louis V. Gerstner, Jr.
Chairman of the Board

Sixteen decisions that *transformed* IBM

TUESDAY, NOVEMBER 10, 1992 C1

WALL STREET JOURNAL

BUY & INVESTING

Mutual Funds	C29	Oil Prices	C13
Nondiv Stocks	C4	OTC Focus	C3
New Securities Issues	C21	Redemptions	C18
NYSE/Amex Bonds	C14	Stock Market Data Bank	C2
NYSE Highs & Lows	C9	Treasury/Agency Issues	C17
NYSE Stocks	C5	U.S. Regional Markets	C19
Old-Lat Trading	C78	World Markets	C11

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'Break Up IBM,' Cry Some Investors Who See Value in Those Baby Blues

HEARD ON THE STREET

By MICHAEL W. MILLER
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK — Investors in International Business Machines are starting to ask a question once unthinkable: Is IBM worth more dead than alive?

With Big Blue's stock mired near a 10-year low, Wall Street is starting to take a hungry look at the dozen increasingly autonomous units into which IBM carved itself last year. Traded separately, the fantasy overhead costs, break all their bad habits and enjoy the juicy market multipliers that software and other high-tech specialties command.

Yesterday, news of a product delay at a competitor helped IBM's stock perk up 1 1/2% to 67 1/2, even though many analysts believe the issue still hasn't hit bottom in its steep autumn dive.

"IBM might have a lot more value broken up," says Charles Biderman, publisher of the Market Trim Tabs investment newsletter. "The train called IBM is headed towards the junkyard, unless the parts of it get off and go their own way."

Don't hold your breath for an out-and-out bust-up takeover of IBM, still priced at \$38 billion. But the company itself is quietly working on ways to give shareholders more value from the Baby Blues.

The current scenario of choice inside IBM, industry officials say: special stocks similar to the General Motors H and E shares, which are pegged to results of the maker's Hughes Aircraft and Elec-

The Story of IBM



	ANNUAL REVENUE (\$bilions)	ESTIMATED PROFIT (\$bilions)	INDUSTRY GROWTH RATE	MARKET SHARE (%)
BIG BLUE	\$67.0	\$2,500	8%-9%	15
SOME BABY BLUES*				
Application Business Systems (midrange computers)	11.4	950	5%-10%	14
Programming Systems (application software)	2.7	290	10%-15%	17
Integrated Systems Solutions Corp. (data processing for outside customers)	0.5	30	15%-20%	2
Pennant Systems (high-end printers)	2.1	30	15%-20%	1
Adstar (disk drives, other computer storage)	11.9	870	20%-40%	1

*Profits if each unit is sold. Stock-price multiples are based on estimated 1992 earnings. Sources: Aries Research; Wall Street analysts

tronic Data Systems businesses, respectively. Compared with an outright spinoff, the GM route would preserve a time-worn strategy to which IBM executives cling with religious zeal: offering its customers one-stop shopping for all sizes of computers.

If there's a stock buyback, a subsidiary to be audited, results to be audited and IBM won't stop. Blues audited sep 1993. So an IBM Please Turn to

Wall Street Houses Devise Plan From Going to Golden

NO. 1

We decided not to die

KEEPING IBM TOGETHER

Did the world need a company like IBM anymore? In the early 1990s, our way of computing and our way of working with customers had fallen out of vogue, and we were on a fast track to being dismantled, from within.

Then, in the spring of 1993, new leadership brought a new vision—and a surprising decision. IBM would stay together. We believed niche players weren't the future. In fact, breaking up the company would have been the end of everything IBM stood for.

We made a big bet that customers needed a partner who could both create technologies and integrate them—with each other, and with the customer's business processes.

At the time, it was a gutsy call. They always are when you're alone. But we decided that we should be true to ourselves. It all started with that.



Chess Grandmaster Garry Kasparov versus IBM supercomputer Deep Blue, May 11, 1997

We reaffirmed our *technical heritage*

REVITALIZING IBM RESEARCH AND DEVELOPMENT

For us, IBM's heritage isn't captured in the volume of patents we earn, as impressive as that is. (In 2001, we became the first company to receive more than 3,000 U.S. patent awards in one year. It was also the ninth straight year we were awarded more patents than any enterprise in any industry.)

Nor is it mostly a function of the discoveries in new fields that are pouring out of our labs, as exciting as those are. (On the horizon, we look to the promise of our pioneering work in areas such as autonomic systems, nanotechnologies and quantum computing.)

For IBM, the true heart of our technical and scientific heritage is in doing research and development that *matter*. IBM's heritage is technology that changes how business is done, how states can govern, how students can learn. IBM's R&D finds its ultimate scorecard not in scientific journals, but in the impact it has on the fundamental problems and opportunities that exist in the world.

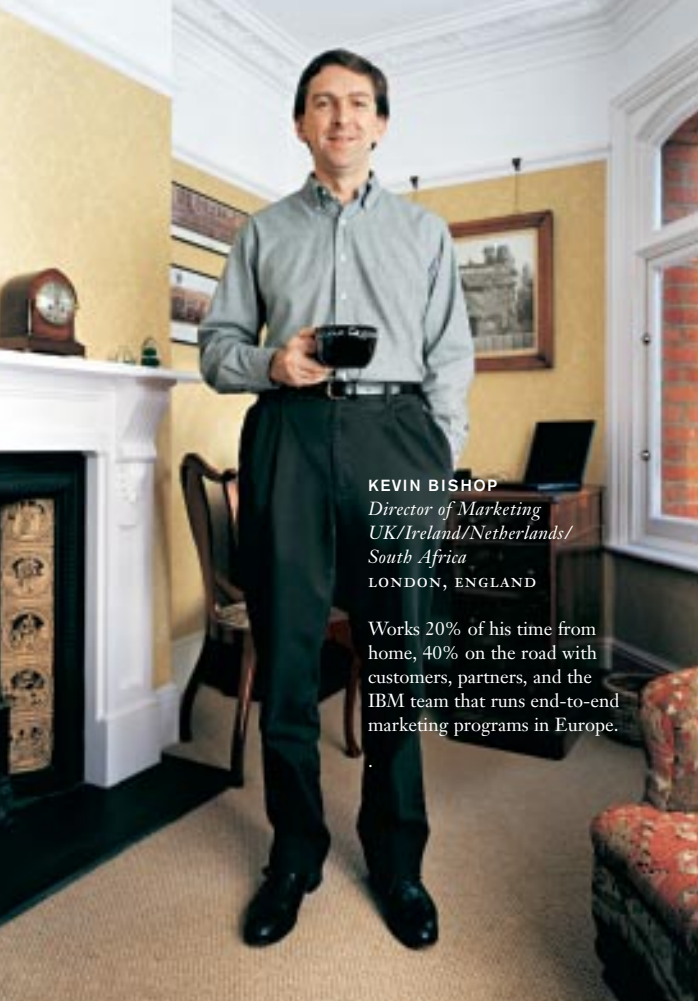
Maybe that's why one Sunday evening in 1997 was such a signal moment. A supercomputer named Deep Blue defeated the reigning chess grandmaster—and announced that IBM was, once again, the place where grand challenges are taken on, and where paradigms get shifted.

In 2001

OUR STRAINED SILICON TECHNOLOGY STRETCHES SILICON TO SPEED
THE FLOW OF ELECTRONS THROUGH A CHIP—POTENTIALLY
boosting chip performance or cutting power consumption BY 35 PERCENT

OUR CARBON NANOTUBE TECHNOLOGY USES TINY CYLINDERS
OF CARBON ATOMS—AS SMALL AS 10 ATOMS ACROSS—TO BUILD TRANSISTORS,
WHICH COULD LEAD TO *smaller, faster, lower-power* COMPUTER CHIPS

OUR RESEARCHERS EXECUTE THE MOST COMPLICATED COMPUTATION
EVER PERFORMED ON A QUANTUM COMPUTER,
A TYPE OF *experimental system* THAT HARNESSSES CERTAIN PROPERTIES IN BILLIONS
OF ATOMS TO PERFORM CALCULATIONS EXPONENTIALLY FASTER
THAN CONVENTIONAL COMPUTERS



KEVIN BISHOP
Director of Marketing
*UK/Ireland/Netherlands/
South Africa*
LONDON, ENGLAND

Works 20% of his time from home, 40% on the road with customers, partners, and the IBM team that runs end-to-end marketing programs in Europe.



ENA D. CANTU
*Supercomputer Storage
and Systems Administrator*
CAMP SPRINGS, MARYLAND

Spends 100% of her time at The National Center for Environmental Predictions, maintaining the NCEP's operational weather and climate forecasting system.



PRISCILLA E. HAY
Senior Problem Manager
IBM Baukham Hills
Command Centre Operations
SYDNEY, AUSTRALIA

Monitors the I/T systems for more than 80 customers simultaneously from the IBM Global Services command center.



KISHORE CHANNABASAVAIH
Executive Architect
Centers for IBM
e-business Innovation
CHICAGO, ILLINOIS

Spends 40% of his time in customer locations, the rest in the IBM multimedia center solving complex e-business problems.

We rewired the enterprise

TRANSFORMING OUR CRITICAL PROCESSES AND
BECOMING AN E-BUSINESS

We had met the enemy, and it was us. Too slow, too costly, too insular.

So in 1994, we rolled up our sleeves and started to transform the way IBM works, from end to end. Most companies attempt one major reengineering project at a time. We launched 11—from the way we manage internal information systems, to the way we develop products and serve customers. It was ambitious—but it wasn't enough.

We came to realize that important organizational change also has to happen in a company's social structures—in how people understand what is expected of them, in how they are rewarded and managed, in the ways that ideas are shared. In order to deliver on our value proposition, we had to change the very nature of work.

Speed

SINCE 1993, *cycle time* FOR LARGE SYSTEMS DEVELOPMENT HAS BEEN SLASHED 56 MONTHS TO 16 MONTHS TODAY. FOR LOW-END SYSTEMS, IT'S SEVEN MONTHS—DOWN FROM TWO YEARS

Superior Quality

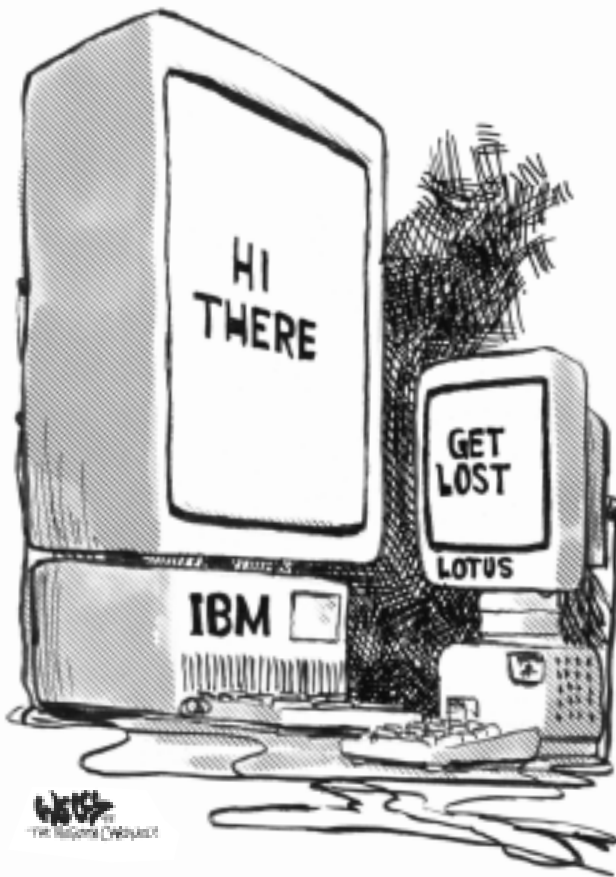
BETWEEN 1997 AND 2001, THE HARDWARE RELIABILITY OF OUR HIGH-END SERVERS *improved by more than 200 percent* WHILE COMPUTING POWER INCREASED BY A FACTOR OF FOUR

Simplicity

SINCE 1993, WE HAVE *reduced I/T spending* BY 31 PERCENT (E.G., BY CONSOLIDATING DATA CENTERS)—FOR A TOTAL SAVINGS OF MORE THAN \$2 BILLION

Trust

EMPLOYEES REGARD IBM'S INTRANET AS THEIR *most trusted source* OF COMPANY INFORMATION—SURPASSING EXTERNAL MEDIA, COWORKERS AND THEIR IMMEDIATE MANAGERS



WCS
The National Computer

NO. 4

We didn't take “*no*” for an answer

WHAT THE LOTUS ACQUISITION TAUGHT US

History records that on June 5, 1995, we launched the hostile takeover of Lotus Development Corp. At the time, it was billed as the largest software acquisition ever. It was actually much bigger than that.

It was the moment that signaled we were out of survival and turnaround mode; when we asserted the will to lead again.

In acquiring Lotus and its elegant collaborative software program, Notes, we simultaneously filled a hole in our portfolio, made a bold move into the world of networked computing, and announced that IBM was back.

With its debut in 1964, the IBM System/360 defined an era in high-end computing. And the name was no accident. The 360, as in the perfect circle, was the paradigm of proprietary systems architecture—its own self-contained world of hardware, software and peripheral equipment.



We fought for an *open world*

THE END OF PROPRIETARY COMPUTING AT IBM

IBM used to be the poster child for closed, proprietary computing. In the early days of the information technology industry, computer makers built systems that were compatible with their own product lines (mostly), but not with anyone else's.

Even today, that's the way a few I/T companies still build their products—locking in customers and locking out flexibility and choice based on architectural “choke” points.

But not IBM. By the 1980s, it was clear that any high-tech company that tried to impose closed technology on customers would be standing on the wrong side of history. Getting to the right side wasn't easy.

It involved opening up our software to run on all the industry-leading platforms, and supporting non-IBM software on our hardware. Even our services business had to change—recommending, installing and supporting non-IBM products.

We did all that, and along the way built a reputation for backing any effort, with any vendor or any customer, to give our products an even more open identity.

IBM PRODUCES MORE SERVER-BASED MIDDLEWARE ON THE
WINDOWS NT OPERATING SYSTEM THAN MICROSOFT

IBM ACTIVELY BACKS THE GLOBAL GRID FORUM
COMMUNITY'S VISION OF OPEN STANDARDS FOR THE “GRID” NETWORKS THAT WILL
UNITE COMPUTER SYSTEMS AROUND THE WORLD,
REGARDLESS OF THEIR LOCATION, OPERATING SYSTEM OR MAKER

IBM IS A LEADING SERVICES PROVIDER FOR
ORACLE AND COMPUTER ASSOCIATES PRODUCTS

1,000 IBM DEVELOPERS—MORE THAN AT ANY OTHER COMPANY—
ARE WORKING ON LINUX

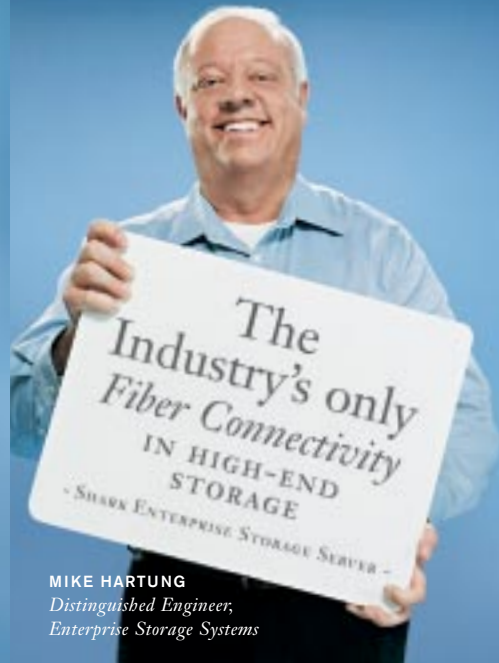
WE DONATED MORE THAN \$40 MILLION IN
APPLICATION DEVELOPMENT TOOLS TO A NEW, INDEPENDENT, OPEN-SOURCE
SOFTWARE COMMUNITY CALLED ECLIPSE



GOPI ADVANI
*Product Development Team Leader,
Wireless RF Products*



WILLIE NATHAN
Software Engineer
S. LYNN SANDERS FORE
*Advisory Engineer,
eServer xSeries Architecture and Technology*



MIKE HARTUNG
*Distinguished Engineer,
Enterprise Storage Systems*



MARCIA SPRINGFIELD
*Manager,
Mobile Hardware and Software Solutions*



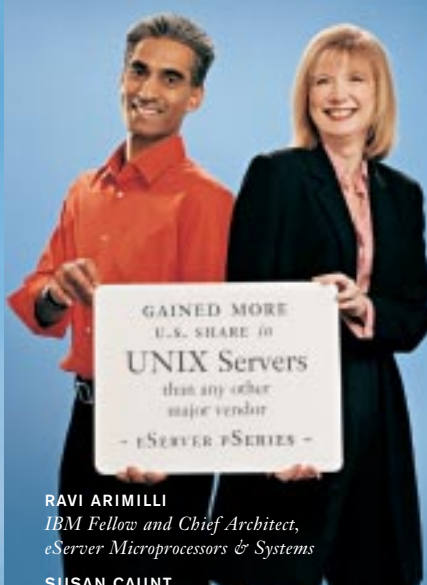
BOAS BETZLER
Senior Software Engineer



DONALD FERGUSON
IBM Fellow



NELSON M. MATTOS
*Distinguished Engineer and Director,
Information Integration—Data Management*



RAVI ARIMILLI
*IBM Fellow and Chief Architect,
eServer Microprocessors & Systems*
SUSAN CAUNT
*Hardware Management Console Project Manager,
pSeries*



DAVE BOUTCHER
*Senior Technical Staff Member,
iSeries Linux Development*

We decided *our products* would set the standard

NOT ON PLANET IBM, BUT ON PLANET EARTH

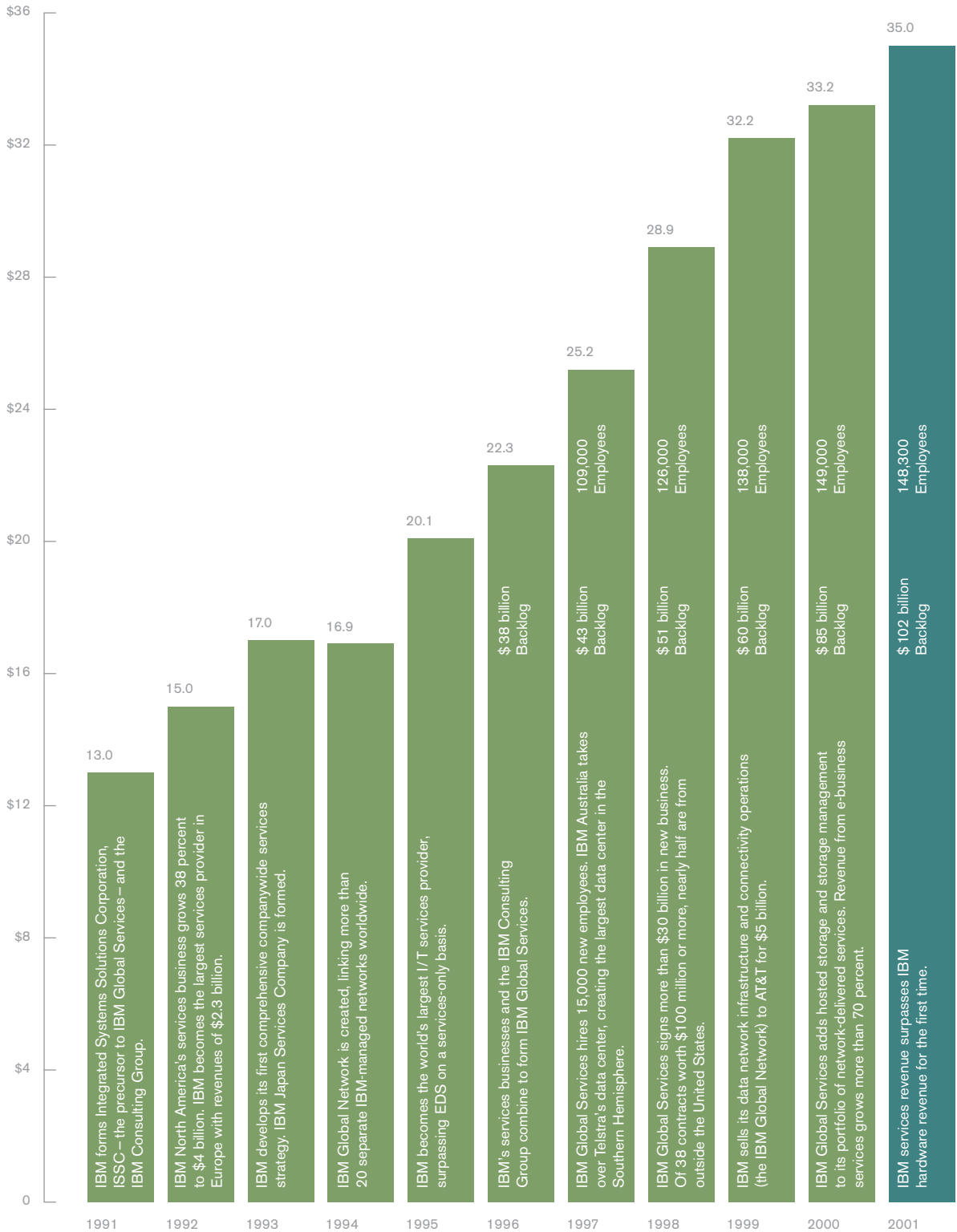
For a long time, we won with such consistency that we started to look for another challenge. We began to compare the performance of our products against *our own* prior generation, regardless of what our competitors were doing. By the early '90s, it was clear we were playing the wrong game.

So we stopped the internal benchmarks, and got serious about winning against the best the marketplace had to offer.

That decision forced us to speed up, to bring new technologies to market on shorter and shorter cycles. And it also triggered a chain reaction across the company—changing our investment and acquisition strategies, our approach to market analysis and the way we prioritize research efforts.

Today, we are the number 1 or number 2 company in servers; collaborative software; custom logic; middleware; I/T services; maintenance; Web software; high-end disk storage; distributed application software; and total software.

It's remarkable how much more you win when you're in the right game.



Total IBM Services Revenue (\$ in billions)

We grew a business from the ground up

THE BIRTH OF IBM GLOBAL SERVICES

Put another way, we realized that the future of the computer industry wasn't in computers.

In 1991, we were a \$64.8 billion company that got less than \$6 billion from non-maintenance services. Ten short years later, the business of information technology *services* generated more than 40 percent of our \$86 billion in sales and became the single largest source of revenue in our portfolio.

How did that happen? It was partly the result of old-fashioned hard work and serious commitment—growing customer by customer; building disciplined management and financial systems; and investing to hire and train experts in everything from I/T consulting, to systems architecture, to Web services. We used our financial strength to fund the expensive push into outsourcing. And we placed informed bets on the future—in areas such as I/T utility services (“e-business on demand”) and hosted storage.

But most important, the success of IBM Global Services comes from something very simple—a clear understanding of customers' needs. We saw that technology and business were converging to create something new—and challenging—for every kind of enterprise. We had the deep experience in both areas to help our customers combine them most effectively.



IBM and Computer & Technologies Software Ltd. form a strategic alliance to provide e-business solutions in China.



Sharp and IBM jointly form a new solutions company and enter into a strategic outsourcing partnership.



IBM and Shanghai Telecom form a strategic alliance to provide e-business hosting services.



IBM and The Bank of China's Jiangsu Branch celebrate the installation of the 100th Shark Enterprise Storage Server.



IBM and the Korea Institute of Science and Technology Information sign Asia's largest supercomputer deal.



Malaysia's CyberVillage Sdn Bhd joins IBM's Accelerated Growth Program.

We put down roots in Asia

CAPTURING NEW MARKETS

For IBM, Asia isn't an "emerging market." We started our first operations there in 1925, and have built a \$17 billion franchise—which alone would make our Asian operations one of the largest information technology companies in the world.

Identifying the world's emerging growth markets isn't that hard. The trick is operating inside those markets as a local enterprise, one that understands business practices and cultural traditions that can form barriers-to-entry more formidable than tariffs or entrenched competitors.

Until the mid-'90s for example, Asian companies staunchly resisted strategic outsourcing, long after other parts of the world had embraced it. When we signed our first outsourcing contracts in Japan, it was because our customers understood that their employees were not moving to a foreign company with a local presence, but to a Japanese company with very familiar values and principles.

STRATEGIC OUTSOURCING REVENUE IN ASIA WENT FROM
NOTHING IN 1995 TO \$2.6 BILLION IN 2001,
WITH 47 PERCENT GROWTH AT CONSTANT CURRENCY LAST YEAR

IN JAPAN, SERVICES REVENUE IN 2001
INCREASED 25 PERCENT IN A VERY DIFFICULT ECONOMY

OUR STAFF IN THE PEOPLE'S REPUBLIC OF CHINA STOOD AT 120 IN 1991.
THAT'S GROWN TO A WORKFORCE OF MORE THAN 11,000 TODAY, INCLUDING
WHOLLY OWNED SUBSIDIARIES AND JOINT VENTURES.
REVENUE INCREASED 30 PERCENT TO \$1.5 BILLION IN 2001

PAUL CHOU

Emerging Interactive Spaces

IBM and Steelcase Inc.: innovative work environments that integrate architecture, furniture design and advanced I/T to increase creativity, improve comfort and provide more personalization.

PAUL BORREL

Product Lifecycle Management

IBM and Dassault Systèmes: advanced solutions that enable product innovation, design collaboration and the sharing of product data with pervasive computing technology.

DAVID E. JOHNSON

Text Mining and Computational Linguistics

IBM and Wachovia: a system that learns and performs fast, accurate and high-volume text documentation categorization.

KATHERINE BETZ

Secure Electronic Payments

IBM, The Bank of Tokyo-Mitsubishi and The Industrial Bank of Japan: a framework for global financial institutions and their corporate customers to use the Internet for payments.

DAVID NAHAMOO

Human Language Technologies

IBM and T. Rowe Price: the first natural language understanding system that allows 401(k) participants to manage their accounts simply by speaking into the phone.



We brought the marketplace into *our labs*

BRINGING CUSTOMER FOCUS TO OUR TECHNICAL COMMUNITY

“IBM products aren’t launched. They escape.”

During the early 1990s, we heard that frequently, both from customers and from our own scientists, engineers and developers.

So we set to work reinventing the way we create, develop and deploy new technologies. We got innovations to market much faster, but we also found we had to do the reverse—bring real-world customer wants and needs into our laboratories.

Today, the linkage between our research and development labs and the marketplace has never been tighter. At the same time our researchers are chasing computational grand challenges or pioneering the frontiers of material science, we’re just as apt to be building prototype solutions with a customer. In fact, one quarter of our researchers are involved in this kind of joint project. Ideas flow in. Technologies flow out. The result is a new type of creative chemical reaction—between the discoveries of the lab and the immediate needs of business—that opens up new possibilities in both.



NINTENDO
GameCube

CANON
PowerShot S30
Digital Camera

e.DIGITAL
Treo 10 Digital
Music Jukebox

DELL
Inspiron 8200 Notebook Computer

We shared the crown jewels

BUILDING THE OEM BUSINESS

There was a time when all our component technologies, such as semiconductors and hard disk drives, went inside our own products. And only there.

That was then, this is now. In order to support our massive investments in R&D, we needed additional revenue streams, so we began doing something previously unthinkable—selling our technology products to other high-tech companies. Fortunately, our technology was so good that we sold a lot of it—multibillion dollars' worth, creating a large OEM (original equipment manufacturer) business.

But that was just for openers. Now is when it gets interesting.

We're entering a period of explosive demand for semiconductors—from processors for the largest servers to chips in everything from your car to your microwave oven, plus billions of Net access devices like intelligent cell phones or PDAs.

Every one of those devices needs memory, storage and communications capability, in addition to the processor. And for every kind of device, there's a slightly different kind of chip design.

This is a good time to have the largest custom chip business in the world. We do. In 2001, IBM was one of only two top-30 chip makers that grew revenue.



COMPAQ
iPAQ Pocket PC



NIKON
Coolpix 5000 Digital Camera



FRONTIER LABS
Nex II Digital
Audio Player



e.DIGITAL
MXP 100 Digital
Audio Player/Voice
Recorder



KYOCERA MITA
ECOSYS Printer
FS-1800



January 2002

We didn't give up on the mainframe

A RETURN TO ENTERPRISE COMPUTING

“I PREDICT THAT THE LAST MAINFRAME WILL BE UNPLUGGED
ON MARCH 15, 1996.”

Stewart Alsop, InfoWorld, March 1991

In 1991, Stewart Alsop was far from alone. Most respected industry pundits were declaring the end of the “mainframe era.” So we don’t hold it against him. We’re just glad he has the grace and good humor to see things differently today.

To be fair, the “mainframe,” circa 1991, *was* a dead end. But we believed (along with a lot of our customers) that this *way* of computing—serious, secure, industrial-strength—would always be in demand.

So we stuck with “big iron,” but reinvented it from the inside—infusing it with an entirely new technology core, reducing its price, and building support for open standards and operating environments like Linux.

Since 1992, shipments of mainframe computing capacity have increased more than 30 percent annually. And in the years since the last one was to have been unplugged, our mainframe business has generated revenues in excess of \$19 billion.

“IT’S CLEAR THAT CORPORATE CUSTOMERS STILL
LIKE TO HAVE CENTRALLY CONTROLLED, VERY PREDICTABLE,
RELIABLE COMPUTING SYSTEMS—EXACTLY THE KIND
OF SYSTEMS THAT IBM SPECIALIZES IN.”

Stewart Alsop, February 2002



JIM HANEY
Vice President
Architecture and Planning
WHIRLPOOL CORPORATION

“In our business, the supply chain is as important to our competitive advantage as the quality of our products. Our WebSphere-based partner trade portal dramatically improved ordering time and cut our costs by more than 80 percent.”

“In today’s economy the investments we make in technology have to pay back. Our Tradetopia extranet assists sales managers and food brokers in planning and tracking trade promotions and in handling deductions. It produced 100 percent ROI in under a year.”

DANIEL P. DILLON
President and Chief Executive Officer
WELCH FOODS, INC.



PHILIP F. MOONEY
Director, Corporate Archives
THE COCA-COLA COMPANY

“Flexible and efficient management of CNN’s huge, daily volume of content is one of the keys to our success. Extending content—such as our 150,000 hours of archive content in a digital world—will be done with enterprise-level media management systems via IBM middleware.”

“In order to understand our brands and their positioning, our employees have to be steeped in the traditions, history and imagery of our company. We’ve been able to bring to life thousands of video clips, photos and documents and make them instantly available to our associates all over the world.”

GORDON CASTLE
Senior Vice President, CNN Technology
CNN



MAYNARD WEBB
President, eBay Technologies
EBAY

“Our business is our website. We’ve got 42 million registered users who are listing millions of items and transacting over \$30 million in gross merchandise sales on the eBay site each day. You don’t run that kind of Web enterprise on anything but industrial-strength platforms.”

“We’re transforming our business with a new e-business infrastructure—powered by IBM database, communications, application and system management software. For customers, this means new and better services. For employees, it means our intranet, e-Spacio, can simplify and speed up how we work.”

JOSE MANUEL AGUIRRE LARIZGOITIA
Senior Vice President and CIO
BBVA GROUP

We majored on *middleware*

BUILDING OUR SOFTWARE BUSINESS

In 1993, nobody would have recognized the term “middleware.” Today, it is nearly 40 percent of the \$230 billion software marketplace.

It’s also what we bet our software business on in 1995, when we were looking for IBM’s next growth opportunities.

Middleware is the collection of products—databases, transaction management systems, messaging, systems management—that lets customers do things they care about. Things like allowing your online bookstore to make recommendations based on prior purchases, or keeping your credit card information confidential when you go to the Net to buy an airline ticket.

Middleware represents 80 percent of our \$13 billion software business. We’re the world’s leading provider, and we’re growing faster than our main competitors.



(music under)

Web Guy: I've got some great ideas for our website. We could have a spinning logo like this one... or a flaming logo. This is cool!

Boss: You know what would be a great idea? If people with PCs anywhere could order our products...and that was all tied together with inventory, billing, vendors. You know, the works. Then, that would change everything.

Web Guy (perplexed): I don't know how to do that.

Closing title shot: IBM helps thousands of companies do real business on the Web.

e-business logo...(music out)

We found *our voice*

REINVIGORATING THE IBM BRAND AND EVANGELIZING E-BUSINESS

We recaptured something we'd lost—our ability to engage our customers and our industry in a meaningful conversation about what matters to us, and to them.

This wasn't about cranking up the volume, issuing more press releases, or producing memorable TV commercials. It was about rediscovering our confidence and articulating what we believe. Things like:

- WE ARE ENTERING A POST-PC ERA.
- THE DOT-COMS ARE FIREFLIES BEFORE THE STORM.
- THE WINNERS IN THIS INDUSTRY WILL DO ONE OF TWO THINGS: INNOVATE OR INTEGRATE.

When we rediscovered our voice, we discovered something else: our sense of direction, the courage to stand apart from the crowd and, ultimately, what it means to speak out like a leader again.

BOB QUINN

Finance Program Manager



KIM SHEDLIN

Administrative Assistant



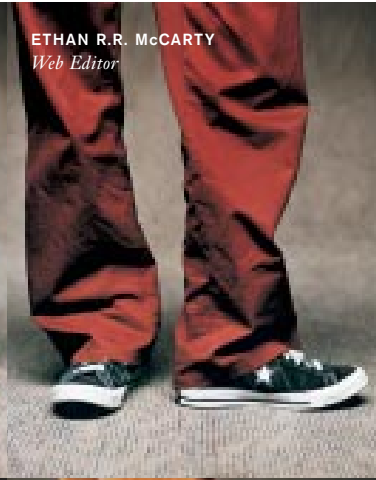
DANIEL DREYER

Human Resources



ETHAN R.R. McCARTY

Web Editor



JIAN M. WU

I/T Specialist



LAUREN WINSTON

*Certified Sales Specialist,
Personal Computing*



BRADFORD HOBBS

*Director, Corporate
Brand Strategy*



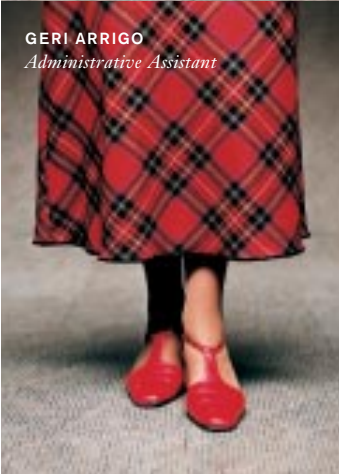
LUBA M. LABUNKA

*Senior Project Manager,
Emerging Market Finance*



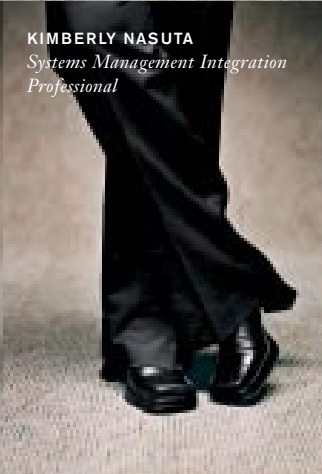
GERI ARRIGO

Administrative Assistant



KIMBERLY NASUTA

*Systems Management Integration
Professional*



LARRY RICCIARDI

Senior Vice President



GRACE SUH

*Program Manager
Corporate Community Relations*



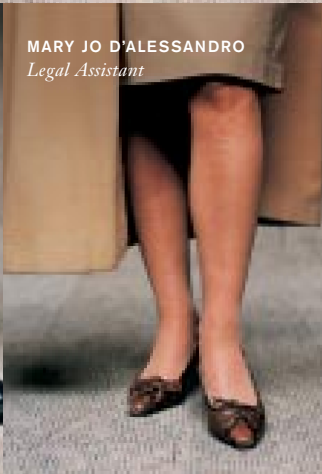
JOHN T. O'LEARY

Software Account Manager



MARY JO D'ALESSANDRO

Legal Assistant



MAUREEN POWER

*Client Services Principal,
J. P. Morgan Chase & Co.*



RICHARD MUSHLIN

*Researcher,
Computational Biology*



We loosened our tie

CHANGING CORPORATE CULTURE

In the early days of the 1990s, we knew that a lot of things about IBM had to change: financial, strategic, operational. We tackled those, and by the middle of the decade, the company was no longer on life-support.

But there was one more hill to climb. In order to deliver on IBM's value proposition—uniting business knowledge and technology to provide integrated solutions for our customers—we had to change something even tougher.

Ourselves.

We've reinvented how we compensate people and who we hire. We provided people with the tools, opportunities and flexibility to control their own work/life balance, and their own learning. We've rethought all kinds of assumptions about management, including the role of the manager.

Changing a company's culture—turning it once again into an unbeatable competitive asset, rather than a near-fatal malady—that's about a lot more than allowing people to bring their dogs into the office or dropping a dress code.

And, for the record, "dropping the IBM dress code" was the biggest culture-change move we *never* made. We simply said IBMers should dress appropriately for the task at hand. We trusted their judgment—on a lot more than clothing.

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We remembered our *middle name*

BUILDING A REPUTATION IN BUSINESS INNOVATION

At our core, we've always been a technology company—including back in the '60s and '70s, when we were taking a consultative approach to transforming customers' back-office processes like accounting and payroll.

In the late 1980s, however, we lapsed. We forgot that the commitment to business solutions—not technology for technology's sake—is what separates IBM from the field.

That's the reason we're no longer organized by geographic regions or product sets, but align our expertise and resources around customers and industries. It's why we created a services business and committed ourselves to integrated solutions.

And it's what led us to define the Internet phenomenon not as "the network" or "the Information Superhighway" or "the wired world," but as "e-business."

It's why we're quite comfortable with our middle name.



INTERNATIONAL BUSINESS MACHINES CORPORATION
500 MADISON AVENUE
NEW YORK 22, N. Y.

OFFICE OF
THE PRESIDENT
Confidential

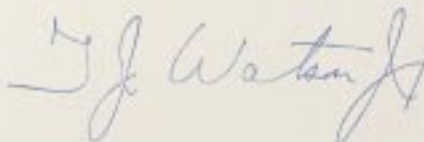
September 21, 1953

Policy Letter #4

The purpose of this letter is to restate for all of the supervisory personnel of the IBM Company the policy of this corporation regarding the hiring of personnel with specific reference to race, color, or creed.

Under the American system, each of the citizens of this country has an equal right to live and work in America. It is the policy of this organization to hire people who have the personality, talent and background necessary to fill a given job, regardless of race, color or creed.

If everyone in IBM who hires new employees will observe this rule, the corporation will obtain the type of people it requires, and at the same time we will be affording an equal opportunity to all in accordance with American tradition.



T. J. Watson, Jr.

We never abandoned *our values*

OUR RESPONSIBILITY TO THE COMMUNITIES IN WHICH WE WORK AND LIVE

Everything else in this report has been about what changed over the past nine years. This is about what didn't.

Long before there was an Internet, before computers, or semiconductors, or even vacuum tubes, there were ethics, corporate citizenship, social and environmental responsibility and fairness.

We make our business in the high-tech revolution of the networked world. But we *built* our business on a system of beliefs. These values transcend the progression of one generation of technology to the next—or, for that matter, of one generation of people to another.

Of course, as the needs within communities changed, so did the nature of our philanthropic efforts, or the way we applied our expertise and technologies. We adapted the approach, but never the underlying principles.

So perhaps this last decision is really more of a pledge, or a promise that a company and its people make to the institution, and to one another: To remain faithful to values that never change. And to remember—at every step of the journey—who we are, and what we stand for.

In 2001

IBM CONTRIBUTED MORE THAN *\$127 million* TO PROGRAMS AROUND
THE WORLD THAT HELP PEOPLE IN NEED

INDIVIDUAL *employees contributed another \$51.2 million* THROUGH MATCHING
GRANTS AND DONATIONS TO NONPROFIT ORGANIZATIONS AND INSTITUTIONS

IBMERS *volunteered more than 4 million hours* OF TIME AND EXPERTISE
TO A BROAD RANGE OF LOCAL CAUSES

IBM CONTINUED ITS COMMITMENT TO *improve the quality*
OF K-12 EDUCATION THROUGHOUT THE WORLD WITH ITS \$70 MILLION
REINVENTING EDUCATION GRANT PROGRAM

U.S. ENVIRONMENTAL PROTECTION AGENCY PRESENTED IBM
THE 2001 ENERGY STAR® *"excellence in corporate commitment"* AWARD

DURING THE PAST SIX YEARS, IBM HAS *increased its number* OF WOMEN
EXECUTIVES WORLDWIDE BY 246 PERCENT

Seven shifts that *will transform* the future (yours, and ours)

1. Computers *will care* for themselves.

Mere humans don't stand a chance of keeping pace with the coming onslaught of data volumes and transaction flows, not to mention the complexity of information systems themselves. Fortunately, mere humans can infuse the systems with the ability to manage the complexity themselves. Called *autonomic computing* (after the human autonomic nervous system that governs activities like heart rate, digestion and breathing), this will make our systems more reliable, self-managing, self-protecting and even self-healing—freeing up enterprises to focus on more creative things, like new uses for those very systems.



2. *Advanced computing devices will take* a lesson from a mollusk.

Scientists today can etch microscopic lines in computing components that are astoundingly fine, but the processes are themselves astoundingly intricate, complex and increasingly expensive. Now, scientists are taking a cue from the lowly abalone, which organically combines materials to form a shell 3,000 times stronger than its component elements. That principle of natural self-assembly is behind using chemical reactions to form materials with built-in nano-scale features. IBM scientists have already moved individual atoms. Tomorrow, they just might be able to make those individual atoms do some amazing work.



3. Enterprises will dismantle *industrial age* workplaces.

Once, we shoehorned people into office complexes so they could be near the filing cabinets and each other. No longer. “The office” will be discarded in response to a changing workforce with radically different expectations, a marketplace that has no time for bureaucracy (or time zones), and technologies that make the traditional workplace an e-workplace. At IBM, we're not only studying this in our labs—we're also learning about it, and living it, in our e-business-enabled work lives.



4. The *small (and energy-efficient)* will pack quite a wallop.



For many of tomorrow's most massive computing challenges, IBM scientists expect to see 10 times the energy efficiency at the same cost by assembling "cellular architectures" of thousands, even millions of simpler microprocessors that will work in parallel on discrete "chunks" of a problem. When aggregations of these power-efficient chips combine their resources over virtualized computing networks, we may see supercomputer performance within reach, not just of enterprises of all sizes, but individuals.

5. Converging technologies may *decode* (and extend) the book of life.

The mapping of the human genome was as much a triumph of advanced computation as of advanced biology. Now that we've created this autobiography of our species—a book 3 billion chemical letters long—what we read there may drive astounding quality-of-life improvements: dramatic reductions in the cycle time for development of new pharmaceuticals; personalized medications that interact with an individual's unique genetic make-up; and the potential to defeat scourges like heart disease or AIDS. Some researchers believe we're on the verge of the first significant increase in life spans—on the order of 20 years—since the introduction of antibiotics.

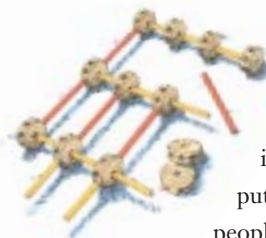


6. You'll be able to manage *an army of "you."*



People used to worry that cyberspace would mean the loss of individual identity. If only. We collect too many identities—passwords, user names and customer profiles that multiply every time we surf a new website—and as a result, fragment the image we present any time we enter a physical store, classroom, website, bank, or government office. The solution? Technologies being developed today by IBM and others can make possible one "virtual identity"—single, encompassing and under our total control through all our daily interactions and transactions. If we've earned preferred-customer status, we'll get it. If we're a first-timer in need of some extra hand-holding, that, too, will be obvious.

7. All computers (and computer users) will join "*the grid.*"



Just as electricity has become part of the global infrastructure on which modern life depends, the same thing is about to happen with computing. What's coming is an interconnected, shared computing infrastructure through which people will access the computational resources of...the world. In essence, millions of computers will be interwoven into a gigantic grid which people will use like a utility. This emerging global infrastructure will be, essentially, like one big computer.

the 1990s, the number of people with a mental health problem has increased in the UK (Mental Health Act 1983, 1990).

There is a growing awareness of the need to improve the lives of people with mental health problems. The Department of Health (1999) has set out a strategy for mental health care in the UK. The strategy is based on the following principles:

• The promotion of mental health and the prevention of mental health problems.

• The provision of a range of services to meet the needs of people with mental health problems.

• The provision of services that are based on evidence-based practice.

• The provision of services that are accessible to all people with mental health problems.

• The provision of services that are cost-effective.

• The provision of services that are of high quality.

• The provision of services that are based on the needs of the community.

• The provision of services that are based on the needs of the individual.

• The provision of services that are based on the needs of the family.

• The provision of services that are based on the needs of the carer.

• The provision of services that are based on the needs of the community.

• The provision of services that are based on the needs of the individual.

• The provision of services that are based on the needs of the family.

• The provision of services that are based on the needs of the carer.

• The provision of services that are based on the needs of the community.

• The provision of services that are based on the needs of the individual.

• The provision of services that are based on the needs of the family.

• The provision of services that are based on the needs of the carer.

• The provision of services that are based on the needs of the community.

• The provision of services that are based on the needs of the individual.

• The provision of services that are based on the needs of the family.

• The provision of services that are based on the needs of the carer.

• The provision of services that are based on the needs of the community.

DEAR FELLOW INVESTOR,

Last year at this time, Lou Gerstner said 2001 would be a “show me” year for IBM. We knew heading into 2001 that global economies were decelerating, and that IBM wouldn’t be immune from the slowdown. We also knew that a tight economy would provide an acid test of our competitive position, and that of our major competitors. No hiding. No getting swept along by a booming economy. *Show me.*

A handwritten signature in blue ink that reads "Sam Palmisano". The signature is fluid and cursive, with the first name "Sam" and last name "Palmisano" clearly legible.

In 2001, I believe IBM showed the world three things:

- The strategies we've been following for the past several years are correct.
- We've produced results through disciplined market-place execution.
- If we can gain share in a declining economy—which IBM did in 2001—then we can keep winning when a rebound occurs.

We delivered strong results in an environment that took a heavy toll on the high-tech sector. For the first time in nearly a decade, the information technology industry shrank. Yet, measured in constant currency, IBM's revenue was up 1 percent. That's a modest increase, to be sure—but it was the first time since the early 1990s that IBM outperformed the industry. Our gross profit margins improved, and we reduced our indirect expense by more than \$1 billion, reinvesting these savings in direct expense that can drive future revenues and share gains. Earnings declined from 2000 levels, yet we delivered very strong profitability—net income of \$7.7 billion for the year and more than \$14 billion of cash from operations.

Our continued strong cash flow gave us the flexibility to make investments in our future—\$5.8 billion in research and development, \$5.7 billion in capital expenditures, and \$1.1 billion for strategic acquisitions to strengthen our portfolio. The bulk of our acquisition investment was used to acquire the database assets of Informix Corp., which improved our share position and

growth potential in the battle for database software leadership. After making all those investments, we used our strong cash position further to increase shareholder value by raising our common stock dividend 8 percent and by repurchasing \$5.3 billion in IBM common shares. We ended the year with a cash balance of \$6.4 billion.

The strength of our performance relative to our mainstream competitors was reflected in a 42 percent increase in our stock price—this during a year when the S&P 500 index declined 13 percent and the NASDAQ was down 21 percent. While market valuations were being decimated across the high-tech sector, our market capitalization at year end was \$208 billion, up 41 percent.

Most encouraging of all, we consistently outperformed our major rivals and gained share in every strategic business segment. This is the overriding message of 2001. We won a lot more than we lost, and based on that record alone, IBM enters 2002 far stronger and better positioned than when last year began.

In an environment in which revenue growth was hard to come by, our two principal growth businesses—software and services—delivered the strongest results.

Software

Our software growth was fueled by strong momentum across our middleware products—the integrating software layer of e-business infrastructure.

- In database and transaction management, we grew and took significant share from the market leaders in both categories.

- WebSphere—our suite of products that allow businesses to build, deploy and manage all manner of e-business operations, grew 50 percent and significantly outpaced its competition.
- Lotus remains the market leader in collaborative middleware, and Tivoli, which develops security and software management products, got stronger throughout 2001 after working through management and product transitions.

Services

In the early 1990s, I was one of the starry-eyed optimists who were flying around closing the initial services contracts. Well, today, IBM is a services-led business in a services-led industry.

Our services story in 2001 mirrors what happened across our entire portfolio: some businesses up, some down, but on balance a solid performance—with underlying dynamics that point to continued strength this year.

The positives start with a dramatically improved services profit performance, contributing nearly half of all IBM pre-tax profit for the year. We increased revenues from services associated with e-business and strategic outsourcing; and revenues from Web hosting jumped 35 percent. Contract signings remained strong, and we closed the year with contracts for \$102 billion in future services revenue.

Even in difficult economic times, customers invest in services to manage technical complexities and financial risks—and especially in the world of e-business, to transform their businesses. However, while some areas of services are countercyclical, others tend to correlate very closely with economic conditions. That's especially true of high-value I/T consulting services—a business that had to work through a significant transition in 2001. As the market shifted and customers deferred spending on consulting engagements, we were initially slow to respond. Throughout 2001, we took steps to rebalance skills in our consulting and systems integration businesses. Based on that work, and a strong pipeline of signings headed into 2002, we expect a markedly improved performance across our services business this year.

Enterprise Systems

Across enterprise systems—eServers and storage subsystems—we had a strong year and gained 3 points of share.

- Revenue from our zSeries mainframes increased—our first full year of revenue growth in the mainframe business since 1989—and we saw a double-digit increase in shipments of computing capacity.
- Our UNIX servers gained significant share. Literally five years to the day after we promised leadership in microprocessor technology on a UNIX platform, our technical team delivered Regatta, the world's fastest UNIX server. Customer demand has been strong.

FINANCIAL HIGHLIGHTS *International Business Machines Corporation and Subsidiary Companies*

(dollars in millions except per share amounts)		
FOR THE YEAR	2001	2000
Revenue	\$ 85,866	\$ 88,396
Net income	\$ 7,723	\$ 8,093
Per share of common stock:		
Assuming dilution	\$ 4.35	\$ 4.44
Basic	\$ 4.45	\$ 4.58
Net cash provided from operating activities	\$ 14,265	\$ 9,274
Investment in plant, rental machines and other property	\$ 5,660	\$ 5,616
Cash dividends paid on common stock	\$ 956	\$ 909
Per share of common stock	\$ 0.55	\$ 0.51
AT YEAR END		
Cash, cash equivalents and marketable securities	\$ 6,393	\$ 3,722
Total assets	\$ 88,313	\$ 88,349
Working capital	\$ 7,342	\$ 7,474
Total debt	\$ 27,151	\$ 28,576
Stockholders' equity	\$ 23,614	\$ 20,624
Common shares outstanding (in millions)	1,723	1,743
Market capitalization	\$ 208,438	\$ 148,146
Stock price per common share	\$ 120.96	\$ 85.00
Number of employees in IBM/wholly owned subsidiaries	319,876	316,303

- In high-end data storage, the product we call “Shark” continued its strong comeback. We grew Shark revenue 32 percent and gained share.

Our major challenges in 2001 came in the two businesses that were most affected by the industry downturn. Our Technology Group—which sells component technologies to high-tech companies and telecommunications firms—was hit hard by the industrywide slump. We also felt the effects of a declining market for personal computers. Throughout 2001 and continuing into this year, we’ve taken steps to improve our long-term competitiveness—rebalancing resources and cost structures in both units. We expect these businesses to show better results in 2002, regardless of economic conditions.

Looking ahead to 2002, we are, like everyone else, watching the economy and anticipating a slow recovery. However, we have not built our 2002 plans around an economic rebound that’s not within our power to control. We’re executing plans to help our customers thrive in this environment; to continue to gain share against our competitors; to drive turnarounds in our underperforming businesses; and to keep advancing productivity gains.

Beyond that, we’re building on what we learned in 2001. Because in addition to being a “show me” year, it was also a “shake out” year. I’m not only talking about all the dot-coms that were flushed out of the system. More important than that, 2001 was a year when the reality of e-business—the serious, pragmatic reality IBM has been talking about for years—finally took hold. As that has happened, more and more people have come to see the

strategic vulnerabilities of many of our one-product, or “pure play,” competitors.

This is important to understand, because the setbacks our competitors have experienced—and the share gains IBM has achieved—are not primarily driven by short-term economic conditions. As Lou Gerstner explains in his letter to you, the I/T industry is undergoing fundamental change. We see the new competitive and customer landscape taking shape around three domains.

INFRASTRUCTURE

The demands of real e-business computing have launched a full-blown movement toward open, secure, reliable, enterprise-scale systems built on integrated, industrial-strength technologies—in other words, the kinds of computing systems that have defined IBM’s franchise. We gained share in every key segment of hardware and software infrastructure last year.

BUSINESS INSIGHT

Customer investment decisions increasingly are being made in favor of partners who can provide industry-specific insight (e.g., on financial services, or life sciences, or retail), in addition to technical expertise. One implication of this shift is obvious: Companies that deliver this kind of industry-based know-how will be able to influence customers’ technology investment decisions.

TECHNICAL INNOVATION

We know—and more important, our customers know—that the computing infrastructure for e-business will be orders of magnitude more complex and sophisticated

than anything that preceded it. That's the kind of challenge that gets the juices flowing across IBM's technical communities. Not only are our scientists and engineers energized by what's ahead, but we've spent decades hiring, investing in and building our technical prowess to prepare for just such a moment.

One indication: In 2001, we became the first enterprise to earn more than 3,000 new U.S. patent awards—our ninth straight year of global patent leadership. Our total (3,411) exceeded the combined total of 12 of the largest I/T companies in the United States.

Every time this industry has moved through a major evolutionary shift, the value of technical leadership has come to the fore. The companies that set the technical agenda also earn the mind share and market share that come with leadership.

In this next phase, those advantages will accrue to the companies that do more than deliver standalone hardware and software. The leader will create the technologies for a new computing infrastructure for e-business. For instance:

- The global I/T infrastructure will have to be able to handle a coming flood of transactions, operations and complexity. And because there aren't enough technologists in the world to manage it all, the systems themselves must become much more spontaneous and "autonomic"—able to regulate, protect, configure and even heal themselves. In 2001, we delivered an autonomic blueprint for the industry and the academic community, and launched our own comprehensive autonomic initiative, beginning with our Project eLiza.

- At the client end of this spectrum, there will be explosive demand for custom-designed, highly energy-efficient chips. They'll be the brains inside everything from tiny medical devices to billions of Net-enabled consumer electronics products. (And, by the way, they'll also be found inside the world's largest servers and storage systems.) Fulfilling that demand is a proposition far different from stamping out millions of look-alike microprocessors for personal computers. Every kind of device will require a slightly different chip design. Our custom logic business is the largest in the world.

- Finally, at the 40,000-foot level, "grid computing" architectures will turn the Internet itself into a gigantic virtual computer that can tap and interconnect all the I/T resources—not just information, but also tools—across multiple enterprises. We're already building one such grid with the University of Pennsylvania, to bring the most advanced techniques in breast cancer screening and diagnosis to patients across the United States.

* * *

I can't close my first letter to IBM's shareholders without a word about the person I succeed in this job, and the legacy that he leaves to all of his IBM colleagues and to anyone with a stake in the success of this company. So I'll just say this: When all's said and done, Lou Gerstner is the man who recreated IBM.

When Lou arrived, IBM's very viability was in question. Even those who thought we'd survive weren't sure it mattered. After all, many technology companies have

CEO'S LETTER

risen from their deathbeds—but they came back smaller, diminished and, frankly, irrelevant. On top of that, many people, even inside IBM, didn't believe an outsider could do the job.

About the only person who didn't have doubts (about almost anything, it seemed!) was Lou. From his first day, he said IBM was going to get back on top. Then he set to work making it so. Nine years later, it's hard to imagine an IBM without a world-class services capability, without a self-renewing capacity for technical innovation and without the strongest product line in its history. Even more astonishing, it's becoming hard to remember an IBM whose culture wasn't grounded in simple-but-vital principles like marketplace obsession, speed, shareholder return and the make-or-break importance of talented, energized people.

That's all part of the IBM Lou envisioned in 1993, and the IBM we've built under his leadership. Along the way, Lou did one more thing. He made all of us in IBM winners again. And because he did, I'm able to tell you, our investors, that your company and its people are strong.

I'm humbled not only to be here at one of the most exciting moments in our industry's history, but to be given the privilege of leading this truly meaningful company, with the finest workforce in business. We've got the right strategic vision—one that is being emulated by many. And if there is one thing this team has proved again and again—whether it was betting on services, creating e-business, embracing Linux, or in the ongoing

work to restructure our PC business—it is that we have the smarts, the agility and the guts to seize a new direction and to lead change.

Together, we're going to build on everything we've done to this point, and make IBM the most successful company in the information technology industry—and a leader among businesses in any industry. The work has already started. In fact, it never stops.



Samuel J. Palmisano
President and Chief Executive Officer