



1988

Annual

Report

On the Cover

Computer aided design (CAD) provides significant benefits for most of the Company's technical products. A dual bore well packer under development at Baker Oil Tools is depicted.

Corporate Profile

Baker Hughes Incorporated provides products and services to the petroleum and mining industries. Twenty-six divisions operate through four major groups: Baker Hughes Production Tools, Baker Hughes Drilling Equipment, Baker Hughes Process Equipment and Baker Hughes Mining Equipment.

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Summary of Selected Financial Data

(In thousands of dollars, except per share amounts)
Years ended September 30,

	1988	1987
Sales	\$1,775,346	\$1,432,138
Services and rentals	<u>540,805</u>	<u>491,460</u>
Total revenues	2,316,151	1,923,598
Net income (loss)	103,247	(254,822)
Net income (loss) per share	.82	(2.22)
Working capital	592,134	500,755
Total assets	2,117,526	2,188,632
Net property, plant and equipment	647,788	737,102
Capital expenditures	62,048	45,298
Depreciation and amortization	122,178	146,718
Long-term debt	440,007	460,767
Stockholders' equity	961,488	915,520
Cash dividends per share of common stock	<u>.46</u>	<u>.39</u>
Number of common shares (000)		
Average during year	117,919	115,791
Outstanding at end of year	118,419	117,490
Number of employees	21,492	21,191

IN THE PAST YEAR, your Company delivered a strong return to profitability despite marketplace conditions that continue to be characterized by essentially flat U.S. drilling activity. Volatile oil prices have, for three years, kept a lid on drilling in the United States. However, the improvements from combining Baker International and Hughes Tool Company came quickly, and will continue into fiscal 1989. We have exceeded our original target of reducing expenses; consolidation savings now exceed \$80 million annually, which, when coupled with slight improvements in drilling mix, product pricing and market share, moved your Company into profitability for the entire year.

Revenues for the year were \$2.32 billion, up 20.4 percent from \$1.92 billion in the prior fiscal



year. Net income was \$103.2 million, or \$.82 per share, compared with a loss of \$254.8 million in fiscal 1987. Pretax operating income, excluding the impact of net unusual credits and pension gains, was \$81.0 million for the year as compared to fiscal 1987's pretax operating loss of \$144.2 million which also excludes items of a nonrecurring nature.

Our long-term strategic priorities will continue to be competing in our high market share product lines, structuring the Company to allow management focus in each market and improving our cost base to operate profitably despite erratic market conditions.

Focusing management by product groups

Baker Hughes is organized into five operating organizations that encompass virtually all of the Company's operations. Baker Hughes Drilling Equipment consists of six divisions that derive most of their revenues from the exploration and drilling phase of the oil and gas industry. Baker Hughes Production Tools includes seven divisions which focus on oilfield completion, production and remedial equipment and services. The B-J Titan and B-J Services International organization provides oilfield pressure pumping services. Baker Hughes Process Equipment includes six divisions that concentrate on the mining and industrial process markets. Baker Hughes Mining Equipment with six divisions manufactures and services heavy underground mining equipment.

Each operating group and division maintains autonomy over its operations; the Company's reporting and control systems, however, provide for close upper management supervision and tight fiscal control.

Concentrating in core businesses

A number of actions were taken by your management in the past year to position the Company in core businesses, where Baker Hughes products hold a number-one or number-two market share position. As a result of core business concentration, several businesses and product lines were sold during fiscal year 1988, to strengthen operations and to enhance future profitability.

Most of Baker Hughes' interest in Vetco Gray was sold to Bain Venture Capital following a 1987 write-down of assets and deconsolidation from the Baker Hughes financial statements. Your Company retains a 10 percent equity interest in Vetco Gray.

The B-J Machinery and Technical Drilling Tool operations were sold to Varco International, for which your Company received notes and an equity interest in VARCO.

Disposal of several other minor product lines and operations during the past fiscal year included Torqmaster pumping units, Econolift pump systems, the production testing operations of Baker Sand Control, and Hughes Mining Tools.

Restructuring of Baker Hughes Mining Equipment Company

During the latter part of fiscal 1988, the Company took steps to enhance the profitability of its non-oilfield business by restructuring the Baker Hughes Mining Equipment operations into two groups, Baker Hughes Process Equipment and Baker Hughes Mining Equipment.

Baker Hughes Process Equipment is engaged in the process function in mining as well as many other industries, such as municipal waste treatment,

pulp and paper, food and others. The divisions in this group produce excellent profits and returns on capital.

Baker Hughes Mining Equipment consists of our underground mining equipment divisions. These divisions manufacture and service vehicles, continuous miners, roof bolters and other products used in mines. The markets served by these divisions have changed in the past few years as mining efficiency has increased. More tons of mined product are removed per man or per machine than at any previous time. These changes require us to focus more closely on this market while also reassessing our strategic position. The new organization is designed to focus on these strategies. We intend to bring this group to a breakeven level in fiscal 1989.

Settling patent infringement lawsuits successfully

During fiscal 1988, two major patent infringement lawsuits involving Smith International and Dresser Industries were settled. The settlement with Smith yielded \$95 million, principally in cash. In the settlement with Dresser Industries, announced on July 21, 1988, Baker Hughes received the minority interest ownership that Dresser held in B-J Titan, a partnership between Baker Hughes and Dresser, and \$23 million in cash. The total value recorded for the Dresser settlement was \$55 million.

Enhancing financial flexibility

Cash from operations, the patent litigation settlements and from asset dispositions has been used to strengthen the Company's balance sheet. Total debt was reduced to \$488 million at September 30, 1988, down nearly \$53 million from the prior year-

end, while cash balances increased to \$68 million from \$11 million in 1987. Fiscal 1988's results include unusual charges of nearly \$103 million caused by the impairment of assets due to changes in market conditions and operating strategies, the disposal of certain businesses and product lines and the continued consolidation of geographic operations. For financial reporting purposes these charges have been netted against the patent litigation settlements of \$150 million, resulting in a net unusual credit of \$47.5 million.

The Company's improved financial condition has permitted the continuation of the \$.46 per share annual dividend. We are extremely pleased that earnings from operations in the fourth quarter exceeded dividend requirements. Your management will continue to evaluate dividend payments on a quarterly basis.

Continuing the commitment to research and development

The Company's long standing commitment to research and development will continue. It is our belief that our success depends on our ability to contribute to cost efficient drilling and production of oil and gas, and to low cost mining of coal and minerals by our customers. As an example, a major thrust of the current R&D effort is directed toward performance drilling, a form of development drilling that is expected to be used more in the recovery of petroleum reserves. By selecting precise drilling targets and by drilling and completing horizontal holes, lower costs per barrel of oil recovered can be achieved. To more effectively address this market, we recently formed a new division, Baker Hughes Drilling Systems, to combine our product and service capability in this growing market.

Preparing for a changing market

The short-term outlook for our markets has been and will remain difficult to forecast as the continuing instability of oil and gas prices makes it a struggle for our customers to plan their programs. However, we are pleased that Baker Hughes products and services are leaders in markets where drilling and remedial production programs are expected to continue:

- Efficient development of existing oil and gas fields,
- Natural gas drilling and production, where the U.S. price is beginning to rise, and
- International drilling, where activity has been less subject to market swings.

We believe our goals for FY 1988 have been accomplished. We thank our employees for their efforts, dedication and support in making the Company's achievements possible.

We regretfully announce that four of our directors, E.H. Clark, Jr. (see next page for a special tribute), Don D. Jordan, Morton M. Winston and Ben F. Love, are retiring this year. Our stockholders owe many thanks to these gentlemen, for their many years of dedicated guidance and counsel.



J. D. Woods

President and Chief Executive Officer

Hubie departs, but his contributions are permanent

This year, and after more than 40 years of service, Hubie Clark will be retiring from your Company. His accomplishments for Baker Hughes, for the entire oil service industry, and for the community in which he lives would fill this entire report. A few examples from his life will have to suffice.

The man

Hubie had graduated from Cal Tech with a bachelor's and a master's in mechanical engineering, both with honors, by 1947. In that same year he went on active duty in the U.S. Navy and joined Baker Oil Tools. The most important thing he did in 1947 was to get married for the first and only time. But for that he needed his parents' permission. In 1947, Hubie was not yet 21 years old.

An engineer who managed well

A consummate engineer with numerous patents, Hubie is one of a rare breed, taking the precision of engineering into the somewhat ill-defined world of management. He developed a planning and control system of measuring performance where we can fairly compare a 2-million-dollar operation with a 200-million-dollar operation.

He developed other systems that put a division's forecasts and actual statistics on one side of one sheet of paper. In a glance, upper management could obtain an understanding of a division's current status. The entire statistical management system at Baker Hughes was developed by Hubie, and it is working as well today as it did 20 years ago — an invaluable legacy to Baker Hughes management.

A manager focused on the future

Hubie became the single most-quoted spokesman for the oil service industry because he built your Company based upon his vision of the future. He brought in computers earlier than others and introduced debt leverage to the old Baker company. He took the Company public. He expanded the original business to take full advantage of the boom in drilling. In 1981, *Dunn's Business Month* voted Baker one of the five best-managed companies in

the U.S. *Fortune Magazine* deemed Baker to have delivered the highest return on stockholder equity of any U.S. industrial company for the ten-year period 1971 – 1981. Hubie earned the respect of our industry, our customers, and the investment community by being right far more often than he was wrong.

A manager focused on the task

During Nixon-era price controls in a flat market for oil services, not unlike today's, the only improvements in revenues came directly from slow-to-be-approved price increases. After several weeks of no action from Washington, Hubie finally decided that something would be done. A young executive was instructed to go to Washington, find the bureaucrat in charge, get the price increase approved, and not return to corporate headquarters until it was done. Off this manager went to Washington.

Since I am still with the company today, it is obvious that I obtained the price increase — and learned a lesson in persistent, focused management.

From my personal point of view, no other individual, short of R.C. Baker and Howard Hughes Sr., had as much impact on the engineering, manufacturing, management, growth, and success of Baker Hughes Incorporated. We respect him and thank him for a job well done and wish Hubie and his lovely wife Patti all the best.

J. D. Woods



THE ONGOING OPERATIONS of Baker Hughes Drilling Equipment realized a significant financial improvement in 1988 as revenues increased by 33% from 1987 levels to \$750 million. Pretax operating profits were \$47 million for the year, an impressive turnaround from last year's \$40 million loss. The turnaround was accomplished through moderate pricing improvements, a domestic activity increase, restructuring of several business units, plus international market share gains. Also during the year, emphasis on balance sheet management resulted in a reduction in net capital employed from \$562 million in 1987 to \$463 million in 1988.

Worldwide drilling activity increased by 13% during the year. Within that increase, however, was a 40% increase in U.S. offshore drilling activity.



Natural diamonds used in drill bits are graded for size and quality before being mounted in a bit.

The critical nature of offshore drilling produces an above average quality of revenue for BHDE divisions. As a result of both volume and improved quality revenues, all BHDE operations were solidly profitable and generated positive cash flow for fiscal year 1988.

During the year, our participation in both domestic and international markets increased significantly. Domestic revenue per active rig increased by 14% year to year as a result of share gains in diamond bits at Hughes Tool, increased participation in the premium casing market by Baker Hughes Tubular Services and Exlog's computerized mud-logging services. International revenues per rig increased 17% due to strong share gains in the North Sea by Milpark Drilling Fluids, Exlog, and Tri-State.

Of significant note for fiscal 1988 was the integration of our high performance drilling products and services to form a new division, Baker Hughes Drilling Systems. This unit combines our broad spectrum of products into integrated drilling systems to improve our customer's efficiency and bring drilling economics in line with the realities of today's world energy market.

Looking forward, U.S. drilling activity is expected to contract slightly from 1988 levels due to low and erratic oil prices. An additional mix change toward gas drilling should occur with favorable margin impact on BHDE divisions. Offsetting this, Gulf of Mexico activity is expected to shift from exploratory drilling toward more development activity. International revenues will grow as a percent of total BHDE revenues as international rig activity, driven by long-term objectives, continues to improve slightly despite the short-term downward movement in oil prices.

The financial data presented in the Operations Review (pages 6-11) is on a current organizational basis and excludes any corporate or unusual items. It is not intended to correspond directly with the accompanying Consolidated Financial Statements and Notes thereto.



Diamond bit manufacture is a meticulous process. A matrix head bit is formed in a graphite mold with pockets for poly-crystalline diamond compacts precisely placed.

Gravel packs in horizontal (or very high angle) holes behave differently from near vertical ones. This unique test system allows observation and variable adjustment to work out methods for successful results.



BAKER HUGHES PRODUCTION TOOLS had a very successful 1988 as revenues from ongoing operations increased 15% to \$630 million and operating income rose 367% to \$70 million. Net capital employed inched up approximately 4% to \$382 million reflecting working capital increases.

All BHPT operating units contributed to the improved performance, as worldwide new well completions, workover activity and oil production grew from the prior year. The profile of revenue for BHPT demonstrates the value of strategic positioning in "Life of the Well" businesses. In FY 1988 half of worldwide revenues came from products and services used in "old" wells, i.e. half the business was independent of new drilling. Newly drilled oil wells account for approximately one third of revenues. Although not totally insulated from world oil prices, BHPT has a large share of revenue in some very stable businesses.

Of particular interest in 1988 were the first horizontal gravel packs performed by Baker Sand Control. The planning and testing (see photographs) required to successfully get tools to the producing zone and then place a successful gravel pack in that zone were pioneered by Baker Sand Control.

Also in 1988, liner hanger installations picked up substantially at Baker Service Tools, as incremental market share was achieved. Baker Oil Tools introduced its elastomer free subsurface safety valves, the first successful such valve for the industry. All sealing surfaces in the entire valve are metal to metal, assuring long-term effectiveness. These tubing conveyed valves have major market potential in the U.S., Gulf of Mexico, Europe and the Far East.

Looking forward to 1989, uncertainty of oil prices may hold new oil well drilling to 1988 levels, but in the U.S., gas well drilling is likely to pro-

ceed at a higher level. Since gas wells are "better customers" for our premium products, this improved profile should prove beneficial to BHPT. The half of our business which is "old well" related should also produce continuing good results.

B - J Titan / B - J Services International

OUR PUMPING SERVICES operations had a significant turnaround in 1988 as revenues rose nearly 20% to \$336 million and prior year operating losses reversed to an \$18 million income. Small increases in both activity and market share enhanced by incremental price improvement contributed to the results. The overall performance of the B-J divisions for 1988 contributed nicely to the Company's earnings.



In high angle wells, tools must pass through varying radii. Baker Sand Control has equipment to test tool passability and functionality.

BAKER HUGHES MINING EQUIPMENT, whose equipment and services profile is principally related to underground coal mining, is plagued by a contracted market place which characterizes the dramatic change in coal mine productivity. Although coal production is continuing to increase, mining equipment purchases for mines have, for the past few years, been at a fraction of previous years. Fiscal 1988 revenues were up 14% to \$227 million from the prior year, however operating losses continued. The focus of intense effort in fiscal 1989, BHMEG is expected to show substantial improvement in the new fiscal year. The divisions that constitute the group are EIMCO Jarvis Clark, EIMCO Coal Machinery, EIMCO Secoma, EIMCO Great Britain, EIMCO South Africa and EIMCO Australia.



TN's Metallurgist-XR analyzer is a field portable spectrograph which can determine which of a wide variety of metallic alloys a new sample is.

BAKER HUGHES PROCESS EQUIPMENT had a very strong year in 1988 with revenues and income rising 18% and 30%, respectively, over 1987 results. Revenues were \$364 million while pretax operating income reached \$33 million. Net capital employed was \$96 million, down slightly from 1987 levels.

Contributing to the improvement were market activity increases led by strong precious metal prices (gold and silver) and equally strong base metal prices, led by copper. Additionally our municipal businesses were improved as were our industrial markets which reflected the general growth in the U.S. and other industrial societies' economies.

Benefits of the combination of Baker and Hughes were also instrumental. Baker Hughes Mining Tools experienced tremendous market share growth and record profits due to the combination of Reed and Hughes blast hole bits as well as big hole heads and cutters for raiseboring and shaft drilling. BGA, Ramsey, Chas. Lewis, WEMCO and EIMCO Process also had excellent years taking advantage of the strong markets and improved technology.

Included in new technology development is the new Metallurgist-XR Analyzer of Ramsey Technology's Texas Nuclear Unit. This field portable instrument is the only noncryogenic high performance spectrometer available as a commercial product.

The continuing positive environment has kept order rates quite strong. As a result, the group had a backlog at year end, which points to an equally positive fiscal 1989.



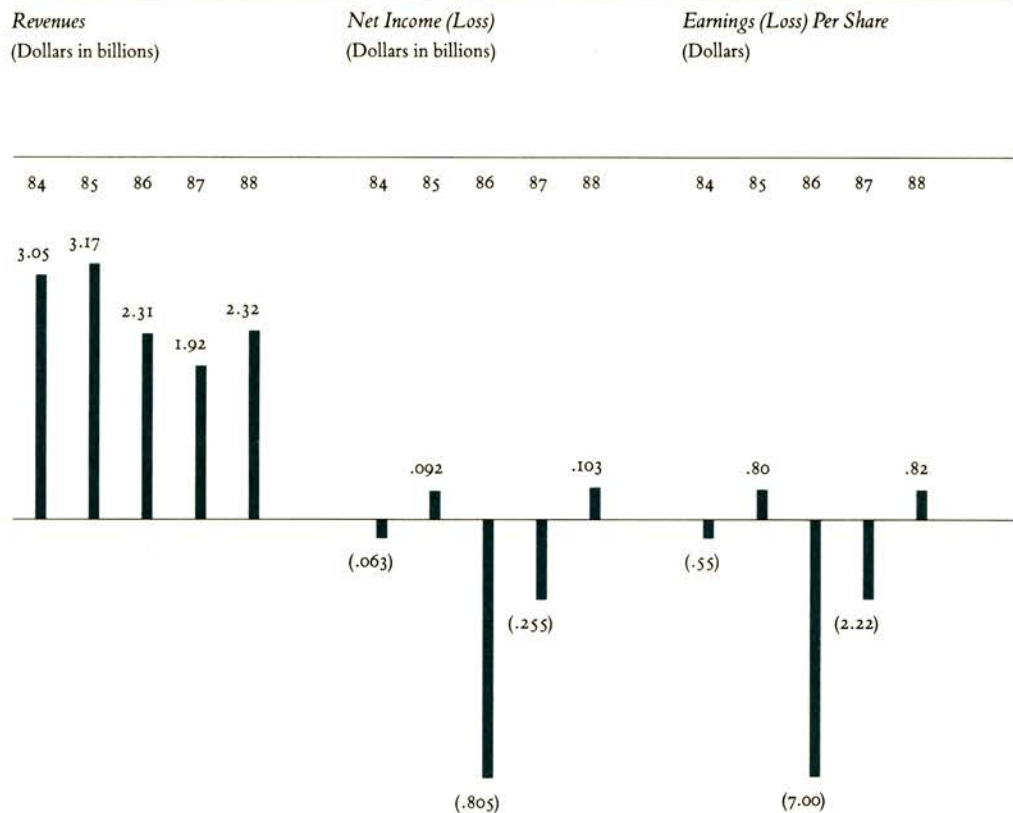
*The heart of the
Metallurgist-XR is
a large mercuric
iodide detector crystal,
grown by a proprie-
tary process at Ramsey
Technology's Texas
Nuclear Unit.*

THE COMPANY'S OPERATIONS were profitable throughout the entire fiscal year demonstrating the effectiveness of combining Baker and Hughes. Although original expectations were to achieve profitability in mid year 1988, by "getting into the black" two quarters early, we were able to achieve pretax operational profit (excluding net unusual credits and pension gains) of \$81 million in fiscal 1988, a significant turnaround from 1987.

Revenues for the year were \$2.32 billion, 20.4% higher than in 1987. There was some improvement in non U.S. oil field activity and mining and process revenues grew with general economic improvement. Pretax income (including unusual credits, pension gains and minority interest) was \$130.6 million, contrasted to the \$268.9 million pretax loss in fiscal 1987. Earnings per share were \$.82 compared to a \$2.22 loss last year.

The significant improvement is attributable principally to the consolidation savings accomplished by combining the two companies, enhanced by slight oil field activity increases outside the U.S., improved activity in the U.S. Gulf of Mexico, higher precious metal and base metal prices which increased our process equipment sales and profits, slight price improvement in our products and services and market share gains.

Cost of sales, services and rentals was \$1.54 billion, up 11% from last year, improving as a percent of revenues, however, to 66.5% from 72.4% in 1987.

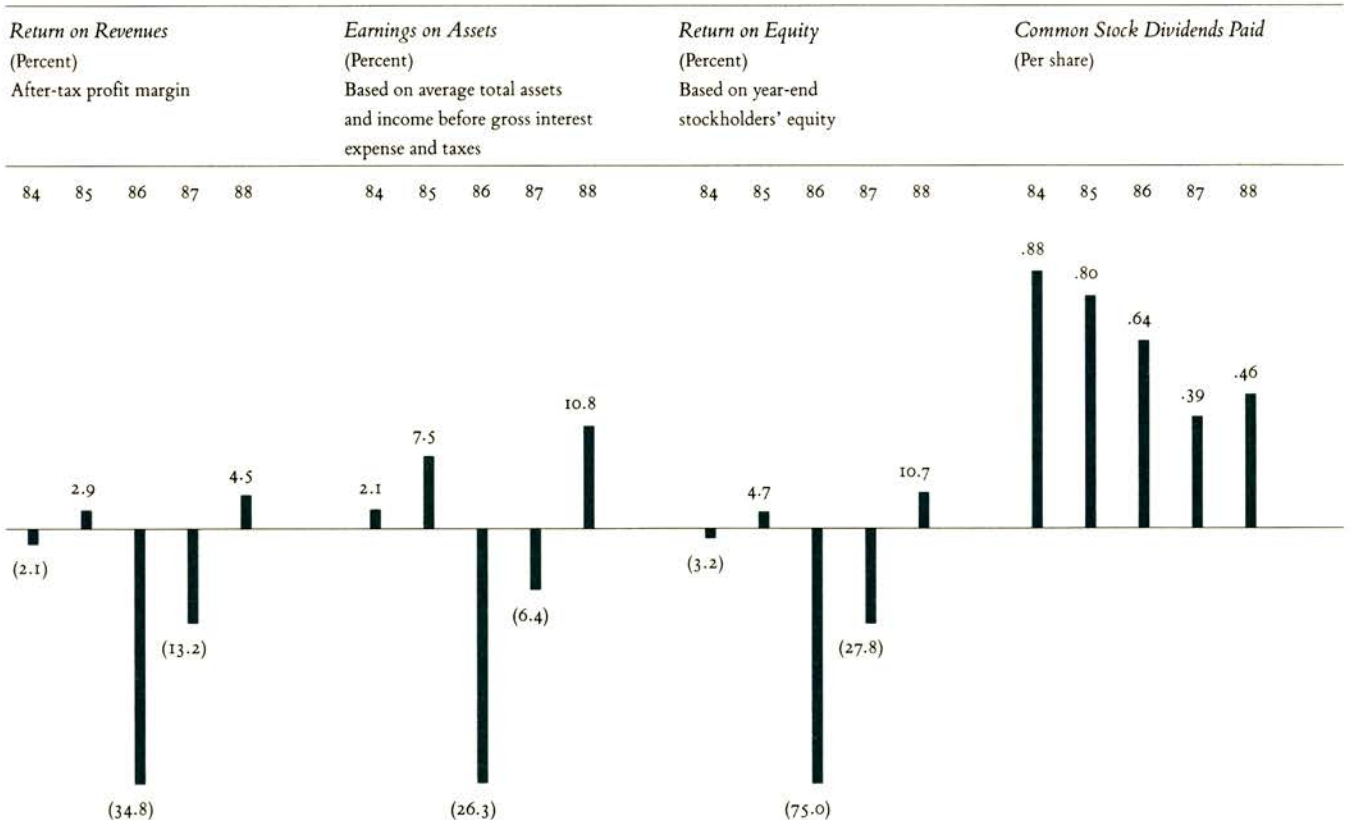


Marketing and field service expense rose 5.7% to \$424.1 million but also declined as a percent of revenues from 20.9% to 18.3%, further enhancing the profit margin.

General and administrative expense grew 6% above 1987 levels to \$209.5 million, and also declined from 10.2% of revenues to 9%.

Interest expense-net declined to \$61.5 million from 1987. A reduction in outstanding debt and interest earned on the patent infringement settlement proceeds were the principal causes of the reduction. Total debt declined from \$540.6 million to \$487.9 million during the year.

Net unusual credits of \$47.5 million resulted from the settlement of two patent infringement lawsuits offset by unusual charges. Smith International, Inc. settled with the Company for \$95 million, principally in cash, and Dresser Industries, Inc. settled for \$23 million in cash and their minority interest ownership in B-J Titan. The value of the B-J Titan interest brought the settlement to \$55 million. Offsetting these credits were charges to operations of \$102.7 million resulting from the Company's determination that certain of its assets had been permanently impaired due to changes in market conditions and operating strategies and that disposal of certain product lines and continued consolidation of geographic operations was necessary.



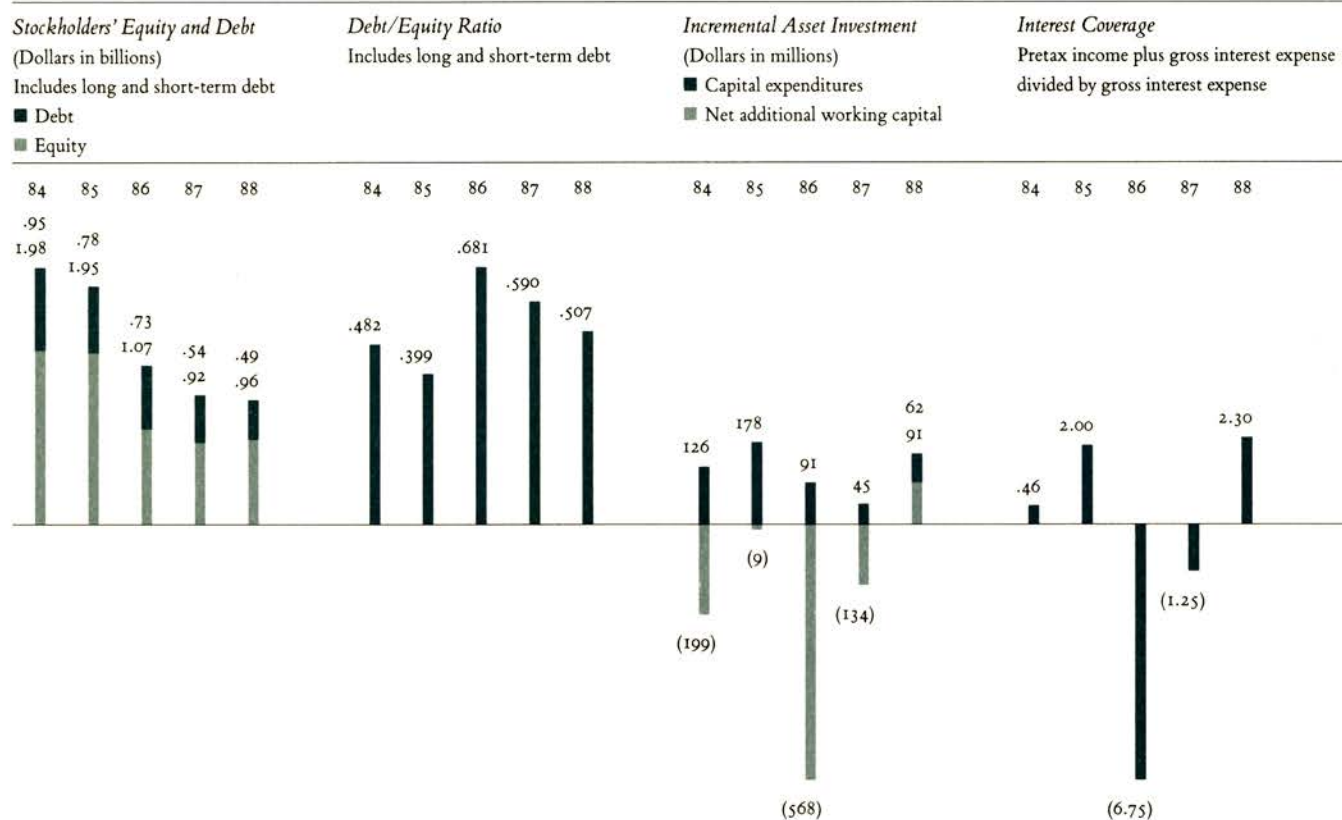
Capital Resources and Liquidity

During fiscal 1988 operational profitability, further balance sheet liquidation, asset sales and the cash portion of the patent litigation settlements provided positive cash flow in excess of dividend requirements. At year end the Company had cash and cash equivalents of \$67.8 million. As the total debt declined and earnings rose, interest coverage increased to 2.3.

Capital expenditures for the year were \$62.0 million, principally in rental equipment and modern production equipment. Cash dividends on common stock amounted to \$54.3 million and on preferred stock, \$7.0 million. The current ratio at year end was 1.97.

Organizational Review

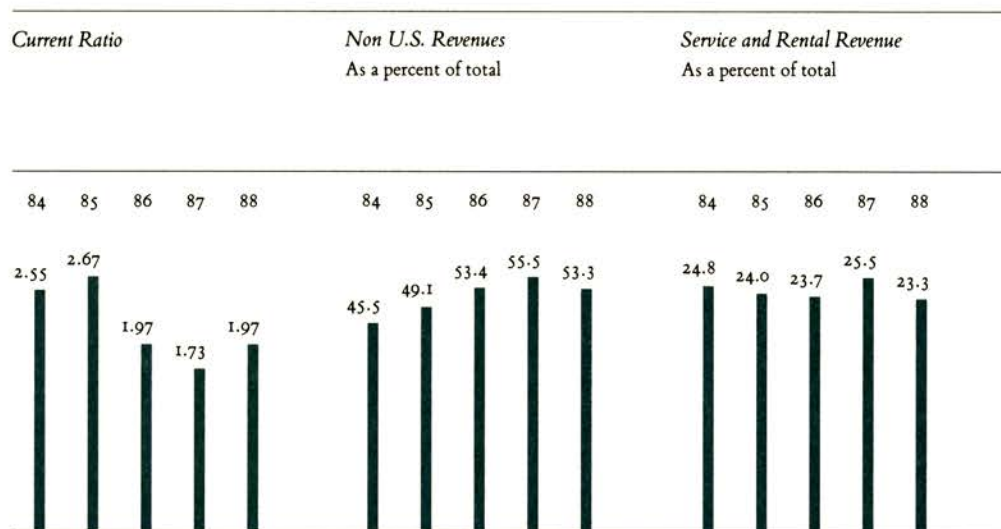
During the year several organizational changes were effected to strengthen the Company's position in its markets. The Baker Hughes Mining Equipment Group was divided into its two components, Baker Hughes Process Equipment Group, headed by Stephen T. Harcrow, and Baker Hughes Mining Equipment Group, headed by Carl W. Schrock. The Process Equipment Group, made up of divisions which service not only mining processes but other industries as well, is headquartered in Houston, Texas. The Mining Equipment Group, made up of underground mining equipment divisions, is headquartered in Meadowlands, Pennsylvania.



In the oil and gas businesses several new division presidents were named, including Joseph Brady at Centrilift, Andrew Szescila at Baker Service Tools and Chris Monauni at Baker CAC. Andrew Schmitt was named Vice President, General Manager of Tri-State Oil Tools. Shortly after fiscal year-end, a new division was formed, Baker Hughes Drilling Systems, to address the growing high technology drilling market. R. Patrick Herbert was named president. Also subsequent to year-end, the company announced the intention to retain B-J Titan and B-J Services as offers received were considered to be below the operations' value. J. William Stewart continues as president of these divisions.

Outlook

We continue to be optimistic about the long range opportunities for Baker Hughes, even as we experience volatile short-term oil prices. In the U.S., natural gas is beginning to demonstrate "shrinkage of the bubble," and worldwide drilling for oil and gas is sufficient for the Company to be profitable at levels above our dividend rate. Additionally, high precious metal and base metal prices should continue to stimulate our process businesses. It seems clear that the Company is positioned to weather the short-term storms and benefit from the long-term need to find and produce more energy resources.



The management of Baker Hughes Incorporated is responsible for the preparation and integrity of the accompanying consolidated financial statements and all other information contained in this Annual Report. The consolidated financial statements have been prepared in conformity with generally accepted accounting principles and include amounts that are based on management's informed judgments and estimates.

In fulfilling its responsibilities for the integrity of financial information, management maintains and relies on the Company's system of internal control. This system includes written policies, an organizational structure providing division of responsibilities, the selection and training of qualified personnel and a program of financial and operational reviews by a professional staff of corporate auditors and the independent public accountants. The system is designed to provide reasonable assurance that assets are safeguarded, transactions are executed in accordance with management's authorization and accounting records are reliable as a basis for the preparation of the consolidated financial statements. Management believes that, as of September 30, 1988, the Company's internal control system provides reasonable assurance that material errors or irregularities will be prevented or detected within a timely period and is cost effective.

Management recognizes its responsibility for fostering a strong ethical climate so that the Company's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the Company's Code of Ethical Conduct which is distributed throughout the Company. Management maintains a systematic program to assess compliance with the policies included in the code.

The Board of Directors, through its Audit/Ethics Committee composed solely of non-employee directors, reviews the Company's financial reporting, accounting and ethical practices. The Audit/Ethics Committee recommends to the Board of Directors the selection of independent public accountants and reviews their fee arrangements. It meets periodically with the independent public accountants, management and the corporate auditors to review the work of each and the propriety of the discharge of their responsibilities. The independent public accountants and the corporate auditors have full and free access to the Audit/Ethics Committee, without management present, to discuss auditing and financial reporting matters.



James D. Woods
President and Chief
Executive Officer



Max L. Lukens
Senior Vice President and
Chief Financial Officer



G. S. Finley
Controller

Stockholders of Baker Hughes Incorporated:

We have audited the consolidated statements of financial position of Baker Hughes Incorporated and its subsidiaries as of September 30, 1988 and 1987 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Baker Hughes Incorporated and its subsidiaries at September 30, 1988 and 1987 and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1988 in conformity with generally accepted accounting principles.

As discussed in Note 11 to the consolidated financial statements, in 1987 the Company changed its method of accounting for pension costs.

Deloitte Haskins & Sells

Houston, Texas
November 16, 1988

Consolidated Statements of Operations

(In thousands of dollars, except per share amounts)				
Years ended September 30,		1988	1987	1986
<i>Revenues:</i>	Sales	\$1,775,346	\$1,432,138	\$1,764,085
	Services and rentals	<u>540,805</u>	<u>491,460</u>	<u>548,593</u>
	Total	<u>2,316,151</u>	<u>1,923,598</u>	<u>2,312,678</u>
<i>Costs and Expenses:</i>	Cost of sales, services and rentals	1,540,078	1,392,280	1,665,891
	Marketing and field service	424,102	401,171	492,646
	General and administrative	209,522	197,147	234,131
	Interest expense—net	61,462	77,161	95,757
	Pension gains—net (Note 11)	(6,000)	(76,765)	
	Unusual charges (credits)—net (Note 4)	(47,475)		919,198
	Combination and divestiture costs (Note 4)		140,000	
	Loss in Vetco Gray Inc. (Note 3)		<u>68,223</u>	<u>11,670</u>
	Total	<u>2,181,689</u>	<u>2,199,217</u>	<u>3,419,293</u>
<i>Income:</i>	Income (loss) before income taxes, minority interest and extraordinary items	134,462	(275,619)	(1,106,615)
	Income taxes (Note 9)	<u>71,235</u>	<u>(14,100)</u>	<u>(144,494)</u>
	Income (loss) before minority interest and extraordinary items	63,227	(261,519)	(962,121)
	Minority interest in (income) loss of subsidiaries	<u>(3,836)</u>	<u>6,697</u>	<u>68,916</u>
	Income (loss) before extraordinary items	<u>59,391</u>	<u>(254,822)</u>	<u>(893,205)</u>
	Extraordinary Items:			
	Reduction of income taxes arising from carryforward of prior years' U.S. operating losses (Note 9)	43,856		
	Gain on pension reversion (Note 11)			96,923
	Loss on early extinguishment of debt (Note 5)			<u>(8,315)</u>
	Net extraordinary gain	<u>43,856</u>		<u>88,608</u>
	Net income (loss)	<u>\$ 103,247</u>	<u>\$ (254,822)</u>	<u>\$ (804,597)</u>
	Income (Loss) Per Share of Common Stock (Note 2):			
	Income (loss) before extraordinary items	\$.45	\$ (2.22)	\$ (7.77)
	Extraordinary items	<u>.37</u>		<u>.77</u>
	Net income (loss)	<u>\$.82</u>	<u>\$ (2.22)</u>	<u>\$ (7.00)</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Financial Position

(In thousands of dollars)
September 30,

1988

1987

Assets:

Current Assets:

Cash and short-term investments, at cost, which approximates market value

\$ 67,823 \$ 11,361

Receivables — less allowance for doubtful accounts:

1988, \$44,557; 1987, \$46,695 480,815 474,405

Inventories (Note 2):

Finished goods 417,304 418,725

Work in process 79,367 80,848

Raw materials 120,996 165,479

Total inventories 617,667 665,052

Prepaid expenses and deferred income taxes (Note 9)

36,000 33,439

Total current assets 1,202,305 1,184,257

Property (Note 2):

Land 52,591 53,176

Buildings 330,848 355,264

Machinery and equipment 1,117,002 1,188,279

Rental tools and equipment 331,203 341,144

Total property 1,831,644 1,937,863

Accumulated depreciation (1,183,856) (1,200,761)

Property — net 647,788 737,102

Other Assets (Note 2):

Property held for disposal 78,658 88,301

Investments, including investments in unconsolidated subsidiaries 41,911 36,197

Long-term notes receivable 55,600 39,623

Other assets 39,795 63,986

Excess costs arising from acquisitions — less accumulated amortization: 1988, \$10,080; 1987, \$8,068 51,469 39,166

Total other assets 267,433 267,273

Total \$2,117,526 \$2,188,632

See Notes to Consolidated Financial Statements

(In thousands of dollars)
September 30,

1988

1987

Liabilities:

Current Liabilities:

Accounts payable—trade	\$ 217,892	\$ 214,759
Short-term borrowings (Note 6)	37,463	46,791
Current portion of long-term debt (Note 6)	10,384	33,056
Accrued employee compensation and benefits	115,727	124,991
Income taxes (Note 9)	35,785	20,191
Accruals relating to combination and divestiture and unusual charges (Note 4)	27,802	74,810
Taxes other than income	24,160	28,424
Accrued insurance	37,798	39,312
Accrued interest	22,579	28,963
Other accrued liabilities	80,581	72,205
Total current liabilities	<u>610,171</u>	<u>683,502</u>
Long-term debt (Note 6)	<u>440,007</u>	<u>460,767</u>
Deferred income taxes (Note 9)	<u>73,373</u>	<u>73,407</u>
Other long-term liabilities	<u>21,485</u>	<u>28,350</u>
Minority interest	<u>11,002</u>	<u>27,086</u>

Stockholders' Equity:

Stockholders' Equity (Notes 2, 3, 6, 7, 8 and 12):

Preferred stock, \$1 par value, authorized 15,000,000 shares; issued: 2,000,000 shares of \$3.50 convertible exchangeable preferred stock, \$1 par value \$50 liquidation preference per share	2,000	2,000
Common stock, \$1 par value (authorized 400,000,000 shares; outstanding 118,419,000 shares in 1988, and 117,490,000 shares in 1987)	118,419	117,490
Capital in excess of par value	895,758	883,941
Retained earnings (deficit)	28,761	(13,226)
Cumulative foreign currency translation adjustment	(83,450)	(74,685)
Total stockholders' equity	<u>961,488</u>	<u>915,520</u>
Total	<u>\$2,117,526</u>	<u>\$2,188,632</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Stockholders' Equity

(In thousands of dollars) For the three years ended September 30, 1988	\$3.50 Convertible Exchangeable Preferred Stock (\$1 Par Value)	Common Stock (\$1 Par Value)	Capital In Excess of Par Value	Retained Earnings (Deficit)	Cumulative Foreign Currency Translation Adjustment	Total
Balance, September 30, 1985		\$114,641	\$761,319	\$1,144,007	\$(72,145)	\$1,947,822
Net loss				(804,597)		(804,597)
Cash dividends on common stock (\$.64 per share)				(73,766)		(73,766)
Foreign currency translation adjustment					1,109	1,109
Other		638	3,754	(2,811)		1,581
Balance, September 30, 1986		115,279	765,073	262,833	(71,036)	1,072,149
Net loss				(254,822)		(254,822)
Cash and accrued dividends on \$3.50 convertible exchangeable preferred stock (\$1.14 per share)				(2,275)		(2,275)
Cash dividends on common stock (\$.39 per share)				(45,836)		(45,836)
Issuance of \$3.50 convertible exchangeable preferred stock	\$2,000		95,400			97,400
Adjustment to conform fiscal year of Hughes Tool Company (Note 1)				26,874		26,874
Foreign currency translation adjustment					(3,649)	(3,649)
Other		2,211	23,468			25,679
Balance, September 30, 1987	2,000	117,490	883,941	(13,226)	(74,685)	915,520
Net income				103,247		103,247
Cash dividends on \$3.50 convertible exchangeable preferred stock (\$3.50 per share)				(7,000)		(7,000)
Cash dividends on common stock (\$.46 per share)				(54,260)		(54,260)
Foreign currency translation adjustment					(8,765)	(8,765)
Other		929	11,817			12,746
Balance, September 30, 1988	<u>\$2,000</u>	<u>\$118,419</u>	<u>\$895,758</u>	<u>\$ 28,761</u>	<u>\$(83,450)</u>	<u>\$ 961,488</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

(In thousands of dollars)				
Years ended September 30,		1988	1987	1986
<i>Cash Flows From Operating Activities:</i>	Net income (loss)	\$ 103,247	\$(254,822)	\$(804,597)
	Adjustments to reconcile net income to net cash provided from operating activities:			
	Depreciation and amortization of:			
	Property	102,615	128,728	183,609
	Debt discount and other assets	19,563	17,990	15,135
	Unusual charges and combination and divestiture costs	102,682	140,000	919,198
	Deferred pension items	(3,715)	14,436	3,300
	Minority interest	3,836	(6,697)	(68,916)
	(Gain) loss on disposal of assets	3,721	(2,114)	(2,425)
	Non-cash proceeds from settlements of litigation	(42,100)		
	Loss in Vetco Gray, Inc.		68,223	11,670
	Change in receivables	(9,159)	29,569	284,868
	Change in accounts payable-trade	(1,614)	8,317	(77,230)
	Change in inventories	12,277	53,095	125,842
	Changes in other current assets and liabilities	(66,238)	(86,328)	(28,877)
	Changes in other noncurrent assets and liabilities	(82,057)	(24,265)	(392,857)
	Foreign currency translation loss	6,876	2,271	1,500
	Net cash flows from operating activities	<u>149,934</u>	<u>88,403</u>	<u>170,220</u>
<i>Cash Flows From Investing Activities:</i>	Property additions	(62,048)	(45,298)	(90,641)
	Proceeds from disposal of assets	79,979	63,282	75,344
	Acquisitions of businesses, net of cash acquired	(2,772)	(34,979)	(25,894)
	Net cash flows from investing activities	<u>15,159</u>	<u>(16,995)</u>	<u>(41,191)</u>
<i>Cash Flows From Financing Activities:</i>	Proceeds from borrowings	96,529	79,433	249,488
	Reduction of borrowings	(149,662)	(268,237)	(297,274)
	Proceeds from issuance of preferred stock		97,400	
	Proceeds from exercise of stock options and stock purchase grants	9,346	16,056	5,902
	Purchase of Baker Hughes common stock			(1,524)
	Dividends on common and preferred stock	(61,260)	(47,294)	(73,766)
	Net cash flows from financing activities	<u>(105,047)</u>	<u>(122,642)</u>	<u>(117,174)</u>
	Adjustment to conform fiscal year of Hughes Tool Company		26,874	
	Effect of exchange rate changes on cash	(3,584)	(8,142)	(3,188)
	Increase (decrease) in cash and short-term investments	56,462	(32,502)	8,667
	Cash and short-term investments, beginning of year	11,361	43,863	35,196
	Cash and short-term investments, end of year	<u>\$ 67,823</u>	<u>\$ 11,361</u>	<u>\$ 43,863</u>

See Notes to Consolidated Financial Statements

1. Basis of Presentation:

On April 3, 1987, Baker International Corporation ("Baker") and Hughes Tool Company ("Hughes") consummated the combination of the companies (the "Combination"), forming Baker Hughes Incorporated. Baker Hughes Incorporated and its majority owned subsidiaries and partnerships (the "Company") serve the worldwide petroleum and mining industries by providing products and services utilized in the exploration, extraction, recovery and processing of, oil and gas and minerals.

The Combination was accounted for as a pooling-of-interests and, accordingly, the consolidated financial statements for years prior to the Combination have been prepared on a basis that includes the accounts of Baker and Hughes. Information concerning common stock, employee stock plans, and per share data has been restated on an equivalent share basis. Consolidated financial statements for the year ended September 30, 1986 include Baker's fiscal year amounts and Hughes' calendar year amounts. Accordingly, Hughes' results of operations for the quarter ended December 31, 1986, adjusted for the pension transaction described below, were reflected in both the 1987 and 1986 consolidated statements of operations. Summarized information concerning the duplicated quarter is as follows: revenues \$165,050,000, loss before income taxes \$32,685,000 and net loss \$24,083,000. In addition, Hughes' dividends of \$2,791,000 for the quarter ended December 31, 1986, are reflected in both the 1987 and 1986 consolidated statements of stockholders' equity.

The following is a reconciliation of revenues and net income of Baker and Hughes (adjusted for the Vetco Gray Inc. deconsolidation discussed below) for the year ended September 30, 1986 (in thousands of dollars):

Revenues:	
Baker (as previously reported)	\$1,557,211
Hughes (year ended December 31)	755,467
Combined	<u>\$2,312,678</u>
Net Loss:	
Baker (as previously reported)	\$ (272,987)
Hughes (year ended December 31)	(475,849)
Pension adjustment	(55,761)
Combined	<u>\$ (804,597)</u>

In December 1986, Hughes received cash of approximately \$77,997,000 and recognized a gain of \$55,761,000 resulting from the termination of certain employee benefit plans. The gain was determined on a basis of accounting that differed from Baker's pension accounting practices. In order to conform the accounting for pensions in the Company's financial statements, and because this transaction would have been a fiscal 1987 item if not for the pooling-of-interests, Hughes' 1986 financial statement amounts were adjusted to eliminate the accounting entries related to the pension termination. The pension termination transaction was included in the Company's fiscal 1987 financial statements. There were no other material adjustments required to conform the accounting practices of the two companies. Certain amounts were reclassified in the financial statements to conform reporting practices.

2. Summary of Significant Accounting Policies: *Principles of consolidation:* The consolidated financial statements include the accounts of Baker Hughes Incorporated and all majority-owned subsidiaries and partnerships. All significant inter-company accounts and transactions have been eliminated in consolidation.

Income (loss) per share: Income (loss) per share amounts are based on the weighted average number of shares outstanding during the respective years (117,919,000 in 1988, 115,791,000 in 1987, 114,921,000 in 1986) and excludes in 1988 the negligible dilutive effect of shares issuable in connection with employee stock plans. Income (loss) per share is adjusted for the cash and accrued dividends on preferred stock.

Inventories: Inventories are stated primarily at the lower of average cost or market.

Property: Property is stated principally at cost less accumulated depreciation, which is generally provided by using the straight-line method over the estimated useful lives of individual items (see Note 4). The Company manufactures a substantial portion of its rental tools and equipment, and the cost of these items represents direct and indirect manufacturing costs.

Property held for disposal: Property held for disposal is stated at the lower of cost or estimated net realizable value.

Excess costs arising from acquisitions: Excess costs arising from acquisitions of businesses are amortized on the straight-line method over the lesser of expected useful life or forty years. During 1986, the Company wrote off a substantial portion of its excess costs (see Note 4).

Foreign currency translation: Gains and losses resulting from balance sheet translation of foreign operations where a foreign currency is the functional currency are included as a separate component of stockholders' equity. Gains and losses resulting from balance sheet translation of foreign operations where the U.S. dollar is the functional currency are included in the consolidated statements of operations.

Statement of cash flows: The accompanying consolidated statements of cash flows are reported in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, which was issued in November 1987. The Company adopted the provisions of the Statement in 1988 and restated previously reported consolidated statements of changes in financial position for 1987 and 1986. For the purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

3. Acquisitions and Dispositions:

In the fourth quarter of fiscal 1986, the Company acquired from Combustion Engineering, Inc. ("C-E") the Vetco Gray Group, a worldwide supplier of drilling equipment and systems for off-shore oil and gas exploration and production and completion equipment and systems for well control during land based drilling and production activities. The Vetco Gray Group was part of a subsidiary, Vetco Gray Inc., ("V-G") of which the Company owned 80.1% of the common stock and to which the Company contributed its Hughes Offshore operations. In exchange for the Vetco Gray Group, C-E received 19.9% of V-G's common stock valued at \$15,267,000; 2,955,878 shares of V-G's redeemable preferred stock valued at \$147,794,000 and \$110,000,000 from bank borrowings made by V-G and a subsidiary of V-G.

During the fourth quarter of fiscal 1987, the Company evaluated its investment in V-G and determined that V-G did not fit into the Company's long-term strategic plan. This decision was based, in part, on the occurrence of events subsequent to the acquisition of V-G. The Company advised C-E that it had no intention of funding the future operations of V-G, nor was it required to do so under the stockholder agreement between C-E, V-G and the Company.

As a result of these factors, the Company determined that its control over the financial and operating activities of V-G was temporary and that the consolidation of V-G was no longer appropriate. Accordingly, the consolidated financial statements for fiscal year 1986 were restated to deconsolidate V-G and to account for the Company's investment in V-G at cost. The Company provided for impairment of its investment in V-G through its proportionate share of losses sustained by V-G through September 30, 1987. As a result, the restatement had no effect on previously reported net income or stockholders' equity of the Company. On September 30, 1987, the Company wrote off its remaining investment in V-G and recognized estimated liabilities of \$3,000,000 related to the disposition of its interest in V-G.

As previously reported, the Company had entered into negotiations with FMC Corporation ("FMC") for the combination of certain of FMC's businesses with V-G. In December 1987, these negotiations were terminated.

In June 1988, the Company sold, with no significant effect on the consolidated financial statements, 87.5% of its 80.1% common stock interest in V-G to Bain Venture Capital. At September 30, 1988, the Company remains contingently liable for certain bank notes issued by V-G amounting to \$16,280,000. These bank notes may be reduced by payments by V-G or through the sale of certain assets of V-G and its subsidiaries pledged to the banks. In addition, the Company is contingently liable for \$2,800,000 of performance bond letters of credit made by the Company on behalf of V-G. The Company does not expect the ultimate resolution of these contingencies to have a significant effect on the Company's financial position or results of operations.

The V-G common stock held by C-E is exchangeable, through warrants, for 1,147,000 shares of the Company's common stock commencing on the later of October 1, 1991 or the date on which at least one share of V-G's preferred stock has been redeemed. The Company has options to purchase any shares of its common stock issued pursuant to the warrants and the V-G common stock held by C-E.

In November 1985, the Company contributed certain of its U.S. drilling fluids net assets, amounting to \$57,000,000, to a partnership, which the Company controls.

During each of the three years in the period ended September 30, 1988, the Company acquired and disposed of several other businesses, none of which, individually or in the aggregate, had a material effect in any of the periods presented on the Company's financial position or results of operations.

4. *Combination and Divestiture Costs; Unusual Charges (Credits)—net:*

In 1988, the Company recognized \$47,475,000 of net unusual credits consisting of the following items:

Patent infringement settlement credits	\$150,157,000
Impairment of assets	(36,300,000)
Operational restructurings	(36,800,000)
Disposal of product lines	(20,800,000)
Other	(8,782,000)
Net unusual credits	<u>\$ 47,475,000</u>

During 1988, the Company settled two patent infringement lawsuits against Smith International, Inc. ("Smith") and Dresser Industries, Inc. ("Dresser"). In December of fiscal 1988, the Company received \$89,750,000 in cash and a \$10,000,000 note (bearing interest at the prime rate of the Chase Manhattan Bank plus 1.5% per annum) from Smith. Of the proceeds, \$95,000,000 has been recorded as an unusual credit and \$4,750,000 has been recorded as interest income in

accordance with the terms of the settlement agreement. In July 1988, the Company received from Dresser \$23,000,000 in cash and Dresser's 27.7% interest in B-J Titan Services Company Partnership of which the Company owned the remaining 72.3%. Accordingly, an unusual credit of \$55,157,000 has been recorded in the fourth quarter of fiscal 1988. As a result, excess costs arising from acquisitions increased \$15,794,000.

During 1988, the Company determined that certain of its assets had been permanently impaired due to changes in market conditions and operating strategies and that disposal of certain product lines and the continued consolidation of geographic operations was necessary. Accordingly, the Company recognized charges to operations totalling \$102,682,000. Of these charges, \$30,300,000 relates to the impairment of assets of part of the Company's pumping services operations in Latin America. \$26,200,000 relates to the writedown of mining equipment inventory and a provision for consolidation of certain businesses, which result from the strategic restructuring of the Company's mining equipment operations and was recorded in the fourth quarter of fiscal 1988.

In connection with the Combination discussed in Note 1, the Department of Justice required the Company to divest Baker's oilfield tricone drilling bit and electric submersible pump businesses (the "Business Units"). In the quarter ended March 31, 1987, the Company entered into agreements to sell the Business Units and recognized a loss of \$48,000,000 on the divestiture. In addition, the Company performed a review of its combined inventories, facilities and workforce levels to identify redundancies resulting from the Combination and recognized a charge to operations of \$92,000,000 attributable principally to consolidation of production facilities and staff reductions.

During the fiscal year ended September 30, 1986, the Company, in response to falling oil prices and the resultant decline in the level of activity in worldwide oil and gas markets, reviewed in detail its asset and workforce levels. The likelihood of continued depressed market conditions led the Company to take a series of actions designed to enhance its ability to operate in the rapidly changed market environment. Such actions included the scaling down of capacity of certain of its manufacturing plants and the planned disposal of certain property, plant and equipment, which was written down to estimated net realizable value. Several of the Company's product lines were streamlined, sold or discontinued, and assets related to these lines were written down to estimated net realizable value. Inventories were written down to better reflect current and anticipated market conditions. Compensation accruals were established for severance and early retirement based on significant workforce reductions. Additionally, the Company wrote off substantially all of the excess costs arising from prior acquisitions (including those related to mining operations) and established additional reserves for accounts receivable to reflect current industry conditions. The financial impact of the actions described above, substantially all of which were of a noncash nature, amounted to an unusual charge of \$919,198,000 (\$744,925,000 or \$6.48 per share, after income taxes and minority interest), as follows:

Property, plant and equipment (including property held for disposal)	\$429,945,000
Excess costs arising from acquisitions	81,057,000
Inventories	241,003,000
Leased facilities and equipment	23,332,000
Accounts receivable	25,280,000
Accrued compensation	22,006,000
Minority interest portion of unusual charge	57,955,000
Other	38,620,000
	<u>\$919,198,000</u>

5. *Extraordinary Loss on Early Extinguishment of Debt:*

In July 1986, the Company retired \$30,352,000 (net of discount) of its Zero Coupon Guaranteed Notes due in 1992 ("the Notes") and replaced them with debt with a substantially lower effective interest rate (see Note 6). The premium paid to retire the Notes resulted in an extraordinary loss of \$8,315,000.

There is no income tax effect on the loss described above due to the Company's net operating loss carryforward position attributable to the unusual charge described in Note 4.

6. *Indebtedness:*

Long-term debt at September 30, 1988 and 1987 consisted of the following:

(In thousands of dollars)	1988	1987
Commercial paper		\$ 4,475
Zero Coupon Guaranteed Notes due 1992 with an effective interest rate of 14.48%, net of unamortized discount of \$37,616 (\$49,026 in 1987)	\$ 61,419	57,695
6.00% Debentures due 2002 with an effective interest rate of 14.66%, net of unamortized discount of \$113,910 (\$116,573 in 1987)	111,090	108,427
4.125% Swiss Franc 200 million Bonds due 1996 (principal and interest payments hedged through a currency swap at an effective interest rate of 7.82%)	103,177	102,503
9% Debentures due November 1, 2008	36,459	47,375
9.5% Convertible Subordinated Debentures due December 15, 2006 convertible into common stock at \$58.91 per share	99,171	99,125
Convertible Subordinated Debentures due through 1994 with an interest rate at September 30, 1988 of prime on \$1,308 and LIBOR + 5/8% on \$9,724 (see Note 8)	11,032	9,711
Other indebtedness with an average interest rate of 8.9% at September 30, 1988	17,659	31,456
Total long-term debt	<u>\$440,007</u>	<u>\$460,767</u>

At September 30, 1988, the Company's principal U.S. bank credit agreements provide for borrowings of up to \$100,000,000 as revolving credit with a maturity date of April 6, 1990. The rate of interest on borrowings under these arrangements is, at the Company's option, the prime rate or 1/2% in excess of the London Interbank Offered Rate (LIBOR) for U.S. dollar deposits or 5/8% in excess of the Domestic Certificate of Deposit Rate. At September 30, 1988, there were no borrowings outstanding under these agreements. The provisions of the revolving credit agreements require a commitment fee of 1/4% per annum on the unused portion.

Additional bank lines of credit at September 30, 1988 include the following:

- \$81,000,000 as revolving credit which bears interest at 1/2% over LIBOR, has no requirement for compensating balances and is repayable in 1990. A commitment fee is payable at a rate of 1/8% per annum on the unused portion. At September 30, 1988, there were no borrowings outstanding under this agreement.
- \$67,500,000 of short-term money market lines of credit available on an as-offered basis. There are no requirements for commitment fees or compensating balances in connection with these agreements. At September 30, 1988, there were no borrowings outstanding under these agreements.

The Company maintains, at all times, unused committed bank lines of credit at least equal to the principal amount of its outstanding commercial paper and money market borrowings. Accordingly, outstanding commercial paper and money market borrowings have been classified as long-term debt in the accompanying consolidated financial statements.

Redemption of the Zero Coupon Notes due 1992 and the 6% Debentures due 2002 may be made at the option of the Company, in whole or in part, at any time at par plus accrued interest. Furthermore, the Zero Coupon Notes due 1992 may be redeemed prior to maturity at prices (expressed as a percentage of principal amount) of 57.16% at September 30, 1988 and scaling upward over time to 86.95% (in each case together with accrued amortization of original issue discount) in the event of certain changes affecting United States or Netherlands Antilles taxation.

The 9% Debentures due November 1, 2008 have a \$2,400,000 per annum sinking fund requirement beginning November 1, 1989 and may be redeemed by paying a premium which decreases proportionally from 4.8% at November 1, 1988 until it is eliminated in 2003. The 9.5% Debentures due December 15, 2006 have a \$5,000,000 per annum sinking fund requirement beginning December 15, 1992 and may be redeemed by paying a premium which decreases proportionally from 3.45% at December 15, 1988 until it is eliminated in 1992. Optional payments, not to exceed the amounts of the mandatory sinking funds requirements, may be made in addition to the mandatory payments. During 1988, the Company repurchased \$11,060,000 of its 9% Debentures due 2008 and \$7,685,000 principal amount of its Zero Coupon Guaranteed Notes due 1992. The net gain on these transactions was not significant.

The provisions of the notes, debentures, bonds and unsecured credit agreements have an effect on the ability of the Company to, without prior written consent, among other things, incur borrowings, sell certain assets, pay cash dividends, acquire other businesses and purchase the Company's capital stock. At September 30, 1988, the Company could pay dividends and purchase the Company's common stock up to an amount not exceeding \$83,961,000.

At September 30, 1988, long-term debt was due in aggregate annual installments of \$10,384,000; \$4,489,000; \$3,027,000; \$64,254,000; and \$7,934,000 in each of the five years in the period ending September 30, 1993.

During 1988 and 1987, the maximum aggregate short-term borrowings outstanding at any month-end were \$62,396,000 and \$104,847,000, respectively; the average aggregate short-term borrowings outstanding based on quarter-end balances were \$47,110,000 and \$63,660,000, respectively; and the weighted average interest rates were 16.6% and 22.6%, respectively. The average interest rates on short-term borrowings outstanding at September 30, 1988 and 1987 were 15.5% and 17.6%, respectively. Throughout the year and at September 30, 1988, substantially all of the Company's short-term borrowings were outside of the United States and denominated in currencies other than the U.S. dollar. A significant portion of such borrowings were in high inflation rate countries in Latin America where such borrowings are incurred as a hedge of a net asset position.

*7. \$3.50 Convertible
Exchangeable
Preferred Stock:*

On June 1, 1987 the Company issued 2,000,000 shares of \$3.50 convertible exchangeable preferred stock (\$1.00 par value per share and \$50.00 liquidation preference per share). The preferred stock is convertible at the option of the holder at any time into the Company's common stock at a conversion price of \$25.50 per share (equivalent to a conversion rate of 1.96 shares of common stock for each share of preferred stock), subject to adjustment in certain events.

The preferred stock is not redeemable prior to May 15, 1990 unless the closing price of the common stock shall have equalled or exceeded 150% of the then effective conversion price for a specified period ending prior to the date notice of redemption is given. The preferred stock will otherwise be redeemable at the option of the Company, in whole or in part, at \$53.15 per share if redeemed prior to May 15, 1989, and at prices decreasing ratably annually to \$50.00 per share from and after May 15, 1997, in each case plus accrued dividends to the date fixed for redemption. Dividends on the preferred stock are cumulative at the rate of \$3.50 per share per annum from the date of original issuance. Such dividends are payable quarterly as declared by the Board of Directors.

Each share of the preferred stock is also exchangeable in whole, but not in part, at the option of the Company on any dividend payment date beginning May 15, 1989, for \$50.00 in principal amount of the Company's 7% Convertible Subordinated Debentures due 2007.

8. *Employee Stock Plans:* The Company has stock option plans which provide for granting of options for the purchase of common stock to officers and other key employees. Such stock options may be granted subject to terms ranging from one to ten years at a price equal to fair market value of the stock at the date of grant.

The stock option activity for the Company during 1988, 1987 and 1986 was as follows:

(In thousands)	1988	1987	1986
Number of shares			
Stock options outstanding, beginning of year	5,685	6,069	5,774
Changes during the year:			
Granted or assumed (per share):			
1988, \$11.75 to \$15.375	876		
1987, \$10.25 to \$20.30		1,078	
1986, \$13.75 to \$16.75			1,265
Exercised (per share):			
1988, \$10.25 to \$20.375	(423)		
1987, \$12.99 to \$25.78		(386)	
1986, \$11.09 to \$16.00			(165)
Exchanged (net)		(839)	
Expired	(1,669)	(237)	(805)
Stock options outstanding, end of year (per share: \$10.25 to \$54.03 at September 30, 1988)	<u>4,469</u>	<u>5,685</u>	<u>6,069</u>

At September 30, 1988, options were exercisable for 2,710,000 shares, and 5,624,000 shares were available for future option grants.

Additionally, the Company has a plan which provides for the sale of convertible debentures to certain officers and certain key employees. An aggregate of \$30,000,000 principal amount of debentures may be issued under the plan which are convertible into shares of common stock after one year. At September 30, 1988, a total of \$11,032,000 principal amount of debentures are outstanding and convertible into 935,000 shares of common stock at \$10.25 to \$21.88 per share.

On September 24, 1986, the Baker Board of Directors approved a program, subsequently approved by Baker stockholders prior to the Combination, pursuant to which employees actively working were granted the right to exchange certain of their stock options and convertible debentures for new options and debentures. The exchange program applies to outstanding stock options and debentures issued between October 1980 and June 1986. The program provides for a 3:2 exchange ratio for stock options and the shares which would have been issuable upon conversion of the debentures at a new price per share of \$10.25, the fair market value of the stock on the exchange date. As a result of employee participation in the exchange program, stock options outstanding were reduced by 839,000 shares; additionally, the outstanding debentures and common stock issuable upon conversion thereof were reduced by \$12,000,000 and 478,000 shares, respectively.

The Company also has two Employee Stock Purchase Plans (the "Plan") under which there remained authorized and available for sale to employees an aggregate of 1,246,000 shares of the Company's common stock. The maximum number of shares subject to each option under the Plan is determined on the date of grant and equals the sum of the payroll deductions authorized by each participating employee (up to 10 percent of regular pay) divided by 85 percent of the fair market value of a share of common stock at the date of grant. Based on the market price of common stock on the date of grant, the Company estimates that approximately 684,500 shares will be purchased under the Plan on July 31, 1989, at \$13.18 per share. Under the plan, 354,000, 711,000 and 455,000 shares were issued at \$13.18, \$7.86 and \$7.86 per share during 1988, 1987 and 1986, respectively.

9. *Income Taxes:*

The geographical sources of income (loss) before income taxes, minority interest and extraordinary items for the three years ended September 30, 1988 were as follows:

(In thousands of dollars)	1988	1987	1986
United States	\$111,160	\$(263,627)	\$ (980,012)
Foreign	23,302	(11,992)	(126,603)
Total income (loss) before income taxes, minority interest and extraordinary items	<u>\$134,462</u>	<u>\$(275,619)</u>	<u>\$(1,106,615)</u>

The provisions (credits) for income taxes for the three years ended September 30, 1988 are summarized as follows:

(In thousands of dollars)	1988	1987	1986
Currently payable (refundable):			
United States	\$ 3,412	\$ (3,524)	\$ 2,922
Foreign	23,713	12,032	20,414
Total currently payable	<u>27,125</u>	<u>8,508</u>	<u>23,336</u>
Deferred:			
United States	(2,695)		(156,747)
Foreign	2,949	(22,608)	(11,083)
Total deferred	<u>254</u>	<u>(22,608)</u>	<u>(167,830)</u>
Utilization of prior years' U.S. operating losses	43,856		
Total provision (credit) for income taxes	<u>\$71,235</u>	<u>\$(14,100)</u>	<u>\$(144,494)</u>

The consolidated effective income tax rates for the three years ended September 30, 1988 varied from the United States statutory income tax rate for the reasons set forth below:

% of Income (Loss) Before Taxes	1988	1987	1986
Statutory income tax rate	34.0	(43.0)	(46.0)
Goodwill write-off and amortization	.3		3.4
Effect of U.S. operating loss (before minority interest and extraordinary items) for which no carry-back or other benefit is recognizable		18.3	19.0
State taxes based on income — net of United States income tax benefit	.4	.1	
Foreign taxes in excess of U.S. tax rate on foreign earnings	18.4	6.0	7.2
United States investment tax credits (flow through method)			2.7
Loss in Vetco Gray Inc.		8.6	
Excise tax on pension reversion gain		1.6	.7
Other — net	(.1)	3.3	
Effective income tax rate	<u>53.0</u>	<u>(5.1)</u>	<u>(13.0)</u>

The sources and amounts of deferred taxes for the three years ended September 30, 1988 were as follows:

(In thousands of dollars)	1988	1987	1986
Reversal of deferred taxes due to net operating loss		\$ (2,874)	\$(159,209)
Depreciation expense	\$ (3,910)	(16,595)	8,199
Inventory valuations — net	491	1,378	(1,871)
Unusual charges	142	1,861	(9,831)
Other — net	3,531	(6,378)	(5,118)
Total deferred tax provision (credit)	<u>\$ 254</u>	<u>\$(22,608)</u>	<u>\$(167,830)</u>

In 1988, the Company utilized approximately \$128,988,000 of U.S. operating loss carryforwards for financial reporting purposes and the related tax benefit of \$43,856,000 has been reflected as an extraordinary credit in the accompanying consolidated statement of operations. At September 30, 1988, the Company had approximately \$360,416,000 of U.S. operating loss carryforwards remaining for financial reporting purposes, which expire in varying amounts between 2001 and 2002. For federal income tax purposes, the net operating loss carryforwards are approximately \$213,403,000, expiring in varying amounts between 2000 and 2002. In addition, the Company had a capital loss carryforward of approximately \$32,937,000, expiring in 1993.

At September 30, 1988, the Company had approximately \$12,558,000 in investment tax credits available to offset future payments of federal income taxes. The investment tax credits expire in varying amounts between 1993 and 2001. The Company had approximately \$25,666,000 of foreign tax credits available to offset future payments of federal income taxes at September 30, 1988. If not used, the foreign tax credits expire in varying amounts between 1990 and 1993. These tax credit carryforwards have not been recognized for financial reporting purposes.

The Company accrues United States income taxes on foreign earnings expected to be repatriated. If such earnings are not repatriated as planned, the taxes previously accrued are credited against the provision for United States income taxes on foreign earnings. Repatriation of all accumulated foreign earnings at September 30, 1988 would have resulted in no additional tax liability. In conjunction with the reversal of deferred tax credits in fiscal 1986 and considering the existence of the U.S. operating loss carryforwards, the Company reversed all previously accrued United States income taxes on unrepatriated foreign earnings.

10. Industry Segment and Geographic Information:

The Company operates principally in three industry segments, two of which provide equipment and services to the petroleum industry:

Drilling Products and Services: Manufacture and sale of equipment and provision of services used in the drilling of oil and gas wells.

Completion, Remedial and Production Products and Services: Manufacture and sale of equipment and provision of services used (after oil and gas wells are drilled) to achieve safety and long-term productivity, provide structural integrity to protect against pressure and corrosion damage and to stimulate or rework wells during their productive lives by chemical, mechanical or other stimulation means.

Mining Products: Manufacture and sale of equipment and provision of repair and other services for the mining and mineral processing industries.

In addition to the three industry segments described above, the Company manufactures and sells other equipment and provides services to industries not related to the petroleum or mining industries (included under "Other Industries" in the following tables).

The Company maintains worldwide manufacturing plants and service locations to serve these industry segments.

Summarized financial information concerning the industry segments and geographic areas in which the Company operated at September 30, 1988, 1987 and 1986 and for each of the years then ended is shown in the following tables:

(In thousands of dollars)	Drilling	Completion, Remedial and Production	Total Petroleum	Mining Industry	Other Industries	Elimi- nations	Total
<i>Operations by Industry Segment:</i>							
<i>1988</i>							
Revenues from unaffiliated customers:							
Sales	\$ 528,394	\$ 652,684	\$ 1,181,078	\$ 394,897	\$ 199,371		\$ 1,775,346
Services and rentals	152,165	364,369	516,534	19,775	4,496		540,805
Intersegment sales	8,249	1,070	9,319	14,372	76	\$(23,767)	
Total revenues	<u>\$ 688,808</u>	<u>\$ 1,018,123</u>	<u>\$ 1,706,931</u>	<u>\$ 429,044</u>	<u>\$ 203,943</u>	<u>\$(23,767)</u>	<u>\$ 2,316,151</u>
Operating income (loss)	<u>\$ 191,236</u>	<u>\$ 47,179</u>	<u>\$ 238,415</u>	<u>\$ (21,056)</u>	<u>\$ 5,003</u>		<u>\$ 222,362</u>
Identifiable assets	<u>\$ 649,520</u>	<u>\$ 851,678</u>	<u>\$ 1,501,198</u>	<u>\$ 306,406</u>	<u>\$ 112,196</u>	<u>\$ (7,439)</u>	<u>\$ 1,912,361</u>
Capital expenditures	<u>\$ 16,714</u>	<u>\$ 32,800</u>	<u>\$ 49,514</u>	<u>\$ 7,777</u>	<u>\$ 4,757</u>		<u>\$ 62,048</u>
Depreciation and amortization	<u>\$ 43,728</u>	<u>\$ 52,587</u>	<u>\$ 96,315</u>	<u>\$ 8,094</u>	<u>\$ 4,861</u>		<u>\$ 109,270</u>
<i>1987</i>							
Revenues from unaffiliated customers:							
Sales	\$ 406,700	\$ 508,021	\$ 914,721	\$ 345,533	\$ 171,884		\$ 1,432,138
Services and rentals	152,734	314,897	467,631	18,648	5,181		491,460
Intersegment sales	2,365	2,452	4,817	12,721	39	\$(17,577)	
Total revenues	<u>\$ 561,799</u>	<u>\$ 825,370</u>	<u>\$ 1,387,169</u>	<u>\$ 376,902</u>	<u>\$ 177,104</u>	<u>\$(17,577)</u>	<u>\$ 1,923,598</u>
Operating income (loss)	<u>\$ (40,903)</u>	<u>\$ (36,019)</u>	<u>\$ (76,922)</u>	<u>\$ (2,070)</u>	<u>\$ 5,686</u>	<u>\$ 2,930</u>	<u>\$ (70,376)</u>
Identifiable assets	<u>\$ 857,143</u>	<u>\$ 814,656</u>	<u>\$ 1,671,799</u>	<u>\$ 306,042</u>	<u>\$ 98,764</u>	<u>\$(18,270)</u>	<u>\$ 2,058,335</u>
Capital expenditures	<u>\$ 14,567</u>	<u>\$ 15,581</u>	<u>\$ 30,148</u>	<u>\$ 11,710</u>	<u>\$ 3,440</u>		<u>\$ 45,298</u>
Depreciation and amortization	<u>\$ 55,928</u>	<u>\$ 63,080</u>	<u>\$ 119,008</u>	<u>\$ 10,430</u>	<u>\$ 5,050</u>		<u>\$ 134,488</u>
<i>1986</i>							
Revenues from unaffiliated customers:							
Sales	\$ 549,067	\$ 716,198	\$ 1,265,265	\$ 322,313	\$ 176,507		\$ 1,764,085
Services and rentals	166,405	343,557	509,962	11,216	27,415		548,593
Intersegment sales	7,519	2,226	9,745	64	1,018	\$(10,827)	
Total revenues	<u>\$ 722,991</u>	<u>\$ 1,061,981</u>	<u>\$ 1,784,972</u>	<u>\$ 333,593</u>	<u>\$ 204,940</u>	<u>\$(10,827)</u>	<u>\$ 2,312,678</u>
Operating loss	<u>\$(486,438)</u>	<u>\$(437,261)</u>	<u>\$(923,699)</u>	<u>\$(18,296)</u>	<u>\$(8,729)</u>	<u>\$(1,335)</u>	<u>\$(952,059)</u>
Identifiable assets	<u>\$ 921,113</u>	<u>\$ 950,014</u>	<u>\$ 1,871,127</u>	<u>\$ 341,167</u>	<u>\$ 122,000</u>	<u>\$(3,642)</u>	<u>\$ 2,330,652</u>
Capital expenditures	<u>\$ 41,292</u>	<u>\$ 36,501</u>	<u>\$ 77,793</u>	<u>\$ 8,500</u>	<u>\$ 4,348</u>		<u>\$ 90,641</u>
Depreciation and amortization	<u>\$ 80,038</u>	<u>\$ 94,131</u>	<u>\$ 174,169</u>	<u>\$ 10,584</u>	<u>\$ 4,617</u>		<u>\$ 189,370</u>

(In thousands of dollars)	Western Hemisphere		Eastern Hemisphere		Eliminations	Total
	United States	Other	Europe	Other		
<i>Operations by Geographic Area:</i>						
<i>1988</i>						
Revenues from unaffiliated customers:						
Sales	\$ 954,939	\$ 313,169	\$ 271,279	\$ 235,959		\$ 1,775,346
Services and rentals	306,875	80,806	81,876	71,248		540,805
Transfer between geographic areas	91,903	18,984	15,268	12,710	\$(138,865)	
Total revenues	<u>\$ 1,353,717</u>	<u>\$ 412,959</u>	<u>\$ 368,423</u>	<u>\$ 319,917</u>	<u>\$(138,865)</u>	<u>\$ 2,316,151</u>
Operating income (loss)	<u>\$ 186,314</u>	<u>\$ (5,606)</u>	<u>\$ 27,894</u>	<u>\$ 13,760</u>		<u>\$ 222,362</u>
Identifiable assets	<u>\$ 1,092,423</u>	<u>\$ 392,217</u>	<u>\$ 306,261</u>	<u>\$ 221,788</u>	<u>\$(100,328)</u>	<u>\$ 1,912,361</u>
Export sales of U.S. companies		<u>\$ 45,495</u>	<u>\$ 34,795</u>	<u>\$ 99,131</u>		<u>\$ 179,421</u>
<i>1987</i>						
Revenues from unaffiliated customers:						
Sales	\$ 757,617	\$ 247,417	\$ 237,802	\$ 189,302		\$ 1,432,138
Services and rentals	283,293	74,697	67,482	65,988		491,460
Transfer between geographic areas	65,801	12,687	20,457	14,585	\$(113,530)	
Total revenues	<u>\$ 1,106,711</u>	<u>\$ 334,801</u>	<u>\$ 325,741</u>	<u>\$ 269,875</u>	<u>\$(113,530)</u>	<u>\$ 1,923,598</u>
Operating income (loss)	<u>\$ (77,861)</u>	<u>\$ 7,174</u>	<u>\$ (3,574)</u>	<u>\$ 955</u>	<u>\$ 2,930</u>	<u>\$ (70,376)</u>
Identifiable assets	<u>\$ 1,176,109</u>	<u>\$ 465,050</u>	<u>\$ 326,063</u>	<u>\$ 222,801</u>	<u>\$(131,688)</u>	<u>\$ 2,058,335</u>
Export sales of U.S. companies		<u>\$ 49,500</u>	<u>\$ 25,159</u>	<u>\$ 110,016</u>		<u>\$ 184,675</u>
<i>1986</i>						
Revenues from unaffiliated customers:						
Sales	\$ 985,762	\$ 278,752	\$ 316,776	\$ 182,795		\$ 1,764,085
Services and rentals	328,034	64,990	68,515	87,054		548,593
Transfer between geographic areas	131,948	6,662	11,215	17,175	\$(167,000)	
Total revenues	<u>\$ 1,445,744</u>	<u>\$ 350,404</u>	<u>\$ 396,506</u>	<u>\$ 287,024</u>	<u>\$(167,000)</u>	<u>\$ 2,312,678</u>
Operating loss	<u>\$ (848,174)</u>	<u>\$ (22,797)</u>	<u>\$ (38,275)</u>	<u>\$ (41,478)</u>	<u>\$ (1,335)</u>	<u>\$ (952,059)</u>
Identifiable assets	<u>\$ 1,383,611</u>	<u>\$ 479,677</u>	<u>\$ 330,035</u>	<u>\$ 224,864</u>	<u>\$ (87,535)</u>	<u>\$ 2,330,652</u>
Export sales of U.S. companies		<u>\$ 76,635</u>	<u>\$ 23,443</u>	<u>\$ 135,688</u>		<u>\$ 235,766</u>

Intersegment sales and transfers between geographic areas are priced at the estimated fair value of the products or services negotiated between the selling and receiving units. Operating income (loss) is total revenues less costs and expenses (including combination and divestiture costs and unusual charges (credits) - net) but before deduction of general corporate expenses, loss in Vetco Gray Inc., and net interest expense of \$87,900,000, \$205,243,000 and \$154,556,000 in 1988, 1987 and 1986, respectively and excluding extraordinary items in 1988 and 1986. Identifiable assets are those assets that are used by the Company's operations in each industry segment or are identified with the Company's operations in each geographic area. Corporate assets consist principally of cash, receivables, prepaid expenses, leasehold improvements, office furniture, assets held for disposal and intangible assets which amount to \$205,165,000, \$130,297,000 and \$180,402,000 at September 30, 1988, 1987 and 1986, respectively.

11. Employee Benefit Plans:

The Company and its subsidiaries have several noncontributory defined benefit pension plans covering various domestic and foreign employees. Additionally, virtually all domestic employees not covered under one of the Company's pension plans are eligible to participate in the Company sponsored Thrift Plan.

Effective October 1, 1986, the Company adopted Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions for its domestic defined benefit plans. Accordingly, the method of determining pension cost beginning in 1987 is not comparable with the prior year. The effect of this change was to decrease pension cost in 1987 by \$2,066,000. Pension expense for these plans was \$3,000,000, \$3,429,000 and \$14,881,000 for 1988, 1987 and

1986, respectively. The 1986 pension expense includes \$4,772,000 relating to an early retirement option offered to eligible employees over 55 years of age who were participants in terminated plans. Generally, the Company makes annual contributions to the plans to the extent they are tax deductible in that year and, at a minimum, the amount necessary to meet ERISA's minimum funding requirements.

During 1988 and 1987, the Company settled and curtailed certain defined benefit pension plans resulting in net gains of \$6,000,000 and \$76,765,000, respectively, determined in accordance with Statement of Financial Accounting Standards No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. Substantially all of these gains would not have been recognized under the previous method of accounting for pension cost. During 1986, the Company terminated two of its major nonunion defined benefit pension plans which resulted in a \$96,923,000 gain. This gain was determined in accordance with APB Opinion No. 8 and, accordingly, is presented as an extraordinary item. In connection with the termination of these nonunion plans in 1986, all active employees in each plan became fully vested upon termination and were offered either a transfer of the current value of their benefit to the Company's Thrift Plan or the purchase of an annuity contract. The transfers to the Thrift Plan totalled \$35,872,000, and the present value of annuity contracts purchased totalled \$82,340,000.

The net domestic pension expense for 1988 and 1987 included the following components (in thousands of dollars):

	1988	1987
Service cost—benefits earned during the period	\$ 1,435	\$ 2,929
Interest cost on projected benefit obligation	3,588	3,030
Actual return on assets	455	(4,254)
Net amortization and deferral	(2,478)	1,724
Net pension expense	<u>\$ 3,000</u>	<u>\$ 3,429</u>

Assumptions used in the accounting for the defined benefit pension plans were:

	1988	1987
Discount rate	9.5%	8.5%
Rates of increase in compensation levels	5.0%	5.0%
Expected long-term rate of return on assets	9.0%	9.0%

The following table sets forth the domestic plans' funded status and amounts recognized in the Company's balance sheet at September 30, 1988 and 1987 (in thousands of dollars).

	1988		1987	
	Overfunded Plans	Underfunded Plans	Overfunded Plans	Underfunded Plans
Actuarial present value of benefit obligations:				
Vested benefit obligation	<u>\$ 5,762</u>	<u>\$ 13,370</u>	<u>\$ 10,652</u>	<u>\$ 11,780</u>
Accumulated benefit obligation	<u>\$ 5,783</u>	<u>\$ 14,595</u>	<u>\$ 11,323</u>	<u>\$ 15,480</u>
Projected benefit obligation	\$ 5,783	\$ 17,447	\$ 12,783	\$ 32,386
Plan assets at fair value	<u>9,922</u>	<u>10,312</u>	<u>19,283</u>	<u>11,798</u>
Projected benefit obligation (in excess of) less than plan assets	4,139	(7,135)	6,500	(20,588)
Unrecognized prior service cost	13	207		164
Unrecognized net (gain) loss	(2,647)	638	(3,178)	(436)
Unrecognized net (asset) liability at transition	<u>2,084</u>	<u>(1,272)</u>	<u>(3,168)</u>	<u>2,188</u>
Prepaid pension cost (pension liability) recognized in the balance sheet	<u>\$ 3,589</u>	<u>\$ (7,562)</u>	<u>\$ 154</u>	<u>\$ (18,672)</u>

Pension plan assets are primarily mortgages, private placements, bonds and common stocks.

The Company's retirement plans for foreign employees are not required to report under ERISA and the Company has not determined the actuarial value of accumulated plan benefits as calculated and discussed above.

The Company's Thrift Plan allows eligible employees to elect to contribute from 2% to 10% of their salaries to an investment trust. Employee contributions are matched by the Company at the rate of \$.50 per \$1.00 up to 6% of the employee's salary. In addition, beginning on January 1, 1987, the Company began contributing for all eligible employees between 2% and 5% of their salary depending on the employee's age as of January 1 each year. Company contributions become fully vested to the employee after five years of employment, or if employed less than five years, at the close of the second plan year after the year in which contributions are made. Supplemental employee contributions are allowed. The Company's contributions to the Thrift Plan and the Savings Plan amounted to \$14,746,000, \$8,853,000 and \$5,597,000 in 1988, 1987 and 1986, respectively.

The Company also provides certain health care (primarily in the U.S.) and life insurance benefits for retired employees. Substantially all employees may become eligible for these benefits if they reach normal retirement age while working for the Company. Costs related to benefits provided for retired employees are expensed as incurred, and for 1988, 1987 and 1986 totalled \$4,585,000, \$5,838,000 and \$3,418,000, respectively.

12. Stockholder Rights Agreement and Other Matters:

On March 23, 1988, the Company adopted a Stockholder Rights Agreement to protect against coercive takeover tactics. Pursuant to the Agreement, on May 6, 1988, the Company distributed to its stockholders one Right for each outstanding share of common stock. Each Right entitles the holder to purchase from the Company .01 of a share of the Series One Junior Participating Preferred Stock and, under certain circumstances, securities of the Company or an acquiring entity at 1/2 market value. The Rights are exercisable only if a person or group either acquires 20% or more of the Company's outstanding common stock or makes a tender offer for 30% or more of the Company's common stock.

The Rights may be redeemed by the Company at a price of \$.03 per Right at any time prior to a person or group acquiring 20% or more of the Company's common stock. The Rights will expire on March 23, 1998.

Supplemental income statement information is as follows:

(In thousands of dollars)			
Years ended September 30,	1988	1987	1986
Maintenance and repairs	\$66,655	\$56,008	\$70,230
Operating leases (generally transportation equipment and warehouse facilities)	41,965	57,160	73,450
Research and development	26,065	29,572	38,337
Taxes other than payroll and income tax	29,782	29,629	37,620
Income taxes paid (refunded)	14,180	(4,990)	(7,240)
Interest paid	65,875	75,190	87,158
Net foreign exchange translation losses	6,876	2,271	1,500

At September 30, 1988, the Company had long-term operating leases covering certain facilities and equipment on which minimum annual rental commitments for each of the five years in the period ending September 30, 1993 were \$37,192,000, \$29,692,000, \$22,392,000, \$15,247,000 and \$12,181,000, respectively, and \$86,882,000 in the aggregate thereafter. The Company has not entered into any significant capital leases.

13. Commitments and Contingencies:

At September 30, 1988, there were no contingencies, claims or lawsuits against the Company, which in the opinion of management, could have a significant effect on its financial position or results of operations.

**Management's Discussion and Analysis of Financial Condition
and Results of Operations**

*Fiscal 1988 Compared
to Fiscal 1987*

Revenues in fiscal 1988 were \$2.3 billion, an increase of 20.4% from fiscal 1987. The increase was primarily attributable to an increase in demand for the Company's oilfield products and services. This increase in demand is related to increased worldwide drilling activity, driven primarily by an increase in U.S. offshore and natural gas drilling. The increased demand has also contributed to the firming of prices for the Company's oilfield products and services. Also contributing to the improvement in revenues was an increase in revenues in the Company's mining business segment, which is reflective of strengthening in several of the markets served by this segment and the weakness of the U.S. dollar as compared to the prior year. The Company's foreign revenues accounted for 53.3% of revenues in 1988, compared to 55.5% in 1987.

Cost of sales, services and rentals increased 10.6% to \$1.5 billion from the 1987 level. The increase is directly attributable to the increase in revenues, however, the rate of increase is substantially lower than the increase in revenues and is reflective of cost containment and consolidation programs as well as the increases of the prices of the Company's products and services.

Marketing and field service expense and general and administrative expense increased 5.7% and 6.3% from 1987, respectively. The increase is substantially lower than the increases in sales due to cost containment and consolidation programs discussed above. General and administrative expense includes gains and losses resulting from the translation of foreign currencies. The Company incurred net foreign exchange translation losses of \$6.9 million and \$2.3 million in fiscal years 1988 and 1987, respectively. The Company expects that foreign exchange losses will remain at this level or increase slightly in the future.

During 1988, the Company recorded unusual credits-net of \$47.5 million. This amount includes credits of \$95 million and \$55.2 million for the patent infringement settlements from Smith International, Inc. and Dresser Industries, Inc., respectively (see Note 4 of Notes to Consolidated Financial Statements). In addition, the unusual credits-net include charges to operations totalling \$102,682,000 resulting from the Company's determination that certain of its assets had been permanently impaired due to changes in market conditions and operating strategies and that disposal of certain product lines and continued consolidation of geographic operations was necessary (see Note 4 of Notes to Consolidated Financial Statements). Of the unusual charge, \$37,807,000 relating primarily to the restructuring of the Company's mining equipment group was recorded in the fourth quarter of fiscal 1988.

Net interest expense was \$61.5 million in fiscal 1988, a decrease of \$15.7 million, or 20.3% from 1987. This decrease is attributable to the interest income earned on the proceeds received from the patent infringement settlements discussed above and a reduction in the amount of outstanding debt.

On an operational basis, income for the year (income before income taxes, minority interest, net unusual credits, and net pension gains) was \$81.0 million compared to an operational loss of \$144.2 million in fiscal 1987.

During fiscal 1988, the Company recorded an extraordinary item of \$43.9 million relating to the reduction of income taxes arising from the carryforward of prior years' U.S. operating losses (see Note 9 of Notes to Consolidated Financial Statements).

The Company anticipates adopting Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, in fiscal 1990 without restatement of prior years. Under this

standard, the provisions of enacted tax laws are applied to the assets and liabilities of the Company to measure the amount of taxes payable or refundable currently or in future years as a result of all events that have been recognized in the financial statements. Due to the Company's operating loss carryforwards from prior years, the Company does not anticipate that the new method of income tax accounting will have a significant effect on its consolidated financial statements.

Capital Generation and Liquidity: Total debt outstanding as of September 30, 1988 was \$487.9 million, a decrease of \$52.8 million, from September 30, 1987. This decrease is primarily due to the repurchase of long-term debt (see Note 6 of Notes to Consolidated Financial Statements) and a reduction of short-term borrowings. The debt to equity ratio at September 30, 1988 was .507 compared to .590 at September 30, 1987. The debt less cash and short-term investments to equity ratio was .437 at September 30, 1988 as compared to .578 at September 30, 1987.

The Company has \$181.0 million of committed bank credit lines as well as \$67,500,000 of short-term money market lines of credit. There were no borrowings against these agreements as of September 30, 1988.

In fiscal 1988, capital expenditures were \$62.0 million compared to \$45.3 million in fiscal year 1987. The ratio of capital expenditures to depreciation increased to 60.5% in fiscal 1988 as compared to 35.2% in fiscal 1987. The Company expects this reinvestment ratio to continue to increase over the next year. Funds provided from operations and outstanding lines of credit are expected to be more than adequate to meet future capital expenditure requirements.

Working capital at September 30, 1988 was \$592.1 million, an increase of \$91.4 million from September 30, 1987. In the Company's opinion, the current ratio of 1.97 indicates an acceptable level of liquidity.

Fiscal 1987 Compared to Fiscal 1986

Revenues in fiscal 1987 were \$1.9 billion, a decrease of 16.8% from fiscal 1986. Through the first three quarters of fiscal 1987, the Company's worldwide oilfield markets continued to be adversely affected by declining drilling activity, excess manufacturing capacity, instability in the price of crude oil and price pressure on products and services. In the fourth fiscal quarter of 1987, the Company's worldwide oilfield markets reflected improvement resulting in an increase in revenues, 14.7% from the third fiscal quarter, due to significant increases in drilling activity, primarily attributable to an average domestic rig count of 1,001 in the fourth fiscal quarter compared to an average domestic rig count of 830 in the first three fiscal quarters. In addition, the price of crude oil stabilized in the fourth fiscal quarter to approximately \$18 to \$20 per barrel. Both of these changes resulted in a softening of the price pressure on the Company's oilfield products and services. The overall decrease in oilfield revenues for fiscal year 1987 was partially offset by an increase in non-U.S. mining revenues. Foreign revenues for the Company's combined oilfield and mining markets accounted for 55.5% of revenues in 1987, compared to 53.4% in 1986. The increase in foreign revenues is attributable to the increase in non-U.S. mining revenues offset in the fourth fiscal quarter by the increase in domestic oilfield revenues.

Cost of sales, services and rentals decreased 16.4% to \$1.4 billion from the 1986 level of \$1.7 billion. The decrease was at a rate comparable to the decrease in revenues due to cost containment programs. In the 1987 fourth fiscal quarter, cost of sales, services and rentals increased 9.0% from the third fiscal quarter on the 14.7% fourth fiscal quarter revenue increase discussed

above. This cost increase is at a rate substantially less than the increase in revenues and is attributable to an improvement in the prices of the Company's products and services and continuing cost containment programs.

Marketing and field service expense and general and administrative expense continued to decrease significantly in fiscal 1987, 17.7%, from the fiscal 1986 total of \$726.8 million. The decreases were attributable to cost containment programs and continued consolidation and restructuring of both oilfield and mining divisions. Marketing and field service expense decreased 18.6% to \$401.2 million from \$492.6 million in fiscal 1986. In the fourth fiscal quarter of 1987, gross profit (revenues less cost of sales, services and rentals and marketing and field service expense) increased 67.3% from the third fiscal quarter as a result of the 14.7% increase in revenues and continuing cost containment programs. General and administrative expense decreased 15.8% to \$197.1 million from the 1986 level of \$234.1 million. General and administrative expense includes net foreign exchange gains and losses resulting from the translation of foreign currencies. The Company incurred net foreign exchange losses of \$2.3 million and \$1.5 million in fiscal years 1987 and 1986, respectively.

In fiscal 1987, the Company adopted Statements of Financial Accounting Standards Nos. 87 and 88, Employers' Accounting for Pensions and Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, respectively. The Company settled three defined benefit pension plans through the purchase of nonparticipating annuity contracts, which resulted in a \$76.8 million gain (see Note 11 of Notes to Consolidated Financial Statements).

During fiscal 1987, the Company charged to operations combination and divestiture costs of \$140.0 million. This charge reflects the loss on the Company's divestiture of several business units required by the Department of Justice and expected costs to consolidate facilities, write-off excess equipment and reduce the workforce as a result of the combination (see Note 4 of Notes to Consolidated Financial Statements). In the comparable 1986 period, the Company recorded an unusual charge to operations of \$919.2 million (\$744.9 million or \$6.48 per share, after income taxes and minority interest), which resulted from the Company's review of its asset and workforce levels in view of continued depressed worldwide oil and gas markets. Substantially all of the unusual charge was non-cash in nature.

During the fourth quarter of fiscal 1987, the Company evaluated its investment in Vetco Gray Inc. ("V-G") and determined that V-G no longer fits into the Company's long-term strategic plan. As a result of this evaluation, the Company believed that its control over the financial and operating activities of V-G was temporary and that the consolidation of V-G was no longer appropriate. Accordingly, the consolidated financial statements for fiscal year 1986 were restated to deconsolidate V-G and to account for the Company's investment in V-G at cost. The restatement had no effect on previously reported net income or stockholders' equity of the Company. The Company provided for impairment of its investment in V-G through its proportionate share of losses sustained by V-G through September 30, 1987. On September 30, 1987, the Company wrote off its remaining investment in V-G and recognized estimated liabilities of \$3 million related to the disposition of its interest in V-G (see Note 3 of Notes to Consolidated Financial Statements).

Net interest expense decreased 19.4% in fiscal 1987 to \$77.2 million from \$95.8 million in fiscal 1986. The decrease was primarily due to a decline in average debt outstanding and a decrease in interest rate levels on the Company's floating rate debt.

On an operational basis, the loss for the year (loss before income taxes and minority interest and excluding the loss in V-G, combination and divestiture costs, unusual charges and the pension reversion gain) was \$144.2 million compared to an operational loss of \$175.7 million in fiscal 1986. For the fourth fiscal quarter of 1987, the operational loss was \$13.3 million compared to an operational loss of \$33.0 million in the third fiscal quarter.

The income tax benefit for fiscal 1987 is less than fiscal 1986 because the latter amount includes the reversal of U.S. net deferred tax credits, as a result of existence of U.S. net operating loss carryforwards. The Company remains in a U.S. net operating loss position. Therefore, the Company does not anticipate that the 1986 Tax Reform Act will have a significant effect on its results of operations in fiscal 1988.

Capital Generation and Liquidity: On June 1, 1987 the Company issued 2,000,000 shares of \$3.50 convertible exchangeable preferred stock, \$1 par value (see Note 7 of Notes to Consolidated Financial Statements). The \$97.4 million net proceeds from the issuance were used to retire debt. During the year the Company called for redemption at par of \$100 million of its 14.25% Notes due December 15, 1988 and repurchased in the open market a total of \$38.2 million of outstanding 9% debentures. The gain resulting from early extinguishment of this debt was not significant. The debt to equity ratio at September 30, 1987 was .590 compared to .681 at September 30, 1986.

During fiscal 1987, the Company entered into two new revolving credit agreements with its principal U.S. and foreign banks of \$100 million and \$81 million, respectively. There were no borrowings against these agreements as of September 30, 1987.

In fiscal 1987, capital expenditures were \$45.3 million compared to \$90.6 million in fiscal 1986. The ratio of capital expenditures to depreciation decreased to 35.2% in fiscal 1987 as compared to 49.4% in fiscal 1986. The Company has continued to spend substantially less than the level of depreciation since the combination (see Notes 1 and 4 of Notes to Consolidated Financial Statements) due to restructuring of existing capacity and because a significant portion of its capacity is relatively new.

Working capital at September 30, 1987 was \$500.8 million, a decrease of \$134.1 million since September 30, 1986. In the Company's opinion, the current ratio of 1.73 indicates an acceptable level of liquidity.

On June 5, 1987 the Company reached an agreement with Smith International, Inc. regarding the settlement of the patent infringement suit outstanding between the companies, whereby the Company was to receive \$95 million plus interest at 10% per annum from July 1, 1987 until payment was received. Cash of \$89,750,000 and a \$10,000,000 note was received in December 1987 (see Note 4 of Notes to Consolidated Financial Statements).

Condensed Comparative Consolidated Financial Information*

(In thousands of dollars except per share amounts)	1988	1987	1986	1985	1984
<i>Summary of Operations:</i>					
Total revenues	<u>\$2,316,151</u>	<u>\$1,923,598</u>	<u>\$2,312,678</u>	<u>\$3,165,244</u>	<u>\$3,049,439</u>
Costs and expenses:					
Costs and expenses applicable to revenues	1,964,180	1,793,451	2,158,537	2,610,503	2,515,109
General and administrative	209,522	197,147	234,131	293,833	270,922
Interest expense — net	61,462	77,161	95,757	119,457	166,657
Loss in Vetco Gray Inc.		68,223	11,670		
Unusual charges (credits) — net	(47,475)		919,198		198,300
Combination and divestiture costs		140,000			
Pension gains — net	<u>(6,000)</u>	<u>(76,765)</u>			
Total costs and expenses	<u>2,181,689</u>	<u>2,199,217</u>	<u>3,419,293</u>	<u>3,023,793</u>	<u>3,150,988</u>
Income (loss) before income taxes, minority interest and extraordinary items	134,462	(275,619)	(1,106,615)	141,451	(101,549)
Income taxes	<u>71,235</u>	<u>(14,100)</u>	<u>(144,494)</u>	<u>52,304</u>	<u>(38,335)</u>
Income (loss) before minority interest and extraordinary items	63,227	(261,519)	(962,121)	89,147	(63,214)
Minority interest in (income) loss of subsidiaries	<u>(3,836)</u>	<u>6,697</u>	<u>68,916</u>	<u>2,683</u>	
Income (loss) before extraordinary items	59,391	(254,822)	(893,205)	91,830	(63,214)
Extraordinary items — net	<u>43,856</u>		<u>88,608</u>		
Net income (loss)	<u>\$ 103,247</u>	<u>\$ (254,822)</u>	<u>\$ (804,597)</u>	<u>\$ 91,830</u>	<u>\$ (63,214)</u>
Net income (loss) per share	<u>\$.82</u>	<u>\$ (2.22)</u>	<u>\$ (7.00)</u>	<u>\$.80</u>	<u>\$ (.55)</u>
Dividends per share of common stock	<u>\$.46</u>	<u>\$.39</u>	<u>\$.64</u>	<u>\$.80</u>	<u>\$.88</u>
<i>Financial Position:</i>					
Cash and short-term investments	\$ 67,823	\$ 11,361	\$ 43,863	\$ 35,196	\$ 71,716
Working capital	\$ 592,134	\$ 500,755	\$ 634,818	\$ 1,202,391	\$ 1,211,090
Total assets	\$ 2,117,526	\$ 2,188,632	\$ 2,511,054	\$ 3,765,269	\$ 3,869,554
Long-term debt	\$ 440,007	\$ 460,767	\$ 638,557	\$ 669,008	\$ 791,239
Stockholders' equity	\$ 961,488	\$ 915,520	\$ 1,072,149	\$ 1,947,822	\$ 1,975,074

*See Note 1 of Notes to Consolidated Financial Statements for basis of presentation.

Corporate Organization

Baker Hughes Drilling Equipment
Howard I. Bull, President

Baker Hughes Production Tools
Joel V. Staff, President

Baker Hughes Process Equipment
Stephen T. Harcrow, President

Baker Hughes Mining Equipment
Carl W. Schrock, President

Divisions

Hughes Tool Company
Houston, Texas
Dale E. Boyer, President

Milpark Drilling Fluids
Houston, Texas
Thomas W. Cason, President

Tri-State Oil Tools
Bossier City, Louisiana
Andrew R. Schmitt, Vice President and General Manager

EXLOG, Inc.
Houston, Texas
John F. Lauletta, President

Baker Hughes Tubular Services
Houston, Texas
David L. Daniel, President

Baker Hughes Drilling Systems
Houston, Texas
R. Patrick Herbert, President

Divisions

Baker Oil Tools
Houston, Texas
Gerald M. Hage, President

Baker Service Tools
Houston, Texas
Andrew J. Szescila, President

Baker Sand Control
Houston, Texas
A. G. Avant, President

Baker Performance Chemicals
Houston, Texas
M. Glen Bassett, President

Baker CAC
Houston, Texas
Chris K. Monauni, President

Centrilift
Claremore, Oklahoma
Joseph F. Brady, President

Develco
San Jose, California
L. H. Rorden, President

Divisions

BGA International
Salt Lake City, Utah
Edward de Boer, President

Ramsey Technology, Inc.
St. Paul, Minnesota
Donald L. Babbitt, President

Chas. S. Lewis
St. Louis, Missouri
William M. Stuart, President

EIMCO Process Equipment
Salt Lake City, Utah
Raymond H. Aldrich, President

WEMCO
Egham, England
James E. Furman, President

Baker Hughes Mining Tools
Grand Prairie, Texas
John A. Alich, Jr., President

Divisions

EIMCO Australia
Sydney, Australia
Christopher Waller, Managing Director

EIMCO Mining Machinery
Fairmont, West Virginia
Larry G. Marteney, President

EIMCO Great Britain
Gateshead, England
A. Ian Smith, Managing Director

EIMCO Jarvis Clark
Burlington, Canada
William S. Price, President

EIMCO Mining Machinery (Pty) Ltd.
Johannesburg, South Africa
Gordon Paterson, Managing Director

EIMCO Secoma
Lyon, France
Gerard Bruere-Dawson, President

B-J Titan Services and B-J Services International
Houston, Texas
J. Wm. Stewart, President

Corporate Organization

Officers

James D. Woods
President and Chief
Executive Officer

Howard I. Bull
Senior Vice President and
President of Baker Hughes
Drilling Equipment

Max L. Lukens
Senior Vice President and
Chief Financial Officer

Joel V. Staff
Senior Vice President and
President of Baker Hughes
Production Tools

Isaac C. Kerridge, Jr.
Vice President

Eric L. Mattson
Vice President and Treasurer

Franklin Myers
Vice President, Secretary
and General Counsel

Phillip A. Rice
Vice President, Human
Resources

Ronald G. Turner
Vice President

G. S. Finley
Controller

Board of Directors

Gordon M. Anderson
Executive Vice President
and Chief Operating
Officer of Santa Fe
International
(Oil Service)

*Jack S. Blanton**
President of Eddy
Refining Company
(Petroleum Products)

Richard M. Bressler
Chairman of the Board,
President and Chief
Executive Officer of
Burlington Northern Inc.
(Transportation & Natural
Resources)

*Harry M. Conger**
Chairman of the Board and
Chief Executive Officer
of Homestake Mining
Company (Precious Metals
Mining)

Dan M. Krause
President of The
Krause Company
(Private Investments)

*Kenneth L. Lay**
Chairman and Chief
Executive Officer of Enron
Corp. (Diversified Energy)

*John F. Maher**
President and Chief
Operating Officer of Great
Western Financial
Corporation
(Financial Services)

Henry F. LeMieux
Former Chairman of the
Board and Chief Executive
Officer of Raymond
International, Inc.
(Construction)

David D. Lybarger
Petroleum Consultant

Robert H. Quenon
President and Chief
Executive Officer of
Peabody Holding Company,
Inc. (Coal Mining & Sales)

Donald C. Trauscht
Vice President—
Finance and Strategy of
Borg-Warner Corporation
(Diversified Products
and Services)

James D. Woods
President and Chief
Executive Officer of Baker
Hughes Incorporated

*Nominee to be presented
to Annual Meeting of
Stockholders, January 25,
1989

Corporate Information

Transfer Agent and Registrar:
Morgan Shareholder
Services Trust Company
New York, New York

Stock Exchange Listings:
Ticker Symbol "BHI" New
York Stock Exchange,
Pacific Stock Exchange, The
Swiss Stock Exchanges

Independent Accountants:
Deloitte Haskins & Sells
Houston, Texas

Form 10-K:
A copy of the Company's
Annual Report to the
Securities and Exchange
Commission (Form 10-K) is
available by writing to:
Ronald G. Turner, Vice
President, Baker Hughes
Incorporated, P.O. Box
4740, Houston, Texas
77210-4740

Annual Meeting:
The Company's Annual
Meeting of Stockholders
will be held at 2 p.m.
on January 25, 1989 at
The Doubletree Hotel
at Post Oak
2001 Post Oak Boulevard
Houston, Texas

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Houston, Texas 77027

*Corporate Offices
Mailing Address:*
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