



Dear IBM Investor:

I am very pleased to report to you on a superb year for your company—a year of record revenue, profit, cash flow and earnings per share. It reflects the hard work of some of the world’s brightest and most innovative women and men—the IBMers I’m proud to call my colleagues. It is also the result of important strategic choices we made several years ago—choices that have put IBM in a strong position to continue to grow profitably, to strengthen our client relationships, and to seize the most attractive opportunities in a very dynamic global economy.

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IBM is a different company today. To understand why, let me briefly describe how we got to our present position.

At the beginning of the decade, all of us in the information technology industry—indeed, in all of business—were confronted with fundamental changes: the reality of global integration, a new computing model and new ways for businesses and institutions to apply technology to create value.



Samuel J. Palmisano
Chairman, President and Chief Executive Officer

It was clear that we had to change—and not only to capture future opportunities. The fact is, if we had stayed still, the company's competitiveness would have been at risk. So we made important decisions, and got to work.

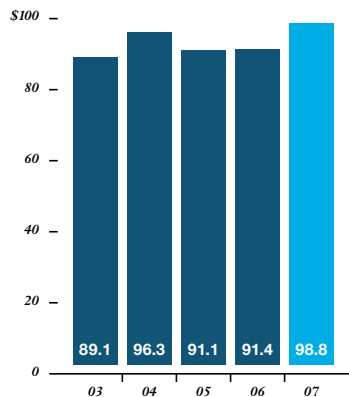
Global integration: As the decade began, we observed the accelerating integration of global economies, and with it the emergence of two important—I would say historic—opportunities. We had a chance to capture rapid growth in dozens of countries as they invested heavily in information technology to modernize their societies. And we could also tap into enormous populations of skills all over the world. We set out to seize both opportunities.

We've made major investments in emerging markets, building up our teams in nations all over the world. At the same time, we have

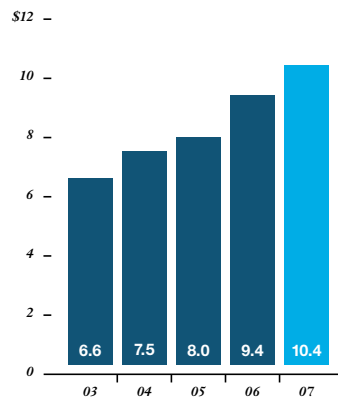
been globally integrating IBM's operations rapidly, locating our work and functions wherever it makes the most sense, based on the right cost, the right skills and the right business environment. Today we have a truly global supply chain; we develop software globally; our network of research laboratories is worldwide; and we deliver services on an unmatched global scale. We are continuing to transform our processes and functions to move IBM to this profoundly new model of the corporation, which we call the Globally Integrated Enterprise.

Results from Continuing Operations

Revenue
(\$ in billions)



Income
(\$ in billions)



2005 performance includes results from four months of the IBM PC business, which was divested on April 30, 2005.

Technology: IBM has been saying it for many years: The basic computing model has changed. The PC model of the 1980s has receded in importance to clients, and has been replaced by a new paradigm, based on openness, networks, powerful new technology and the integration of digital intelligence into the fabric of work and life.

As you know, we have dramatically changed our mix of products, services, skills and technologies. We exited businesses like PCs and hard disk drives—businesses that we had invented. We shifted our internal R&D and have made more than 60 acquisitions over the past five years. At the time, many were skeptical—but one need only look at today's headlines to see how strongly some PC-era leaders are trying to move away from the old model and embrace the new one.

IBM's product and technology portfolio today is built around networked, modularized and embedded technologies, including

service-oriented architecture (SOA), information on demand, virtualization and open, modular systems for businesses of all sizes. IBM is a leader in all these areas.

Put it all together, and IBM today is very different from what it was when we entered the decade.

Business: Impelled by this new global arena and new technology model, business leaders expanded their horizons—driven both by competitive pressures and a remarkable array of new innovation capabilities. No longer content with cost savings from off-the-shelf technologies and solutions, they were seeking to innovate. And this involved not just their products and services, but their entire companies: business processes, management systems, policies and even their core business model. To accomplish that, they were looking to integrate advanced technology deep into their processes and operations. Our worldwide survey of CEOs has consistently confirmed this shift in businesses' perceptions and priorities.

To deliver this kind of client value requires intimate knowledge of each client and the ability to make that knowledge operational on a daily basis—and that can't be done from corporate headquarters. So we changed our own processes and organization to push decision-making and delegation closer to the marketplace.

A Transformed Company Put it all together, and IBM today is very different from what it was when we entered the decade. We are different strategically, with clarity around our twin imperatives of innovation and global integration. We are different operationally, with a lower center of gravity in our operations and with continually improving efficiency and productivity. And we have a business model that is better aligned with our clients' needs and that generates stronger profitability and cash flow. We see no major strategic shift on the horizon for our company.

So, how is this transformed company performing? Let me briefly recap 2007. It was, quite simply, a great year for IBM.

Revenue and income: We delivered our strongest revenue growth since 2003 and our strongest profit performance in more than a decade. Our revenue as reported was a record \$98.8 billion, up 8 percent. Pretax income from continuing operations was \$14.5 billion, an increase of 9 percent and another record.

Margins: IBM's gross profit margin rose for the fourth consecutive year—to 42.2 percent, up more than five points since 2003. We achieved this by continuing to shift our business mix to more profitable segments, such as software, and by focusing on productivity. Our pretax income margin rose to 14.7 percent. Both margins are at their highest in more than a decade. The improvement in our pretax

income margin compares very favorably to our technology peers and to the companies of the Dow 30. We have reversed the margin decline of the late 1990s, and we have a stronger business model today, with less volatility and more high-profit revenue opportunity.

Earnings per share: We have continued to achieve strong EPS growth. Last year was another record, with diluted earnings per share from continuing operations of \$7.18, up 18 percent. This marked 20 straight quarters of EPS growth.

Cash flow: IBM has consistently generated strong cash flow. In 2007 our net cash from operations, excluding the year-to-year change in Global Financing receivables, was \$17.4 billion—an increase of \$2.1 billion from last year. Our business model has allowed us to generate more than \$70 billion in cash flow over the past five years. IBM ended 2007 with \$16.1 billion of cash and marketable securities.

Our balance sheet remains strong, and the company is well positioned to take advantage of new strategic opportunities.

Investment and return to shareholders: Our superior cash flow has enabled us to invest in the business—through strategic acquisitions and capital expenditures to drive growth—and to generate substantial returns to investors through increased dividends and significant share repurchase. Our 2007 cash investment was \$1 billion for 12 acquisitions—six of them in key areas of software. And after investing \$6.2 billion in R&D and \$5 billion in net capital expenditures, we were able to return a record of nearly \$21 billion to you—\$18.8 billion through share repurchase and \$2.1 billion through dividends—or more than 100 percent of our net earnings. This year's dividend increase was 33 percent, marking the 12th year in a row in which we have raised our dividend. In the last two years, IBM has doubled its quarterly dividend.

Our balance sheet remains strong, and the company is well positioned to take advantage of new strategic opportunities.

The results of IBM's strategic choices and actions over the last several years have been better client focus, clearer marketplace differentiation and a stronger financial engine. We have also achieved superior flexibility—a competitive advantage in uncertain economic times. This strengthened business model and our excellent performance in 2007 have increased our confidence that we will meet our 2010 objective of \$10 to \$11 in earnings per share. I think the information on pages 6 to 7 will help you understand the sources of that confidence.

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The IBM Difference We have entered 2008 with strong momentum—but can we sustain it? This is a legitimate question, especially given the current economic indicators in the United States and other parts of the developed world. A number of companies aren't sounding

very optimistic. At IBM, we have a different view. The reason why is best understood in terms of five key factors that differentiate our company today.

1. Our global reach and scale. IBM's global operations are accelerating our company's growth. IBM today does business in 170 countries and enjoys an increasingly broad-based geographic distribution of revenue. In 2007, 63 percent of our revenue came from outside the United States.

Many people think of "emerging markets" as the so-called BRIC countries of Brazil, Russia, India and China—and last year our revenue increased 26 percent in those markets. But our global footprint extends much farther. Consider more than 50 countries—including Czech Republic, Poland, Malaysia, Singapore, South Africa, Venezuela and Mexico—in each of which we grew more than 10 percent in local currency in 2007. In aggregate, IBM's business in this group grew at a rate of more than 20 percent in local currency last year and comprised 15 percent of our geographic revenues.

2. Our infrastructure leadership. IBM arguably invented the concept of the data center, and today our solutions provide a foundation for more of the world's IT infrastructure than any other company. So we are well positioned to serve businesses across the world's emerging markets that are installing their first data centers—as well as those in the developed world that are upgrading and transforming their existing infrastructure.

However, today's opportunity is not simply about replicating or upgrading what already exists. The data center itself is going through its most significant transformation in decades. According to one IT analyst firm, more than 70 percent of Global 1000 companies will have to modify their data centers significantly during the next five years. This is driven not only by new technology but by new business imperatives: constraints on power and real estate; systems that are grossly underutilized; and the need for greater flexibility to innovate business processes and models.

These needs have shaped our transformed portfolio. Our green data center solutions dramatically impact energy efficiency and physical space constraints, while also helping our planet. Demand is climbing for these solutions, and we hit more than \$400 million in signings last year, after introducing the offering in the third quarter. Virtualization, which significantly improves system utilization, generated about \$200 million in incremental gross profit for us in 2007. And our industry-leading solutions in SOA enable clients to reinvent their entire business model.

Clients in both the developed and developing worlds will be migrating to this new data center model, and IBM is very well positioned.

Generating Higher Value at IBM

1 Several years ago, we saw change coming.

Value was shifting in the IT industry, driven by the rising tide of global integration, a new computing paradigm and new client needs.

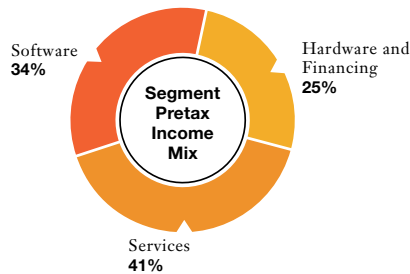
- Economies of developing nations were growing rapidly, driven by historic investments in fundamental business infrastructure. Enterprises were looking to tap skills and expertise available all over the world and to integrate their operations globally.
- Change in computing architecture was rippling across the data center and the network, along with a proliferation of technology infused into all aspects of work and life.
- Companies were seeking to integrate advanced technology with their business processes and operations, not only to reduce costs, but to enable innovation and growth.

2 We remixed our businesses in order to move to the emerging higher-value spaces.

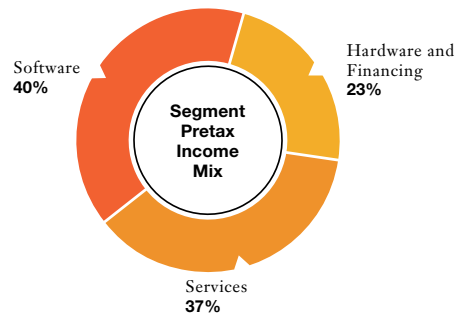
We exited commoditizing businesses like PCs and hard disk drives, and strengthened our position in areas like service-oriented architecture (SOA), information on demand, virtualization and open, modular systems for businesses of all sizes.

Over the past five years we have acquired more than 60 companies to complement and scale our portfolio of products and offerings. This has changed our business mix toward higher-value, more profitable segments of the industry.

2003
IBM pretax income \$9.4 billion
IBM pretax margin 10.6%



2007
IBM pretax income \$14.5 billion
IBM pretax margin 14.7%



3 And we decided to become a globally integrated enterprise in order to participate in the world's growth markets and improve IBM's productivity.

IBM operates in 170 countries and enjoys an increasingly broad-based geographic distribution of revenue. Our non-U.S. operations generated 63 percent of IBM's revenue in 2007.

Last year our revenue increased 26 percent (18 percent in local currency) in the BRIC countries—Brazil, Russia, India and China. But our global footprint extends much farther. Consider more than 50 countries—

including Czech Republic, Poland, Malaysia, Singapore, South Africa, Venezuela and Mexico—in each of which we grew more than 10 percent in local currency in 2007. In aggregate, IBM's business in this group grew at a rate of more than 20 percent in local currency last year, and comprised 15 percent of our geographic revenues.

Strong Geographic Growth



2007 Revenue by Geographic Region (excludes OEM)

21%
Asia Pacific

36%
Europe, Middle East and Africa

43%
Americas

4 As a result, IBM is a higher-performing enterprise today than it was a decade ago.

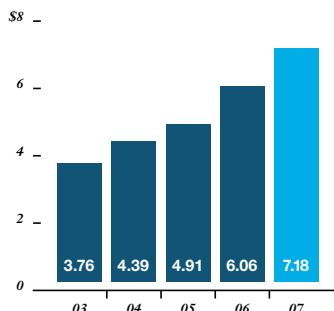
Our business model is more aligned with our clients' needs and generates better financial results.

We have achieved record earnings per share ...

Pretax earnings from continuing operations were \$14.5 billion, an increase of 9 percent. Diluted earnings per share were \$7.18, up 18 percent, marking 20 straight quarters of growth and five consecutive years of double-digit growth.

Earnings Per Share

(from continuing operations)

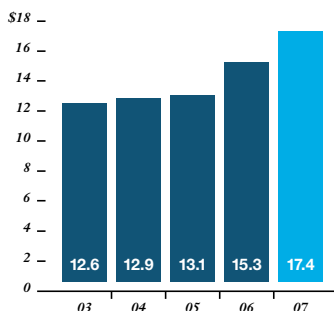


... and record cash performance.

In 2007 our net cash from operations, excluding the year-to-year change in Global Financing receivables, was \$17.4 billion—an increase of \$2.1 billion from last year.

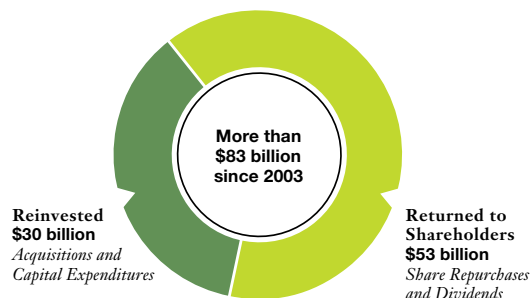
Net Cash from Operations, Excluding Global Financing Receivables

(\$ in billions)



5 That has enabled us to invest in future sources of growth and provide record return to investors ...

Primary Uses of Cash over the Past Five Years



... while continuing to invest in R&D—more than \$29 billion over the past five years.

6 This gives us confidence that we can achieve our long-term financial objectives.

In May 2007 we shared with investors our 2010 Earnings Per Share Roadmap—which explains how we expect to achieve EPS growth of 14 to 16 percent and \$10 to \$11 in earnings per share by 2010. We did

so to give our shareholders a clear understanding of the key factors driving IBM's long-term financial objectives. In 2007 we made progress toward our 2010 objectives by growing earnings per share 18 percent.

2010 Earnings Per Share Roadmap



Key Drivers

Revenue growth:

We maintain historical revenue growth through annuity businesses, global presence and a balanced business mix.

Margin expansion:

We focus on delivering higher value to clients and on increasing productivity, to improve profitability.

Share repurchases:

Our strong cash generation lets us return value to shareholders by reducing shares outstanding while reinvesting for future growth.

Growth initiatives and future acquisitions:

We invest in key growth initiatives and strategic acquisitions to complement and scale our product portfolio.

Retirement-related savings:

We expect to achieve retirement-related cost savings over the next several years, driven in part by Plan redesigns.

3. Our technology leadership. IBM's leadership position in IT infrastructure is underpinned by a superior technology base. In 2007, for the 15th consecutive year, IBM was issued more U.S. patents (3,125) than any other company. And our offerings in the year ahead look especially promising. Major IBM product launches will include our next-generation System z mainframe; System p servers, which bring POWER6 innovation to the entry level; and POWER-based virtualization offerings, which improve energy and space efficiency for UNIX customers. We are also introducing a new BladeCenter offering and a highly innovative storage architecture, thanks to our acquisition of XIV. Finally, we expect to see continued strong growth in strategic middleware fueled by organic investment and strategic software acquisitions—such as FileNet and Cognos, which have augmented our information on demand capabilities.

4. Our delivery of unique client value. As we head into uncertain economic times in some parts of the world, one fact remains constant: Businesses continue to invest in IT. It saves them money and manages business-critical needs—such as enterprise security, real-time analytics, risk management, business intelligence, business optimization and transformation, as well as how a company expands its client base in order to gain share. Companies are seeking to identify and classify security risks and protect their data from all forms of attack. They face regulatory demands and pressure to increase productivity without buying more “stuff.” They need to use both structured and unstructured data—such as the information contained in memos, reports and phone calls—to generate reports to their customers in minutes, not days.

In addition, we are seeing multiple areas of investment growth within particular industries. For example, telecommunications companies continue to upgrade their infrastructure to broadband. Also, utilities face outdated systems, the transformation from analog to digital and new regulatory requirements. Across the world, businesses and institutions are continuing to make investments that save them money, preserve capital and address issues they simply may not defer.

5. Our financial strength and flexibility. As I've described, our focus on higher-value offerings helps drive profitable growth and strong cash generation, which have enabled IBM to return value to shareholders and to invest opportunistically for growth. We also possess the financial capacity to adjust to changes in near-term business conditions, thanks to a business model in which about 50 percent of the company's revenues are recurring streams—far less subject to volatility in uncertain economic conditions.

We believe these differentiating capabilities—our global presence and integration; preeminence in the data center; technology leadership; and the ability to deliver measurable client value—will be drivers of profitable growth in both good times and bad. As a result,

we believe that IBM has excellent opportunities in 2008 and beyond—in an environment that presents significant challenges for our competitors. They are not as global, as strong in high-growth segments or as able to deliver complete solutions, nor do many have the experience and discipline to adjust their economic models as conditions require.

So we will pursue growth, while at the same time remaining prudent and disciplined about expenses and productivity. That is, we will operate ambidextrously—seizing the new opportunities that the external marketplace presents, while never ceasing to reexamine our own operations or to transform our organization. This is difficult; not every workforce has the focus and maturity to do it. But IBM has been here before, and we know what to do. Historically, this is when we have gone on offense.

A New World At the opening of this letter, I said that we intend to capitalize on our strengths in order to seize the growth, profit and leadership opportunities presented by today's global marketplace. Let me close with some thoughts on what will be required of any company seeking to do that.

On the prospects for continued global growth: When people look out at the global economy today, some are concerned about ripple effects. They fear the impact on overall growth—even in the developing world—of a possible downturn in parts of the developed world. Now, I'm not an economist, but let me offer a perspective based on my experiences as I visit IBM's clients and our own operations around the world.

You only have to get outside of the United States to see that something very new is happening today. The world's growth markets are no longer as dependent on import-export, on the exchange of raw materials for industrial goods. Instead, they are innovating. They are differentiating. Most importantly, their people are becoming consumers; they're joining the middle class. Hundreds of millions of people are opening their first bank accounts, getting their first cell phones, using their first credit cards. Tens of millions are buying their first automobiles. These are historic developments, and are pretty far removed from economic fluctuations in the United States, Europe and Japan.

Hundreds of millions of people are opening their first bank accounts, getting their first cell phones, using their first credit cards.

And consider what has to happen to give all of those people cell phones, financial services and cars. Infrastructure has to be built and developed, and not only the IT infrastructure I discussed earlier, but business infrastructure—for banking, manufacturing, telecommunications, transportation and government services.

Your company knows a thing or two about how to build both kinds of infrastructure to support the way the world works. We've been doing that for nearly 100 years. However, our ability to focus on markets that are small today but with great upside potential was inhibited in the past by our own organizational structure. When you group such smaller markets with big ones, they tend to be overshadowed and to lack proper management attention, investment, skills and support.

That is the reason we are creating a new Growth Markets organization, to be headquartered in Shanghai. Its goal is to accelerate IBM's global growth significantly. I believe this is the best way to ensure that these markets get the talent, investment and attention they deserve and need in order to keep growing.

On local engagement: To be truly global today, a company has to do a lot more than set up sales offices or research facilities in multiple markets, or send its people on international assignments. Doing business in the developing world is about relationships, not just transactions. You have to engage at the level of culture, as well as process. You have to build trust. You have to be integrated on the ground, working shoulder-to-shoulder with local suppliers, governments and communities, and understanding their point of view on business and innovation. You have to help them advance their agendas, not just your own. And you have to train your leaders everywhere to be global leaders.

This takes time. You can't "leapfrog" into being a global company. You've got to be committed for the long term, and you have to invest, on multiple levels. IBM has some unique historical, organizational and skill advantages here—but they will only remain advantages to the extent that we continue to make them real every day, in IBMers' actions, behavior and relationships as global professionals and global citizens.

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On developing global professionals and citizens: Of all the issues facing business and society with regard to global integration, perhaps the most challenging is this: How does the individual compete and win in a global economy? This is, on the one hand, what makes globalization such an emotional and polarizing issue to many people. But it also opens up some of the most promising opportunities for organizational innovation in business today—driven by the need to help our people succeed in this new environment.

Last year we introduced the IBM Global Citizen's Portfolio. It aims to provide our employees with the tools they need to enhance their expertise in a global context. Those tools include a matching fund to

support the IBMer's own learning and exploration—even if not related to his or her current job. We are helping retiring IBMers to transition to second careers in teaching, government service and nongovernmental organizations. And we've established a program called the Corporate Service Corps, in which teams of high-potential IBMers from around the world—our leaders of the future—will come together for one-month projects on economic development, environmental and other problems in developing countries.

The underlying idea here is that individuals are in the best position to make decisions about their own work, learning and careers. This shift of control and decision-making to the IBMer represents a very new relationship between enterprises and individuals—and that involves a certain degree of risk. Sharing power always does. But if you trust your strategy, your capabilities and your people—and if you are confident that all are grounded in a set of shared values—then this is the kind of innovation you pursue. It's one more example of playing offense in a very new game.

I'm deeply gratified that our employees' reaction to the Global Citizen's Portfolio has been so enthusiastic. We are, for instance, oversubscribed by thousands of applicants for the Corporate Service Corps. IBMers have a very mature understanding of today's new environment. They know the world is changing. They don't expect—or in many cases, even want—what business used to provide. What they do want is an opportunity and some help to learn and grow, so they can effectively compete on a world stage. This is probably the single strongest reason for my confidence in IBM's future.

...

As we enter a new era of technology, business and global society, I am proud of the worldwide IBM team for bringing us to this point, and I am grateful to you, our shareholders, for your support in our journey. I hope and trust that you are pleased with how your company is growing and evolving. My colleagues and I are excited by the possibilities for how we, together with our clients, our partners and you, can bring this remarkable enterprise into its next era of leadership and discovery.



Samuel J. Palmisano
Chairman, President and Chief Executive Officer

Financial Highlights

International Business Machines Corporation and Subsidiary Companies

(\$ in millions except per share amounts)

FOR THE YEAR:	2007	2006
Revenue	\$ 98,786	\$ 91,424
Income from continuing operations	\$ 10,418	\$ 9,416
(Loss)/income from discontinued operations	(00)	76
Net income	\$ 10,418	\$ 9,492
Earnings/(loss) per share of common stock:		
Assuming dilution:		
Continuing operations	\$ 7.18	\$ 6.06
Discontinued operations	(0.00)	0.05
Total	\$ 7.18	\$ 6.11
Basic:		
Continuing operations	\$ 7.32	\$ 6.15
Discontinued operations	(0.00)	0.05
Total	\$ 7.32	\$ 6.20
Net cash provided by operating activities from continuing operations	\$ 16,094	\$ 15,019
Capital expenditures, net	4,968	4,737
Share repurchase	18,828	8,084
Cash dividends paid on common stock	2,147	1,683
Per share of common stock	1.50	1.10
AT YEAR END:	2007	2006
Cash, cash equivalents and marketable securities	\$ 16,146	\$ 10,657
Total assets	120,431	103,234
Working capital	8,867	4,569
Total debt	35,274	22,682
Stockholders' equity	28,470	28,506
Common shares outstanding (in millions)	1,385	1,506
Market capitalization	\$149,744	\$146,355
Stock price per common share	\$ 108.10	\$ 97.15
Number of employees in IBM/wholly owned subsidiaries	386,558	355,766