

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORKINTERNATIONAL BUSINESS MACHINES
CORPORATION,

Plaintiff,

vs.

MARK D. PAPERMASTER,

Defendant.

08 Civ. 9078 (KMK)

**DECLARATION OF
BLAIR G. CONNELLY**

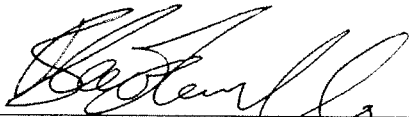
I, Blair G. Connelly, hereby certifies and declares:

1. I am a member in good standing of the United States District Court for the Southern District of New York and a member of the law firm of Latham & Watkins LLP. I represent the Defendant, Mark D. Papermaster, in the above-captioned matter.
2. I respectfully submit this Affidavit in support of the Defendant's Memorandum in Opposition to Plaintiff's Motion for Preliminary Injunction (the "Opposition Memorandum.").
3. Attached hereto as Exhibit A are true and complete copies of the relevant portions of Apple Inc.'s Form 10K Annual Report, filed on November 15, 2007 and referenced in Defendant's Opposition Memorandum.
4. Attached hereto as Exhibit B are true and complete copies of the relevant portions of IBM's Form 10K Annual Report, filed on February 28, 2008 and referenced in Defendant's Opposition Memorandum.
5. Attached hereto as Exhibit C is a true and complete copy of the article, Robert Faletta and Robert DeMarzo, *Interview With IBM Chairman and CEO, Sam Palmisano, Part Two*, ChannelWeb, Feb. 27, 2004, <http://www.crn.com/it-channel/18831503> (last visited Oct. 31,

2008), which is referenced in our Opposition Memorandum.

I declare under penalty of perjury that the foregoing is true and correct.

Executed: October 31, 2008
New York, New York



Blair G. Connelly

EXHIBIT A

The Business section and other parts of this Annual Report on Form 10-K ("Form 10-K") contain forward-looking statements that involve risks and uncertainties. Many of the forward-looking statements are located in "Management's Discussion and Analysis of Financial Condition and Results of Operations." Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Forward-looking statements can also be identified by words such as "anticipates," "believes," "estimates," "expects," "intends," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled "Risk Factors" under Part I, Item 1A of this Form 10-K. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.

PART I

Item 1. Business

Company Background

Apple Inc. and its wholly-owned subsidiaries (collectively "Apple" or the "Company") design, manufacture, and market personal computers, portable digital music players, and mobile communication devices and sells a variety of related software, services, peripherals, and networking solutions. The Company sells its products worldwide through its online stores, its retail stores, its direct sales force, and third-party wholesalers, resellers, and value-added resellers. In addition, the Company sells a variety of third-party Macintosh ("Mac"), iPod and iPhone compatible products, including application software, printers, storage devices, speakers, headphones, and various other accessories and peripherals through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers. The Company's fiscal year is the 52 or 53-week period that ends on the last Saturday of September. Unless otherwise stated, all information presented in this Form 10-K is based on the Company's fiscal calendar.

Business Strategy

The Company is committed to bringing the best personal computing, portable digital music and mobile communication experience to students, educators, creative professionals, businesses, government agencies, and consumers through its innovative hardware, software, peripherals, services, and Internet offerings. The Company's business strategy leverages its unique ability to design and develop its own operating system, hardware, application software, and services to provide its customers new products and solutions with superior ease-of-use, seamless integration, and innovative industrial design. The Company believes continual investment in research and development is critical to the development and enhancement of innovative products and technologies. In addition to evolving its personal computers and related solutions, the Company continues to capitalize on the convergence of the personal computer, digital consumer electronics and mobile communications by creating and refining innovations, such as the iPod, iPhone, iTunes Store, and Apple TV. The Company's strategy also includes expanding its distribution network to effectively reach more of its targeted customers and provide them with a high-quality sales and post-sales support experience.

Digital Lifestyle

The Company believes that for both professionals and consumers the personal computer has become the center of an evolving digital lifestyle by integrating with and enhancing the utility of advanced digital devices such as the Company's iPods, iPhones, digital video and still cameras, televisions, personal digital assistants, and other digital devices. The attributes of the personal computer that enable this functionality include a high-quality user interface, easy access to relatively inexpensive data storage, the ability to run complex applications, and the ability to connect easily to a wide variety of other digital devices and to the Internet. The Company is the only participant in the personal computer industry that controls the design

and development of the entire personal computer—from the hardware and operating system to sophisticated software applications. This, along with its products' creative industrial designs, intuitive ease-of-use, and built-in graphics, multimedia and networking capabilities, positions the Company to offer innovative integrated digital lifestyle solutions.

Expanded Distribution

The Company believes a high-quality buying experience with knowledgeable salespersons who can convey the value of the Company's products and services greatly enhances its ability to attract and retain customers. The Company sells many of its products and resells certain third-party products in most of its major markets directly to consumers, education customers, and businesses through its retail and online stores. The Company has also invested in programs to enhance reseller sales, including the Apple Sales Consultant Program, which places Apple employees and contractors at selected third-party reseller locations. The Company believes providing direct contact with its targeted customers is an efficient way to demonstrate the advantages of its Mac computers and other products over those of its competitors.

At the end of fiscal 2007, the Company had opened a total of 197 of its own retail stores, including 174 stores in the U.S. and a total of 23 stores in Canada, Japan, U.K. and Italy. The Company has typically located its stores at high-traffic locations in quality shopping malls and urban shopping districts.

One of the goals of the retail initiative is to expand the Company's installed base through sales to customers who currently do not already own the Company's products. By operating its own stores and locating them in desirable high-traffic locations, the Company is better positioned to control the customer buying experience and attract new customers. The stores are designed to simplify and enhance the presentation and marketing of the Company's products and related solutions. To that end, retail store configurations have evolved into various sizes in order to accommodate market-specific demands. The stores employ experienced and knowledgeable personnel who provide product advice and certain support services. The stores offer a wide selection of third-party hardware, software, and various other accessory products and peripherals selected to complement the Company's own products.

Education

Throughout its history, the Company has focused on the use of technology in education and has been committed to delivering tools to help educators teach and students learn. The Company believes effective integration of technology into classroom instruction can result in higher levels of student achievement, especially when used to support collaboration, information access, and the expression and representation of student thoughts and ideas. The Company has designed a range of products and services to address the needs of education customers. These products and services include the Company's Mac computers, iPods, iTunes, and Apple TV, in addition to various solutions for video creation and editing, wireless networking, professional development, and one-to-one (1:1) learning. A 1:1 learning solution typically consists of a portable computer for every student and teacher along with the installation of a wireless network.

Creative Professionals

Creative professionals constitute one of the Company's most important markets for both hardware and software products. This market is also important to many third-party developers who provide Mac-compatible hardware and software solutions. Creative customers utilize the Company's products for a variety of activities including digital video and film production and editing; digital video and film special effects, compositing and titling; digital still photography and workflow management; graphic design, publishing, and print production; music creation and production; audio production and sound design; and web design, development, and administration.

The Company designs its high-end hardware solutions, including servers, desktops, and portable Mac systems, to incorporate the power, expandability, and features desired by creative professionals. The Company's operating system, Mac OS X, incorporates powerful graphics and audio technologies and

features developer tools to optimize system and application performance when running creative solutions provided by the Company or third-party developers.

Other

In addition to consumer, education and creative professional markets, the Company provides hardware and software products and solutions for customers in the information technology, science, business, and government markets.

Business Organization

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments consist of the Americas, Europe, Japan, and Retail. The Americas, Europe, and Japan reportable segments do not include activities related to the Retail segment. The Americas segment includes both North and South America. The Europe segment includes European countries as well as the Middle East and Africa. The Retail segment operates Apple-owned retail stores in the U.S., Canada, Japan, the U.K. and Italy. Each reportable geographic operating segment and the Retail operating segment provide similar hardware and software products and similar services. Further information regarding the Company's operating segments may be found in Part II, Item 7 of this Form 10-K under the heading "Segment Operating Performance," and in Part II, Item 8 of this Form 10-K in Notes to Consolidated Financial Statements at Note 9, "Segment Information and Geographic Data."

Products

The Company offers a range of personal computing products including desktop and portable personal computers, related devices and peripherals, and various third-party hardware and software products. In addition, the Company offers software products including Mac OS® X, the Company's proprietary operating system software for the Mac®; server software and related solutions; professional application software; and consumer, education and business oriented application software. The Company also designs, develops and markets to Mac and Windows users its family of iPod® digital music players and its iPhone™ mobile communication device, along with related accessories and services including the online distribution of third-party content through the Company's iTunes Store™. The Company's primary products are discussed below.

Hardware Products

The Company offers a range of personal computing products including desktop and notebook computers, server and storage products, related devices and peripherals, and various third-party hardware products. The Company's Mac desktop and portable systems feature Intel microprocessors, the Company's Mac OS X Version 10.5 Leopard™ ("Mac OS X Leopard") operating system that became available in October 2007 and iLife® suite of software for creation and management of digital photography, music, movies, DVDs, and website. The Company's transition from PowerPC to Intel microprocessors for Mac systems was completed in August 2006, and its transition for Xserve® was completed in November 2006. There are potential risks and uncertainties associated with the transition to Intel microprocessors, which are further discussed in Item 1A of this Form 10-K under the heading "Risk Factors."

MacBook® Pro

The MacBook Pro family of notebook computers is designed for professionals and advanced consumer users. First introduced in January 2006, the MacBook Pro includes a 15-inch or 17-inch widescreen display, a built-in iSight® video camera, Front Row™ with the Apple Remote, and the MagSafe® magnetic power adapter. In June 2007, the Company updated its MacBook Pro models to include the latest Intel Core 2 Duo processors and the Nvidia GeForce 8600M GT graphics controller. MacBook Pro includes up to 4GB of 667MHz DDR2 main memory with an 800 MHz frontside bus, a Serial ATA hard drive, and a slot-loading double-layer SuperDrive®. In addition, every MacBook Pro features a 1-inch thin aluminum enclosure and includes AirPort Extreme® 802.11n wireless networking, Bluetooth 2.0+EDR, Gigabit

Ethernet, USB 2.0 and FireWire® ports, audio input and output ports, a DVI video-out port, an ExpressCard/34 slot, scrolling trackpad, and backlit keyboard.

MacBook®

The MacBook is designed for consumer and education users. First introduced in May 2006, the MacBook includes a 13-inch widescreen display, a built-in iSight video camera and the MagSafe magnetic power adapter. In May 2007, the Company updated its MacBook models with faster Intel Core 2 Duo processors running at up to 2.16GHz, Intel integrated graphics, support for up to 4GB of 667MHz DDR2 main memory, a Serial ATA hard drive, and a slot-loading Combo optical drive or double-layer SuperDrive. In addition, MacBook models include AirPort Extreme 802.11n wireless networking, Bluetooth 2.0+EDR, Gigabit Ethernet, USB 2.0 and FireWire ports, audio input and output ports, a mini-DVI video output port, and scrolling trackpad.

Mac® Pro

The Mac Pro desktop computer is targeted at business and professional users and is designed to meet the performance, expansion, and networking needs of the most demanding Mac user. The Mac Pro features two Intel Xeon dual-core or quad-core processors running at up to 3.0GHz, with 4MB and 8MB of shared Level 2 cache and independent 1.33GHz front-side buses, 667MHz fully buffered memory, and a 256-bit wide memory architecture. The Mac Pro also features a direct attach storage solution for snap-in installation of up to four 750GB Serial ATA hard drives for a total of 3TB of internal storage. Every Mac Pro includes three full-length PCI Express expansion slots and one double-wide PCI Express graphics slot to support double-wide graphics cards. The Mac Pro also includes dual Ethernet ports, optical digital input and output ports, analog audio input and output ports, and multiple FireWire 400, FireWire 800 and USB 2.0 ports.

iMac®

The iMac desktop computer is targeted at consumer, education and business customers. In August 2007, the Company updated the iMac to include 2.0GHz, 2.4GHz or 2.8GHz Intel Core 2 Duo processors, up to 4 GB of 667 MHz DDR2 SDRAM, a faster graphics card using ATI Radeon HD 2400 XT or ATI Radeon HD 2600 PRO graphics, and slot-loading double-layer SuperDrive. All iMac models include a built-in iSight video camera, AirPort Extreme 802.11n wireless networking, Bluetooth 2.0+EDR, built-in Gigabit Ethernet, USB 2.0 and Fire Wire ports, and mini-DVI video out.

Mac® mini

In February 2006, the Company introduced the Intel-based Mac mini that includes Front Row with the Apple Remote. The Mac mini offers 1GB of 667MHz memory expandable to 2GB and either a 1.83GHz or 2.0GHz Intel processor. Every Mac mini includes built-in Gigabit Ethernet, AirPort Extreme 802.11g wireless networking, Bluetooth 2.0+EDR, a total of four USB 2.0 ports, and one FireWire 400 port. Mac mini includes a full-size DVI interface and a VGA-out adapter to connect to a variety of displays, including televisions, and features both analog and digital audio outputs.

Xserve® and Xserve RAID Storage System

Xserve is a 1U rack-mount server powered by two dual-core 64-bit Intel Xeon processors running at up to 3.0GHz and features Mac OS® X Server 10.5, which became available in October 2007. Xserve supports up to 32GB of RAM, remote management and internal serial attached SCSI ("SAS") or serial ATA ("SATA") storage drives of up to 2.25TB, with optional internal hardware RAID. The Company's Xserve RAID storage system delivers up to 10.5TB of Fiber Channel attached hardware RAID storage capacity and also expanded support for Mac OS X and heterogeneous environments.

25,000 photos, or a combination of each and is capable of displaying content in high definition resolution up to 720p. Apple TV connects to a broad range of widescreen televisions and home theater systems and comes standard with high-definition multimedia interface, component video, and both analog and digital optical audio ports. Using high-speed AirPort® 802.11n wireless networking, Apple TV can auto-sync content from one computer or stream content from up to five additional computers directly to a television. The Company began shipping Apple TV in March 2007.

Software Products and Computer Technologies

The Company offers a range of software products for education, creative professional, consumer, business and government customers, including Mac OS X, the Company's proprietary operating system software for the Mac; server software and related solutions; professional application software; and consumer, education, and business oriented application software.

Operating System Software

Mac OS® X is built on an open-source UNIX-based foundation. Mac OS X Leopard is the sixth major release of Mac OS X and became available in October 2007. Leopard includes 300 new features and introduces a new desktop with Stacks, a new way to easily access files from the Dock; a redesigned Finder™ that lets users quickly browse and share files between multiple Macs; Quick Look, a new way to instantly see files without opening an application; Spaces™, an intuitive new feature used to create groups of applications and instantly switch between them; and Time Machine™, an effortless way to automatically back up everything on a Mac.

Application Software

iLife® '08

In August 2007, the Company introduced iLife '08, the latest release of its consumer-oriented digital lifestyle application suite, which features iPhoto®, iDVD®, GarageBand®, iWeb™, iTunes® and iMovie® '08. All of these applications are Universal, meaning that they run natively on both Intel and PowerPC-based Mac computers ("Universal").

iPhoto® is the Company's consumer-oriented digital photo software application. iPhoto '08 adds new features for organizing and browsing photos, including event-based grouping, new professional quality image editing tools, and enables publishing to .Mac Web Gallery. .Mac Web Gallery, is fully integrated with iPhoto '08 and iMovie '08, allowing .Mac users to share photos and movies over the web. iPhoto '08 features print, photo book, greeting card, and calendar layout tools and integrated online ordering services.

iMovie® '08 is a new version of the Company's consumer-oriented digital video editing software application. iMovie® '08 provides new tools for quick movie creation and video enhancements, including transitions, titles, music and sound effects. Projects in iMovie® '08 can also be published to .Mac Web Gallery.

iDVD® is the Company's consumer-oriented software application that enables users to turn iMovie files, QuickTime® files, and digital pictures into interactive DVDs that can be played on most consumer DVD players. iDVD '08 features 10 new Apple-designed menu themes in both widescreen (16:9) and standard (4:3) formats.

GarageBand® is the Company's consumer-oriented music creation software application that allows users to play, record and create music using a simple interface. With GarageBand, software instruments, digital audio recordings and looping tracks can be arranged and edited to create songs. GarageBand '08 allows users to export finished songs to their iTunes library, or publish a podcast through iWeb and .Mac that includes artwork, sound effects, and music jingles.

Protection Plan. The AppleCare Protection Plan is a fee-based service that typically includes three years of phone support and hardware repairs, dedicated web-based support resources, and user diagnostic tools.

Markets and Distribution

The Company's customers are primarily in the education, creative professional, consumer, and business markets. The Company distributes its products through wholesalers, resellers, national and regional retailers and cataloguers. No individual customer accounted for more than 10% of net sales in 2007, 2006, or 2005. The Company also sells many of its products and resells certain third-party products in most of its major markets directly to consumers, education customers, and businesses through its own sales force and retail and online stores.

Competition

The Company is confronted by aggressive competition in all areas of its business. The markets for consumer electronics, personal computers, related software and peripheral products, digital music devices and related services, and mobile communication devices are highly competitive. These markets are characterized by rapid technological advances in both hardware and software that have substantially increased the capabilities and use of personal computers, other digital electronic devices, and mobile communication devices that have resulted in the frequent introduction of new products with competitive price, feature, and performance characteristics. Over the past several years, price competition in these markets has been particularly intense. The Company's competitors who sell personal computers based on other operating systems have aggressively cut prices and lowered their product margins to gain or maintain market share. The Company's financial condition and operating results can be adversely affected by these and other industry-wide downward pressures on gross margins. The principal competitive factors include price, product features, relative price/performance, product quality and reliability, design innovation, availability of software and peripherals, marketing and distribution capability, service and support, and corporate reputation. Further, as the personal computer industry and its customers place more reliance on the Internet, an increasing number of Internet devices that are smaller, simpler, and less expensive than traditional personal computers may compete for market share with the Company's products.

The Company's music products and services have faced significant competition from other companies promoting their own digital music and content products and services, including those offering free peer-to-peer music and video services. The Company believes it currently retains a competitive advantage by offering superior innovation and integration of the entire solution including the hardware (personal computer and iPod), software (iTunes), and distribution of content (iTunes Store and iTunes Wi-Fi Music Store). However, the Company expects competition in this space to intensify as competitors attempt to imitate the Company's approach to tightly integrating these elements within their own offerings or, alternatively, collaborate with each other to offer solutions that are more integrated than those they currently offer. Some of these current and potential competitors have substantial resources and may be able to provide such products and services at little or no profit or even at a loss to compete with the Company's offerings.

The Company is currently focused on market opportunities related to mobile communication devices including the iPhone. The mobile communications industry is highly competitive with several large, well-funded, and experienced competitors. The Company faces competition from mobile communication device companies that may attempt to imitate some of the iPhone's functions and applications within their own smart phones. This industry is characterized by aggressive pricing practices, frequent product introductions, evolving design approaches and technologies, rapid adoption of technological and product advancements by competitors, and price sensitivity on the part of consumers.

The Company's future financial condition and operating results are substantially dependent on the Company's ability to continue to develop improvements to the Mac platform and to the Company's

hardware, software and services related to consumer electronic devices, including iPods, and mobile communication devices, including iPhone.

Raw Materials

Although most components essential to the Company's business are generally available from multiple sources, certain key components including, but not limited to, microprocessors, enclosures, certain LCDs, certain optical drives, and application-specific integrated circuits ("ASICs") are currently obtained by the Company from single or limited sources. Some key components, while currently available to the Company from multiple sources, are at times subject to industry-wide availability constraints and pricing pressures. In addition, the Company uses some components uncommon to the rest of the personal computer, consumer electronics and mobile communication industries, and new products introduced by the Company often initially utilize custom components obtained from only one source until the Company has evaluated whether there is a need for, and subsequently qualifies, additional suppliers. If the supply of a key or single-sourced component to the Company were to be delayed or curtailed or in the event a key manufacturing vendor delayed shipment of completed products to the Company, the Company's ability to ship related products in desired quantities and in a timely manner could be adversely affected. The Company's business and financial performance could also be adversely affected depending on the time required to obtain sufficient quantities from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components may be affected if suppliers were to decide to concentrate on the production of common components instead of components customized to meet the Company's requirements. The Company attempts to mitigate these potential risks by working closely with these and other key suppliers on product introduction plans, strategic inventories, coordinated product introductions, and internal and external manufacturing schedules and levels. Consistent with industry practice, the Company acquires components through a combination of formal purchase orders, supplier contracts, and open orders based on projected demand information. The Company's purchase commitments typically cover its requirements for periods ranging from 30 to 150 days.

The Company believes there are several component suppliers and manufacturing vendors whose loss to the Company could have a material adverse effect upon the Company's business and financial condition. At this time, such vendors include Agere Systems, Inc., Ambit Microsystems Corporation, Ampere Technology Limited, ASUSTeK Corporation, ATI Technologies, Inc., Atheros Communications Inc., AU Optronics Corporation, Broadcom Corporation, Chi Mei Optoelectronics Corporation, Cypress Semiconductor Corporation, Hitachi Global Storage Technologies, Hon Hai Precision Industry Co., Ltd., Infineon Technologies AG, Intel Corporation, Inventec Appliances Corporation, LG. Phillips Co., Ltd., Matsushita, Murata Manufacturing Co., Ltd., National Semiconductor Corporation, NVIDIA Corp., Inc., Quanta Computer, Inc., Renesas Semiconductor Co. Ltd., Samsung Electronics, Sony Corporation, Synaptics, Inc., Texas Instruments, and Toshiba Corporation. Certain of these vendors are the sole-sourced supplier of components and manufacturing outsourcing for many of the Company's key products, including but not limited to, assembly of most of the Company's portable Mac computers, iPods, and iPhones.

Research and Development

Because the personal computer, consumer electronics, and mobile communication industries are characterized by rapid technological advances, the Company's ability to compete successfully is heavily dependent upon its ability to ensure a continual and timely flow of competitive products, services, and technologies to the marketplace. The Company continues to develop new products and technologies and to enhance existing products in the areas of computer hardware and peripherals, consumer electronics products, mobile communication devices, system software, applications software, networking and communications software and solutions, and Internet services and solutions. The Company may expand the range of its product offerings and intellectual property through licensing and/or acquisition of third-party business and technology. The Company's research and development expenditures totaled \$782 million, \$712 million, and \$535 million in 2007, 2006, and 2005, respectively.

described in Part I, Item 3, "Legal Proceedings," several derivative complaints and a class action complaint have been filed in state and federal courts against the Company and certain current and former directors and executive officers pertaining to allegations relating to past stock option grants. The Company has provided the results of its investigation to the SEC and the United States Attorney's Office for the Northern District of California, and the Company has responded to their requests for documents and additional information. The Company intends to continue to provide its full cooperation.

On April 24, 2007, the SEC filed an enforcement action against two former officers of the Company. In announcing the lawsuit, the SEC stated that it would not bring an enforcement action against the Company based in part on the Company's "swift, extensive, and extraordinary cooperation in the Commission's investigation." According to the SEC's statement, the Company's "cooperation consisted of, among other things, prompt self-reporting, an independent internal investigation, the sharing of the results of that investigation with the government, and the implementation of new controls designed to prevent the recurrence of fraudulent conduct."

No assurance can be given regarding the outcomes from litigation, regulatory proceedings, or government enforcement actions relating to the Company's past stock option practices. These and related matters have required, and will continue to require, the Company to incur substantial expenses for legal, accounting, tax, and other professional services, and may divert management's attention from the Company's business. If the Company is subject to adverse findings, it could be required to pay damages and penalties and might face additional remedies that could harm its financial condition and operating results.

Global markets for personal computers, digital music devices, mobile communication devices, and related peripherals and services are highly competitive and subject to rapid technological change. If the Company is unable to compete effectively in these markets, its financial condition and operating results could be materially adversely affected.

The Company competes in global markets that are highly competitive and characterized by aggressive price cutting, with its resulting downward pressure on gross margins, frequent introduction of new products and products, short product life cycles, evolving industry standards, continual improvement in product price/performance characteristics, rapid adoption of technological and product advancements by competitors, and price sensitivity on the part of consumers.

The Company's ability to compete successfully depends heavily on its ability to ensure a continuing and timely introduction of new innovative products and technologies to the marketplace. The Company believes it is unique in that it designs and develops virtually the entire solution for its personal computers, consumer electronics, and mobile communication devices, including the hardware, operating system, several software applications, and related services. As a result, the Company must make significant investments in research and development. By contrast, many of the Company's competitors seek to compete aggressively on price and maintain very low cost structures. If the Company is unable to continue to develop and sell innovative new products with attractive margins, its financial condition and operating results may be materially adversely affected.

In the market for personal computers and peripherals, the Company faces a significant number of competitors, many of which have broader product lines and larger installed customer bases. There has also been a trend toward consolidation that has resulted in larger and potentially stronger competitors. Price competition has been particularly intense as competitors selling Windows-based personal computers have aggressively cut prices and lowered product margins. The Company also faces increased competition in certain of its key market segments, including consumer, education, professional and consumer digital video editing, and design and publishing. An increasing number of Internet devices that include software applications and are smaller and simpler than traditional personal computers compete for market share with the Company's existing products.

The Company is currently the only maker of hardware using the Mac OS. The Mac OS has a minority market share in the personal computer market, which is dominated by makers of computers using competing operating systems, most notably Windows. The Company's financial condition and operating results substantially depend on its ability to continually develop improvements to the Mac platform to maintain perceived design and functional advantages. Use of unauthorized copies of the Mac OS on other companies' hardware products may result in decreased demand for the Company's hardware products, and materially adversely affect its financial condition and operating results.

The Company is currently focused on opportunities related to digital content distribution, consumer electronic devices, including iPod and Apple TV, and mobile communication devices, including iPhone. The Company faces substantial competition from companies that have significant technical, marketing, distribution, and other resources, as well as established hardware, software, and digital content supplier relationships, and also competes with illegitimate ways to obtain digital content. The Company expects competition to intensify as competitors attempt to imitate the Company's approach to providing these components seamlessly within their individual offerings or work collaboratively to offer integrated solutions. Some current and potential competitors have substantial resources and experience, and they may be able to provide such products and services at little or no profit or even at a loss. There can be no assurance the Company will be able to continue to provide products and services that effectively compete.

To remain competitive and stimulate customer demand, the Company must successfully manage frequent product introductions and transitions.

Due to the highly volatile and competitive nature of the personal computer, consumer electronics and mobile communication industries, the Company must continually introduce new products and technologies, enhance existing products, and effectively stimulate customer demand for new and upgraded products. The success of new product introductions depends on a number of factors, including timely and successful completion of development efforts, market acceptance, the Company's ability to manage the risks associated with new products and production ramp issues, the availability of application software for new products, the effective management of purchase commitments and inventory levels in line with anticipated product demand, the availability of products in appropriate quantities and costs to meet anticipated demand, and the risk that new products may have quality or other defects in the early stages of introduction. Accordingly, the Company cannot determine in advance the ultimate effect new product introductions and transitions will have on financial condition and operating results.

The Company faces substantial inventory and other asset risk.

The Company records a write-down for product and component inventories that have become obsolete or are in excess of anticipated demand or net realizable value and accrues necessary reserves for cancellation fees for orders of products and components that have been cancelled. The Company also reviews its long-lived assets for impairment whenever events or changed circumstances indicate the carrying amount of an asset may not be recoverable. If the Company determines that impairment exists, it records a write-down equal to the amount by which the carrying value of the assets exceeds its fair market value. Although the Company believes its inventory, asset, and related provisions are currently adequate, given the rapid and unpredictable pace of product obsolescence in the global personal computer, consumer electronics, and mobile communication industries, no assurance can be given that the Company will not incur additional inventory or asset related charges. Such charges have had, and may have, a material adverse effect on the Company's financial condition and operating results.

The Company must order components for its products and build inventory in advance of product announcements and shipments. Because the Company's markets are volatile, competitive and subject to rapid technology and price changes, there is a risk the Company will forecast incorrectly and order or produce excess or insufficient inventories of components or products. Consistent with industry practice, components are normally acquired through a combination of purchase orders, supplier contracts, and open orders based on projected demand. Such purchase commitments typically cover forecasted component and

manufacturing requirements for 30 to 150 days. The Company's financial condition and operating results have been in the past and may in the future be materially adversely affected by the Company's ability to manage its inventory levels and respond to short-term shifts in customer demand patterns.

Future operating results depend upon the Company's ability to obtain key components, including microprocessors and NAND flash memory, at favorable prices and in sufficient quantities.

Because the Company currently obtains certain key components, including microprocessors, enclosures, certain LCDs, certain optical drives, and application-specific integrated circuits ("ASICs"), from single or limited sources, the Company is subject to significant supply and pricing risks. Many of these and other key components that are available from multiple sources, including NAND flash memory, DRAM memory, and certain LCDs, are subject at times to industry-wide shortages and significant commodity pricing fluctuations. The Company has entered into certain agreements for the supply of critical components at favorable pricing, but there is no guarantee that the Company will be able to extend or renew these agreements on favorable terms upon expiration or otherwise obtain favorable pricing in the future. Therefore, the Company remains subject to significant risks of supply shortages and/or price increases that can have a material adverse effect on its financial condition and operating results. The Company expects to experience decreases in its gross margin percentage in fiscal year 2008, as compared to levels achieved during fiscal year 2007, due in part to current and expected future price increases for certain components. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Gross Margin."

The Company's new products often use custom components from only one source until the Company has evaluated whether there is a need for, and subsequently qualifies, additional suppliers. Where a component or product uses new technologies, initial capacity constraints may exist until the suppliers' yields have matured. The Company and other producers in the personal computer, consumer electronics and mobile communication industries also compete for various components with other industries that have experienced increased demand for their products. The Company uses some custom components that are not common to the rest of the personal computer, consumer electronics or mobile communication industries. Continued availability of these components at acceptable prices may be affected if producers decide to concentrate on the production of components other than those customized to meet the Company's requirements. If the supply of a key component for a new or existing product were delayed or constrained, or if such components were available only at significantly higher prices, the Company's financial condition and operating results could be materially adversely affected.

The Company depends on component and product manufacturing and logistics services provided by third parties, many of whom are located outside of the U.S.

Most of the Company's components and products are manufactured in whole or in part by third-party manufacturers, most of which are located outside of the U.S. A significant concentration of this outsourced manufacturing is currently performed by only a few third-party manufacturers, often in single locations. The Company has also outsourced much of its transportation and logistics management. While these arrangements may lower operating costs, they also reduce the Company's direct control over production and distribution. It is uncertain what effect such diminished control will have on the quality or quantity of products or services, or the Company's flexibility to respond to changing conditions. In addition, the Company relies on third-party manufacturers to adhere to the Company's supplier code of conduct. Although arrangements with such manufacturers may contain provisions for warranty expense reimbursement, the Company may remain responsible to the consumer for warranty service in the event of product defects. Any unanticipated product defect or warranty liability, whether pursuant to arrangements with contract manufacturers or otherwise, could have a material adverse effect on the Company's reputation, financial condition and operating results.

Final assembly of the Company's products is currently performed in the Company's manufacturing facility in Cork, Ireland, and by external vendors in California, Korea, China and the Czech Republic. Currently,

Net Sales

Fiscal years 2007 and 2005 spanned 52 weeks while fiscal year 2006 spanned 53 weeks. This additional week is added to the first fiscal quarter approximately every six years to realign fiscal quarters with calendar quarters.

Net sales and Mac unit sales by operating segment and net sales and unit sales by product follow (net sales in millions and unit sales in thousands):

	September 29, 2007	Change	September 30, 2006	Change	September 24, 2005
Net Sales by Operating Segment (a):					
Americas net sales	\$ 11,596	23%	\$ 9,415	41%	\$ 6,658
Europe net sales	5,460	33%	4,096	33%	3,073
Japan net sales	1,082	(11)%	1,211	31%	924
Retail net sales	4,115	27%	3,246	42%	2,278
Other Segments net sales (b)	1,753	30%	1,347	35%	998
Total net sales	\$ 24,006	24%	\$ 19,315	39%	\$ 13,931
Unit Sales by Operating Segment:					
Americas Mac unit sales	3,019	24%	2,432	11%	2,184
Europe Mac unit sales	1,816	35%	1,346	18%	1,138
Japan Mac unit sales	302	(1)%	304	(3)%	313
Retail Mac unit sales	1,386	56%	886	45%	609
Other Segments Mac unit sales (b)	528	58%	335	16%	290
Total Mac unit sales	7,051	33%	5,303	17%	4,534
Net Sales by Product:					
Desktops (c)	\$ 4,020	21%	\$ 3,319	(3)%	\$ 3,436
Portables (d)	6,294	55%	4,056	43%	2,839
Total Mac net sales	10,314	40%	7,375	18%	6,275
iPod	8,305	8%	7,676	69%	4,540
Other music related products and services (e)	2,496	32%	1,885	110%	899
iPhone and related products and services (f)	123	NM	—	NM	—
Peripherals and other hardware (g)	1,260	15%	1,100	(2)%	1,126
Software, service, and other sales (h)	1,508	18%	1,279	17%	1,091
Total net sales	\$ 24,006	24%	\$ 19,315	39%	\$ 13,931
Unit Sales by Product:					
Desktops (c)	2,714	12%	2,434	(3)%	2,520
Portables (d)	4,337	51%	2,869	42%	2,014
Total Mac unit sales	7,051	33%	5,303	17%	4,534
Net sales per Mac unit sold (i)	\$ 1,463	5%	\$ 1,391	1%	\$ 1,384
iPod unit sales	51,630	31%	39,409	75%	22,497
Net sales per iPod unit sold (j)	\$ 161	(17)%	\$ 195	(3)%	\$ 202
iPhone unit sales	1,389	NM	—	NM	—

Notes:

- (a) During 2007, the Company revised the way it measures the Retail Segment's operating results to a manner that is generally consistent with the Company's other operating segments. Prior period results have been reclassified to reflect this change to the Retail Segment's operating results along with the corresponding offsets to the other operating segments. Further information regarding the Company's operating segments may be found in Notes to Consolidated Financial Statements at Note 9, "Segment Information and Geographic Data."
- (b) Other Segments include Asia Pacific and FileMaker.
- (c) Includes iMac, eMac, Mac mini, Mac Pro, Power Mac, and Xserve product lines.
- (d) Includes MacBook, iBook, MacBook Pro, and PowerBook product lines.
- (e) Consists of iTunes Store sales, iPod services, and Apple-branded and third-party iPod accessories.

- (f) Derived from handset sales, carrier agreements, and Apple-branded and third-party iPhone accessories.
- (g) Includes sales of Apple-branded and third-party displays, wireless connectivity and networking solutions, and other hardware accessories.
- (h) Includes sales of Apple-branded operating system, application software, third-party software, AppleCare, and Internet services.
- (i) Derived by dividing total Mac net sales by total Mac unit sales.
- (j) Derived by dividing total iPod net sales by total iPod unit sales.

NM = Not Meaningful

The following table reconciles changes in the Company's accrued warranties and related costs (in millions):

	2007	2006	2005
Beginning accrued warranty and related costs	\$ 284	\$ 188	\$ 105
Cost of warranty claims	(281)	(267)	(188)
Accruals for product warranties	227	363	271
Ending accrued warranty and related costs	<u>\$ 230</u>	<u>\$ 284</u>	<u>\$ 188</u>

The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third-party. However, the Company has not been required to make any significant payments resulting from such an infringement claim asserted against itself or an indemnified third-party and, in the opinion of management, does not have a potential liability related to unresolved infringement claims subject to indemnification that would have a material adverse effect on its financial condition or operating results. Therefore, the Company did not record a liability for infringement costs as of either September 29, 2007 or September 30, 2006.

Concentrations in the Available Sources of Supply of Materials and Product

Certain key components including, but not limited to, microprocessors, enclosures, certain LCDs, certain optical drives, and application-specific integrated circuits ("ASICs") are currently obtained by the Company from single or limited sources which subjects the Company to supply and pricing risks. Many of these and other key components that are available from multiple sources including, but not limited to, NAND flash memory, DRAM memory, and certain LCDs, are at times subject to industry-wide shortages and significant commodity pricing fluctuations. In addition, the Company has entered into certain agreements for the supply of critical components at favorable pricing, and there is no guarantee that the Company will be able to extend or renew these agreements when they expire. Therefore, the Company remains subject to significant risks of supply shortages and/or price increases that can adversely affect gross margins and operating margins. In addition, the Company uses some components that are not common to the rest of the global personal computer, consumer electronics and mobile communication industries, and new products introduced by the Company often utilize custom components obtained from only one source until the Company has evaluated whether there is a need for and subsequently qualifies additional suppliers. If the supply of a key single-sourced component to the Company were to be delayed or curtailed, or in the event a key manufacturing vendor delays shipments of completed products to the Company, the Company's ability to ship related products in desired quantities and in a timely manner could be adversely affected. The Company's business and financial performance could also be adversely affected depending on the time required to obtain sufficient quantities from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components may be affected if producers were to decide to concentrate on the production of common components instead of components customized to meet the Company's requirements. Finally, significant portions of the Company's CPUs, iPods, iPhones, logic boards, and other assembled products are now manufactured by outsourcing partners, primarily in various parts of Asia. A significant concentration of this outsourced manufacturing is currently performed by only a few of the Company's outsourcing partners, often in single locations. Certain of these outsourcing partners are the sole-sourced supplier of components and manufacturing outsourcing for many of the Company's key products, including but not limited to, assembly

Percentage of Salary Payable As Performance-Based Cash Incentives

Operating Income	Revenue		
	Below Objective	Meet Objective	Above Objective
Below Objective	0%	25%	up to 50%
Meet Objective	25%	50%	up to 75%
Above Objective	up to 50%	up to 75%	up to 100%

The performance goals are aggressive. Thus, there is considerable risk that payments will not be made at all or will be made at less than 100%. For the past three years, the performance goals have reflected double-digit growth in both revenue and operating income. In four of the past eight years, Apple did not meet one or both performance goals. This uncertainty ensures that any payments under the plan are truly performance-based, consistent with the plan's objectives.

At the end of the year, the Committee determines the amount of the award to be paid to each officer by comparing actual results to the performance goals. The Committee may, in its discretion, reduce (but not increase) the amount of any individual award based on the officer's overall performance. The plan does not provide for the adjustment or recovery of an award paid to a named executive officer if the results in a previous year are subsequently restated or adjusted in a manner that would have originally resulted in a smaller award.

5. *The Role of Consultants*

The Compensation Committee has selected and directly retained the services of Frederic W. Cook & Co., Inc., an executive compensation consulting firm. No member of the Compensation Committee or any named executive officer has any affiliation with F.W. Cook. The Committee periodically seeks input from F.W. Cook on a range of external market factors, including evolving compensation trends, appropriate comparison companies and market survey data. F.W. Cook also provides general observations on Apple's compensation programs, but it does not determine or recommend the amount or form of compensation for any executives.

6. *The Role of Peer Groups, Surveys and Benchmarking*

With the assistance of F.W. Cook, the Committee identified peer companies for fiscal 2007 that compete with Apple in the labor and capital markets and that follow similar pay models. The Committee established the two peer groups listed below, one consisting of large technology companies and another consisting of large retailers. The retail peer group is a relevant comparison group for the Senior Vice President, Retail Sales; the technology peer group is relevant for the other four named executive officers.

Technology Companies		Retail Companies
Adobe Systems	IBM	The Gymboree Corporation
Amazon.com	Intel	Limited Brands
Applied Materials	Microsoft	Nike
Cisco Systems	Motorola	Polo Ralph Lauren
Comcast	Oracle	Restoration Hardware
Dell	Qualcomm	Sharper Image
eBay	Sprint Nextel	Target
EMC	Sun Microsystems	Tiffany & Co.
Google	Texas Instruments	Tween Brands
Hewlett-Packard	Xerox	Wal-Mart

EXHIBIT B

PART I

Item 1. Business:

International Business Machines Corporation (IBM or the company) was incorporated in the State of New York on June 16, 1911, as the Computing-Tabulating-Recording Co. (C-T-R), a consolidation of the Computing Scale Co. of America, the Tabulating Machine Co. and The International Time Recording Co. of New York. Since that time, IBM has focused on the intersection of business insight and technological invention, and its operations and aims have been international in nature. This was signaled over 80 years ago, in 1924, when C-T-R changed its name to International Business Machines Corporation. And it continues today: IBM is a globally integrated innovation company, serving the needs of enterprises and institutions worldwide. To help clients achieve growth, effectiveness, efficiency and the realization of greater value through innovation, IBM draws upon the world's leading systems, software and services capabilities.

* * *

Description of Business

IBM is a globally integrated enterprise that targets the intersection of technology and effective business. The company seeks to be a partner in its clients' success by enabling their own capacity for distinctive innovation. To help clients achieve growth, effectiveness, efficiency and the realization of greater value through innovation, IBM draws upon the world's leading systems, software and services capabilities.

IBM'S STRATEGY

In IBM's view, today's networked economy has created a global business landscape and a mandate for business change. Integrated global economies have opened markets of new opportunity and new sources of skills. The Internet has enabled communication and collaboration across the world and brought with it a new computing model premised on continuous global connection. In that landscape, companies can distribute work and technology anywhere in the world.

Given these opportunities, IBM is working with its clients to develop new business designs and technical architectures that allow their businesses the flexibility required to compete in this new landscape. The business is also adjusting its footprint towards emerging geographies, tapping their double-digit growth, providing the technology infrastructure they need, and taking advantage of the talent pools they provide to better service the company's clients.

IBM's strategy addresses this new era and delivers value to its clients through three strategic priorities:

Focus on Open Technologies and High-Value Solutions

The PC era has ended, representing a fundamental shift in the technology requirements of the company's clients. IBM is well positioned to provide its enterprise clients the open technologies and high-value solutions they will need to compete.

- *IBM is leveraging its leadership position in the convergence of software and services, in SOA, in virtualization, in high-performance chips, in open and modular IT—continuing its shift from commoditizing segments to higher value segments with better profit opportunity.*
- *The company continues to be a leading force in open source solutions to enable its clients to achieve higher levels of interoperability, cost efficiency and quality.*

Deliver Integration and Innovation to Clients

Changes in the market have caused IBM's clients to seek flexibility and innovation in everything from technical architecture to their business model. In response, IBM is focused on delivering integration and innovation to its clients—offering them technologies and services that support real value creation.

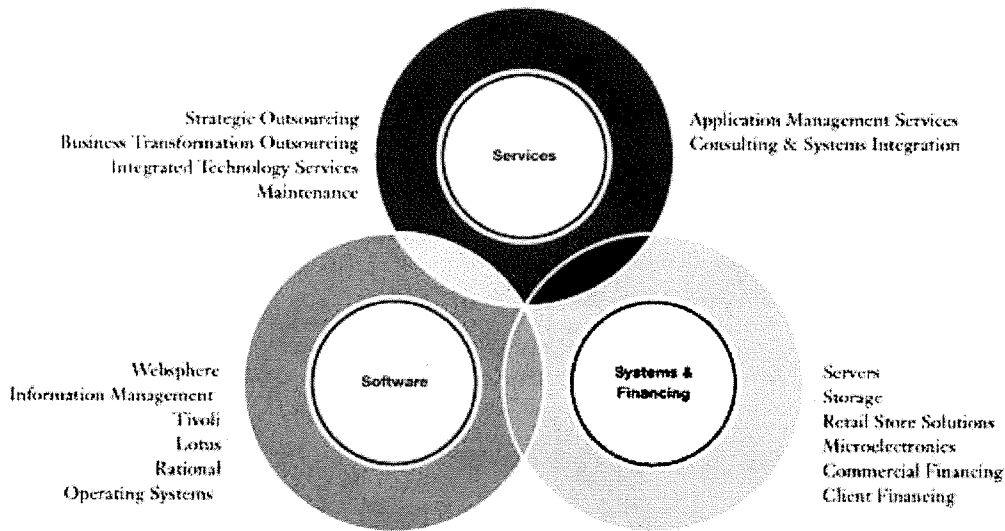
- *IBM has a long heritage of transforming the business operations of large enterprises and has earned the trust to be their innovation partner and global integrator.*
- *The company has a deep set of global assets and capabilities it is applying to improve services profitability, both for its clients and for itself.*

Become the Premier Globally Integrated Enterprise

As global networks and technology capabilities change business economics, legacy business designs can quickly become non-competitive. IBM believes a globally integrated enterprise, designed for this new landscape can compete effectively and will benefit from the opportunities offered.

- *To reshape its business for the global economy, IBM has replaced vertical hierarchies with horizontally integrated teams.*
- *Across the business, the company has made significant investments in emerging markets, taking core processes and functions that were once managed regionally and shifting them to a globally integrated model.*

Looking forward, IBM is confident it understands the economic shift of globalization, the evolution of the new computing model and the powerful role of innovation in this new landscape. Its unique capabilities are well adapted to help the company's clients innovate and compete effectively in the new landscape.



BUSINESS SEGMENTS AND CAPABILITIES

The company's major operations comprise a Global Technology Services segment; a Global Business Services segment; a Systems and Technology segment; a Software segment; and a Global Financing segment.

Global Services is a critical component of the company's strategy of providing IT infrastructure and business insight and solutions to clients. While solutions often include industry-leading IBM software and hardware, other suppliers' products are also used if a client solution requires it. Contracts for IBM services—commonly referred to as "signings"—can range from less than one year to over ten years. Within Global Services there are two reportable segments: Global Technology Services and Global Business Services.

Global Technology Services (GTS) segment primarily reflects IT infrastructure services and business process services, delivering value through the company's global scale, standardization and automation.

GTS Capabilities

Strategic Outsourcing Services. Comprehensive IT services integrated with business insight working with clients to reduce costs and improve productivity through the outsourcing of processes and operations.

Business Transformation Outsourcing. A range of offerings from standardized processing platforms and Business Process Outsourcing through transformational offerings that delivers improved business results to clients through the strategic change and/or operation of the client's business processes, applications and infrastructure.

Integrated Technology Services. Services offerings that help clients access, manage and support their technology infrastructures, through a combination of skilled resources, software and IBM's knowledge of business processes.

Maintenance. A number of support services from product maintenance through solution support to maintain and improve the availability of clients' IT infrastructure.

Global Business Services (GBS) segment primarily reflects professional services and application outsourcing services, delivering business value and innovation to clients through solutions which leverage industry- and business-process expertise.

GBS Capabilities

Consulting and Systems Integration. Delivery of value to clients through consulting services for client-relationship management, financial management, human capital management, business strategy and change, and supply-chain management.

Application Management Services. Application development, management, maintenance and support services for packaged software, as well as custom and legacy applications. Delivering value through the company's global resource capabilities, industry knowledge, and the standardization and automation of application development.

Systems and Technology segment provides IBM's clients with business solutions requiring advanced computing power and storage capabilities. Approximately 55 percent of the Systems and Technology's server and storage sales transactions are through the company's business partners; approximately 45 percent are direct to end-user clients, more than 40 percent of which are through the Internet at ibm.com. In addition, Systems and Technology provides leading semiconductor technology and products, packaging solutions and engineering technology services to clients and for IBM's own advanced technology needs. While not reported as external revenue, systems hardware is also deployed to support services solutions.

Systems and Technology Capabilities

Servers. IBM systems, which are typically connected to a network and provide the required infrastructure for business. These systems use both IBM and non-IBM operating systems and all IBM servers can also run Linux, a key open source operating system. (System z, System i, System p, System x and BladeCenter).

Storage. Information infrastructure products and solutions, which address critical client requirements for information retention and archiving, availability and virtualization, and security and compliance. The portfolio consists of a broad range of disk and tape storage systems and software.

Microelectronics. Semiconductor design and manufacturing for use in IBM systems and for sale to external clients.

Engineering and Technology Services. System and component design services, Blue Gene "supercomputer systems," outsourcing of clients' design teams and technology and manufacturing consulting services.

Retail Store Solutions. Point-of-sale retail systems (network connected cash registers) as well as solutions which connect them to other store systems (for example, inventory).

Software consists primarily of middleware and operating systems software. Middleware software enables clients to integrate systems, processes and applications across a standard software platform. IBM middleware is designed to open standards which allows the efficient integration of disparate client applications that may have been built internally, or provided by package software vendors or system integrators. Operating systems are the software engines that run computers. In addition, Software includes Product Lifecycle Management software which primarily serves the Industrial sector. Approximately two-thirds of external software segment revenue is annuity-based, coming from recurring license charges and on-going subscription and support from one-time charge (OTC) arrangements. The remaining one-third of external revenue relates to OTC arrangements, in which the client pays one up-front payment for a perpetual license. Typically, arrangements for the sale of OTC software include one year of maintenance. The client can also purchase ongoing maintenance after the first year, which includes product upgrades and technical support. While not reported as external revenue, software is also deployed to support services solutions.

Software Capabilities

WebSphere Software. Management of a wide variety of business processes using open standards to interconnect applications, data and operating systems. Provides the foundation for Web-enabled applications and is a key product set in deploying a Services Oriented Architecture.

Information Management Software. Advanced database, content management and information integration software that helps companies integrate, manage and gain value from their business information.

Tivoli Software. Software for infrastructure management, including security and storage management that will help organizations better manage their IT infrastructure to more effectively deliver IT services.

Lotus Software. Collaboration, messaging and social networking software that enables businesses to communicate, collaborate and increase productivity.

Rational Software. Software tools that help clients manage their software development processes and capabilities.

Item 1A. Risk Factors:

Economic Environment and Corporate IT Spending Budgets: If overall demand for systems, software and services changes, whether due to general economic conditions or a shift in corporate buying patterns, sales performance could be impacted. IBM's diverse set of products and offerings is designed to provide more consistent results in both strong and weak economic environments. The company addresses this by not only having a mix of offerings with long-term cash and income streams, as well as cyclical transaction-based sales, but also by continually developing competitive products and solutions and effectively managing a skilled resource base. IBM continues to transform itself to take advantage of shifting demand trends, focusing on client or industry-specific solutions, business performance and open standards.

Internal Business Transformation and Global Integration Initiatives: IBM continues to drive greater productivity, flexibility and cost savings by transforming and globally integrating its own business processes and functions. In addition to eliminating redundancies and overhead structures to drive productivity, this integration has improved IBM's capacity to innovate by providing greater clarity of key priorities around shared goals and objectives and leads to a sharper focus for the company on learning, development and knowledge sharing. As IBM continues to drive higher levels of automation and integration into its business, IBM's dependency on internal IT systems also increases.

Innovation Initiatives: IBM invests to improve its ability to help its clients innovate. Investment may occur in the research and development of new products and services, as well as in the establishment of new collaborative and co-creation relationships with developers, other companies and other institutions. To deliver value that helps clients differentiate themselves for competitive advantage, IBM has been moving away from commoditized categories of the IT industry and into areas in which it can differentiate itself through innovation and by leveraging its investments in R&D. In the highly competitive IT industry, with large diversified competitors as well as smaller and nimble single technology competitors, IBM's ability to continue its cutting-edge innovation is critical to maintaining and increasing market share. IBM is managing this risk by more closely linking its R&D organization to industry-specific and client-specific needs. In addition, IBM has one of the strongest brand names in the world, and its brand and overall reputation depends in part on its ability to continue to stand for industry-leading technology and solutions that provide business advantages.

Open Standards: The broad adoption of open standards is essential to the computing model for on demand business and is a significant driver of collaborative innovation across all industries. Without interoperability among all manner of computing platforms, the integration of any client's internal systems, applications and processes remains a monumental and expensive task. The broad-based acceptance of open standards—rather than closed, proprietary architectures—also allows the computing infrastructure to more easily absorb (and thus benefit from) new technical innovations. IBM is committed to fostering open standards because they are vital to the On Demand Operating Environment, and because their acceptance will expand growth opportunities across the entire business services and IT industry. There are a number of competitors in the IT industry with significant resources and investments who are committed to closed and proprietary platforms as a way to lock customers into a particular architecture. This competition may result in increased pricing pressure and/or IP claims and proceedings.

Investing in Growth Opportunities: The company is continuing to refocus its business on the higher-value segments of enterprise computing—providing technology and transformation services to clients' businesses. Consistent with that focus, the company continues to significantly invest in growth opportunities, as a way to drive revenue growth and market share gains. IBM continues to invest in dozens of emerging growth countries including Brazil, Russia, India and China. The developing nature of emerging growth countries presents political, social and economic risks to IBM's business, including

regulations. Compliance with environmental laws and regulations is not expected to have a material adverse effect on the company's financial position, results of operations and competitive position.

Tax Matters: The company is subject to income taxes in both the United States and numerous foreign jurisdictions. IBM's provision for income taxes and cash tax liability in the future could be adversely affected by numerous factors including, but not limited to, income before taxes being lower than anticipated in countries with lower statutory tax rates and higher than anticipated in countries with higher statutory tax rates, changes in the valuation of deferred tax assets and liabilities, and changes in tax laws, regulations, accounting principles or interpretations thereof, which could adversely impact the company's results of operations and financial condition in future periods. In addition, IBM is subject to the continuous examination of its income tax returns by the Internal Revenue Service and other tax authorities. The company regularly assesses the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of its provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on the company's provision for income taxes and cash tax liability.

Internal Controls: Effective internal controls are necessary for the company to provide reasonable assurance with respect to its financial reports and to effectively prevent fraud. If the company cannot provide reasonable assurance with respect to its financial reports and effectively prevent fraud, the company's operating results could be affected. Pursuant to the Sarbanes-Oxley Act of 2002, the company is required to furnish a report by management on internal control over financial reporting, including management's assessment of the effectiveness of such control. Internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Therefore, even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. In addition, projections of any evaluation of effectiveness of internal control over financial reporting to future periods are subject to the risk that the control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. If the company fails to maintain the adequacy of its internal controls, including any failure to implement required new or improved controls, or if the company experiences difficulties in their implementation, the company's business and operating results could be harmed, the company could fail to meet its financial reporting obligations, and there could be a material adverse effect on the company's stock price.

Use of Estimates: In connection with the application of generally accepted accounting principles (GAAP) and the preparation of the Consolidated Financial Statements, the company uses certain estimates and assumptions, which are based on historical experience and management's knowledge of current events and actions that the company may undertake in the future. The company's most critical accounting estimates are described in the Management Discussion on pages 47 to 49 of IBM's 2007 Annual Report to Stockholders. In addition, as discussed in note N, "Contingencies and Commitments" on pages 94 through 96 of IBM's 2007 Annual Report to Stockholders, the company makes certain estimates under the provisions of SFAS No. 5, "Accounting for Contingencies", including decisions related to legal proceedings and reserves. While management believes that these estimates and assumptions are reasonable under the circumstances, by definition they involve the use of judgment and the exercise of discretion, and therefore, actual results may differ.

Competitive Conditions: The company operates in businesses that are subject to intense competitive pressures. The company's businesses face a significant number of competitors, ranging from some of the world's largest global enterprises to an increasing number of relatively small, rapidly growing and highly specialized organizations. The company believes that its combination of technology, performance, quality, reliability, price and the breadth of products and service offerings are important competitive factors. Intense competitive pressures could affect prices or demand for the company's products and services, resulting in reduced profit margins and/or loss of market opportunity. Unlike

many of its competitors, the company has a broad set of capabilities and businesses and must allocate resources across these businesses while competing with companies that specialize in one or more of these product lines. As a result, the company may not fund or invest in certain of its businesses to the same degree that its competitors do, and these competitors may have greater financial, technical and marketing resources available to them than the businesses against which they compete.

Volatility of Stock Price: The company's stock price is affected by a number of factors, including quarterly variations in financial results, the competitive landscape, general economic and market conditions and estimates and projections by the investment community. As a result, like other technology companies, the company's stock price is subject to significant volatility.

Dependence on Key Personnel and Reliance on Critical Skills: Much of the future success of the company depends on the continued service, availability and integrity of skilled personnel, including technical, marketing and staff resources. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense. Changing demographics and labor work force trends may result in a loss of knowledge and skills as experienced workers retire. In addition, companies in the information technology and services industry whose employees accept positions with IBM may claim that IBM has interfered with noncompete obligations of their former employees, engaged in unfair hiring practices or that the employment of these persons by IBM would involve the disclosure or use of trade secrets. Any such claims could limit or prevent IBM from hiring employees or cause it to incur liability for damages or substantial costs in defending the company or its employees against these claims, whether or not they have merit. Further, many of IBM's key personnel receive a total compensation package that includes equity awards. New regulations, volatility in the stock market and other factors could diminish the company's use, and the value, of the company's equity awards, putting the company at a competitive disadvantage or forcing the company to use more cash compensation.

Relationships with Critical Suppliers: IBM's business employs a wide variety of components, supplies, services and raw materials from a substantial number of suppliers around the world. Certain of the company's businesses rely on single or a limited number of suppliers, although the company makes every effort to assure that alternative sources are available if the need arises. The failure of the company's suppliers to deliver components, supplies, services and raw materials in sufficient quantities and in a timely manner could adversely affect the company's business. In addition, any defective components, supplies or materials, or inadequate services, received from suppliers could reduce the reliability of the company's products and services and harm the company's reputation.

Currency and Customer Financing Risks: The company derives a significant percentage of its revenues from its affiliates operating in local currency environments and those results are affected by changes in the relative values of non-U.S. currencies and the U.S. dollar. Further, inherent in the company's customer financing business are risks related to the concentration of credit, client creditworthiness, interest rate and currency fluctuations on the associated debt and liabilities, the determination of residual values, and the financing of other than traditional IT assets. The company employs a number of strategies to manage these risks, including the use of derivative financial instruments. Derivatives involve the risk of non-performance by the counterparty. In addition, there can be no assurance that the company's efforts to manage its currency and customer financing risks will be successful.

Customer Credit Risk on Receivables: The company's client base includes many worldwide enterprises, from small and medium businesses to the world's largest organizations and governments, with a significant portion of the company's revenue coming from global clients in the company's Financial Services, Public, and Small and Medium business sectors. The company's financial performance is exposed to a wide variety of industry sector dynamics worldwide. Most of the company's sales are on an open credit basis and the company performs ongoing credit evaluations of its clients'

EXHIBIT C



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Interview With IBM Chairman and CEO, Sam Palmisano, Part Two

Making IBM a Gentler Giant

By [Robert Faletra](#) and [Robert DeMarzo](#)

2:09 PM EST Fri. Feb. 27, 2004

From the February 27, 2004 issue of ChannelWeb

Small in services? Didn't IBM (NYSE:IBM) Global Services produced some \$42.6 billion in sales last year?

Palmisano: The world thinks we're big only because we're two times the other guy [EDS].

We're very small. We're only nine percent share, 9.5 or 9.7. We're not even relevant in this space. But because everybody else is like 5 [percent], you know. I think a reasonable share position is like 15 or something. You know, everything else we had in the 20s or 30s [in market share]. This is our smallest share business. It's true. I mean, we'd like it be more like our other businesses.

But is it still a big piece of IBM but low in market share. That's the way you look at it

Palmisano: No, a huge piece of IBM, but relative to the market. Relative to the market of our servers which are in the 30s in share, storage is in the teens, which is one of our lower share businesses. Our middleware, now WebSphere vs. BEA, is 30.

But back to ease of doing business. Is IBM almost too big for it to be easy to business with?

Palmisano: No. And here's my point. I've got to answer your question, but my point is that we dealt with the partners in the way IBM dealt with itself. So it wasn't inconsistent. Then we said, no, no, the market's re-integrating, the clients are re-integrating. So we have to deal with the partners differently. We need to re-integrate. We can't give them 30 versions of our terms and conditions sliced and diced. And so what we need to do strategically is establish a relationship with the partner and IBM and make it a lot easier to do business.

So what kind of changes does that portend?

Palmisano: Software is now going to be solving client problems not going to market by WebSphere, database, Lotus, Rational, etc. but by industry set.

Services has been half industry and half, they call it line of business, but it's product line--BCS, integration, outsourcing--it's always industry. And the hardware also. I mean, Bill Zeitler's team [IBM's hardware group] is also looking at how you bring it all together. So strategically when we talk about re-integrating, because that's what's the market's driving, we need to get to an environment strategically where the partner can be able to pick the capabilities from IBM, whatever they happen to be.

Hardware platform, middleware express layers, let's say if it's SMB, or middleware platform. You're right, services if they're going to resell our services or their own services, they're going to build it around there, so that they take the capability of IBM not strictly the brand term and condition of IBM. Now, strategically, as you guys know, I think everybody would say that's exactly the right thing to do.

So, are you getting there?

Palmisano: Transitioning, well, it's a more complex transition because yes, we can't just transition and leave them behind because of the income flow. I mean, it's easier, quite honestly, guys, for me to transition IBM and get people focused this way than to transition [the entire partner ecosystem] because I'm dealing with my own economics.

So what about the transition for partners?

Palmisano: That ecosystem I need to help with. I mean, as we say this is where we want to go, I've got to make sure as we move them I don't hurt the profit. I mean, I shouldn't say I, but IBM. I think the partners would say, yes, it will simplify it. I got it, it makes sense. So strategically, conceptually the world says yes, I just want to take IBM capability and help me create value. But if I say this at PartnerWorld, there will be no debate.

But partners will worry about the bumps along the way.

Palmisano: I know, evolving it's the tricky thing. And evolving it around the world, because our partners are global, they're not regional. So it's multi dimensions of the evolution. But I think if we could agree, all of us could agree that this is the path we want to go down and then keep working together, because the best way for us to work with the partners as you know is to have an open dialogue and communications.

And we have to be fluid, and in a way we have to trust each other. We have to trust each other. So therefore this is open dialogue and communications. At the same time IBM today has a very strong point of view. We do. We have a strong point of view around the importance of standards. We have a strong point of view around the importance of adding value around integrating. We have strong points of view.

We want more people in our ecosystem committed to standards-based computing architectures. Now, I understand that that can run on our stuff, it can run on H-P, it can run on Sun. I got it. We'll go make sure that we have the best cost points and the best technology.

But we're committed to standards and we want our partners with us there, on open standards based architectures. We are going to be biased, right? People that are committed to a proprietary approach, we're not going to have as much interested in helping as those committed to standards.

People that want to work with us to get to standards based computing models, we are very open and willing to invest in. People that feel that they've to stay on proprietary approaches, they've made a business decision.

But there are proprietary companies that probably want to invest in them, but we're not that proprietary company. So I'm trying to be...we are insisting that guys buy in.

Now, you buy in to our standards based approach, we'll more than [INAUDIBLE] a lot around marketing, collateral materials, a lot of the things we've done through the partners and all the programs. We're willing to go leverage our marketing to help the partners.

But if you're going to go take a proprietary approach not a standards based approach, then we don't have the same level of interest, because that's another ecosystem.

So you want these guys to commit more to the IBM way of thinking...

Palmisano: No, more to standards. Open standards. It's not an IBM thing; it's an industry thing. We want them committed more to open standards. And it's not an IBM thing; this is the industry. We just think there's a need for an ecosystem committed around standards. There's clearly a huge ecosystem committed to proprietary approaches, as you know. Huge. And so all we're saying is we want some counterbalance.

Earlier when you were were talking about re-integration at the customer level, it sounds like a mid- to high-market enterprise sell. What is the message to partners that are in the SMB space?

Palmisano: Well, what do they suggest we should do differently? [Get] more local relationships?

Perhaps it's that and communication the IBM value in the SMB space, understanding the solutions and being easier to do business with.

Palmisano: Let me come back at it because one of the things we've tried to do, that's why I was trying to get your feedback, but it's good feedback, because one of the things we tried to do was this territory model, we started with 300, I think it's 277... put them back in the field, they can do promotional pricing, they create their own ecosystem with partners.

I just reviewed the guys in the District of Columbia [they got capital] the other day, they're growing 25 percent a year and they're going to grow 25 percent this year. And they have a couple thousand customers in their territory, probably half are not IBM half are IBM, typical, as you'd expect.

And they work with, gosh, she showed me the chart [I'd be wrong] but it's probably 60 or 70 local partners. It's not just the big guys. And we did co-marketing together, doing demand creation together, they're passing leads.

The territory managers have the capability to promotional price, so they're working this thing. ibm.com is generating demand, they're passing it. So some places it's working, I just saw one that's working really well. I'm sure, You could give me...I [hope] you'll give me 10 others that aren't working very well.

I mean, I got...the 300, I know that's clearly going to be the case. But my only point is I think the model is right, and if you think about what the regional guys want, the regional guys want the ability to sort of work with us, be able to be quickly on pricing so if there's a competitive situation, that's why we gave them promotional pricing, to the territory managers.

And some way to jointly do demand creation. I mean, the [INAUDIBLE] we all want the same thing. We've got to create demand, so it's a little of that local advertising, what have you, go to some business shows, get some leads,

You know, HP (NYSE:HPQ) is making a big push in the consumer electronics space. Are you planning to jump in?

Palmisano: We are enterprise. We used to be in retail. We were in retail, we were in retail PC. Remember we had, we were an Internet service provider, a thing called IBM GN, the IBM Global Network.

We are enterprise. We [make] no bones of what we are, we know what we are. We are the leading company in the enterprise. There's only one sector we're not number one in, that's industrial. And then mid sized enterprise, we'll be two. We were three; we'll be two.

Why enterprise? Faster growing than the other segments [including] consumer. Right? Better margins. On our model, it's very straightforward: we want to be able to generate return on invested capital better than the average.

We're better than the industry, so put that aside. Better than the S&P 500, because if we can generate higher returns than the average of the S&P 500, our multiple of our stock is at a premium for this year and last year for the first time since 1985. We've got to continue to do it. And that's why we like enterprise, because it generates more shareholder value.

Strategically I don't think you can do both. I know other companies think you can. They think you can learn in consumer electronics and music downloading and exploit. I mean, I listen to it...it's so different. The business model is so different. I don't know how you do that. I'm not saying it's wrong; I just don't know how you execute it. I do know how you execute enterprise, I do understand how to take share enterprise and win with clients. I understand how to generate better returns, significantly better than guys who are trying to do both. It's not even close. But you know, better returns.

But other people have made other choices strategically. I think it's hard to do. It's hard to do.

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