

Dear IBM Investor,

In my letters to you over the past several years, I have described IBM's view of how the information technology industry is being radically reshaped by developments in technology, its application in business and the onrush of globalization. I have also reported on the actions we have taken to capitalize on these shifts and to position our company for long-term prosperity.

**AS A RESULT OF THESE ACTIONS**, IBM has emerged from this period a very different company. We are much more focused on the high-value segments of our industry, better balanced, more productive and more profitable than just a few years ago. Our solid results in 2005 are a consequence of this repositioning, and of the innovation and marketplace execution of more than 329,000 IBMers around the world.

Our revenue in 2005 was \$88.3 billion, up 3 percent, without our divested personal computer business. Revenue as reported was \$91.1 billion, down 5 percent. Pre-tax earnings from continuing operations were \$12.2 billion, an increase of 15 percent; and diluted earnings per share were \$4.91, up 12 percent. Excluding non-recurring items, our earnings per share increased 18 percent, to \$5.32. Particularly noteworthy was a rise of 3.2 points in IBM's gross profit margin, to 40.1 percent.

After investing \$5.8 billion in R&D, \$3.5 billion in net capital expenditures and \$1.5 billion for acquisitions, we ended the year with \$13.7 billion of cash, including marketable securities. Over the past several years, IBM has consistently generated return on invested capital significantly above the average for the S&P 500, and we did so again in 2005, with ROIC of 24 percent, excluding Global Financing and non-recurring items. We were able to return a record of nearly \$9 billion to you — \$7.7 billion through share repurchase and \$1.2 billion through dividends.

After lots of hard work to remix our portfolio of businesses and to improve IBM's overall competitiveness, I believe the headwinds we faced entering the decade are largely behind us. In this letter, I will describe the performance of IBM's three major businesses. I will also describe why I believe that our business model, based on the twin pillars of



Samuel J. Palmisano  
*Chairman, President and Chief Executive Officer*

integration and innovation, and underpinned by a strong financial footing, is unique—and why we are strongly positioned to capture the most attractive growth and profit opportunities in the years ahead.

### Leadership Businesses and Leadership Results

Our results in 2005 were achieved through the marketplace performance of our major businesses—Systems and Technology, Software, and Services. Let me describe that performance briefly for each.

**SYSTEMS AND TECHNOLOGY:** Our company’s technology strength is the result of long-term investments we’ve made over many years, investments that are now bearing fruit. Last year, IBM’s Systems and Technology business extended its industry leadership, enhancing its competitive standing and staking out advantageous positions in growth markets of the future. Since 2000, IBM’s total share of the server market has grown 9.5 points in annual revenue, according to industry analyst IDC.

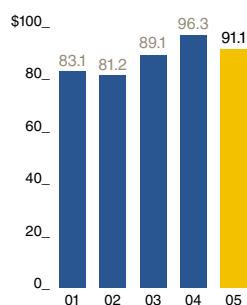
Our Systems and Technology revenues in 2005 were up 5 percent. In the fourth quarter, shipments of MIPS (millions of instructions per second) for our zSeries mainframes grew 28 percent year-to-year—our largest quarter of MIPS shipments on record, leading to our highest mainframe revenue

since the fourth quarter of 1998. pSeries UNIX servers had a strong year, growing 15 percent, with double-digit growth in all geographies. We believe this was the fourth straight year of improvement in pSeries’ market position. We expect to maintain our leadership in the fast-growing Blade server business, with a 2005 growth rate of 65 percent. In addition, our system storage business was up 15 percent for the year, driven by our mainstay disk and tape products. And our emerging technologies also gained momentum, such as storage virtualization, which added 1,700 clients.

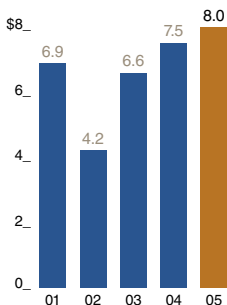
Led by our sweep of the three major gaming platforms, IBM’s microelectronics business achieved 16 percent growth. Revenue from our 300-millimeter wafer products grew strongly in 2005—including more than 250 percent growth in the fourth quarter. Engineering & Technology Services grew 39 percent for the year. The Cell Broadband Engine, our revolutionary microprocessor developed through a unique technology collaboration with Sony and Toshiba, is bringing the capabilities of supercomputer-level simulation to multiple arenas, including consumer electronics, healthcare and defense. Recently we combined a number of these engineering and technology operations into a new unit, Technology Collaboration Solutions, to bring greater focus and

## Results from continuing operations

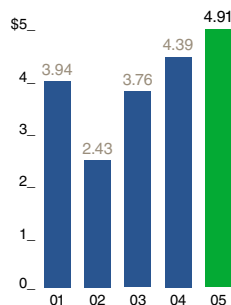
**Revenue**  
(Dollars in billions)



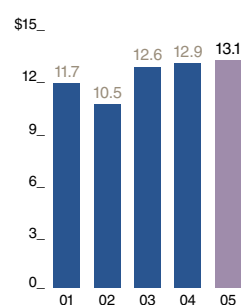
**Income**  
(Dollars in billions)



**Earnings per share—  
assuming dilution**  
(In dollars)



**Net cash from operating  
activities, excluding Global  
Financing receivables**  
(Dollars in billions)



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

resources to the opportunities we see in collaborative innovation. There is large and growing demand across engineering-intensive industries—from automotive and aerospace to telecommunications and medical equipment—to leverage the technologies and research prowess of partners. This is not outsourced R&D, but true shoulder-to-shoulder collaboration. The ability to extend IBM’s legendary technology strengths to clients to accelerate their own product and service R&D is a powerful proposition that no one in our industry can easily match.

**SOFTWARE:** Software revenues totaled \$15.8 billion in 2005, an increase of 4 percent. We believe we improved our competitive position in all five of our key middleware brands. Indeed, 2005 marked a milestone for our software business. As I’ve reported to you for several years, we have been focusing our internal software R&D and acquisition efforts on the high-growth middleware segment of the software opportunity. Last year, for the first time, more than half of our software revenue came from strategic middleware products vs. the slower growth host or legacy platforms.

In software, as in systems, the technology bets we made several years ago are paying off. Companies are seeking to dissolve barriers that impede the flow of information within the enterprise by deploying open, standards-based middleware to integrate their IT systems and to maximize digital assets in all their forms. There is a significant shift underway in the world of software toward what is called service-oriented architecture (SOA), which allows companies to be much more flexible and responsive. As the worldwide leader in middleware, IBM is in a strong position to capitalize on the SOA market, which some analysts expect to more than double, to \$143 billion, by 2008.

Our WebSphere middleware family grew 10 percent in 2005, with particular strength in Application Servers and Portals, which grew 15 percent and 12 percent, respectively. Information management software grew 8 percent, fueled by our content management and information integration products—a set of offerings that we are enhancing with a \$1 billion

investment in a new “information on demand” practice we announced this February, including advanced tools and 10,000 additional practitioners located in centers of excellence around the world. Our Rational software tools grew 4 percent for the year, and Tivoli 11 percent—including 24 percent growth for Tivoli storage software, as clients continued their strong adoption of our virtualization technologies. In addition, our 2005 acquisitions of companies such as Ascential, Bowstreet, SRD and DWL have strengthened our hand in other high-growth areas, including business integration and Web-enabled software.

**GLOBAL SERVICES:** IBM Global Services remains the leading IT services company in the world, with more than twice the revenue of our nearest rival. We are ranked as the number-one service provider in IT outsourcing, Web hosting and consulting & systems integration. Revenues from Global Services in 2005 totaled \$47.4 billion, an increase of 2 percent. Our backlog is estimated at \$111 billion, the same as a year ago.

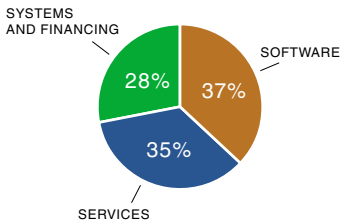
We’ve been seeing a transition in services over the past few years, a shift to smaller deals of shorter duration. These are good opportunities—if you can recalibrate your sales model to capture them in addition to the traditional “mega-deals.” And the profitability of these kinds of deals is very attractive, if your global cost structure is competitive. We had to address both our sales model and services cost structure last year, and we did so. We also took other actions to strengthen our services business—shifting thousands of employees into global delivery centers; rebalancing our Integrated Technology Services portfolio; and doubling the resources dedicated to integrated solutions, which we expect will account for 70 percent of the total IT opportunity by 2008. These changes give us a platform for increasing growth in 2006.

I want to call out in particular our continuing progress in the high-growth market we call Business Performance Transformation Services. This is where

# Moving to a high-value model

IBM's Segment Pre-Tax Income in 2005 was balanced among its three primary businesses.

Pre-Tax Income 2005\*



\* Excludes 2Q restructuring charges and PCs. Software includes Enterprise Investments.

## Systems and Financing

World leader in server sales. IBM has improved its server market position by 9.5 points since 2000. Blade server revenue grew by 65 percent in 2005. IBM leads in supercomputers, with 219 of the top 500 systems—including number one (BlueGene/L) and five of the top ten.

## Software

World leader in middleware and the second-largest software business overall. IBM is the market leader in information management software, all application integration and middleware categories; instant messaging software for corporations; portal software; and systems management and systems operations software.

## Services

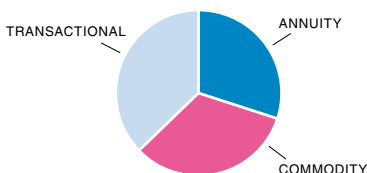
World leader in IT services and consulting. IBM has approximately 198,000 services professionals globally. Offerings include datacenter outsourcing, business transformation services, consulting, systems integration, application management services, infrastructure and system maintenance and Web hosting. IBM Global Services signings grew 9 percent in 2005.

The company has steadily shifted its business mix toward more profitable, innovation-based segments.

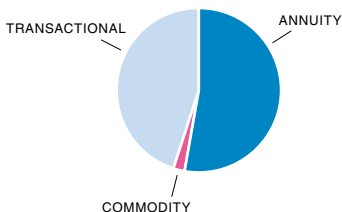
## Business Revenue Mix

The company's business mix has shifted away from commoditizing segments, such as PCs, hard disk drives and DRAMs, and toward higher value businesses: *transactional*, which provide near-term income; and *annuity*, which provide predictable, long-term income, supplying capital to invest in future growth.

1996



Today\*

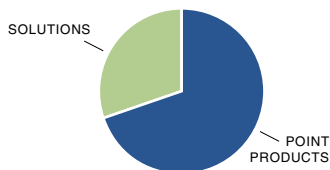


\* Post PC divestiture

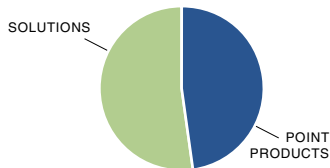
## Transaction Revenue Mix

IBM uses the cash from its reliable annuity businesses to fund investment in high-value integrated solutions: offerings that integrate services and technology to solve a business or infrastructure problem. Clients increasingly seek solutions rather than "point-product" purchases of particular technologies and products.

1996



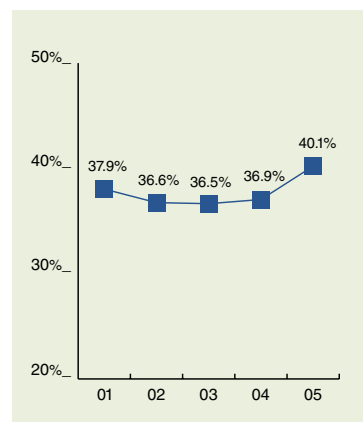
Today\*



## Profitability

As a result of these shifts, the company has improved its gross profit margins over the past five years. IBM's margin is the highest it has been since 1996.

Gross Profit Margin



# Capturing growth opportunities and increasing efficiency

IBM continually identifies and seizes future high-growth opportunities.

## Emerging Countries

IBM continues to extend its reach into high-growth markets around the world. In 2005, excluding PCs, the company grew in:

Brazil . . . . .	29%
China . . . . .	9%
India . . . . .	59%
Russia . . . . .	29%

## Emerging Customer Sets

In 2005, excluding PCs, IBM achieved strong growth in such key sectors as:

Healthcare . . . . .	20%
Travel & Transportation . . . . .	16%
Consumer Products . . . . .	11%
Small & Medium-sized Business . . . . .	6%

## Emerging Business

### Transformation Opportunities

- **Business Performance Transformation Services:** an estimated \$500 billion market for transforming operations such as supply chain management, engineering and design services, human resource management and customer care. IBM's BPTS revenue was \$4 billion in 2005, up 28 percent.
- **Service-Oriented Architecture (SOA):** Based on industry standards and Web services software, SOA is an important new way for businesses to share and integrate previously fragmented data and business processes. IBM is the leading SOA provider, with nearly 500 certified partners around the world.

### Emerging Technology Opportunities

- **Technology Collaboration Solutions:** This new unit consolidates many of IBM's technology strengths and extends them to clients to accelerate their own product and service R&D. The Engineering & Technology Services unit grew revenue 39 percent in 2005.
- **Advanced Microprocessor Technology:** IBM's revenue from advanced semiconductors for consumer electronics, telecommunications, healthcare and other industries grew by 16 percent in 2005, driven by improved manufacturing yields for game processors.

IBM is integrating all its capabilities for its clients.

## Global Integration

IBM is integrating its businesses into a single global system—increasing flexibility, creating a more complete view of operations and identifying new sources of talent and skills. This system features:

- **Global delivery centers:** The company shifted more than 18,000 employees into these in 2005.
- **Globally integrated manufacturing:** Nine plants have been integrated into a single flexible network capable of sharing workloads across clients, products and geographies.
- **Globally integrated corporate functions:** These include legal, human resources, finance, information technology and real estate site operations.
- **Global skills marketplace:** IBM's Professional Marketplace system lets IBM consulting partners manage skills globally. It indexes the skills of 68,000 professionals worldwide.

## A Flatter Organization

IBM is pushing decision-making closer to the client, and lowering the company's "center of gravity."

- **Sales support centers:** Piloted successfully in Europe, these "deal hubs" help sales teams by coordinating technical support, pricing, legal and quality assurance. In 2006 the company will deploy deal hubs in Asia/Pacific and North and South America.
- **Restructured operations in Europe:** IBM moved most client-facing leaders closer to their customers in 2005.
- **New lead-management process:** The On Target system—which generated more than \$100 million in incremental revenue as a limited pilot in 2005—helps sellers identify and prioritize potential clients. It will be expanded to 15 countries in 2006.

## Greater Organizational Efficiency

The steps described here have improved IBM's cost structure and organizational efficiency.

- **Reduced costs:** Areas such as procurement, hardware, IT equipment and connectivity have contributed to the overall margin improvement and enabled greater competitiveness in key markets. IBM is applying these supply chain principles to its services business.
- **Decreased inventory:** Inventory levels were reduced by more than \$250 million in 2005, adjusted for the sale of the PC business.
- **Speedier procurement:** Over the past decade the time to process a purchase order has decreased from one month to a few hours.



we apply our technology prowess and economies of scale to running and transforming business processes for our clients—from supply chain, to human resources, to logistics and more. Our BPTS revenue increased 28 percent in 2005, to \$4 billion. We have more than tripled our resources focused on BPTS since early 2004. Several of our 16 acquisitions in 2005 were aimed at strengthening our BPTS capabilities in such areas as healthcare, the order-to-cash cycle and “applications on demand” for small and medium businesses. We’re increasing investments in engineering collaboration. And we recently created a new unit to consolidate and accelerate our efforts in business transformation outsourcing, including a promising opportunity to deliver more standardized business processing services, mainly to smaller enterprises.

### Integrate to Innovate

Each of our three major businesses is a multi-faceted leader in its own right. But they are not standalone entities. They work together in a model defined by integration and innovation—the imperatives that we believe are increasingly shaping business and society in the 21st century. This ability to integrate and innovate is unique to IBM, and sets us apart from our competition.

- *Innovation* is increasingly what businesses and institutions of all kinds seek, in response to a “flattening” world of ever-more intense and global competition. That sounds simple enough—but it’s not just about building a “better mousetrap.” The kind of innovation companies need today goes beyond products or services, involving all aspects of the enterprise—from business processes and models to management systems, culture and policies. Accomplishing this kind of systemic innovation requires a unique blend of business and technology, and a deep understanding of the new tools, techniques and capabilities that have come of age today.
- *Integration* of technology with business design is now possible as never before—and therefore is

necessary as never before, for companies that hope to remain competitive. After decades of new technology invention, we are entering a phase familiar to economic historians who study technological revolutions. This is when new technologies get infused into every aspect of business and society. And this is when lasting value is created and real money gets made. Increasingly today, it’s playing out on a global stage—and that, in turn, is driving a new model of the corporation itself. We’re shifting away from the 20th century multinational and toward a new way to integrate the components of business activity on a global basis. We call this the “globally integrated enterprise.”

Those who succeed in this new era will seize upon innovation and integration to differentiate themselves from their rivals—including the new ones that will arise continually from all corners of an increasingly interconnected planet.

We’ve been talking for several years about the bifurcation of our industry and the fundamental choice that companies in IT have to make between two radically different business models. One of those is to compete on low price in rapidly commoditizing segments. These types of businesses focus on revenue growth, but their models, based on commodity products and services, inherently do not produce superior profit margins. The other is to compete by creating unique, differentiating value through innovation. As you know, we have chosen to be the provider of high-value, innovative solutions. But candidly, we were not well positioned to be a high-value leader as recently as a few years ago. We were weighed down by commoditizing business lines with eroding profit margins.

Today, we have succeeded in moving almost entirely out of commoditizing areas. In addition, we have shifted our transaction mix more toward higher value solutions and away from individual product sales. In large measure as a result of those changes, our gross profit margin is the best it’s been since 1996, and the company is much better balanced in terms of profit

contribution. When you exclude second-quarter restructuring charges and PCs, about 37 percent of our profit last year was from software, including enterprise investments; about 28 percent from systems and financing; and about 35 percent from services.

### An Innovation Company

If you understand the broad economic and societal changes taking place, the transformation of our company to capitalize on them and the resulting mix of our business, it should be apparent that IBM in 2006 is neither a “computer company” *nor* a “services company.” We are not even “an IT company.” IBM today, perhaps more than any time in our history, is an innovation company. We have a distinctive point of view on how innovation is changing, and a unique set of capabilities to enable our clients to capture its benefits. In a word, we are their innovation partner. We make them innovative—the innovators’ innovator, if you will.

You’d never see this, though, if you only looked through the lens of the IT industry’s traditional segmentation: hardware, software, services and their many product-specific subsets. Further, that view doesn’t just obscure the picture of IBM; it also distorts the reality of how technology is acquired and used by businesses today. Companies, governmental agencies, educational and healthcare organizations and other enterprises and institutions everywhere are faced with opportunities and threats, and in response they need to innovate. That’s the industry we are part of, and those are the marketplace realities everyone in it needs to address.

For IBMers, this deeper notion of innovation is what we mean when we talk about “innovation that matters”—one of three core values we collectively defined for our company three years ago in one of our all-company jams. IBMers around the world are tremendously excited about the possibilities being unlocked by this broad and ambitious notion of innovation. And we’re eager to share our point of view with clients, partners and our thousands of collaborators across business, government, education and every area of society.

To that end, we have prepared a companion document to this annual report, describing some of the powerful tools, techniques and new models that are available and affordable for innovators today. *It’s a Great Time To Be an Innovator* also contains the stories of IBM clients who are using these new capabilities to enhance their own unique strengths and thus achieve differentiation and competitive advantage. I think you’ll find it informative, and I hope it stimulates ideas about how your own organization or community could benefit from the new possibilities for innovation.

### An Integrated Company

For IBM, the key to capturing all this value we’re creating through innovation is to integrate it for our clients. Operationally, that raises two key questions: Where is it best for that integration to occur, and around what?

I believe the right place to integrate IBM is close to the action—which is why we’ve been working hard to “lower the center of gravity” of our company. Starting in Europe, for instance, we implemented a new management system in 2005 that flattened the organizational structure and moved more client-facing leaders out into local markets—the biggest such change there in nearly half a century. It used to be that 44 percent of executives were in headquarters offices; now, 84 percent of them are working in-country. In addition, we have tripled the number of people working in or serving emerging markets such as China, India, Brazil and Russia—where together our business grew 23 percent last year, excluding PCs.

At the same time, we have shifted pricing authority down to the country level. We also created “deal hubs” to give our teams a single point of contact for sales support and other client services. They’ve been an immediate success. Win rates are up across the board—with double-digit increases in the countries of Europe where we piloted the hubs. We will roll out new deal hubs in the Americas, Asia, Australia and additional parts of Europe in the first half of this year.



When it comes to the second question—on what basis are we integrating?—the answer lies in our core values. For the IBMers who shaped these values, they are much more than vague aspirations. They are, in fact, a set of decision-making criteria that guide how we organize and run the company. A little more than a year ago, tens of thousands of IBMers came together to turn our values into dozens of specific actions and changes—many of which we implemented in 2005. I've described some of them, such as the deal hubs, in this letter.

These steps to transform our company were crucial, and that work will never stop. But being a values-managed company applies at the top, as well. That's why, at the beginning of this year, I decided to disband the senior leadership structure that had been in place in IBM for more than a decade, and to replace it with one based on simpler, clearer criteria for our top positions.

First, we formed a new group of IBM's senior-most leaders who will be accountable for the performance and execution of our business. Second, we created a broader group that will focus specifically on integrating IBM on the basis of our values. Both groups met for the first time about a month ago to discuss how to bring to bear all of IBM's capability to drive marketplace results. I know from the team's energy and commitment that this move was the right thing to do.

### Innovation that Matters

These days, you'd have to look long and hard to find a company that *doesn't* say it is committed to innovation. But innovation of the sort I've discussed here—the kind that's grounded in the integration of business and technology, that draws on multi-faceted collaboration and that functions in a truly global way—is devilishly hard.

For all the reasons I've shared with you in this letter, I believe that IBM has an unmatched ability to deliver this sort of innovation. We are the only company that couples broad expertise across industries and business processes with deep technology capability. We have a unique understanding of information technology's potential and future

trajectory, because we're at the forefront of creating both. We are rapidly becoming a model of global integration—leveraging economies of scale and expertise for the benefit of our clients and our own operational effectiveness. And while many companies consult or offer piece-part technologies and services, we are distinct in our ability to integrate the right technologies, expertise and partnerships in ways that enable our clients to be truly special.

"Innovation that matters" is, finally, central to IBM's identity—to why our employees choose us; why our partners and clients look to collaborate with us; and why you, our owners, invest in us. And interestingly, this same vision is showing up more and more these days among companies, governments, educators, healthcare practitioners and communities around the world.

For IBM, this is gratifying, and hopeful. As we enter a promising new era, 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 as we have repositioned the company to be the innovation leader. I and my colleagues are delighted and challenged by the prospect of advancing this work, and by what, together with our clients, our partners and you, we can do to lead it.



Samuel J. Palmisano  
*Chairman, President and Chief Executive Officer*

The selected references in this letter to the company's financial results: (1) excluding the effects of the divestiture of the company's PC business, (2) excluding non-recurring items, (3) excluding the Global Financing Business and (4) at constant currency are non-GAAP financial measures and are made to facilitate a comparative view of the company's ongoing operational performance. See the company's Form 8-K dated January 17, 2006, Attachments II and III, for additional information on the use of these non-GAAP financial measures.

# Financial Highlights

(Dollars in millions except per share amounts)

FOR THE YEAR	2005	2004
Revenue	\$ 91,134	\$ 96,293
Income from continuing operations	\$ 7,994	\$ 7,497
Loss from discontinued operations	(24)	(18)
Income before cumulative effect of change in accounting principle	7,970	7,479
Cumulative effect of change in accounting principle**	(36)	—
Net income	\$ 7,934	\$ 7,479

Earnings/(loss) per share of common stock:

Assuming dilution:		
Continuing operations	\$ 4.91	\$ 4.39
Discontinued operations	(0.01)	(0.01)
Before cumulative effect of change in accounting principle	4.90	4.38
Cumulative effect of change in accounting principle**	(0.02)	—
Total	\$ 4.87*	\$ 4.38
Basic:		
Continuing operations	\$ 4.99	\$ 4.48
Discontinued operations	(0.02)	(0.01)
Before cumulative effect of change in accounting principle	4.98*	4.47
Cumulative effect of change in accounting principle**	(0.02)	—
Total	\$ 4.96	\$ 4.47

Net cash provided by operating activities from continuing operations	\$ 14,914	\$ 15,349
Capital expenditures, net	3,527	3,745
Share repurchase	7,739	7,145
Cash dividends paid on common stock	1,250	1,174
Per share of common stock	0.78	0.70

AT YEAR END	2005	2004
Cash, cash equivalents and marketable securities	\$ 13,686	\$ 10,570
Total assets	105,748	111,003
Working capital	10,509	7,357
Total debt	22,641	22,927
Stockholders' equity	33,098	31,688
Common shares outstanding (in millions)	1,574	1,646
Market capitalization	\$ 129,381	\$ 162,223
Stock price per common share	\$ 82.20	\$ 98.58
Number of employees in IBM/wholly owned subsidiaries	329,373	329,001

\* Does not total due to rounding.

\*\* Reflects implementation of FASB Interpretation No. 47. See note B, "Accounting Changes," on pages 61 and 62 for additional information.