

INTERNATIONAL BUSINESS MACHINES CORP  
Form 8-K  
December 30, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 8-K**

**CURRENT REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of Report: **December 30, 2004**  
(Date of earliest event reported)

**INTERNATIONAL BUSINESS MACHINES CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**  
(State of Incorporation)

**1-2360**  
(Commission File Number)

**13-0871985**  
(IRS employer Identification No.)

**ARMONK, NEW YORK**  
(Address of principal executive offices)

**10504**  
(Zip Code)

**914-499-1900**

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

- o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

- o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

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Item 7.01 (Regulation FD Disclosure).

As previously disclosed by IBM, on December 7, 2004, IBM and Lenovo Group Limited announced a definitive agreement under which Lenovo will acquire IBM's Personal Computing Division (PCD). Attachment I of this Form 8-K, which is hereby furnished, contains combined financial statements for PCD at June 30, 2004, December 31, 2003, 2002 and 2001.

IBM's web site ([www.ibm.com](http://www.ibm.com)) contains a significant amount of information about IBM, including financial and other information for investors ([www.ibm.com/investor/](http://www.ibm.com/investor/)). IBM encourages investors to visit its various web sites from time to time, as information is updated and new information is posted.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

Date: December 30, 2004

By: /s/ Timothy S. Shaughnessy  
Timothy S. Shaughnessy  
Vice President and Controller

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**Personal Computing Division**

**A Division of International Business Machines Corporation**

**Combined Financial Statements**

**June 30, 2004**

**December 31, 2003, 2002 and 2001**

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**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Financial Statements**

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**Combined Financial Statements**

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**PricewaterhouseCoopers LLP**  
PricewaterhouseCoopers Center  
300 Madison Avenue  
New York NY 10017  
Telephone (646) 471 3000  
Facsimile (813) 286 6000

**Report of Independent Registered Public Accounting Firm**

**To the Stockholders and Board of Directors of International Business Machines Corporation:**

In our opinion, the accompanying Combined Financial Statements and related footnotes appearing on pages 3 through 38 present fairly, in all material respects, the financial position of the Personal Computing Division ( PCD or the Business ), a division of International Business Machines Corporation, at June 30, 2004, December 31, 2003, December 31, 2002 and December 31, 2001, and the results of its operations and cash flows for the six-month period ended June 30, 2004 and for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Business management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note D, the Business and its parent, International Business Machines Corporation engage in extensive intercompany transactions, and the Business relies on its parent for substantially all of its operational and administrative support for which it is allocated costs on a basis that management believes is appropriate in the circumstances. The amounts recorded for these transactions and allocations are not necessarily representative of the amounts that would have been reflected in the financial statements had the Business been an entity operated independently of the parent.

PricewaterhouseCoopers LLP  
New York, New York  
December 16, 2004



**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Statement of Operations**

	NOTES	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
		2004	2003 (UNAUDITED)	2003	2002	2001
<b>(US dollars in millions)</b>						
<b>NET REVENUE:</b>						
External sales		\$ 5,003	\$ 4,160	\$ 9,288	\$ 8,962	\$ 9,745
Sales to IBM	<b>D</b>	214	136	278	275	333
Total net revenue		5,217	4,296	9,566	9,237	10,078
<b>COST OF REVENUE:</b>						
External sales		4,492	3,668	8,327	8,066	8,815
Sales to IBM	<b>D</b>	214	136	278	275	333
Total cost of revenue		4,706	3,804	8,605	8,341	9,148
Gross profit		511	492	961	896	930
<b>EXPENSE AND OTHER INCOME:</b>						
Selling, general and administrative	<b>N</b>	511	489	1,013	1,038	1,201
Research, development and engineering	<b>O</b>	70	72	139	138	179
Intellectual property income		(27)	(30)	(75)	(118)	(134)
Other (income) and expense		1	(4)	1	(94)	(23)
<b>TOTAL EXPENSE AND OTHER INCOME</b>		555	527	1,078	964	1,223
<b>LOSS BEFORE INCOME TAXES, MINORITY INTERESTS AND CHANGE IN ACCOUNTING PRINCIPLE</b>						
Provision for income taxes	<b>M</b>	74	51	115	86	77
Minority interests	<b>J</b>	21	11	26	17	17
Net loss before change in accounting principle		(139)	(97)	(258)	(171)	(387)
Effect of change in accounting principle	<b>C</b>					10
<b>NET LOSS</b>		\$ (139)	\$ (97)	\$ (258)	\$ (171)	\$ (397)

The accompanying notes on pages 8 through 38 are an integral part of the combined financial statements.

**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Statement of Financial Position**

(US dollars in millions)	NOTES	AT JUNE 30: 2004	2003	AT DECEMBER 31: 2002	2001
<b>ASSETS</b>					
Current assets:					
Cash		\$ 297	\$ 211	\$ 199	\$ 110
Accounts receivable trade (net of allowances of \$7 million in 2004, \$7 million in 2003, \$9 million in 2002 and \$14 million in 2001)		398	470	425	443
Inventories, net	F	279	235	216	322
Prepaid expenses and other current assets		192	120	118	151
<b>Total current assets</b>		<b>1,166</b>	<b>1,036</b>	<b>958</b>	<b>1,026</b>
Plant and other property	G	806	968	1,129	1,149
Less: Accumulated depreciation	G	498	607	728	718
Plant and other property, net	G	308	361	401	431
Investments and sundry assets	H	60	61	58	38
<b>TOTAL ASSETS</b>		<b>\$ 1,534</b>	<b>\$ 1,458</b>	<b>\$ 1,417</b>	<b>\$ 1,495</b>
<b>LIABILITIES AND INVESTED EQUITY/(DEFICIT)</b>					
Current liabilities:					
Taxes	M	\$ 21	\$ 35	\$ 18	\$ 17
Accounts payable		1,441	1,457	1,168	956
Compensation accruals		30	41	51	53
Deferred revenue		21	24	47	30
Warranty accruals		289	237	196	181
Rebates and returns accrual		175	193	176	191
Software royalties payable		159	166	145	107
Other accrued expenses and liabilities		57	43	47	40
<b>Total current liabilities</b>		<b>2,193</b>	<b>2,196</b>	<b>1,848</b>	<b>1,575</b>
Warranty accruals non-current		229	191	144	133
Minority interests and other long-term liabilities	J	87	62	53	53
<b>TOTAL LIABILITIES</b>		<b>2,509</b>	<b>2,449</b>	<b>2,045</b>	<b>1,761</b>
Contingencies and commitments					
	L				
IBM's net investment		(973)	(984)	(613)	(288)
Accumulated other comprehensive income/(loss)	K	(2)	(7)	(15)	22
<b>TOTAL INVESTED EQUITY/(DEFICIT)</b>		<b>(975)</b>	<b>(991)</b>	<b>(628)</b>	<b>(266)</b>
<b>TOTAL LIABILITIES AND INVESTED EQUITY/(DEFICIT)</b>		<b>\$ 1,534</b>	<b>\$ 1,458</b>	<b>\$ 1,417</b>	<b>\$ 1,495</b>

The accompanying notes on pages 8 through 38 are an integral part of the combined financial statements.

**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Statement of Invested Equity/ (Deficit)**

	IBM S NET INVESTMENT	ACCUMULATED OTHER COMPREHENSIVE INCOME /(LOSS)	TOTAL
<b>(US dollars in millions)</b>			
<b>2001</b>			
Invested equity/(deficit), January 1, 2001	\$ (182)	\$	\$ (182)
Net investment by IBM	291		291
Net loss plus gains and (losses) included in other comprehensive income/ (loss):			
Net loss	(397)		(397)
Gains and (losses) included in other comprehensive income/(loss) (net of tax):			
Net unrealized gains on SFAS No. 133 cash flow hedge derivatives during 2001 (net of tax)		17	17
Foreign currency translation adjustments (net of tax)		5	5
<b>Invested equity/(deficit), December 31, 2001</b>	<b>(288)</b>	<b>22</b>	<b>(266)</b>
<b>2002</b>			
Net investment by IBM	(155)		(155)
Net loss plus gains and (losses) included in other comprehensive income (loss):			
Net loss	(171)		(171)
Gains and (losses) included in other comprehensive income/(loss) (net of tax):			
Net unrealized losses on SFAS No. 133 cash flow hedge derivatives during 2002 (net of tax)		(24)	(24)
Foreign currency translation adjustments (net of tax)		(13)	(13)
Tax effect stock transactions	1		1
<b>Invested equity/(deficit), December 31, 2002</b>	<b>(613)</b>	<b>(15)</b>	<b>(628)</b>
<b>2003</b>			
Net investment by IBM	(113)		(113)
Net loss plus gains and (losses) included in other comprehensive income/ (loss):			
Net loss	(258)		(258)
Gains and (losses) included in other comprehensive income/(loss) (net of tax):			
Net unrealized losses on SFAS No. 133 cash flow hedge derivatives during 2003 (net of tax)		1	1
Foreign currency translation adjustments (net of tax)		7	7
<b>Invested equity/(deficit), December 31, 2003</b>	<b>\$ (984)</b>	<b>\$ (7)</b>	<b>\$ (991)</b>

The accompanying notes on pages 8 through 38 are an integral part of the combined financial statements.



**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Statement of Invested Equity/ (Deficit)**

	IBM S NET INVESTMENT		ACCUMULATED OTHER COMPREHENSIVE INCOME /(LOSS)		TOTAL	
<b>(US dollars in millions)</b>						
<b>Invested equity/(deficit), December 31, 2003</b>	\$	(984)	\$	(7)	\$	(991)
<b>2004</b>						
Net investment by IBM		150				150
Net loss plus gains and (losses) included in other comprehensive income/ (loss):						
Net loss		(139)				(139)
Gains and (losses) included in other comprehensive income/(loss) (net of tax):						
Net unrealized gains on SFAS No. 133 cash flow hedge derivatives during first six months of 2004 (net of tax)				7		7
Foreign currency translation adjustments (net of tax)				(2)		(2)
<b>Invested equity/(deficit), June 30, 2004</b>	\$	(973)	\$	(2)	\$	(975)

The accompanying notes on pages 8 through 38 are an integral part of the combined financial statements

**Personal Computing Division**  
**A Division of International Business Machines Corporation**  
**Combined Statement of Cash Flows**

	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003 (UNAUDITED)	2003	2002	2001
<b>(US dollars in millions)</b>					
<b>CASH FLOW FROM OPERATING ACTIVITIES:</b>					
Net loss	\$ (139)	\$ (97)	\$ (258)	\$ (171)	\$ (397)
Adjustments to reconcile net loss to cash provided by operating activities:					
Depreciation	28	31	61	64	83
Deferred income taxes		1	2	4	(3)
Net loss/(gain) on asset sales and other	1	(4)	(2)	(93)	
Minority interest expense	21	11	26	17	17
Change in operating assets and liabilities:					
Receivables	68	34	(24)	29	303
Inventories	(46)	(68)	(34)	76	230
Other assets	(56)	(13)	17	27	55
Accounts payable	(14)	37	268	175	(502)
Other liabilities	66	(28)	115	77	15
<b>NET CASH (USED IN)/PROVIDED BY OPERATING ACTIVITIES</b>	<b>(71)</b>	<b>(96)</b>	<b>171</b>	<b>205</b>	<b>(199)</b>
<b>CASH FLOW FROM INVESTING ACTIVITIES:</b>					
Payments for plant and other property	(36)	(71)	(97)	(86)	(107)
Proceeds from disposition of plant and other property	5	72	73	163	2
Transfers of assets at net book value to/(from) IBM	41	15	7	(10)	95
Distributions to joint venture minority interest holders	(4)	(4)	(31)	(32)	(28)
Proceeds from disposition of other investments		1	2	3	2
<b>NET CASH PROVIDED BY/(USED IN) INVESTING ACTIVITIES</b>	<b>6</b>	<b>13</b>	<b>(46)</b>	<b>38</b>	<b>(36)</b>
<b>CASH FLOW FROM FINANCING ACTIVITIES:</b>					
Net IBM investment	150	25	(113)	(155)	291
Proceeds from receipts of short-term financing		12			
<b>NET CASH PROVIDED BY/(USED IN) FINANCING ACTIVITIES</b>	<b>150</b>	<b>37</b>	<b>(113)</b>	<b>(155)</b>	<b>291</b>
Effect of exchange rate changes on cash	1			1	
Net change in cash	86	(46)	12	89	56
Cash at January 1	211	199	199	110	54
<b>CASH AT JUNE 30, AND DECEMBER 31</b>	<b>\$ 297</b>	<b>\$ 153</b>	<b>\$ 211</b>	<b>\$ 199</b>	<b>\$ 110</b>

The accompanying notes on pages 8 through 38 are an integral part of the combined financial statements.



## Notes to Combined Financial Statements

### A Description of Business and Basis of Presentation

The Personal Computing Division (PCD or the Business) is a division of International Business Machines Corporation (IBM). The Business develops, manufactures and markets personal computer products including a wide variety of notebook and desktop computers and related accessories. The Business operates worldwide through three primary sales/distribution channels including: direct/large enterprise customers; distributors, remarketers and resellers; and internet/direct order channels.

IBM facilitates the financing of product purchases from the Business, including, but not limited to, providing commercial loans and lease financing to IBM's business partners which include distributors, resellers, and other remarketers of PCD's products. In addition, IBM provides end-user financing, including leasing, installment loans and other facilities to end-users of personal computer equipment, including customers of IBM's business partners.

The Combined Financial Statements have been derived from the accounting records of IBM using the historical bases of assets and liabilities of PCD. The June 30, 2003 data contained in these Combined Financial Statements is unaudited and presented for comparative purposes. Management believes the assumptions underlying the Combined Financial Statements are reasonable. However, the Combined Financial Statements included herein may not necessarily reflect the Business' results of operations, financial position and cash flows in the future or what its results of operations, financial position and cash flows would have been had the Business operated as a stand-alone entity during the periods presented.

The Business and its parent, IBM, engage in extensive intercompany transactions, and the Business relies on its parent for substantially all of its operational and administrative support for which it is allocated costs on a basis that management believes is appropriate in the circumstances. The amounts recorded for these transactions and allocations are not necessarily representative of the amounts that would have been reflected in the financial statements had the Business been an entity operated independently of the parent.

The Combined Financial Statements include allocations of certain IBM corporate expenses, including centralized research, legal, human resources, payroll, accounting, employee benefits, real estate, insurance, information technology, telecommunications, treasury and other IBM corporate and infrastructure costs. The expense and cost allocations have been determined on bases that IBM and the Business consider to be a reasonable reflection of the utilization of services provided or the benefit received by the Business during the periods presented. In addition to the allocated costs, the Business also receives charges based on agreements between the Business and other entities within IBM for operational and functional support in critical areas such as the following: direct sales and marketing; manufacturers' warranty (including fulfilling obligations under product warranties); brand marketing; procurement; financing; information technology; logistics and fulfillment services; site management and real estate; research and development; licensing of brand names, trademarks, know-how, and other intellectual property; human resources; tax-related services; intellectual property management and royalty settlement services.

IBM uses a centralized approach to cash management and financing of its operations. Transactions relating to the Business are accounted for through the IBM net investment account for the Business. Accordingly, none of the IBM cash, cash equivalents or debt at the corporate level has been assigned to the Business in the Combined Financial Statements. Cash in the Combined Financial Statements represents amounts held locally by the Business' operations in China and South Korea. See note T, Subsequent Events, on page 33 for a description of the September, 2004 agreement to dissolve the Business' joint venture in South Korea.



See note D, Transactions with IBM on pages 15 to 18 for further description of the relationships the Business has with IBM.

All references to dollar amounts in the Notes to the Combined Financial Statements are in US dollars.

*Risks and Uncertainties*

The Business has from inception operated as an integrated part of IBM and within the IBM infrastructure. As a consequence, the Business has not operated as a stand-alone business. The Business benefits from centralized IBM functions, such as global procurement and integrated supply chain. The historical financial statements may, therefore not reflect the results of operations, financial position or cash flows that would have resulted had the Business been operated as a separate entity.

The Business purchases all of its microprocessors from a single supplier and a significant amount of its personal computer products are shipped preloaded with software from a single supplier.

The Business currently sources a significant amount (over 40 percent in the first six months of 2004 and over 50 percent in 2003) of its products from one external supplier. If this supplier were unable to deliver products for an extended period of time, the Business would be required to find replacement products from an alternative supplier or suppliers, which may not be available on a timely or cost effective basis.

Additionally, greater than 50 percent (in the first six months of 2004) and greater than 30 percent (in 2003) of the Business products are manufactured as part of joint ventures with third parties, primarily in Asia. These relationships are important to the Business meeting its production commitments. See note T, Subsequent Events, on page 33 for a description of the September, 2004 agreement to dissolve the Business joint venture in South Korea.

During the periods presented, the Business experienced quality issues with certain components of the product set. The warranty costs associated with these quality issues were charged to Cost of revenue External sales. The Business had total warranty costs of \$365 million and \$226 million for the periods ended June 30, 2004 and 2003, respectively, and \$586 million, \$430 million and \$452 million in the years ended December 31, 2003, 2002 and 2001, respectively.

In addition, a significant portion of the Business customers finance their purchases through commercial loans from IBM's financing operations. This financing component is an integral part of the relationship which the Business has with its customers and business partners.

*Liquidity*

The Business has a history of recurring losses, negative working capital and an accumulated deficit. The ability to settle obligations as they come due is dependent on IBM funding the operations on an ongoing basis. IBM is committed to funding the operations as necessary to meet the obligations of the Business as they come due, for as long as the Business is owned and controlled by IBM.

**B Significant Accounting Policies**

*Principles of Combination*

The Combined Financial Statements have been prepared for the Business as it was historically managed within IBM's management and measurement system and includes the global historical assets, liabilities and operations for which management is responsible, including certain joint venture investments, adjusted as necessary to conform with accounting principles generally accepted in the United States of America (GAAP). All significant intra-company transactions within the Business have been eliminated. All significant transactions between the Business and other entities of IBM are included in these Combined Financial Statements. All intercompany transactions are considered to be effectively settled for cash in the Combined Statement of Cash Flows at the time the transaction is recorded. Certain assets and liabilities of the Business, which are included in these Combined Financial Statements may, or may not, be indicative of the Business on a stand-alone basis.

*Use of Estimates*

The preparation of Combined Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts that are reported in the Combined Financial Statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Business may undertake in the future, actual results may be different from the estimates. These estimates include, but are not limited to, allowance for price protection, returns and other vendor support arrangements, allowance for doubtful accounts, realization of deferred tax assets, inventory valuation allowances, warranty obligations and employee compensation accruals.

*Revenue*

The Business recognizes revenue when it is realized or realizable and earned. The Business considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable and collectibility is reasonably assured. Delivery is considered to have occurred upon transfer of title and risk of loss to the customer, generally at shipment, and revenue is recognized provided there are no unfulfilled business obligations that affect customer's final acceptance of the arrangement. Any cost of these obligations is accrued when the corresponding revenue is recognized. The Business and IBM allocate revenue from multiple-element arrangements on a relative fair value basis in accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. The Business estimates and records incentive offerings, including price protection, promotions, and other volume-based incentives, and expected returns as reductions of revenue.

*Expense and Other Income*

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative (SG&A) expense is charged to operations as incurred. Expenses of promoting and selling products and services are classified as selling expense and include such items as advertising, sales commissions and travel. General and administrative expense includes such items as executive salaries, office supplies, non-income taxes, insurance and office rental. In addition, general and administrative expense includes other operating items such as a provision for doubtful accounts and workforce accruals for contractually obligated payments to employees terminated in the ongoing course of business.

RESEARCH, DEVELOPMENT AND ENGINEERING

Research, development and engineering (RD&E) costs are expensed as incurred.

INTELLECTUAL PROPERTY INCOME

As part of the Business' ongoing business investment in research and development (R&D), the Business licenses the rights to certain of IBM's intellectual property (IP) including internally-developed patents through licensing/royalty-based arrangements. Licensing/royalty-based arrangements involve transfers in which the Business earns the income over time, or the amount of income is not fixed or determinable until the licensee sells future related products (i.e., variable royalty, based upon licensee's revenue).

#### OTHER (INCOME) AND EXPENSE

Other (income) and expense includes principally gains from sales of manufacturing operations, interest income and foreign currency transaction gains and losses.

#### *Depreciation and Amortization*

Plant and other property are carried at cost and are depreciated over their estimated useful lives using the straight-line method. Plant and other property are included in the Combined Statement of Financial Position when they are managed by the Business i.e., landlord-tenant basis and are not necessarily reflective of ownership. Depreciation charges for Plant and other property managed by the Business which are utilized by other IBM units are recovered in occupancy/usage billings to such IBM units resulting in a cost/expense reduction to the Business. Refer to Note D, Transactions with IBM, on pages 15 to 18. The estimated useful lives of depreciable properties generally are as follows: buildings, 50 years; building equipment, 20 years; land improvements, 20 years; plant, laboratory and office equipment, 2 to 15 years; and computer equipment, 1.5 to 5 years.

**Retirement-Related Benefits**

The Business employees and IBM employees that provide direct support to the Business participate in certain defined benefit pension plans, certain defined contribution plans and certain nonpension postretirement benefit plans, all of which are sponsored by IBM. The Business accounts for costs related to defined benefit pension and nonpension postretirement benefit plans on a multi-employer plan basis as a participant, in accordance with Statement of Financial Accounting Standards (SFAS) No. 87, *Employers Accounting for Pensions*, and SFAS No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*, respectively. SFAS No. 87 provides that an employer that participates in a multi-employer defined benefit plan is not required to report a liability beyond the contributions currently due and unpaid to the plan. As a consequence, no assets or liabilities relative to these retirement-related plans have been included in the Combined Statement of Financial Position. See note R, *Retirement-Related Benefits*, on pages 28 and 29 for further information regarding the plans in which the Business employees participate.

**Stock-Based Compensation**

The Business employees participate in IBM's various incentive award plans. The Business applies the provisions of Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for stock-based compensation arrangements. Accordingly, the Business records expense for grants of employee stock-based compensation awards equal to the excess of the market price of the underlying IBM shares at the date of grant over the exercise price of the stock-related award, if any (known as the intrinsic value). Generally, all employee stock options are issued with an exercise price equal to or greater than the market price of the underlying shares at grant date and therefore, no compensation expense is recorded. In addition, no compensation expense is recorded for purchases of IBM stock made by the Business employees under the IBM Employee Stock Purchase Program (ESPP) in accordance with APB No. 25. Additionally, the intrinsic value of restricted stock units and certain other stock-based awards issued to employees as of the date of grant is amortized to compensation expense over the vesting period. To the extent there are performance criteria that could result in an employee receiving more or less (including zero) IBM shares than the number of units granted, the unamortized compensation is marked to market during the performance period based upon the intrinsic value at the end of each quarter.

The following table summarizes the pro forma operating results of the Business, had compensation cost for stock-based awards granted and employee stock purchases under the ESPP (see note Q, *Stock-Based Compensation Plans* on pages 26 and 27) been determined in accordance with the fair value-based method prescribed by SFAS No. 123, *Accounting for Stock-Based Compensation*.

	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003	2003	2002	2001
(US dollars in millions)					
Net loss, as reported	\$ (139)	\$ (97)	\$ (258)	\$ (171)	\$ (397)
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	3	2	3	5	5
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	13	16	29	35	32
Pro forma net loss	\$ (149)	\$ (111)	\$ (284)	\$ (201)	\$ (424)



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The pro forma amounts that are disclosed in accordance with SFAS No. 123 reflect the portion of the estimated fair value of awards that was earned for the periods present above. The fair value of stock option grants was estimated using a Black-Scholes option-pricing model with the assumptions listed in the table below. The assumptions used and fair values of such awards are indicative of an IBM stock option and may not necessarily be representative of the value of a comparable award granted by the Business.

	FOR THE SIX MONTHS ENDED JUNE 30:				FOR THE YEAR ENDED DECEMBER 31:					
	2004		2003		2003		2002		2001	
Option term (years)	5		5		5		5		5	
Volatility	38.6%		39.9%		39.9%		40.4%		37.7%	
Risk-free interest rate (zero coupon U.S. treasury note)	3.4%		2.6%		2.9%		2.8%		4.4%	
Dividend yield	0.7%		0.7%		0.7%		0.7%		0.5%	
Weighted-average fair value per option	\$	36	\$	29	\$	30	\$	32	\$	42

**Income Taxes**

The Business' income taxes as presented are calculated on a separate tax return basis, although the Business' operations have historically been included in IBM's U.S. federal and state tax returns or non-U.S. jurisdictions tax returns. IBM's global tax model has been developed based on its entire portfolio of businesses. Accordingly, the Business' tax results as presented are not reflective of the results that the Business would have generated on a stand-alone basis.

Income tax expense is based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences between asset and liability amounts that are recognized for financial reporting purposes and the amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. Valuation allowances are recognized to reduce deferred tax assets to the amount that is more likely than not to be realized.

**Translation of Non-U.S. Currency Amounts**

Assets and liabilities of non-U.S. operations that conduct business in a local currency environment are translated to U.S. dollars at year-end exchange rates for the periods ending December 31, 2003, 2002 and 2001, and at June 30, 2004 exchange rates for the six months ended June 30, 2004. Income and expense items are translated at weighted-average rates of exchange prevailing during the year or the six month periods as presented. Translation adjustments are recorded within Invested equity/(deficit).

For operations that conduct business in U.S. dollars, or whose economic environment is highly inflationary, Inventories, Plant and other property, net and other non-monetary assets and liabilities are translated at approximate exchange rates prevailing when the Business acquired the assets or liabilities. All other assets and liabilities of these entities are translated at year-end exchange rates for the periods ending December 31, 2003, 2002 and 2001, and at June 30, 2004 exchange rates for the six months ended June 30, 2004. Cost of revenue and depreciation are translated at historical exchange rates. All other income and expense items are translated at the weighted-average rates of exchange prevailing during the year or the six month periods as presented. Gains and losses that result from translation are included in net loss.



*Derivatives*

The Business recognizes derivative instruments including designated hedging transactions in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, and SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, (SFAS No. 133). All derivatives are recognized at fair value and are reported in Investments and sundry assets or Minority interests and other long-term liabilities in the Combined Statement of Financial Position.

The Business' primary derivative usage is designated as hedging the variability of cash flows of forecasted transactions based on changes in foreign currency rates. Changes in value of effective cash flow hedges are recorded net of applicable taxes, in Accumulated other comprehensive income/(loss), a component of Invested equity/(deficit). These accumulated amounts are reclassified to Cost of revenue in the period that Net loss is affected by the variability of the underlying cash flow. The reclassified amount is the applicable offsetting amount of the gain or loss deferred in Invested equity/(deficit) relating to the cash flows impacting that period's Net loss. Changes in the value of derivatives that are not designated as hedges at inception or after designation of a previously designated hedge, as well as changes in the value of derivatives designated as hedges that do not offset the underlying hedged item throughout the designated hedge period, are recorded in Net loss each period and in Other (income) and expense.

The Business reports cash flows resulting from the Business' derivative financial instruments consistent with the classification of cash flows from the underlying hedged items as Cash flow from operating activities within the Combined Statement of Cash Flows.

See note I, Derivatives and Hedging Transactions, on pages 19 and 20 for a description of the derivative instruments used by the Business.

#### ***Inventories***

Raw materials, work in process and finished goods are stated at the lower of average cost or net realizable value. Included in inventory are those goods which are located at third party manufacturers for which the Business retains risk of loss.

#### ***Allowance for Uncollectible Receivables***

An allowance for uncollectible trade receivables is recorded based on a combination of write-off history, aging analysis, and any specific known troubled accounts.

#### ***Factoring***

The Business applies the provisions of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities when accounting for the sale of certain receivables to its parent company, IBM. In accordance with the provisions of SFAS No. 140, these transactions have been accounted for as sales and are not subject to recourse. As a result the related receivables have been excluded from the accompanying Combined Statement of Financial Position. For such receivable sales, the Business retains the obligation to dealers and remarketers for price protection, stock rotation and related vendor support and has reflected this as a liability in the Combined Financial Statements.

#### ***Royalties***

The Business has royalty-bearing license agreements with vendors that allow the Business to sell certain products which are protected by patent, copyright or license. Royalty costs are included in Cost of revenue when the products are delivered.

***Product Warranties***

The Business records warranty liabilities for the estimated costs that may be incurred under its basic warranty for which the Business is obligated to perform. The Business estimates its warranty costs based on historical warranty claim experience for eligible products under warranty. Estimated costs for warranties applicable to revenue recognized in the current period are charged to Cost of revenue. These costs primarily include technical support, parts, and labor associated with warranty repair and service actions. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligation based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates. Extended post-warranty service contracts are excluded from these financial statements as these contracts are managed by a separate IBM business entity.

## C Accounting Changes

### *Standards Implemented*

In January 2003, the FASB issued FASB Interpretation Number 46 (FIN 46), Consolidation of Variable Interest Entities, (effective for the year ended December 31, 2003) and amended it by issuing FIN 46-R in December 2003. Such guidance addresses consolidation by business enterprises of variable interest entities (VIEs) that either: (1) do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) have equity investors that lack an essential characteristic of a controlling financial interest. The company chose to apply the guidance of FIN 46-R, as of March 31, 2004 in accordance with the Interpretation's transition provisions. Neither of these accounting pronouncements had a material impact on the Business Combined Financial Statements.

On January 1, 2003, the Business adopted SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 provides accounting and reporting guidance for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction or normal operation of a long-lived asset. SFAS 143 requires the recording of an asset and a liability equal to the present value of the estimated costs associated with the retirement of long-lived assets for which a legal or contractual obligation exists. The asset is required to be depreciated over the life of the related equipment or facility, and the liability is required to be accreted each year based on a present value interest rate. The adoption of the standard did not have a material effect on the Business Combined Financial Statements.

In 2003, the EITF reached a consensus relating to the accounting for multiple-element arrangements: Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 was adopted effective July 1, 2003 and did not have a material impact on the Business Combined Financial Statements.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. FIN 45 also requires the recognition of a liability by a guarantor at the inception of certain guarantees that are entered into or modified after December 31, 2002. The Business has adopted the disclosure requirements of FIN 45 (see note B, Significant Accounting Policies, on page 13 under Product Warranties, and note L Contingencies and Commitments, on pages 21 to 23) and applied the recognition and measurement provisions for all material guarantees entered into or modified in periods beginning January 1, 2003. The initial adoption of the recognition and measurement provisions of FIN 45 did not have a material impact on the Business Combined Financial Statements.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 addresses significant issues relating to the implementation of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and develops a single accounting model, based on the framework established in SFAS No. 121 for long-lived assets to be disposed of by sale, whether such assets are or are not deemed to be a business. SFAS No. 144 also modifies the accounting and disclosure rules for discontinued operations. The standard was adopted on January 1, 2002, and did not have a material impact on the Business Combined Financial Statements.

On January 1, 2001, the Business adopted SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedge Activities, and SFAS No. 149, Amendments of Statement 133 on Derivative Instruments and Hedging Activities, (SFAS No. 133). SFAS No. 133 establishes accounting and reporting standards for derivative

instruments. As of January 1, 2001, the adoption of the new standard resulted in a cumulative effect charge of \$10 million included in the effect of change in accounting principle in the Combined Statement of Operations.

Effective January 1, 2001, the Business adopted SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of SFAS No. 125. This statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. It also revises the accounting standards for securitizations and transfers of financial assets and collateral. The adoption did not have a material effect on the Business Combined Financial Statements. The standard also requires new disclosures that are not applicable to the Business.

## **D Transactions with IBM**

### *Revenue/Cost of Revenue*

The Business derived revenue from IBM of \$214 million and \$136 million, during the six months ended June 30, 2004 and 2003, respectively. In addition, the Business derived revenue from IBM of \$278 million, \$275 million and \$333 million, during each of the years ended December 31, 2003, 2002 and 2001, respectively. The revenue stream is valued at manufacturer's cost, consistent with how these product transactions were recorded within IBM. In addition, there is no stated or implied warranty on these transactions, i.e. the IBM user is responsible for any repair costs.

### *IBM Global Financing*

IBM Global Financing (IGF, a division of IBM) is in the business of financing customer purchases of IBM products and services. IGF facilitates customer purchases of the Business products through commercial lending and end-user leasing or loan arrangements. In this regard, certain dealers and remarketers obtain commercial loans and certain end-users obtain leases or loans to finance their purchases of products from the Business. IGF financing arrangements are conducted on an arms-length basis with customers and IGF regularly secures its interests in or takes title to financed products.

IGF originations of commercial loans to finance dealer and remarketer purchases of products from the Business approximated \$3,628 million and \$3,024 million for the six months ended June 30, 2004 and 2003, respectively. In addition, IGF originations of commercial loans approximated \$6,651 million, \$6,043 million, and \$7,103 million in 2003, 2002 and 2001, respectively. For such financed purchases, the Business retains the obligations to the dealers and remarketers for price protection, stock rotation, and related vendor support. This is recorded in the Rebates and returns accrual line in the Combined Statement of Financial Position.

IGF originations of leases to finance end-user customer purchases of products from the Business or from dealers and remarketers approximated \$393 million and \$488 million for the six months ended June 30, 2004 and 2003, respectively. In addition, IGF originations of leases to finance end-user customer purchases approximated \$1,054 million, \$1,164 million, and \$1,703 million in 2003, 2002 and 2001, respectively. IGF originations of customer loans to finance end-user customer purchases of products from the Business approximated \$16 million and \$18 million for the six months ended June 30, 2004 and 2003, respectively. IGF originations of customer loans to finance end-user customer purchases were \$68 million, \$46 million and \$179 million in 2003, 2002 and 2001, respectively.

Where concentrations with a particular dealer, remarketer or end-user customer exceed established IBM credit limits, or in certain other circumstances relating to credit quality, IGF requires an indemnification from the Business prior to the extension of credit. In these situations,

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the Business assumes the repayment risk on credit extended by IGF on its behalf. The amount of outstanding receivables due to IGF for such indemnifications was less than \$1 million as of June 30, 2004 and December 31, 2003. The Business did not realize significant losses through such indemnifications during the periods presented.

As compensation to IGF for providing commercial lending facilities to the dealers and remarketers of the Business products and in addition to the returns earned by IGF on commercial lending and end-user leasing transactions, IGF charges the Business annually, market-rate based fees. Such fees, included in the income statement under Selling, general and administrative expense, amounted to \$33 million and \$29 million for the six months ended June 30, 2004 and 2003, respectively. Such fees were \$63 million, \$57 million and \$64 million during 2003, 2002 and 2001, respectively.

**Working Capital Management**

As part of the Business' working capital and liquidity management, the Business has entered into certain sales of receivables contracts with IBM. These sales transfer all rights, title and interest in the receivables to IBM at formulaically determined prices (factoring). The Business retains no residual credit exposure to the factored receivables. The Business does have a continued responsibility to service the receivables and remit collections to IBM. Without this factoring program, the Business' gross accounts receivable would have been \$156 million higher at June 30, 2004 and \$161 million, \$126 million and \$139 million higher at December 31, 2003, 2002 and 2001, respectively.

**Allocated Costs/Expenses**

The Business receives support from IBM for certain corporate expenses, including centralized research and development, legal, human resources, payroll, accounting, information technology services, telecommunications, treasury and other IBM corporate and sales support/infrastructure costs. The costs of providing these services have been allocated to the Business on bases that management considers to be appropriate and provide a reasonable reflection of the utilization of services provided or benefits received by the Business during the periods presented on a consistent basis. The allocation bases used include gross profit, revenue and operating expenses.

Allocated costs included in the accompanying Combined Statement of Operations follow:

	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003	2003	2002	2001
(US dollars in millions)					
Cost of revenue	\$ 4	\$ 6	\$ 11	\$ 1	\$ (7)
Selling, general and administrative	187	150	321	344	382
Research, development and engineering	6	4	9	11	10
Other (income) and expense	4	5	10	(2)	(7)

**Agreements With IBM**

The Business has entered into various agreements to procure certain services from IBM. Prices and rates for such services are based on predetermined or otherwise negotiated amounts between IBM divisions. The following table, followed by a brief description, details the cost of services provided by IBM to the Business under such agreements:

	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003	2003	2002	2001
(US dollars in millions)					
Services provided by IBM:					
Cost of revenue:					



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Warranty costs	\$	238	\$	200	\$	421	\$	347	\$	361
Hardware costs		56		59		115		352		613
Overhead costs		74		58		134		122		135
IT services		45		57		105		85		91
Product distribution costs		31		37		73		80		100
Technology support costs		11		8		14		13		19
Software costs		3		4		7		6		6
Other		9		12		21		17		14
Total cost of revenue	\$	467	\$	435	\$	890	\$	1,022	\$	1,339
Selling, general and administrative	\$	170	\$	162	\$	337	\$	268	\$	308
Research, development and engineering	\$	13	\$	15	\$	29	\$	32	\$	34
Other (income) and expense	\$		\$	(10)	\$	(10)	\$	(41)	\$	(31)

*Cost of revenue:* These charges to the Business primarily include warranty, hardware, overhead, IT services, product distribution, technology support, and software costs. Warranty costs are charged based on each occurrence. Generally, component hardware costs are charged based on internally established transfer prices between IBM divisions. Overhead costs include employee benefits and occupancy costs related to the Business manufacturing employees and procurement expenses. IT services are charged based on a combination of factors including usage and headcount. Product distribution costs are charged based on actual usage of freight carriers. Technology support costs are charged based on direct expenses including occupancy costs, salaries and benefits. Software costs are charged based on other IBM divisions royalty and software development charges.

*Selling, general and administrative:* These charges to the Business primarily include IT services, fees paid to IGF for commercial lending activities, direct channel fees, marketing and sales programs, employee benefits, occupancy costs, customer fulfillment costs, administrative support, and human resources support. IT services are charged based on a combination of factors including usage and headcount. IT services charged to the Business were \$25 million and \$27 million for each of the six month periods ended June 30, 2004 and 2003, respectively and \$54 million, \$57 million, and \$62 million during each of the years ended December 31, 2003, 2002 and 2001, respectively. Direct channel fees are charged to the Business based on direct expenses including occupancy costs, salaries and benefits. Marketing and sales programs are charged based on direct expenses including marketing materials and development costs, occupancy costs, salaries and benefits. Employee benefits and occupancy costs for the Business employees are charged from IBM. Customer fulfillment costs are charged based on direct expenses including occupancy costs, salaries and benefits. Administrative and human resources support are charged based on direct expenses including occupancy costs, salaries and benefits. As noted under the IBM Global Financing section on page 15, fees paid as compensation to IGF for providing commercial lending facilities to the dealers and remarketers of the Business products were \$33 million and \$29 million for each of the six month periods ended June 30, 2004 and 2003, respectively and \$63 million, \$57 million and \$64 million during each of the years ended December 31, 2003, 2002 and 2001, respectively.

*Research, development and engineering services:* The costs of providing these services are charged to the Business based on employee benefits and occupancy costs for the Business employees performing research, development and engineering services. Additionally, the direct development expenses of other IBM divisions including occupancy costs, salaries and benefits, and IT services are charged from IBM.

*Other (income) and expense:* These amounts primarily include credits transferred to the Business from IBM that compensate the Business for taking certain low or negative margin contracts.

The Business passes through costs for amounts charged by IBM and its entities that are related to other IBM divisions. Additionally the Business has various agreements to provide services to other IBM divisions. The following table details the annual pass through costs and charges for services provided to other IBM divisions followed by a brief description.

**FOR THE SIX  
MONTHS ENDED  
JUNE 30:**

**FOR THE YEAR ENDED  
DECEMBER 31:**

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	2004	2003	2003	2002	2001
<b>(US dollars in millions)</b>					
Costs and charges for services provided to other IBM divisions (reductions of the following categories):					
Cost of revenue:					
Hardware costs	\$ 16	\$ 14	\$ 24	\$ 34	\$ 38
Overhead costs	55	59	106	117	170
Software costs	7	9	17	19	12
Product distribution costs	4	3	7	12	30
Technology support costs	1	4	7	26	26
Other	17	17	30	21	24
Total cost of revenue	\$ 100	\$ 106	\$ 191	\$ 229	\$ 300
Selling, general and administrative	\$ 61	\$ 54	\$ 119	\$ 132	\$ 235
Research, development and engineering	\$ 3	\$ 3	\$ 6	\$ 16	\$ 4

*Cost of revenue:* These charges to IBM divisions primarily include both pass through costs and services provided to other IBM divisions for hardware, overhead, software, product distribution and technology support. The Business sources certain hardware components from its suppliers for other IBM divisions. Overhead costs charged to other IBM divisions primarily include procurement expenses, manufacturing employees' salaries and benefits, and occupancy costs. Software costs are charged based on external software developers' royalty related to other IBM divisions' products. Product distribution costs are charged based on actual usage of freight carriers. Technology support costs are charged based on direct expenses including occupancy costs, salaries and benefits. These costs have been included as a reduction of Cost of revenue.

*Selling, general and administrative:* These charges to IBM primarily include both pass through costs and services provided to other IBM divisions for marketing and sales programs, administrative support, human resources support and legal support. Marketing and sales programs are charged based on direct expenses including marketing materials and development costs, occupancy costs, salaries and benefits. Administrative and human resources support are charged based on direct expenses including occupancy costs, salaries and benefits. These costs have been included as a reduction of Selling, general and administrative expense.

*Research, development and engineering services:* These charges are primarily for research, development and engineering services activities provided by the Business to other IBM divisions and include direct development expenses, occupancy costs, salaries and benefits.

## **E Sale of Manufacturing Operations**

In January 2002, the Business sold certain of its North American and European desktop personal computer manufacturing operations to Sanmina SCI. Along with the sale, the Business entered into a three year outsourcing agreement with Sanmina SCI to manufacture personal computers for the Business. As a result of this transaction, the company sold fixed assets and inventory valued at approximately \$65 million and a \$91 million gain was recorded in Other (income) and expense in the Combined Statement of Operations. In January of 2003, the Business sold additional fixed assets and inventory valued at approximately \$61 million, as well as certain of its mobile personal computer manufacturing operations processes to Sanmina SCI. The result of this transaction was a \$5 million gain recorded in Other (income) and expense in the Combined Statement of Operations.

## **F Inventories, net**

	AT JUNE 30:		AT DECEMBER 31:	
	2004	2003	2002	2001
(US dollars in millions)				
Finished goods	\$ 172	\$ 152	\$ 141	\$ 194
Work in process and raw materials	107	83	75	128
Total	\$ 279	\$ 235	\$ 216	\$ 322

**G Plant and Other Property, net**

	AT JUNE 30: 2004*		AT DECEMBER 31: 2002		2001		
<b>(US dollars in millions)</b>							
Land and land improvements	\$	38	\$	42	\$	50	
Buildings and building improvements		407		490		513	
Plant, laboratory and office equipment		361		436		586	
		806		968		1,129	
Less: Accumulated depreciation		498		607		728	
Total	\$	308	\$	361	\$	401	
						\$	431

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\* Effective May 1, 2004, the Business no longer manages the Guadalajara, Mexico site. As a result of this change in management, Plant and other property, net was reduced by \$33 million. This is reflected in the Combined Statement of Cash Flows in Transfer of assets at net book value to/(from) IBM.

**H Investments and Sundry Assets**

	AT JUNE 30:		AT DECEMBER 31:	
	2004	2003	2002	2001
(US dollars in millions)				
Deferred taxes	\$ 32	\$ 32	\$ 24	\$ 20
Goodwill	19	18	18	13
Other assets	9	11	16	5
Total	\$ 60	\$ 61	\$ 58	\$ 38

**I Derivatives and Hedging Transactions**

In the normal course of operations, the Business is exposed to foreign currency fluctuations. The Business limits these risks by following established risk management policies and procedures including the use of derivatives. The Business does not use derivatives for trading or speculative purposes. Further, the Business has a policy of only entering into contracts with carefully selected major financial institutions based upon their credit ratings and other factors, and maintains strict dollar and term limits that correspond to the institution's credit rating.

The Business' operations generate non-functional currency, and generate and remit non-functional currency for third party vendor payments and intercompany payments for goods and services with IBM. In anticipation of these foreign currency cash flows and in view of the volatility of the currency markets, the business selectively employs foreign exchange forward and option contracts to manage its currency risk. At December 31, 2003 and June 30, 2004, the maximum remaining maturity of these derivative instruments was approximately 3 months.

At June 30, 2004, the assets recorded in the Combined Statement of Financial Position related to cash flow hedges was \$1.0 million.

At December 31, 2003, the net liabilities recorded in the Combined Statement of Financial Position related to cash flow hedges was \$5.3 million and consisted of \$0.1 million of assets and \$5.4 million of liabilities. At December 31, 2002, the net liabilities recorded in the Combined Statement of Financial Position related to cash flow hedges was \$5.8 million and consisted of \$0.2 million of assets and \$6.0 million of liabilities. At December 31, 2001, the assets recorded in the Combined Statement of Financial Position related to cash flow hedges was \$19.8 million.

The Business has recorded approximately \$6.4 million of net losses in Accumulated other comprehensive income/(loss) as of December 31, 2003, net of tax, the entire balance of which is expected to be reclassified to net income within the next year, providing an offsetting economic impact against the underlying anticipated cash flows hedged. There were no net gains or losses recorded in Accumulated other comprehensive income/(loss) at June 30, 2004.

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The following table summarizes activity in the Accumulated other comprehensive income/(loss) section of the Combined Statement of Invested Equity/(Deficit) related to all derivatives classified as cash flow hedges held by the Business during the periods January 1, 2001 (the date of the Business adoption of SFAS No. 133) through June 30, 2004:

	DEBIT/ (CREDIT)
<b>(US dollars in millions, net of tax)</b>	
Beginning balance as of January 1, 2001	\$
Net gains reclassified into operations from Invested equity/(deficit) during 2001	6
Changes in fair value of derivatives in 2001	(23)
December 31, 2001	(17)
Net losses reclassified into operations from Invested equity/(deficit) during 2002	(20)
Changes in fair value of derivatives in 2002	44
December 31, 2002	7
Net losses reclassified into operations from Invested equity/(deficit) during 2003	(26)
Changes in fair value of derivatives in 2003	25
December 31, 2003	6
Net losses reclassified into operations from Invested equity/(deficit) during 2004	3
Changes in fair value of derivatives in 2004	(9)
June 30, 2004	\$

At June 30, 2004 and December 31, 2003, there were no significant gains or losses on derivative transactions or portions thereof that were either ineffective as hedges, excluded from the assessment of hedge effectiveness, or associated with an underlying exposure that did not occur; nor are there any anticipated in the normal course of business.

Derivative operations are provided through the centralized risk management and treasury functions of IBM. In addition to the specific direct hedge program above, the Business Combined Statement of Operations includes an allocation of gains/losses related to IBM's global hedging programs. See note D, Transactions with IBM, on pages 15 to 18 for further information regarding the allocation of certain IBM costs to the Business.

## J Minority Interests and Other Long-Term Liabilities

The Business has investments in joint ventures whose assets, liabilities and operations are included in the Combined Financial Statements. The Business manages the operations of the joint ventures. The joint ventures have both personal computer (PC) operations and non-personal computer operations. The results of the joint ventures non-personal computer operations have been excluded from the results of the Business. Included in the Combined Statement of Operations are the results of the joint ventures PC operations offset by minority interest expense (net of tax) of \$21 million and \$11 million, for the six month periods ended June 30, 2004 and June 30, 2003, respectively, and \$26 million, \$17 million and \$17 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Additionally, dividend distributions to parties holding a minority interest totaled \$4 million for the six month periods ended June 30, 2004 and 2003, and \$31 million, \$32 million and \$28 million for the years ended December 31, 2003, 2002 and 2001, respectively. Such amounts are included in the Combined Statement of Cash Flows as Investing Activities.

At December 31, 2003, 2002 and 2001, included in the Combined Statement of Financial Position is minority interest in joint ventures of \$56 million, \$48 million and \$48 million, respectively, which reflects the original investment by parties holding a minority interest in such joint ventures, along with their proportional share of the joint venture earnings, losses and distributions. At June 30, 2004, minority interest in joint ventures totaled \$77 million, of which \$16 million represents the amount related to the Business South Korean joint venture.

See note T, Subsequent Events, on page 33 for a description of the 2004 agreement to dissolve the Business joint venture in South Korea.



**K Comprehensive Income/(Loss\*)**

	FOR THE SIX MONTHS ENDED JUNE 30:			FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003	2003	2002	2001	
(US dollars in millions)						
Net loss	\$ (139)	\$ (97)	\$ (258)	\$ (171)	\$ (397)	
Net unrealized gains/ (losses) on cash flow hedge activities	7	7	1	(24)	17	
Foreign currency translation adjustment	(2)	7	7	(13)	5	
Comprehensive income/(loss)	\$ (134)	\$ (83)	\$ (250)	\$ (208)	\$ (375)	

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\*Net of tax.

**L Contingencies and Commitments**

The Business is involved in a variety of claims, suits, investigations and proceedings that arise from time to time in the ordinary course of its business, including actions with respect to contracts, intellectual property (IP), product liability, employment, and environmental matters. The following is a discussion of some of the more significant legal matters involving the Business.

On July 31, 2003, the U.S. District Court for the Southern District of Illinois, in Cooper et al. vs. The IBM Personal Pension Plan and IBM Corporation, held that IBM's pension plan violated the age discrimination provisions of the Employee Retirement Income Security Act of 1974 (ERISA). On September 29, 2004, IBM announced that IBM and plaintiffs agreed in principle to resolve certain claims in the litigation. Under the terms of the agreement, plaintiffs will receive an incremental pension benefit in exchange for the settlement of some claims, and a stipulated remedy on remaining claims if plaintiffs prevail on appeal. Under the terms of the settlement, the judge will issue no further rulings on remedies. This settlement, together with a previous settlement of a claim referred to as the partial plan termination claim resulted in IBM taking a one-time charge of \$320 million in the third quarter of 2004.

This agreement ends the litigation on all but two claims, which are associated with IBM's cash balance formula. IBM will appeal the rulings on these claims. IBM continues to believe that its pension plan formulas are fair and legal. The company has reached this agreement in the interest of the business and IBM shareholders, and to allow for a review of its cash balance formula by the Court of Appeals. IBM continues to believe it is likely to be successful on appeal.

The agreement stipulates that if IBM is not successful on appeal of the two remaining claims, the agreed remedy will be increased by up to \$1.4 billion a \$780 million remedy for the claim that IBM's cash balance formula is age discriminatory, and a \$620 million remedy for the claim that transition arrangements regarding opening account balances during the 1999 conversion were also age discriminatory (referred to as the always cash balance claim). The maximum additional liability the company could face as a result of the claims being appealed in this case is therefore capped at \$1.4 billion.

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In the coming months, class members will receive formal notice of the settlement and the judge will hold a fairness hearing. Once the settlement is approved, IBM will appeal the liability rulings for the cash balance claims. As a result, the entire process could take over 2 years before reaching final conclusion.

On June 2, 2003 IBM announced that it received notice of a formal, nonpublic investigation by the Securities and Exchange Commission (SEC). The SEC is seeking information relating to revenue recognition in 2000 and 2001 primarily concerning certain types of client transactions. IBM believes that the investigation arises from a separate investigation by the SEC of Dollar General Corporation, a client of IBM's Retail Stores Solutions unit, which markets and sells point of sale products.

On January 8, 2004, IBM announced that it received a Wells Notice from the staff of the SEC in connection with the staff's investigation of Dollar General Corporation, which as noted above, is a client of IBM's Retail Stores Solutions unit. It is IBM's understanding that an employee in IBM's Sales & Distribution unit also received a Wells Notice from the SEC in connection with this matter. The Wells Notice notifies IBM that the SEC staff is considering

recommending that the SEC bring a civil action against IBM for possible violations of the U.S. securities laws relating to Dollar General's accounting for a specific transaction, by participating in and aiding and abetting Dollar General's misstatement of its 2000 results. In that transaction, IBM paid Dollar General \$11 million for certain used equipment as part of a sale of IBM replacement equipment in Dollar General's 2000 fourth fiscal quarter. Under the SEC's procedures, IBM responded to the SEC staff regarding whether any action should be brought against IBM by the SEC. The separate SEC investigation noted above, relating to the recognition of revenue by IBM in 2000 and 2001 primarily concerning certain types of client transactions, is not the subject of this Wells Notice.

In January 2004, the Seoul District Prosecutors Office in South Korea announced it had brought criminal bid rigging charges against several companies, including IBM Korea and LG IBM (a joint venture between IBM Korea and LG Electronics) and had also charged employees of some of those entities with, among other things, bribery of certain officials of government-controlled entities in Korea, and bid rigging. IBM Korea and LG IBM cooperated fully with authorities in these matters. A number of individuals, including former IBM Korea and LG IBM employees, were subsequently found guilty and sentenced. IBM Korea and LG IBM were also required to pay fines. Effective October 1, 2004, IBM Korea was debarred from doing business directly with certain government controlled entities in Korea until August 31, 2005. That order does not prohibit IBM Korea from selling products and services to business partners who sell to government controlled entities in Korea. In addition, the U.S. Department of Justice and the SEC have both contacted IBM in connection with this matter.

In accordance with SFAS No. 5, Accounting for Contingencies, the Business records a provision with respect to a claim, suit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can reasonably be estimated. Any provisions are reviewed at least quarterly and are adjusted to reflect the impact and status of settlements, rulings, advice of counsel and other information pertinent to a particular matter. Any recorded liabilities for the above items, including any changes to such liabilities during each of the three years in the period ended December 31, 2003 were not material to the Combined Financial Statements. Based on its experience, the Business believes that the damage amounts claimed in the matters referred to above are not a meaningful indicator of the potential liability.

Litigation is inherently uncertain and it is not possible to predict the ultimate outcome of the matters discussed above. While the Business will continue to defend itself vigorously in all such matters, it is possible that the Business' financial condition, results of operations, or cash flows could be affected in any particular period by the resolution of one or more of these matters. Whether any losses, damages or remedies finally determined in any such claim, suit, investigation or proceeding could reasonably have a material effect on the Business' financial condition, results of operations, or cash flow will depend on a number of variables, including the timing and amount of such losses or damages, the structure and type of any such remedies, the significance of the impact any such losses, damages or remedies may have on the Combined Financial Statements, and the unique facts and circumstances of the particular matter which may give rise to additional factors.

*Commitments*

The Business generally offers three-year warranties for its products. The company estimates the amount and cost of future warranty claims for its current period sales. These estimates are used to record accrued warranty cost for current period shipments. The company uses historical warranty claim information, as well as recent trends that might suggest that past cost information may differ from future claims.

Changes in the Business' warranty liability balance are illustrated in the following table:

	2004	2003	2002	2001
(US dollars in millions)				

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Balance at January 1	\$	428	\$	340	\$	314	\$	275
Current period accruals		218		381		298		295
Accrual adjustments to reflect actual experience		90		107		40		55
Charges incurred		(218)		(400)		(312)		(311)
Balance at June 30, 2004 and December 31, 2003, 2002 and 2001	\$	518	\$	428	\$	340	\$	314

Warranty costs disclosed on page 9 in the Risks and Uncertainties section, includes items that are charged directly to Cost of revenue, External sales in the current year, and are not reflected in the warranty liability balance above.

In the ordinary course of its business, the Business enters into agreements that obligate it to purchase all or a portion of its requirements of a specific product, commodity or service from a supplier or vendor. These agreements are generally entered into in order to secure pricing or other negotiated terms and may or may not specify fixed or minimum quantities to be purchased. The Business has entered into several agreements that include commitments to purchase goods and services of either a fixed or minimum quantity that meet any of the following criteria: (1) non-cancelable, (2) the Business would incur a cancellation penalty, or (3) the Business must make specified minimum payments even if it does not take delivery of the contracted products or services. If the obligation to purchase goods or services is non-cancelable, the entire value of the contract was included in the table below. If the obligation is cancelable, but the Business would incur a penalty if cancelled, the dollar amount of the penalty was included as a purchase obligation. Contracted minimum amounts specified in take-or-pay contracts are also included in the table below as they represent the portion of each contract that is a firm commitment.

	Total									
	Contractual									
	Payment		Payments Due In							
	Stream		2004		2005		2006		2007	
<b>(US dollars in millions)</b>										
Purchase obligations as of June 30, 2004	\$	1,465	\$	102	\$	437	\$	451	\$	475

The Business has a purchase commitment with Hitachi, Ltd. (Hitachi) for the purchase of hard drives for its notebook and desktop computer products. The purchase commitment specifies a minimum purchase requirement of \$32 million in 2004 of its hard drives. For 2005 through 2007, the purchase commitment requires the Business to source 70 percent and 50 percent of its 2.5 and 3.5 hard drives, respectively. The Business has estimated this purchase commitment to be \$426 million, \$449 million, and \$475 million for 2005, 2006, and 2007, respectively, based on its forecasted sales, volume growth, and anticipated average purchase price for each year.

## M Taxes

	FOR THE SIX MONTHS ENDED JUNE 30:			FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003		2003	2002	2001
<b>(US dollars in millions)</b>						
Income before income taxes:						
U.S. operations	\$ (307)	\$ (230)	\$	(448)	\$ (302)	\$ (382)
Non-U.S. operations	263	195		331	234	89
Total income before income taxes	\$ (44)	\$ (35)	\$	(117)	\$ (68)	\$ (293)

The provision for income taxes by geographic operations is as follows:

	FOR THE SIX MONTHS ENDED JUNE 30:			FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003		2003	2002	2001
<b>(US dollars in millions)</b>						
U.S. operations	\$ 25	\$ 17	\$	41	\$ 31	\$ 29
Non-U.S. operations	49	34		74	55	48
Total provision for income taxes	\$ 74	\$ 51	\$	115	\$ 86	\$ 77



The components of the provision for income taxes by taxing jurisdiction are as follows:

	FOR THE SIX MONTHS ENDED JUNE 30:		FOR THE YEAR ENDED DECEMBER 31:		
	2004	2003	2003	2002	2001
(US dollars in millions)					
U.S.:					
Current	\$	\$	\$		