We've never been a "computer company."

Over nearly a century in business, our products and services have undergone continual reinvention — from scales and time clocks to mainframes, software and high-end consulting.
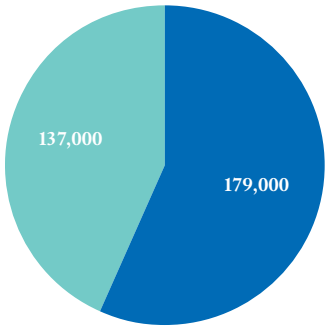
Today's portfolio of businesses is markedly different than it was just a few years ago, and we're quite certain we'll be in a host of different businesses another century down the road.

The fact is, we have never defined IBM in terms of a product, or a charismatic leader, or the location of our headquarters.

We simply committed ourselves to lead in the development of state-of-the-art technologies and in how they're applied to solve our clients' biggest and most pressing problems.
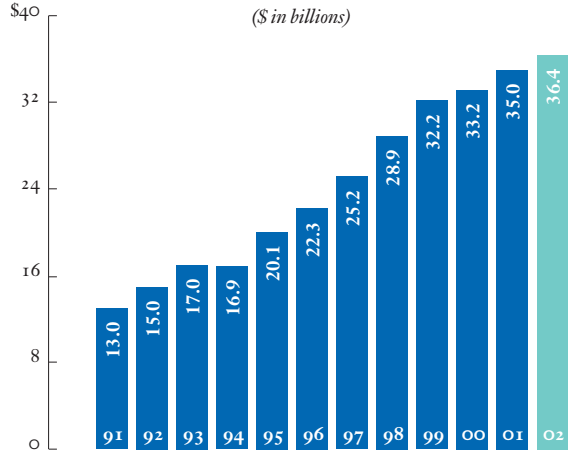
Of course, *being* that kind of company entails constant transformation, and not just of the product line. It requires progressive mind-sets and management systems. Because the technologies change. So do the problems. So do we.
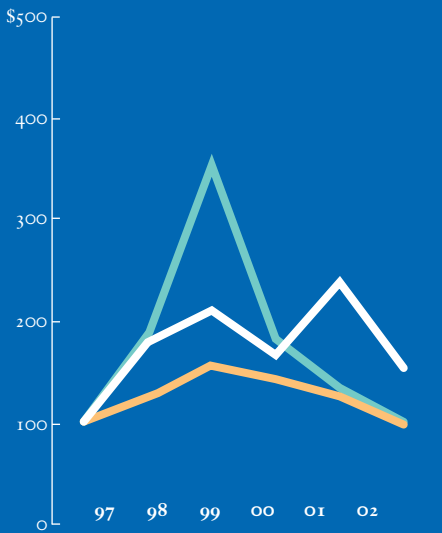
IBM 2002 GLOBAL WORKFORCE DISTRIBUTION

137,000

179,000

- Rest of the World
- United States

IBM GLOBAL SERVICES REVENUE
($ in billions)

Year	Revenue
91	13.0
92	15.0
93	17.0
94	16.9
95	20.1
96	22.3
97	25.2
98	28.9
99	32.2
00	33.2
01	35.0
02	36.4

COMPARISON OF FIVE-YEAR CUMULATIVE RETURN FOR IBM, S&P 500 STOCK INDEX, AND S&P COMPUTERS INDEX (EXCLUDING IBM)

- IBM common stock
- S&P Computers (hardware) Index (excluding IBM)
- S&P 500 Stock Index

$39 BILLION:

amount IBM spent on its supply chain in 2002 — buying goods and services from 33,000 suppliers

This is an important time for the information technology
industry and, by extension, every institution
and enterprise that relies on its products and services.
The industry is changing in fundamental ways.

That starts with changes in the computing model itself—the infrastructure of products, systems, software and interconnections that allows computing to happen. For the first time in the history of the industry, all that underlying technology is going to be based on open standards rather than closed, proprietary architectures controlled by one or two companies.

This will shift the industry's competitive landscape in fundamental ways. Most important, it puts the client in the driver's seat. Technical architectures built on open standards give clients far more flexibility and control over their technology investments.

And an open infrastructure also is the key to any organization's ability to integrate all its internal systems, and then connect with all the computing devices, applications and business processes of its trading partners and clients.

In short, the shift in the computing model allows enterprises to tackle new kinds of business problems and explore new models of commercial activity; and it signals a basic redefinition of the value that clients expect from their investments in information technology.

IBM'S BUSINESS MODEL

This kind of tectonic plate shift in the IT industry obviously has major implications for IBM—the world's largest information technology company.

Our business portfolio ranges from services (including business transformation consulting, systems integration and strategic outsourcing) to software, hardware, fundamental research, financing and the component technologies used to build larger systems—in other words, virtually the full scope of the computing model referred to earlier.

Since 1987, **MOST OF IBM'S REVENUES HAVE COME FROM ITS NON-U.S. OPERATIONS**

However, the fundamental strength of our business model doesn't come from our breadth, but from our ability to combine the resources of the portfolio—including deep industry-specific insight—and deliver integrated business solutions.

TOWARD AN 'ON DEMAND' WORLD

That approach—starting with a business issue and then assembling the right combination of technologies and skills to address it—has never been more important than it will be in the coming years. That's because there are forces converging on organizations today that are driving new choices about business designs and the computing infrastructures that support them. We call this evolution of business and computing "e-business on demand."

Essentially on demand is about achieving dramatically increased levels of responsiveness to all kinds of changing conditions—in financial markets, labor markets, or geopolitical and competitive arenas—in order to provide products or services in business, government, education or healthcare on demand.
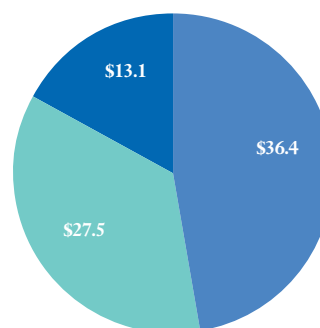
Clients making this transformation increasingly will rely on partners that can deliver both the new computing infrastructure and, importantly, insight into the marketplace and competitive pressures of their industries.

1992 chart: $11.1 · $15.0 · $33.8
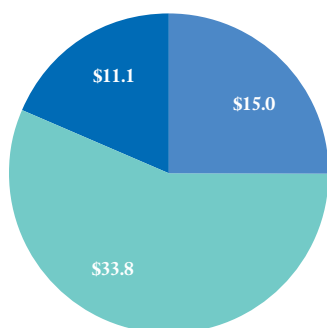
● *Services* ● *Hardware* ● *Software*

2002 chart: $13.1 · $36.4 · $27.5

● *Services* ● *Hardware* ● *Software*

This is why we believe that for the foreseeable future the IT industry will be led by those companies that can deliver value in the form of expertise, insight and relationships — rather than just product prowess alone, which has been the traditional basis of leadership.

AN INDUSTRY DIVIDING

This shift in what clients expect from their information technology providers is, in turn, driving a broad-based restructuring of the industry's economic fundamentals. We're watching the industry bifurcate into radically different types of businesses — one focused on creating high-value products and services for clients; the other devoted to delivery of lower-cost, and more standard products.

IBM has chosen to compete in the higher-value segments of the industry — a logical choice, given our range of capacities and unique ability to integrate them for clients.

That decision is driving changes within our portfolio of businesses — increasing our presence in such segments as high-end consulting, and reducing our presence in more cyclical or standard segments that no longer fit the parameters of our model.

In 2002, for example, IBM acquired 12 businesses and exited others. The need for this kind of responsiveness and adaptation to a rapidly evolving world is exactly what we are describing to our clients. And one of the issues we help them understand is the impact of these business decisions on people. That impact can't be eliminated, but IBM endeavors to minimize it, and provides a range

of transition assistance described in greater detail in the Our People section of this report.

The largest of the 2002 acquisitions added roughly 30,000 professionals from the former Pricewaterhouse-Coopers Consulting — dramatically expanding our capability to deliver high-value business insight and strategic consulting services for clients in industries including financial services, healthcare, the public sector and telecommunications.

At the other end of the spectrum, 2002 saw IBM exit the market for hard disk drives. IBM sold its hard disk drive manufacturing business to Hitachi — effectively exiting that market segment, but doing so in a way that preserved opportunities for the affected IBM employees, who joined a technology leader with a long-term commitment to success in the HDD marketplace.

2002 Revenue	**$81.2 billion**
Income from continuing operations	**$5.3 billion**
Discontinued operations: Loss from discontinued operations	**($1.8 billion)**
Net income	**$3.6 billion***
Employees	**315,889**
Stockholders of record	**674,362**

An estimated additional 1,800,000 stockholders own IBM stock through brokerage firms, banks, credit unions and other financial institutions.

*Net income does not total due to rounding.

WHAT DOES IT MEAN TO BE 'OFFSHORE'?

BY DOMINIQUE CERUTTI

General Manager, IBM Global Services,
Europe, Middle East, Africa

THE TENOR of the current debate about what the media have dubbed "off-shoring" suggests that business stumbled onto the concept of globalization sometime in the first half of 2003.

No doubt, this is a lightning rod issue in the IT industry in Europe and the United States right now. But attempts to explain it in terms of work that belongs in the developed world versus the rest of the world ignore the realities of global finance, trade and communications, not to mention the global nature of competition for everything from marketshare to talent.

The fact is, any workforce is a constantly evolving portfolio of skills that clients value. That's especially true in any services business, in which you are continually acquiring or developing new skills, while other skills fall out of demand.

IBM employs the world's largest professional workforce. We have been sourcing talented people the world over for more than 70 years, and will continue to invest and build capability around the world to better serve our clients.

That said, what's happening now isn't just garden-variety globalization. There is something new. And it's accelerating based on three factors: the rise of deep, technically proficient workforces in nations that have developed world-class educational systems; the well-documented wage differentials in many of these countries; and an economic environment that drives intense client focus on value and productivity.

Think about what has already happened with manufacturing in the United States and much of Europe. The simplistic view is that work left for lower-cost jurisdictions. What really happened is that processes were divided up, and some kinds of manufacturing—but not all manufacturing—moved to other regions. As that happened, the skills required and the talent available to perform the work became differentiating for the economies where the work was being done.

I suspect the progression in software and services will be very similar. Aspects of the process will move, at the same time growth occurs in other areas. I don't think too many people would be surprised by that, argue with the competitive realities that are at work here, or pretend that businesses have the choice of sheltering all the jobs in the developed world from new kinds of global competition.

We've gone through many periods of this kind of churn, and seen certain sectors or segments of the economy contract while others grew. The net outcome is always an economy and a commercial environment that are more productive, with higher real income and better jobs and more opportunities.

The near-term concern among IT workers is entirely understandable. It is a mistake, however, to confuse change with decline.

The last two years have taken a serious toll on one of the cornerstones of a free economy and an open society — investor confidence in what businesses say and do. A succession of events — starting with the dot-com crash, exacerbated by the global economic downturn, and then the financial and ethical failures of a few public enterprises — has cast doubt on how companies govern themselves and conduct their business.

IBM's management system is designed around a consistent set of operating standards and objectives the world over. This is enforced along two dimensions: a set of commitments to ethics, integrity and standards of behavior made periodically by each employee; and a long-standing commitment to management oversight by a Board that's largely independent and free of any relationship that would interfere with its exercise of sound, impartial business judgment.

While the makeup of the Board may shift over time, IBM policy since 1994 has required that the majority of Board members are independent. Current committees include the Executive Committee, the Audit Committee, the Directors and Corporate Governance Committee, and the Executive Compensation and Management Resources Committee.

The Directors and Corporate Governance Committee periodically reviews Board member relationships with IBM to confirm their continued independence as defined by the U.S. Securities and Exchange Commission.

This committee was formed in 1993. All four members are independent directors. One of the committee's principal functions is to review and consider IBM's position and practices on issues of corporate public responsibility, including workforce diversity, protection of the environment and philanthropic contributions. It also reviews and considers stockholder proposals dealing with issues of public and social interest.

The committee also is responsible for identifying and selecting appropriate director candidates. It factors into its analysis the diversity of a candidate's experience, background and skills, with the goal of ensuring the Board reflects a diversity of race, gender, perspective and culture. The current Board meets this goal, with directors from academic and professional organizations, as well as leaders of corporations both within and outside the United States, and from both genders and various racial and ethnic backgrounds.

GLOBAL MANAGEMENT SYSTEM

Formal corporate policies issued by the IBM chief executive officer govern companywide actions within IBM and actions with all third parties.

Corporate policies address issues that are considered fundamental and of enduring importance while ensuring compliance with legal directives. Representative corporate policies include:

- Business Conduct and Ethics
- Workforce Diversity
- Political Contributions and Employee Participation in Politics
- Responsibility for Employee Well-Being and Product Safety
- Data Privacy
- Commitment to Diverse Business Relationships
- Environmental Affairs

ADDRESSING THE
CRISIS OF CONFIDENCE

BY DAN O'DONNELL

*Vice President, Assistant General Counsel
and Secretary*

THE FIRST STEP toward rebuilding investor confidence is strict compliance with the law. That mandate is not subject to interpretation. It is fundamental. But it is not sufficient.

Because if we know anything, it's that the letter of the law will not deter all bad actors. Speeders will always speed, and arsonists will still start fires. The restoration of investor confidence may start with compliance, but it will always be grounded in a higher ethical and moral imperative, and the integrity of individuals.

What has to happen?

First, businesses must communicate clearly and completely, and reassure stakeholders that the business is being conducted in compliance with the law, *and* according to the highest ethical standards. This will be accomplished by not just saying the words, but by actually delivering information about the business in much more thorough, consistent and transparent ways.

Next, corporate boards are vital. The record proves they perform remarkably well in the vast majority of situations. That said, for the system to work, boards must be continually evaluated, focusing on two fronts — the quality of the directors and their independence.

IBM is a fortunate company. We have the ability to attract the very best directors, with a mix of skills and expertise, and with diverse backgrounds, talents and perspectives. To give the IBM Board the power to do its job, we've maintained a long-standing practice that the majority of its members are outside directors, who are neither officers nor employees of IBM. As of August 2003, 10 of our 11 Board members are independent, and all members of each of the **standing** Board committees are independent.

A decade ago, IBM was also at the forefront on issues of board oversight through the creation of a committee devoted exclusively to matters of corporate governance. Since then, our Directors and Corporate Governance Committee has been responsible for the review and articulation of the Board's governance practices and for performing functions such as the periodic assessment of the independence of directors.

In the end though, the work of earning investor confidence transcends external rules, controls and oversight. Confidence rises and falls based on another set of basics — the core values and standards of behavior expected of leaders, and of every individual in the corporation.

This onus falls squarely on corporations, their boards, their management and every employee — not as impersonal institutions or representatives of them — but as people. In the end, this is a question of values, not of process.

Corporate Instructions are directives issued by corporate staff executives to help ensure uniform practices across the company. These instructions address processes and requirements in areas ranging from human resources, environmental affairs, community relations and governmental programs to marketing, finance, intellectual property, real estate, manufacturing and sourcing.

IBM maintains a
broad range of programs supporting
STAKEHOLDER ENGAGEMENT
including surveys, studies, councils,
focus groups and open communications
channels with publics including
*Employees, Suppliers,
Clients, Business Partners, Stockholders
and Alliance Partners*

In developing its plans and business objectives, IBM assesses a variety of external forces, evaluates the potential risks, and considers a range of industry, economic and social factors. Once developed, a system of measurement has been designed to track progress, communicate the areas most important to meeting IBM business goals, and alert management to potential problem areas so that corrective action can be taken. Among the standards applied are measurement and tracking of changes to:

- Client satisfaction
- Marketshare
- Financial performance
- Environmental performance
- Quality
- People

These internal controls, and an ongoing internal audit program, are designed to give management the operational controls to confirm for stockholders and appropriate government agencies that the recording of financial results conforms with generally accepted accounting principles and with assurance that transactions are executed in accordance with management authorization. They also help IBM operate in accordance with its own policies and directives.

BUSINESS CONDUCT GUIDELINES

The first version of the IBM Business Conduct Guidelines was drafted in the 1960s as a common set of principles to help each employee understand accepted standards of behavior. The Guidelines outline IBM's legal requirements and provide guidance on the company's business values. All employees worldwide are periodically required to read and certify their compliance.

Each section of the Business Conduct Guidelines covers an area in which employees have responsibilities to the company.

- Personal conduct and protection of IBM's assets
- Obligations in conducting IBM's business with other people and organizations
- Personal responsibilities, such as public service, use of insider information, and avoiding conflicts of interest

INTERNAL AUDITS AND CONTROLS

IBM has a comprehensive approach to providing the Board of Directors and management with the tools they need to measure risk and audit performance. These include:

- Independent and objective assessments of IBM's system of internal controls
- Guidance in managing control risks for IBM stakeholders
- Proactive support to improve control posture
- Assistance in performing self-assessments
- Independent investigations into allegations of fraud and violations of IBM's Business Conduct Guidelines

To promote compliance, the general auditor and the audit and business controls staff:

- Have unrestricted access to all functions, records, property and personnel.
- Allocate Internal Audit and Business Controls resources, define the engagement plan, and apply the techniques required to accomplish Internal Audit and Business Controls objectives.
- Require line management response to recommendations.
- Have full and free access to the Audit Committee.

The general auditor provides periodic updates to the Audit Committee and reports within IBM to the chief financial officer.

FIVE-YEAR COMPARISON OF SELECTED FINANCIAL DATA

($ in millions, except share amounts)

FOR THE YEAR	98	99	00	01	02
Revenue	$ 77,548	$ 83,334	$ 85,089	$ 83,067	$81,186
Income from continuing operations	5,469	7,359	7,874	8,146	5,334
Income/(loss) from discontinued operations	859	353	219	(423)	(1,755)
Net income	6,328	7,712	8,093	7,723	3,579
Earnings/(loss) per share of common stock:					
Assuming dilution:					
Continuing operations	2.84	3.93	4.32	4.59	3.07
Discontinued operations	0.45	0.19	0.12	(0.24)	(1.01)
Total	3.29	4.12	4.44	4.35	2.06
Basic:					
Continuing operations	2.92	4.06	4.45	4.69	3.13
Discontinued operations	0.46	0.20	0.12	(0.24)	(1.03)
Total	3.38	4.25*	4.58*	4.45	2.10
Cash dividends paid on common stock	814	859	909	956	1,005
Per share of common stock	0.43	0.47	0.51	0.55	0.59
Investment in plant, rental machines and other property	6,520	5,959	5,616	5,660	5,022
Investment in research, development and engineering — net	5,046	5,219	5,084	4,986	4,750
Return on stockholders' equity	37.2%**	39.1%**	40.0%**	35.3%**	15.5%
AT END OF YEAR					
Total assets	$ 88,160**	$ 89,571**	$ 90,412**	$ 90,303**	$96,484
Net investment in plant, rental machines and other property	19,631	17,590	16,714	16,504	14,440
Working capital	5,533	3,577	7,474	7,342	7,102
Total debt	29,413	28,354	28,576	27,151	26,017
Stockholders' equity	19,383**	20,426**	20,550**	23,448**	22,782
Employees (IBM/wholly owned subs)	291,067	307,401	316,303	319,876	315,889
Employees (less than wholly owned subs)	21,704	17,176	21,886	25,403	22,282
Complementary	36,900	29,800	25,500	21,300	17,250

Does not total due to rounding.
**Reclassified to conform with 2002 presentation.*

There is at least one inevitable outcome of the increasingly interconnected nature of the world's markets, trading relationships and commercial business models. And it has everything to do with standards. Standards of behavior.

That's because enterprises making the transition to "on demand" ways of working and managing themselves will seek much tighter integration of their business processes with those of their trading partners — to distribute risk, share accountability, and create far more flexible and variable cost structures.

That, in turn, drives new thinking about any company's responsibility to promote standards of behavior across these new business ecosystems — business practices, environmental practices, safety and working conditions.

At the same time we're working with clients to help them implement these more integrated business relationships, we're also building such relationships with our own suppliers — and either instituting new practices or reaffirming existing policies, such as our commitment to work with environmentally responsible companies.

Our first corporate directive in this area was issued in the late 1970s to prevent the transfer of responsibility for environmentally sensitive operations to any company lacking the commitment or capability to manage them properly.

While this corporate directive initially applied to hazardous waste disposal vendors only, its scope has been expanded over the years to include production-related suppliers and product disposal vendors. IBM evaluates these vendors, their facilities and methods prior to approving them. In order to verify that their environmental operations remain satisfactory, vendors are periodically re-evaluated.

Any concern arising during one of these evaluations is addressed with the supplier or vendor and must be resolved to IBM's satisfaction. IBM's conformance with these evaluation programs is part of its comprehensive audit program.

As part of the commitment to environmental management leadership, IBM encourages its suppliers to pursue ISO 14001 registration. A copy of IBM's letter to suppliers regarding ISO 14001 can be found at www.ibm.com/procurement.

IBM also shares expertise and technology as appropriate with many of its suppliers. This not only helps support the company's environmental objectives; for suppliers, it helps improve their own environmental performance.

For example, IBM Brazil was instrumental in establishing two industry groups focused on sharing their environmental expertise with small- and medium-size businesses. Their efforts not only helped those businesses and the environment, they also helped create responsible suppliers for IBM.

FOSTERING DIVERSITY

Building a community of diverse suppliers increases IBM's opportunity to hear new ideas, apply different approaches, and gain access to additional solutions that respond to client needs.

Our supplier diversity program expands purchasing opportunities for businesses owned and operated by minorities, women, gays, lesbians, people with disabilities and veterans. This program increases opportunities for nonprofit organizations that employ people with disabilities and for small businesses located in historically underutilized business zones.

In 2002, IBM procured $1.4 billion of goods/services from 582 businesses owned and operated by minorities, women, veterans, people with disabilities, gays and lesbians — the third year in a row we exceeded $1 billion.

RAISING THE BAR ON BUSINESS SUPPLIER CONDUCT

BY THEO FLETCHER
Vice President, Global Procurement Operations

THE IDEA that businesses have an opportunity to promote standards across the supply chain is not an entirely new thought. And there's already been a lot of progressive work among trading partners, mainly geared toward quality standards and client satisfaction.

But in an on demand world, the ante goes way up. Supply chain relationships become fundamental to your client's experience with your product or service, with your brand image, and with your reputation for socially responsible practices and behaviors.

So, beginning this year, IBM has added a new level of rigor to its oversight for some suppliers, which are being required to respond to a questionnaire about their performance on social responsibility, occupational health and safety, labor and employment practices, security, and environmental standards (which we've been monitoring for years).

We're starting this process with our large suppliers in emerging markets — where there may have been questions about how companies address matters of social responsibility. We will implement this survey with a broader group of suppliers next year.

This is in addition to our traditional expectations, defined in legal agreements that commit suppliers to honor the laws and regulations in the countries in which they operate.

The survey is a first step — and a significant one — toward more proactive involvement with our suppliers in the areas of social and environmental standards. Most important, it lets our suppliers know what we consider to be acceptable behavior, and it will help us make informed choices from the outset.

The goal isn't about micromanaging the daily activity of our suppliers, but about learning more about how they operate, and then aligning our interests in ways that encourage sound practices and develop sound global markets.