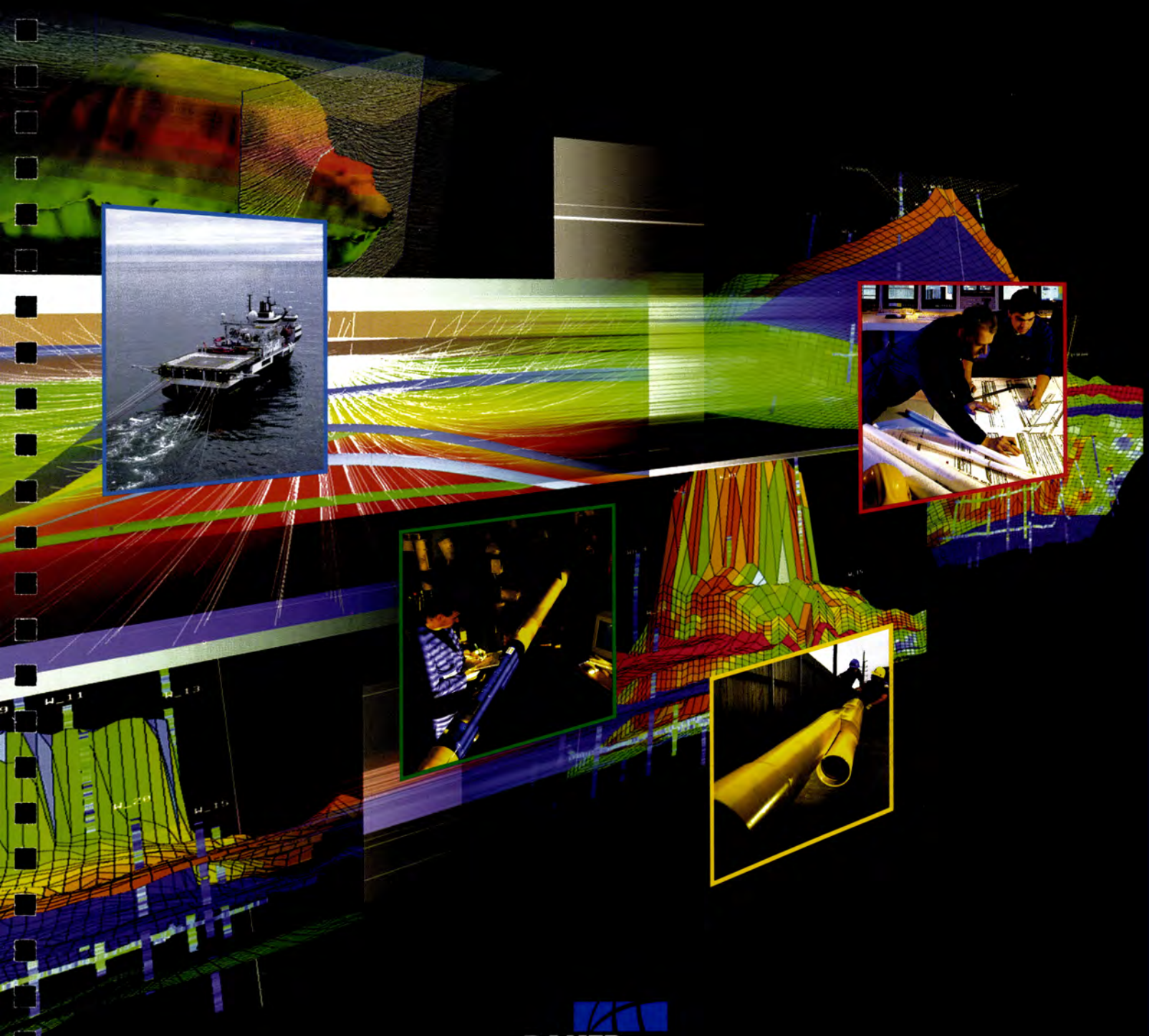
Annual 1998 Report



BAKER HUGHES

Baker Hughes is a leading supplier of reservoir-centered products, services, and systems to the worldwide oil and gas industry, and a leading supplier of separation technologies to the worldwide process industries.

OILFIELD OPERATIONS

WESTERN GEOPHYSICAL – a leading seismic company, providing comprehensive resources for geophysical exploration, reservoir description, and field development.

BAKER ATLAS – providing a complete range of downhole petrophysical and geophysical data acquisition, processing, and analysis services, including openhole and cased-hole logging, perforating, and pipe recovery services.

BAKER HUGHES INTEQ – a leading, advanced technology supplier of directional drilling, measurement-while-drilling, drilling fluids, and well-site information management services.

BAKER OIL TOOLS – a world leader in completion, workover, and fishing technologies.

HUGHES CHRISTENSEN– a leading supplier of roller cone and PDC drill bits.

CENTRILIFT – a leading provider of electric submersible pump systems.

BAKER PETROLITE – a leading specialty chemical supplier to the petroleum production, transportation, and refining industries.

E&P SOLUTIONS – providing reservoir-centered expertise to assist oil company clients and partners in basin analysis, prospect identification, and field development.

BAKER PROCESS

BAKER PROCESS – serving the worldwide process industry with a broad range of liquid/solid and liquid/liquid separation technologies.

Selected Financial Highlights

(In millions, except per share amounts)	1998[1]	Transition Period[2]	1997[3]	1996[3]
Revenues	$6,311.9	$1,572.9	$5,343.6	$4,445.8
Operating income (loss)	(135.7)	202.6	460.5	454.2
Income (loss) from continuing operations before cumulative effect of accounting change	(297.4)	111.2	200.9	246.4
Income (loss) from continuing operations	(297.4)	111.2	188.8	246.4
Net income (loss)	(297.4)	114.0	33.9	302.1
Per Share of Common Stock:				
Income (loss) from continuing operations before cumulative effect of accounting change				
Basic	(0.92)	0.35	0.67	0.86
Diluted	(0.92)	0.34	0.66	0.85
Net income (loss)				
Basic	(0.92)	0.36	0.11	1.05
Diluted	(0.92)	0.35	0.11	1.04
Working capital	1,414.6	1,502.7	1,398.4	1,856.1
Total assets	7,810.8	7,230.6	7,087.0	5,796.6
Long-term debt	2,726.3	1,605.3	1,473.3	1,124.2
Stockholders' equity	3,199.4	3,519.0	3,491.5	3,190.9
Debt/equity ratio	.87	.51	.46	.37
Number of shares:				
Outstanding at year end	327.1	316.8	316.5	289.5
Average during year	321.7	316.2	299.5	287.7
Number of employees (thousands)	32.3	33.4	31.6	25.6
Income (loss) from continuing operations before cumulative effect of accounting change	$(297.4)	$111.2	$200.9	$246.4
Add: Nonrecurring items, net of tax[4]	637.9		165.3	
Operational net income	340.5	111.2	366.2	246.4
Per Share of common stock:				
Operational net income				
Basic	1.06	0.35	1.22	0.86
Diluted	1.04	0.34	1.19	0.85

1) Fiscal year (12 months ended December 31)

2) Transition Period (3 months ended December 31, 1997)

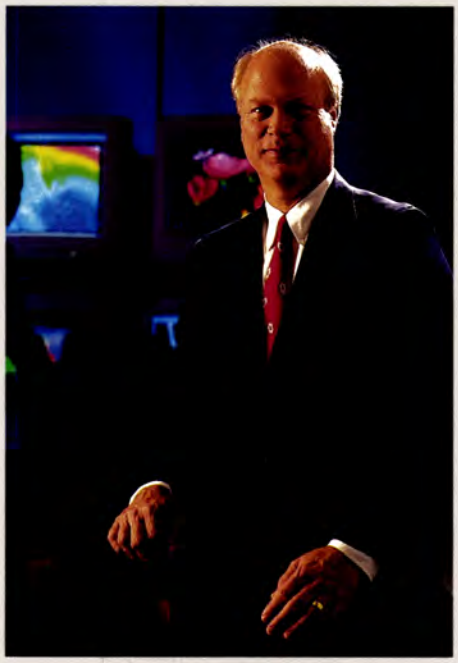
3) Fiscal year (Baker Hughes results for the 12 months ended September 30 plus Western Atlas results for the 12 months ended December 31)

4) Includes merger and acquisition related costs, spin-off related costs, unusual, and other nonrecurring items.

Letter to Shareholders

1998 was a year of dramatic contrasts for the industry and for Baker Hughes. A vibrant oilfield turned abruptly at mid-year into a contracting market, and we shifted our operating focus accordingly. In the midst of dramatic change in our business conditions, we completed our most strategic investment since the formation of Baker Hughes by merging with Western Atlas. This addition extends our ability to provide "life-of-field" technologies and services for our clients, an area with growing opportunities in the coming years.

For the six months ended June 30 1998, Baker Hughes revenues were up 29% over the same period in 1997, and our primary focus was managing growth. By mid-year, demand for our services declined as the Asian crisis and lower oil prices resulted in reduced exploration and production expenditures. Throughout the second half of the year, oil prices remained below $15 per barrel, and oil companies made significant budget cuts, particularly in marginal Western Hemisphere fields.



Revenues in the third quarter were down 5% sequentially and fell another 10% sequentially in the fourth quarter. Even though growth had reversed in the second half of 1998, revenues for the 1998 calendar year were $6.3 billion, up 18 % from $5.3 billion in the 1997 fiscal year. Operating earnings per share (diluted) were $1.04 in 1998, down from $1.19 in the fiscal year 1997, reflecting the deteriorating market conditions. Since the market downturn, our focus has been on cost control and on capital management in this difficult economic environment.

The year was impacted by pretax charges totaling $809 million ($638 million after tax), which included asset write-offs and write-downs, merger related charges, and severance costs. These charges resulted in a loss from continuing operations of $297 million or ($0.92) per share (diluted) for the year, compared to income from continuing operations of $189 million or $0.62 per share (diluted) during fiscal year 1997.

Western Atlas Merger Completed on August 10, 1998, the Western Atlas acquisition was the company's most important transaction since Baker International and Hughes Tool Company combined in 1987. The merger makes the company one of the leading integrated oilfield service providers. More significantly, we have transformed Baker Hughes from a provider of discrete oil well products and services into an integrated, life-of-the-field service company focused on the reservoir.

Preparing for the Future While we expect the current difficult market conditions to continue through 1999, the petroleum service industry's medium and long-term prospects remain strong. Current low levels of investment in petroleum development, if continued, will ultimately result in real declines in production. As the world economy recovers, hydrocarbon demand will increase, leading inevitably to higher oil prices and higher required levels of exploration and production activity. Baker Hughes will be ready for the industry's revival, although the timing of the correction remains unclear.

Even in these difficult times, Baker Hughes will continue to invest in innovative technologies, services, and business processes to assure our competitiveness in the future. We are leveraging our leadership in both discovery and recovery technologies to commercialize

new systems that add value for our customers and, in turn, build value for our shareholders. The AutoTrak℠, Edge, HydroSep™, 4-D and 4-component seismic, and STAR Imager℠ systems are examples of recent technology investments that have resulted in important new Baker Hughes products. The company plans to invest more than $220 million in new technology development in 1999.

Managing for Today While investing for a promising future, we also must manage the company to keep our costs in line with market activity. We have cut discretionary spending and have announced plans to reduce our workforce by more than 18% from peak levels in May 1998. While painful, these staff reductions are needed to size the business to the new market reality.

We also are implementing in 1999 a return-on-capital-based measurement system that will provide a framework for financial management and incentive compensation. This new measure, linking the income statement and balance sheet, is called Baker Value Added (BVA). Improving returns on capital will become the major incentive measurement metric throughout Baker Hughes as we go forward.

Operations Organization In June 1998, Thomas R. Bates, Jr., formerly president and chief executive officer of Weatherford Enterra, Inc., joined Baker Hughes as a senior vice president of the company. Tom has more than 25 years of experience in the oil and gas service business and is a strong addition to the management team. In August, we organized Baker Hughes oilfield operations into two groups focused on the discovery and recovery phases of our business. Tom heads the Discovery Group, consisting of Western Geophysical, Baker Atlas, and Baker Hughes INTEQ. Andy Szescila, most recently president of Baker Hughes Oilfield Operations, now heads the Recovery Group, which includes Baker Oil Tools, Baker Petrolite, Centrilift, and Hughes Christensen.

Special Thanks John R. Russell, president of Baker Hughes and former president and chief executive officer of Western Atlas, retired after serving 30 years with the company. John's leadership was a key factor in building Western Atlas into a premier reservoir company. John will remain on the Baker Hughes Board of Directors, where he will join former Western Atlas directors Alton J. Brann, Joseph T. Casey, and Claire W. Gargalli. John F. Maher will complete his tenure with the Board this year. We have appreciated his direct and valued guidance over the past decade.

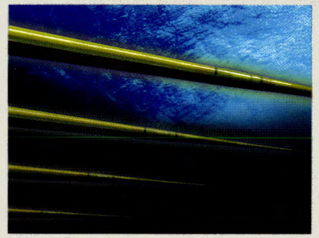
New Synergies In closing, I want to thank the employees of Baker Hughes for their hard work and dedication during a very difficult year. As a combined team, we have already made great progress in bringing the Western Atlas businesses into the company and properly sizing our entire organization. Even in the first few months of the "new" Baker Hughes, our employees have created synergies that clearly confirm the strategic vision of the merger. Our continued success as a reservoir-centered company will be a direct result of their talents and continuing commitment.

Max L. Lukens
Chairman, President, and Chief Executive Officer

1998 Highlights

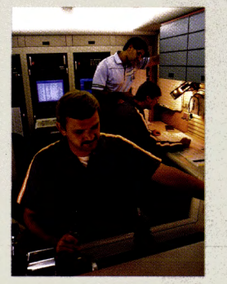
JANUARY

Western Geophysical conducted the first Sentry℠ solid-streamer survey offshore Croatia in rough seas that would have shut down a conventional streamer vessel. This was the first use of the new streamers in the Europe/Africa region.



MARCH

Western Geophysical set an industry record for seismic data turnaround by delivering 1800 km² of fully processed 3-D data just 27 days after the last shotpoint, cutting the previous record by 43 days. The *Western Legend* acquired the surveys in the Natuna Sea, offshore Indonesia. • Baker Atlas acquired WEDGE DIA-Log, a wireline company specializing in cased-hole and pipe recovery services, and made it an operating unit. • Acquired the assets of Western Rock Bit Company Limited, the exclusive distributor for Hughes Christensen in Canada.



APRIL

Baker Oil Tools introduced marine completion and stimulation services to the Gulf of Mexico with the 226-ft *M/V Republic Tide* vessel. • Acquired KREBS Petroleum Technologies, a provider of separation technology to the upstream oil and gas industries, and combined it with the Baker Process company. • Saved $1.4 million in operating costs for a Norwegian client by drilling 8,800 ft with

INTEQ's AutoTrak drilling system equipped with a Hughes Christensen PDC bit.

MAY

Announced that a definitive merger agreement between Baker Hughes and Western Atlas Inc. was unanimously approved by both boards of directors on May 10. • Acquired Z&S Geoscience Ltd., a premier provider of geological processing and interpretation services, and integrated it with Baker Atlas.

JUNE

Acquired over 100,000 km² of 3-D seismic data in the first phase of Western Geophysical's ambitious exploration program for offshore West Africa. • Successfully tested a revolutionary new-generation logging service developed jointly with Shell and under exclusive contract for Shell.

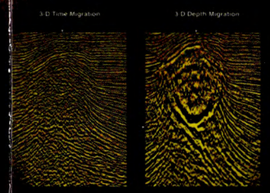
Advancing discovery and recovery

Baker Hughes technology and services deliver value by reducing costs and improving ultimate recovery throughout the life of the reservoir, from the earliest stages of discovery through management of mature fields. The facing illustration shows application of both information technology and downhole drilling, completion, and production systems in hydrocarbon discovery and recovery.

To image the earth's subsurface, seismic vessels tow air guns and multiple seismic streamers containing hydrophones. Acoustic energy from the air guns is reflected by rock layers below the ocean floor, detected by the hydrophones and recorded onboard the vessel.

Onboard processing has reduced the seismic data acquisition and processing time from several months to several weeks.

Seismic data processing services use sophisticated imaging systems to accurately depict complex geological structures and delir eate the reservoir.

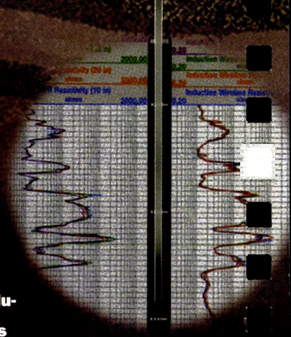


New 3-D depth imaging technology now can clearly define potential reservoirs below salt formations. This enables oil companies to develop deepwater prospects that previously were bypassed.

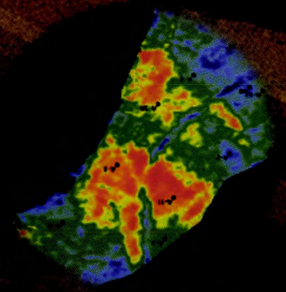
During land 3-D surveys, seismic crews lay geophone cables along precisely-located survey lines. Acoustic energy from huge vibrator trucks is reflected from the rock layers below, received by the geophones, recorded, and processed to create images of the subsurface.

Seismic surveys in shallow-water and wetland transition zones require specialized technology, including energy sources, receivers, and telemetry systems.

Imaging tools use acoustic, resistivity, and magnetic technologies to create a picture of the geologic features, rock textures, permeability, and fracture systems in the reservoir.



Processed logs from wireline and LWD systems help oil companies evaluate the formation's prodcution potential.



By combining seismic and well-logging data, reservoir experts can develop an integrated reservoir description to optimize productivity over the life of the field.

Specialty chemicals help prevent corrosion and scaling in producing wells. On the surface, chemicals also treat produced fluids, improve the efficiency of pipelines, and enhance the refining process.

Innovative drilling fluids – including advanced water–base and synthetic fluid systems – enhance drilling performance without harming the environment.

Ocean-bottom cable (OBC) technology can be used for 4-D seismic projects over producing fields in shallow-water regions. By comparing a new 3-D seismic survey to earlier surveys, reservoir experts can assess fluid flow over time and take steps to help recover additional reserves.

Well-site data management systems handle large amounts of real-time and processed data to support the drilling and completion processes.

Measurement-while-drilling (MWD) systems provide directional and formation data that help keep the well in the reservoir pay zone for thousands of feet.

A high-level multilateral junction branches a single well into two or more legs with separate production from each zone.

Logging services use specialized instruments to acquire electromagnetic, sonic, and nuclear measurements. These readings help quantify geologic properties and fluid content in formations surrounding the well.

Rotary steerable systems are automated drilling tools that efficiently steer the drill bit along a programmed trajectory.

Advanced PDC and roller cone bit technologies achieve high rates of penetration and long drilling runs.

Well completion/production systems maximize recovery from the reservoir. They include packers, perforating systems, flow control devices, electric submersible pumps, and sand control technology.

Intelligent completion systems are expected to optimize production with fiber-optic instrumentation and controls.

New downhole oil/water separation technology can reduce the volume of produced water and its associated costs.

JULY

Baker Hughes INTEQ introduced the AutoTrak rotary closed loop drilling system to North America on a complex well for Spirit Energy.

of the world's largest land 3-D programs. • Installed the world's first Level 6 multilateral well near Bakersfield, California, using Baker Oil Tools' proprietary FORMation™ junction.

AUGUST

Completed merger of Baker Hughes Incorporated and Western Atlas, following shareholder approval, on August 10. • Completed Phase 1 of Western Geophysical's offshore Nova Scotia 2-D multiclient seismic survey in deepwater areas off eastern Canada. • Helped Petroleum Development Oman drill and complete its 1,000th horizontal well. Baker Hughes provided services on all 1,000 wells, which total 5.9 million ft of horizontal hole. • Completed the first deepwater Level 5 multilateral completion for Petrobras in the Campos Basin offshore Brazil. In the same field, Baker Oil Tools and INTEQ performed two horizontal gravel packs in more than 2,500 ft of water. • Formed Baker Hughes E&P Solutions division to focus on basin analysis, prospect identification, and field development.

OCTOBER

Baker Petrolite moved into its new world headquarters in Sugar Land, Texas, combining the R&D laboratories and administrative offices of Baker Performance Chemicals and Petrolite, which was acquired in 1997. • Formed Baker Process as a single unit combining the separation technology businesses of EIMCO, Bird Machine, and Baker Hughes Process Systems.

NOVEMBER

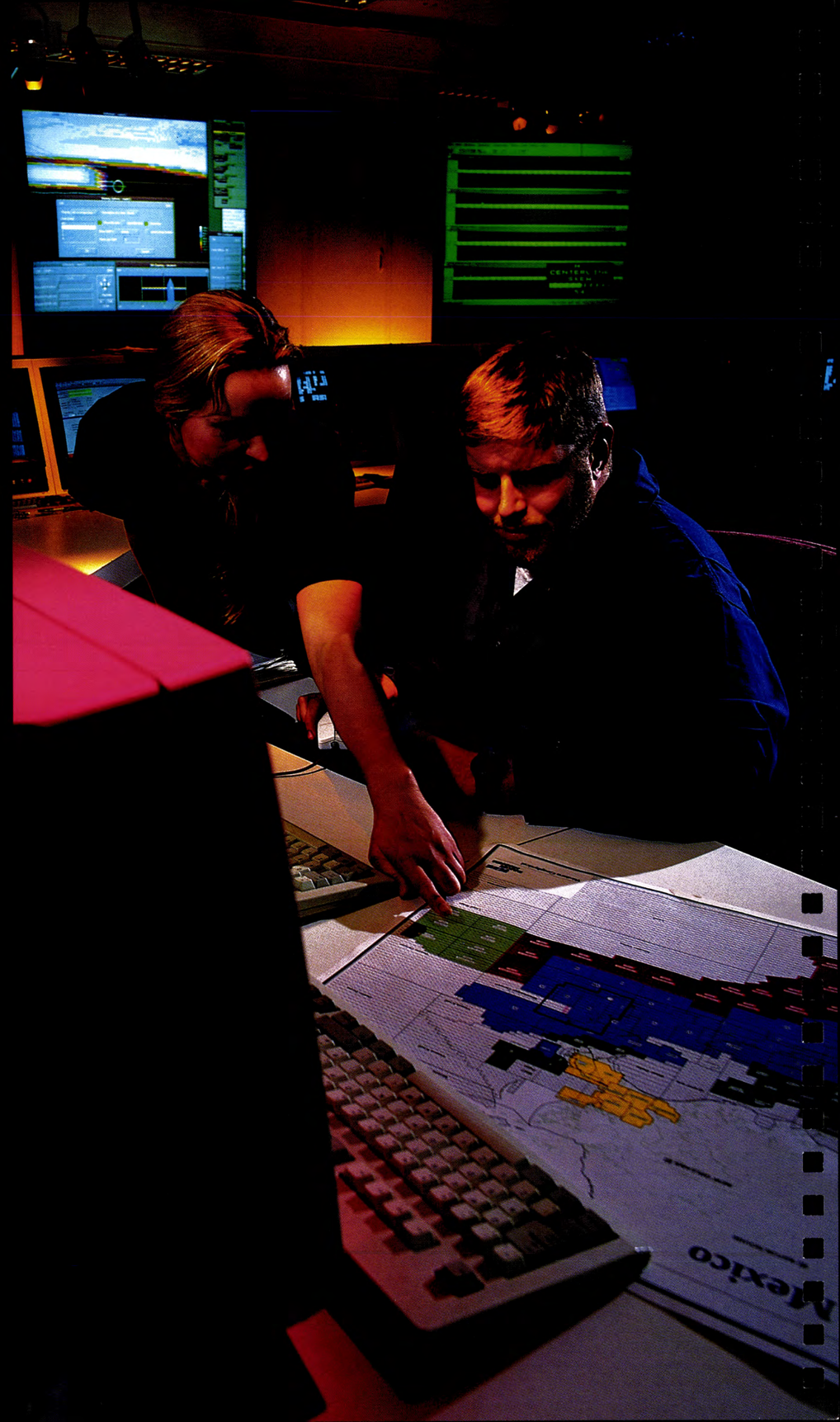
Western Geophysical completed a 3-D survey in Brunei using the largest transition-zone operation ever assembled. Over 5,600 recording channels were used to acquire 106 million traces over swamps, jungles, townships, and refineries. • Baker Atlas used the new-generation Reservoir Characterization Instrument (RCI℠) to acquire highly accurate pressure, hydrocarbon, and water samples from multiple well intervals in the Asia-Pacific region, saving the client $1.5 million in rig-time costs.

SEPTEMBER

Western Geophysical was awarded a major contract in Algeria to acquire a 200-km² land 3-D seismic survey over high sand dunes in the Menzel Lejmat area. By extending Western's ongoing 2,000-km² survey, the contract made the Algerian survey one

EXPLORATION

In 1998, Baker Hughes complemented its leading downhole technology with new information capabilities in seismic exploration, formation evaluation, and reservoir management. Now Baker Hughes can offer oil companies comprehensive services over the life of the reservoir, from prospect evaluation through optimum hydrocarbon recovery. At right, position analysts on the Western Monarch seismic vessel monitor onboard processing 150 miles off the Alabama coast.



Exploration technology advances discovery

Baker Hughes provides advanced technology and services to help oil companies discover oil and gas reserves.

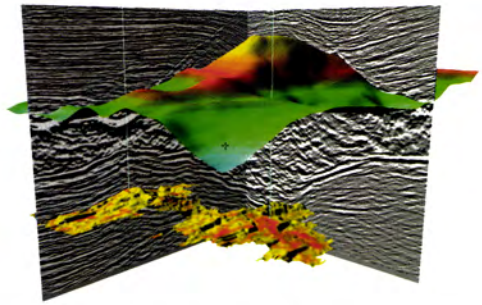
Operating worldwide, Western Geophysical crews acquire seismic data in 2-D, 3-D, and 4-D surveys on land, in deep water, and across shallow-water transition zones. With the world's most advanced fleet of seismic vessels, the company is an industry leader in marine acquisition technology with innovations like the Sentry solid-streamer system to acquire high-quality data in rough seas and OBC technologies to acquire continuous coverage over congested fields and in shallow-water regions. Accurate positioning through GPS surveying systems, advanced telemetry, and extensive experience at gathering data over sand dunes, in urban areas, and through wetlands helped the company gain major contracts in Algeria, Abu Dhabi, and Egypt during 1998.

The company also is a leader in seismic data processing, using powerful computers and advanced software to transform vast amounts of data into images of the geologic structure deep inside the earth. Western's super-seismic vessels perform onboard data processing to speed data turnaround. Recent advances in complex imaging include 3-D prestack and poststack depth imaging of salt bodies and the reservoirs beneath them. Not only are these techniques applicable in the Gulf of Mexico, but they also are helping clients in other promising deepwater provinces, such as offshore West Africa and Brazil.

During the year, Western Geophysical added to its extensive inventory of multiclient seismic data by completing surveys off Nova Scotia, India, Pakistan, Vietnam, and Australia. The company also continued to acquire data for its Ultra Survey™ program, which spans more than 1,000 blocks of the central Gulf of Mexico.

In addition, Western Geophysical vessels began conducting an extensive seismic survey in the near shore and deep waters off Angola in an exclusive agreement with the Angolan national oil company. To support growing activity in this region, the company opened a new data processing center in Luanda, Angola. Through a continuous satellite link, the Luanda Center operates as part of Western's global processing network. The network includes centers in London, Houston, Denver, and Perth as well as many remote facilities and onboard processing systems on the company's seismic vessels.

High-resolution logging instruments and sampling tools help operators evaluate rock properties and producible fluids on exploration wells. The STAR Imager℠ service from Baker Atlas combines resistivity and acoustic imaging sensors to accurately describe rock layers and fractures in the reservoir.



Experienced geoscientists in Western Geophysical's Exploration and Reservoir Information Services (ERIS) group use the latest 3-D visualization and data processing resources to enhance exploration and production projects. This work provides detailed images of salt bodies and formations that may be reservoirs beneath them, enabling oil companies to develop promising deepwater fields.

Baker Hughes INTEQ introduced the industry's smallest-diameter MWD resistivity system. The 3 1/8-in. OD UltraSlim MPR tool can be run on drill pipe or coiled tubing.

By applying new information technology to the drilling process, Baker Hughes achieved breakthrough drilling performance in 1998. Technical innovations maintained the company's leadership in directional drilling, measurement-while-drilling, and drill bit technology. New synergies were developed across product lines to increase value for clients. Here, the drilling crew guides an AutoTrak system into a well in the Troll field offshore Norway.

Advanced drilling technology

In 1998, drilling reached a new level of high-technology with innovative systems from Baker Hughes.

For example, the AutoTrak system from INTEQ combines the advantages of continuous rotation with computerized guidance and geosteering systems for major improvements in drilling efficiency, hole condition, and drilling accuracy. Developed in conjunction with ENI-AGIP, S.p.A, the new system already has drilled more than 300,000 ft in extended-reach and complex-profile wells in the North Sea.

Hughes Christensen continued its technical leadership in roller cone and diamond drill bits by introducing its premium Spectrum™ product line in 1998. This rollout included the successful launch of UltraMax™ Tricone® bits for demanding applications where performance improvements add the most value. The UltraMax bits feature a patented second-generation metal seal design that substantially improves bit life in motor drilling applications. Many UltraMax bits have turned over a million revolutions before being pulled from the hole.

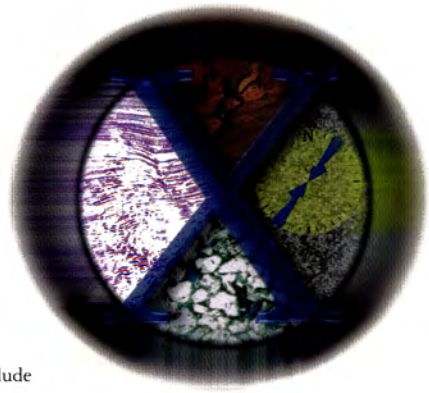
Hughes Christensen also introduced two new PDC designs. The Black Diamond™ and BlackTrax™ series of bits feature new PDC technology and engineered cutter placement to fine tune bit performance for the application.

Baker Hughes INTEQ's drilling fluids business gained momentum in 1998 with ongoing strengths in glycol fluid systems and reservoir drill-in fluids. Advanced modeling software and proprietary rheological analysis equipment helped the company gain deepwater fluids contracts in the Gulf of Mexico. INTEQ fluids engineers also worked with Hughes Christensen drill bit designers to develop and apply drilling fluids technology to enhance penetration rates with polished PDC cutter bits. In addition, INTEQ fluids and Baker Oil Tools completions engineers collaborated to formulate fluid systems to protect the reservoir from damage during drilling and subsequent gravel pack completion operations.

Baker Hughes information technology at the surface also improved client drilling capabilities during the year. New hardware and software systems enhanced data acquisition, decision-making, and safety. INTEQ's new RIGLINK™ data communications system connected clients to their well sites via the Internet. And Hughes Christensen applied its MAPIT™ bit database and OASIS™ engineering service to gain preferred-supplier status with important clients in Europe, Venezuela, and the United States.

Geologists, petrophysicists, and geophysicists from Baker Atlas, INTEQ, and Western Geophysical combined their talents and experience in Geoscience Centers to serve clients with formation evaluation, geosteering, and reservoir description services.

Hughes Christensen runs new drill bits at the Baker Hughes Experimental Test Area near Tulsa, Oklahoma. Research engineers use the site's fully-instrumented drilling rig to evaluate new technology.



Baker Atlas openhole logging services include advanced formation evaluation measurements and borehole imaging. The new XMAC℠ system, a new-generation acoustic logging service, accurately determines a variety of geophysical, petrophysical, and rock mechanical properties to maximize reservoir productivity.

A Baker Hughes INTEQ field service engineer employs cutting-edge drilling fluids monitoring technology to optimize drilling performance on a Gulf of Mexico deepwater well.

Baker Hughes continued to advance its position as a leader in completions and production with the commercialization of emerging technologies and acquisition of complementary capabilities to enhance hydrocarbon recovery. In the process, Baker Hughes made progress toward realizing its Downhole Factory™ concept. Here, field engineers prepare to run a Level 3 mulit-lateral completion on a well in Dubai, U.A.E.

New systems advance recovery

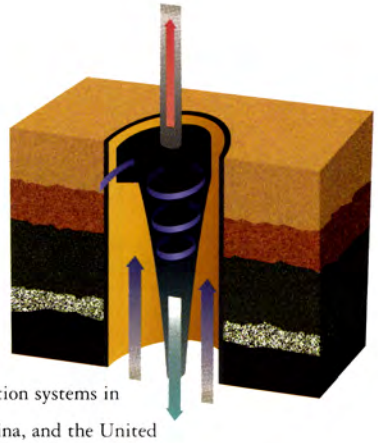
During 1998, Baker Hughes made the multilateral completion an increasingly valuable solution for hydrocarbon recovery. Offshore Brazil, Baker Oil Tools installed a record Level 5 multilateral to construct a dual-leg injection well from a rig floating in nearly 2,000 ft of water. In California, Baker Oil Tools successfully ran its first FORMation junction Level 6 multilateral. A dualcasing junction was run in the hole and expanded, then the two laterals were drilled and completed to produce from separate zones. Worldwide, Baker Hughes has drilled and completed several hundred multilaterals, including more than 30 Level 3 completions for PDO in Oman.

Baker Oil Tools continued industry-leading developments toward cost-effective, intelligent completions. The company already has installed 60 EDGE® Remote Actuation Systems, saving time and reducing risk in deepwater and extended-reach wells. More recent developments have combined advanced electronics, fiber-optic sensors, and hydraulic controls to create the FORCE™ completion system. This innovation senses conditions in the producing well and enables an operator to adjust hydrocarbon flow by remote control. And in a joint project, Baker Oil Tools and Baker Atlas developers are engineering an even more versatile, all-electric intelligent completion system.

Baker Hughes intelligent recovery technologies are not limited to individual wells. For example, the Baker Multi-Well Network Interface™ is an all-digital well-site control system that continuously monitors downhole pressure and temperature from multiple wells and automatically controls field production. Integrating technology from Baker Oil Tools and Centrilift, BMW systems were installed on the North Slope of Alaska in 1998.

For deepwater applications, Baker Petrolite has developed special defoamers and paraffin inhibitors to improve productivity. The division also helps oil companies manage their chemical programs for safe, efficient deepwater operations.

Baker Oil Tools, Baker Atlas, and INTEQ technologies comprise a single source for underbalanced completions and workovers. New composite bridge plugs, wireline and perforating services, downhole motors, fishing tools, and coiled tubing services — all from Baker Hughes — make well stimulation faster and more effective.



Centrilift, Baker Process, and Baker Oil Tools successfully installed HydroSep downhole oil/water separation systems in Canada, Argentina, and the United States. On a recent joint industry test, the system handled up to 23,000 barrels of fluid per day, reinjecting water that comprised 90% of total flow.

Centrilift's Electro Coiled Tubing™ system efficiently installs electric submersible pumps and is the first viable installation with the power cable run inside the tubing. Oil companies in California and Alaska have achieved cost savings and increased production using the new system.

Leadership Team (from right)

ERIC L. MATTSON Senior Vice President and Chief Financial Officer Baker Hughes Incorporated. Mr. Mattson has been chief financial officer for Baker Hughes since 1993. Previously, he served as vice president and treasurer for Baker Hughes Incorporated and as assistant treasurer for Baker International. He came to the company in 1980 from Pittsburgh National Bank where he was vice president. He holds B.S. and M.B.A. degrees from Pennsylvania State University.

G. STEPHEN FINLEY Senior Vice President and Chief Administrative Officer Baker Hughes Incorporated. Mr. Finley has held his current office since 1995. Before that, he was vice president-controller for Baker Hughes Incorporated. He also served as vice president-finance for the TOTCO and Tri-State Oil Tools units. He joined Baker Oil Tools in 1982 as group financial manager. He earned a B.S. degree from Indiana State University.

JOHN "ANDY" O'DONNELL Vice President, Business Process Development Baker Hughes Incorporated. Mr. O'Donnell manages Project Renaissance, an enterprise-wide cost-savings effort started in 1997. Most recently, he was vice president-manufacturing for Baker Oil Tools. He joined Hughes Tool Company in 1975. He holds a B.S. degree from the University of California and an M.B.A. degree from Pepperdine University.

LAWRENCE O'DONNELL, III Vice President and General Counsel Baker Hughes Incorporated. Prior to taking his present assignment in 1995, Mr. O'Donnell served as vice president-general counsel for Baker Hughes Oilfield Operations and as corporate secretary. He joined Baker Hughes in 1991 as deputy general counsel. He holds a B.S. degree in engineering from the University of Texas and a J.D. from the University of Houston.

MATTHEW G. DICK President Baker Process. Mr. Dick was named president of Baker Process in 1996. His earlier executive roles included assignments as vice president of operations and manufacturing at INTEQ, Hughes Christensen, and Baker Oil Tools. He also has served as managing director of affiliated companies in the U.K., India, and Brazil.

RAY A. BALLANTYNE Vice President, Marketing, Technology, and Business Development Baker Hughes Incorporated. Mr. Ballantyne was appointed to his current position in 1998. He had been vice president-worldwide marketing for Baker Oil Tools and served as vice president-international operations for Baker Service Tools. He joined Baker Hughes in 1984 when it acquired Edeco, where he was chief executive officer. Mr. Ballantyne studied at Dundee College of Technology and Strathclyde University in Scotland.

Leadership Team (Discovery Group)

(front)
THOMAS R. BATES, JR. SENIOR VICE PRESIDENT AND PRESIDENT - DISCOVERY GROUP. Mr. Bates joined the company in 1998 as senior vice president-corporate strategy and assumed his current role after completion of the Western Atlas merger. Previously, he was president and chief executive officer, Weatherford Enterra, Inc, and president of Schlumberger Anadrill. Mr. Bates holds B.S., M.S., and Ph.D. degrees in mechanical engineering from the University of Michigan.

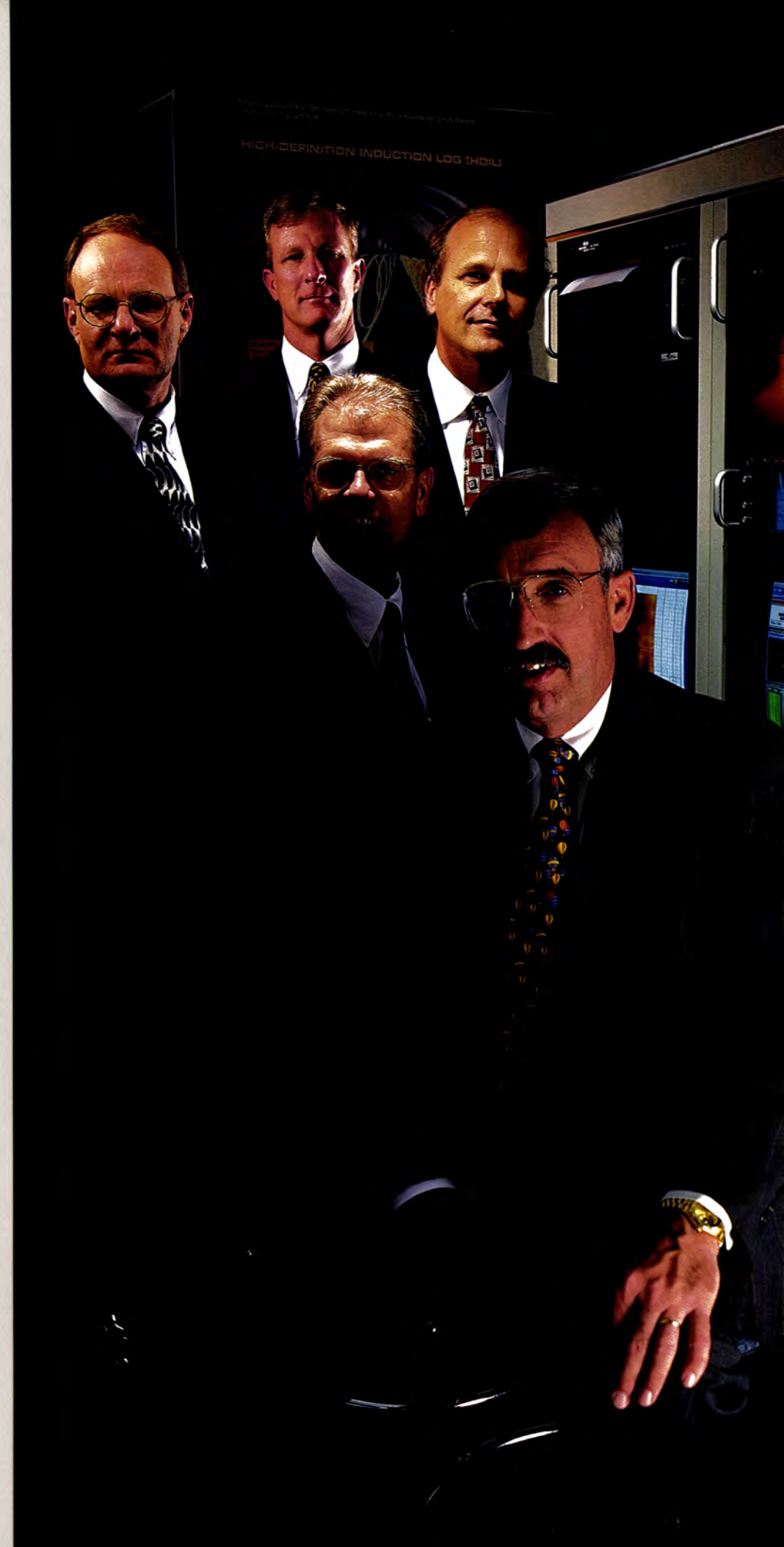
(center)
GARY E. JONES PRESIDENT BAKER ATLAS. Mr. Jones has been president of his operating unit since 1997. He has served as vice president-business development for Western Atlas International and vice president-Latin America for Western Geophysical. He joined Western Geophysical in 1980 as a field seismologist. He holds B.S. and M.A. degrees in geophysics from the University of Arizona.

(standing from right)
TIMOTHY J. PROBERT PRESIDENT BAKER HUGHES INTEQ. Before assuming his current post in 1996, Mr. Probert served as president of Baker Hughes Process Equipment Company, Eastman Christensen, and Milpark Drilling Fluids operating units. He also has held executive roles in operations and marketing. Mr. Probert joined EXLOG in 1972 as a well-site geologist. He holds a B.Sc. degree from the University of London.

RICHARD C. WHITE PRESIDENT WESTERN GEOPHYSICAL. Prior to taking his current post in 1995, Mr. White was senior vice president and chief operating officer for Western Geophysical. He also has served the company as an operations vice president and in a variety of field management assignments. He joined Western Geophysical in 1978 as a field clerk. Mr. White received a B.S. degree in geology from Bloomsburg University of Pennsylvania.

(E&P Solutions)

GERALD M. GILBERT PRESIDENT E&P SOLUTIONS. Mr. Gilbert was named vice president of E&P Services in 1995. He also has served as Western Geophysical' s vice president-technology and as general manager, land geophysical operations, in Europe, Africa, and the Middle East. He came to the company in 1991 from Halliburton where he was vice president-worldwide geophysical operations. He holds a B.S. degree from the University of Texas and an M.S. degree from Southern Methodist University.



Leadership Team (Recovery Group)

(seated)

ANDREW J. SZESCILA SENIOR VICE PRESIDENT AND PRESIDENT - RECOVERY GROUP. Mr. Szescila took on his current role in 1998. Previously, he was president of Baker Hughes Oilfield Operations and has served as president of Hughes Christensen, BJ Services International, and Baker Service Tools. He also has served as marketing vice president for various divisions. He joined Baker Oil Tools in 1973 as a region engineer. Mr. Szescila earned a B.S. degree from Mississippi State University.

(standing from right)

EDWIN C. HOWELL PRESIDENT BAKER OIL TOOLS. Named to his current role in 1989, Mr. Howell also has served as president of Baker Service Tools and vice president-general manager of Baker Performance Chemicals. He joined the company as a sales/service engineer for oilfield chemicals. Mr. Howell earned B.S. and M.B.A. degrees from the University of Southern California.

D.J. (DOUG) WALL PRESIDENT HUGHES CHRISTENSEN COMPANY. Mr. Wall joined Hughes Christensen as president in 1997. Previously, he was president of Western Rock Bit, then Hughes Christensen's distributor in Canada. He has spent most of his management career with leading Canadian drilling contractors. Mr. Wall holds a B.A. degree from the University of Calgary and an M.B.A. degree from the University of Alberta.

M. GLEN BASSETT PRESIDENT BAKER PETROLITE. Named president of Baker Petrolite when it was formed in 1997, Mr. Bassett had held the same position at Baker Performance Chemicals since 1983. He also has served as vice president-research and manufacturing for BPCI. He joined Petrolite in 1968 and held research, sales, and manufacturing positions. Mr. Bassett holds a B.S. degree from Louisiana Tech University.

JOSEPH F. BRADY PRESIDENT CENTRILIFT. Before taking his current post in 1988, Mr. Brady served as president of Baker Lift Systems and Baker CAC. He joined Baker in 1981 as vice president-engineering of the Kobe, Inc unit. Mr. Brady began his career as an automotive design engineer. He holds a B.S. degree from the General Motors Institute and an M.B.A. degree from Michigan State University.

Selected Financial Data

(In millions, except per share amounts)	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996	1995	1994
Revenues	$ 6,311.9	$ 1,572.9	$ 5,343.6	$ 4,445.8	$ 3,920.4	$ 3,699.3
Costs and expenses:						
Costs of revenues	4,710.9	1,045.7	3,676.9	3,062.8	2,711.4	2,551.5
Selling, general and administrative	1,301.8	324.6	1,036.1	889.2	818.2	831.9
Merger related costs	219.1					
Unusual charge	215.8		52.1	39.6		31.8
Acquired in-process research and development			118.0			
Operating income of business sold						(10.5)
Total	6,447.6	1,370.3	4,883.1	3,991.6	3,529.6	3,404.7
Operating income (loss)	(135.7)	202.6	460.5	454.2	390.8	294.6
Interest expense	(149.0)	(24.5)	(91.4)	(87.9)	(89.1)	(106.4)
Interest income	3.6	1.1	3.6	4.9	6.6	5.2
Spin-off related costs			(8.4)			
Gain on sale of Varco stock				44.3		
Gain on sale of Pumpsystems						101.0
Income (loss) from continuing operations before income taxes, extraordinary loss and cumulative effect of accounting changes	(281.1)	179.2	364.3	415.5	308.3	294.4
Income taxes	(16.3)	(68.0)	(163.4)	(169.1)	(126.9)	(123.5)
Income (loss) from continuing operations before extraordinary loss and cumulative effect of accounting changes	(297.4)	111.2	200.9	246.4	181.4	170.9
Extraordinary loss						(44.3)
Cumulative effect of accounting changes			(12.1)		(14.6)	(44.2)
Income (loss) from continuing operations	(297.4)	111.2	188.8	246.4	166.8	82.4
Discontinued operations, net of tax		2.8	(154.9)	55.7	38.4	38.0
Net income (loss)	$ (297.4)	$ 114.0	$ 33.9	$ 302.1	$ 205.2	$ 120.4
Per share of common stock:						
Income (loss) from continuing operations before extraordinary loss and cumulative effect of accounting changes:						
Basic	$ (.92)	$ .35	$ .67	$ .86	$ .55	$ .59
Diluted	(.92)	.34	.66	.85	.54	.58
Dividends	.46	.12	.46	.46	.46	.46
Financial position:						
Working capital	$ 1,414.6	$ 1,502.7	$ 1,398.4	$ 1,856.1	$ 1,812.2	$ 1,584.4
Total assets	7,810.8	7,230.6	7,087.0	5,796.6	5,435.2	5,141.3
Long-term debt	2,726.3	1,605.3	1,473.3	1,124.2	1,295.3	1,128.0
Stockholders' equity	3,199.4	3,519.0	3,491.5	3,190.9	2,870.3	2,886.8

See Notes 1 and 2 of Notes to Consolidated Financial Statements for a discussion of the Merger with Western Atlas Inc. and the adoption of new accounting standards in 1997. In 1995, the Company adopted a new accounting standard related to the accounting for postemployment benefits. In 1994, the Company adopted new accounting standards related to accounting for income taxes and employers accounting for post retirement benefits other than pensions. See Note 7 of Notes to Consolidated Financial Statements for a discussion of acquisitions made in 1998, the Transition Period, 1997 and 1996. The Company sold EnviroTech Pumpsystems and EnviroTech Measurements and Controls in 1994. See Note 8 of Notes to Consolidated Financial Statements for a description of the unusual and other nonrecurring charges in 1998, 1997 and 1996. The unusual charge in 1994 consisted of the restructuring and reorganization of certain Oilfield divisions and the discontinuance of an MWD product line, offset by an insurance recovery. The Company repurchased or defeased debt in 1994 resulting in an extraordinary loss.

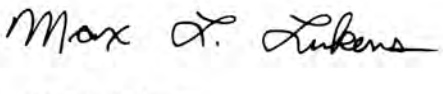
Management Report of Financial Responsibilities

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. 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 December 31, 1998, 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.

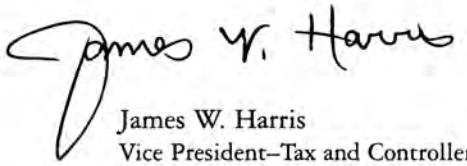
Management recognizes its responsibility for fostering a strong ethical climate so that the Company's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the Company's Standards of Conduct which is distributed 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 nonemployee 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 arrangement. 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.



Max L. Lukens
Chairman, President
and Chief Executive Officer

Eric L. Mattson
Senior Vice President
and Chief Financial Officer



James W. Harris
Vice President–Tax and Controller

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the consolidated financial statements of Baker Hughes Incorporated ("Baker Hughes" or the "Company") for the year ended December 31, 1998, the three months ended December 31, 1997 and for the years ended September 30, 1997 and 1996 and the related notes to consolidated financial statements.

FORWARD-LOOKING STATEMENTS

MD&A includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, (each a "Forward-Looking Statement"). The words "anticipate," "believe," "expect," "plan," "intend," "estimate," "project," "forecasts," "will," "could," "may" and similar expressions are intended to identify forward-looking statements. No assurance can be given that actual results may not differ materially from those in the forward-looking statements herein for reasons including the effects of competition, the level of petroleum industry exploration and production expenditures, world economic conditions, prices of, and the demand for, crude oil and natural gas, drilling activity, weather, the legislative environment in the United States and other countries, OPEC policy, conflict in the Middle East and other major petroleum producing or consuming regions, the development of technology that lowers overall finding and development costs and the condition of the capital and equity markets.

Baker Hughes' expectations regarding its level of capital expenditures and its capital expenditures on Project Renaissance described in "Investing Activities" below are only its forecasts regarding these matters. In addition to the factors described in the previous paragraph and in "Business Environment," these forecasts may be substantially different from actual results, which are affected by the following factors: the accuracy of the Company's estimates regarding its spending requirements, regulatory, legal and contractual impediments to spending reduction measures; the occurrence of any unanticipated acquisition or research and development opportunities; changes in the Company's strategic direction; and the need to replace any unanticipated losses in capital assets.

CHANGE IN YEAR-END

On August 27, 1998, the Board of Directors of Baker Hughes approved a change in the fiscal year end of the Company from September 30 to December 31, effective with the calendar year beginning January 1, 1998. A three-month transition period from October 1, 1997 through December 31, 1997 (the "Transition Period") precedes the start of the 1998 fiscal year. "1997" and "1996" refer to the respective years ended September 30, the Transition Period refers to the three months ended December 31, 1997, and "1998" refers to the twelve months ended December 31, 1998.

MERGER

On August 10, 1998, Baker Hughes completed a merger ("the Merger") with Western Atlas Inc. ("Western Atlas") by issuing 148.6 million shares of its common stock for all of the outstanding common stock of Western Atlas. Each share of Western Atlas common stock was exchanged for 2.7 shares of Baker Hughes common stock. Western Atlas is a leading supplier of oilfield services and reservoir information technologies for the worldwide oil and gas industry. It specializes in land, marine and transition-zone seismic data acquisition and processing services, well-logging and completion services and reservoir characterization and project management services.

The Merger was accounted for as a pooling of interests and, accordingly, all prior period consolidated financial statements of Baker Hughes have been restated to include the results of operations, financial position and cash flows of Western Atlas. Information concerning common stock, employee stock plans and per share data has been restated on an equivalent share basis. The consolidated financial statements as of September 30, 1997 and for each of the two years in the period ended September 30, 1997 include Baker Hughes' previous September 30 fiscal year amounts and Western Atlas' December 31 calendar year amounts for the respective fiscal years of Baker Hughes. Consolidated financial statements for the three months ended December 31, 1997 include amounts for Baker Hughes and Western Atlas for the three months ended December 31, 1997. As a result, Western Atlas' results of operations for the three

months ended December 31, 1997 are included in both the consolidated financial statements for the year ended September 30, 1997 and for the three months ended December 31, 1997.

BUSINESS ENVIRONMENT

The Company is primarily engaged in the oilfield service industry. Oilfield operations generated more than 90 percent of the Company's consolidated revenues in 1998, the Transition Period, 1997 and 1996 and currently consists of eight business units–Baker Atlas, Baker Hughes INTEQ, Baker Oil Tools, Baker Petrolite, Centrilift, E&P Solutions, Hughes Christensen and Western Geophysical - that manufacture and sell equipment and provide related services used in the drilling, completion, production, and maintenance of oil and gas wells and in reservoir measurement and evaluation. The business environment for the Company and its corresponding operating results are affected significantly by the petroleum industry exploration and production expenditures. These expenditures are influenced strongly by oil company expectations about the supply and demand for crude oil and natural gas, energy prices, and finding and development costs. Petroleum supply and demand, pricing, and finding and development costs, in turn, are influenced by numerous factors including, but not limited to, those described above in "Forward-Looking Statements."

Four key factors that currently influence the worldwide crude oil market and therefore current and future expenditures for exploration and development by our customers are:

- The degree to which certain large producing countries, in particular Saudi Arabia and Venezuela, are willing and able to restrict production and exports of crude oil.
- The increasing rate of depletion of known hydrocarbon reserves. Technological advances are resulting in accelerated decline rates and shorter well lives. In general, accelerated decline rates require additional customer spending to hold production levels.
- The level of economic growth in certain key areas of the world, particularly developing Asia, where the correlation between energy demand and economic growth is particularly strong.
- The amount of crude oil in storage relative to historic levels.

These four factors, together with oil and gas company projections for future commodity price movement, influence overall levels of expenditures for exploration and development by the Company's customers.

More specifically, two key factors influence the level of exploration and development spending:

Technology: Advances in the design and application of more technologically advanced products and services allow oil and gas companies to drill fewer wells, place the wells they drill more precisely in the higher yielding or more easily produced hydrocarbon zones of the reservoir, and allow operators to drill, complete, and operate wells at lower overall costs.

Price Volatility: Changes in hydrocarbon markets create uncertainty in the future price of hydrocarbons and therefore create uncertainty about the aggregate level of customer spending. Multiyear projects, such as deepwater exploration and drilling, are the least likely to be impacted by price volatility. Projects with relatively short payback periods or low profit margins, such as workover activity or the extraction of heavy oil, are more likely to be impacted.

Crude oil and natural gas prices and the Baker Hughes rotary rig count are summarized in the tables below as averages for the periods indicated and are followed by the Company's outlook. While reading the Company's outlook set forth below, caution is advised that the factors described above in "Forward-Looking Statements" and "Business Environment" could negatively impact the Company's expectations for oil demand, oil and gas prices, and drilling activity.

Oil and Gas Prices

	1998	Transition Period	1997	1996
West Texas Intermediate Crude ($/bbl)	14.41	20.02	21.83	20.51
U. S. Spot Natural Gas ($/mcf)	2.01	2.72	2.47	2.21

Crude oil prices experienced record low levels in 1998, trading below $15/bbl for most of the year and averaging only $14.41/bbl – the lowest yearly average recorded since 1983 and down over 30 percent from year-ago levels. Prices were lower due to increased supply from renewed Iraqi exports, increased OPEC and non-OPEC production, higher inventories (particularly in North America) and a simultaneous slowing of demand growth due to the Asian economic downturn and a generally warmer than normal winter. U.S. natural gas weakened in 1998 compared to the prior year periods, also due to the abnormally warm winter weather.

Rotary Rig Count

	1998	Transition Period	1997	1996
U.S.–Land	703	873	788	652
U.S.–Offshore	123	125	118	107
Canada	259	448	340	247
North America	1,085	1,446	1,246	1,006
Latin America	243	280	277	279
North Sea	52	55	58	53
Other Europe	46	56	57	69
Africa	74	75	80	76
Middle East	166	165	150	138
Asia pacific	173	173	181	173
International	754	804	803	788
Worldwide	1,839	2,250	2,049	1,794
U.S. Workover	1,088	1,427	1,412	1,306

Outlook

The factors discussed above resulted in historically high inventory levels and lower oil prices by the end of 1998. Oil prices that had ranged from $18-$26/bbl in 1997 fell to $15-$18/bbl in the first part of 1998. At the end of 1998 oil prices were trading between $10-$13/bbl. In response to lower oil prices and expectations for continued low oil prices in 1999, oil companies cut upstream capital spending particularly in the second half of 1998.

Baker Hughes expects oil prices to remain at relatively low levels throughout 1999, strengthening modestly from current levels towards the latter part of 1999. As a result, 1999 oil company capital spending is expected to decline approximately 25-30 percent from 1998 spending levels. Cuts in upstream capital spending were more significant in North and South America than in the Eastern Hemisphere in 1998. The Company expects customer spending in the Eastern Hemisphere to be reduced more significantly in 1999. Customer spending is expected to decline sequentially during the first two quarters of 1999 before stabilizing in the second half of the year.

DISCONTINUED OPERATIONS

On October 31, 1997, Western Atlas distributed all the shares of UNOVA, Inc. ("UNOVA"), its then wholly owned industrial automation systems subsidiary, as a stock dividend to its shareholders (the "Spin-off"). The operations of UNOVA for the Transition Period, 1997 and 1996 are classified as discontinued operations in the Company's consolidated financial statements. For periods prior to the Spin-off, cash, debt, and the related net interest expense were allocated based on the capital needs of UNOVA's operations. All corporate general and administrative costs of the Company are included in continuing operations and no allocation was made to UNOVA for any of the periods presented.

The UNOVA results of operations for 1997 include a $203.0 million charge for acquired in-process research and development activities related to UNOVA's acquisition of Norand Corporation and United Barcode Industries in April 1997.

ACQUISITIONS

In addition to the acquisitions discussed below, the Company made several acquisitions to expand its technology base and to increase its presence in key geographic areas. None of these acquisitions individually or in the aggregate are material to the Company's consolidated financial statements.

1998

In April 1998, the Company acquired all the outstanding stock of WEDGE DIA-Log, Inc. ("WEDGE") for $218.5 million in cash. WEDGE specializes in cased-hole logging and pipe recovery services. Also in April 1998, the Company acquired 3-D Geophysical, Inc. ("3-D") for $117.5 million in cash. 3-D is a supplier of primarily land-based seismic data acquisition services. The purchase method of accounting was used to record both of these acquisitions. The operating results of these acquisitions are included in the consolidated statement of operations from their respective acquisition date.

1997

In July 1997, the Company completed the acquisition of Petrolite Corporation ("Petrolite"). Baker Hughes issued 19.3 million shares of its common stock having an aggregate value of $730.2 million. Additionally, the Company assumed Petrolite's outstanding vested and unvested employee stock options which had a fair market value of $21.0 million, resulting in total consideration of $751.2 million. The Company recorded an unusual charge of $35.5 million related to the combination of Petrolite with Baker Performance Chemicals, the Company's existing oilfield and industrial chemicals operations, forming Baker Petrolite, a leading provider of oilfield chemicals in the major oilfield markets.

Also in July 1997, the Company acquired Drilex International Inc. ("Drilex"), a provider of products and services used in the directional and horizontal drilling and workover of oil and gas wells, for 2.7 million shares of the Company's common stock. The acquisition of Drilex, which has been combined with the operations of Baker Hughes INTEQ, provides the Company with an increased presence in the U.S. land directional and horizontal drilling market. In connection with the acquisition of Drilex, the Company recorded an unusual charge of $7.1 million related to transaction and other one-time costs.

RESULTS OF OPERATIONS

Revenues

Revenues for 1998 were $6,311.9 million, an increase of 18.1 percent over 1997 revenues of $5,343.6 million. The increase was due, in part, to acquisitions in 1998 and in the latter part of 1997, offset by activity level declines as rig counts in 1998 fell 12.9 percent in North America and 6.1 percent outside North America when compared to 1997. These activity declines were brought about by the significant drop in the price of oil and natural gas in the second half of 1998 and the resultant decrease in customer spending. Approximately 65 percent of the Company's revenues were derived from international activities in 1998 and 1997.

Quarterly revenues peaked in the June 1998 quarter at $1,659.7 million and declined $240.5 million, or 14.5 percent, to $1,419.2 million by the December 1998 quarter. The impact on the Company's business was most dramatic in North America land-based activity and in Venezuela. Excluding acquisitions, Western Geophysical is the only division that reported revenue increases in the second half of 1998 as it benefited from strong licensing sales of multiclient seismic data, where customer spending has been less impacted by fluctuations in oil prices. The Company expects revenues in the March 1999 quarter to be lower than the revenues reported for the December 1998 quarter.

Revenues for the three months ended December 31, 1997 were $1,572.9 million, an increase of 30.4 percent over revenues for the three months ended December 31, 1996 of $1,206.7 million. The revenue improvement resulted from higher activity levels as the worldwide rig count increased 14.7 percent.

Revenues for 1997 were $5,343.6 million, an increase of 20.2 percent over 1996 revenues of $4,445.8 million. Revenue from 1997 acquisitions contributed $218.7 million of the revenue improvement in 1997. Revenue growth in 1997 outpaced the 14.2 percent increase in the worldwide rig count. In particular, revenues in Venezuela increased $136.2 million, or 55.2 percent in 1997 when compared to 1996, as that country continued to work towards its then-stated goal of significantly increasing production.

Gross Margin

Gross margins for 1998, the Transition Period, 1997 and 1996, were 25.4 percent, 33.5 percent, 31.2 percent and 31.1 percent, respectively. The decrease in 1998 is due primarily to other nonrecurring charges recorded in costs of revenues of $305.0 million as discussed in "Unusual and Other Nonrecurring Charges," manufacturing under-absorption and pricing pressure experienced during the last half of 1998. The increases in the Transition Period, 1997 and 1996 result primarily from higher incremental gross profit on increasing revenues, changes in the revenue mix and continued emphasis on productivity and cost improvements.

Selling, General and Administrative

Selling, general and administrative ("SG&A") expense as a percent of consolidated revenues for 1998, the Transition Period, 1997

and 1996, were 20.6 percent, 20.6 percent, 19.4 percent and 20.0 percent, respectively. In 1998, other nonrecurring charges totaling $68.7 million were recorded in SG&A, offset by cost reduction efforts taken in the September and December 1998 quarters. In 1997, SG&A expense as a percent of consolidated revenues declined compared to 1996 due to foreign exchange gains incurred in 1997 compared to foreign exchange losses incurred in 1996 offset by higher marketing costs due to increased activity levels.

Merger Related Charges

In connection with the Merger, in 1998 the Company recorded Merger related costs of $219.1 million. The categories of costs incurred, the actual cash payments made in 1998 and the accrued balances at December 31, 1998 are summarized below:

	Total	Amounts paid in 1998	Accrued Balance at December 31, 1998
Cash costs			
Transaction costs	$ 51.5	$ 46.9	$ 4.6
Employee costs	87.7	66.7	21.0
Other Merger integration costs	21.7	9.8	11.9
Subtotal cash cost	160.9	$123.4	$ 37.5
Noncash	58.2		
Total	$ 219.1		

Transaction costs of $51.5 million include banking, legal and printing fees and other costs directly related to the Merger. The Company had contracted for and incurred most of the cost of the services for the remaining accrual; however, such amounts had not been paid. The Company expects that all amounts accrued for transaction costs will be paid by June 30, 1999.

Employee-related costs of $87.7 million consist of payments made to certain officers of Western Atlas and Baker Hughes pursuant to change in control provisions and severance benefits paid to terminated employees whose responsibilities were deemed redundant as a result of the Merger. Accrued employee costs, other than retirement benefits, at December 31, 1998 of $12.8 million are scheduled to be paid to the employees upon leaving the Company during the first quarter of 1999. The remaining accrued employee costs at December 31, 1998 of $8.2 million represent retirement benefits of certain employees that will be paid, in accordance with the terms of the agreements, over the lives of the covered employees.

Other integration costs include the costs of changing legal registrations in various jurisdictions, terminating a joint venture as a result of the Merger, changing signs and logos at the Company's major facilities around the world, and other integration costs. The Company expects that the remaining balance of $11.9 million for other integration costs will be paid by June 30, 1999.

The noncash charge of $58.2 million consists of a charge of $45.3 million related to the triggering of change of control rights contained in certain Western Atlas employee stock option plans that were not converted to Baker Hughes options concurrent with the Merger; a charge of $3.9 million for the issuance of the Company's common stock pursuant to certain stock plans as a result of the change in control; and a $9.0 million charge recorded to write-off the carrying value of a product line that was discontinued as a result of the Merger.

Unusual and Other Nonrecurring Charges

1998

The Company had experienced high growth levels for its products and services from 1994 through the second quarter of 1998. During the third and fourth quarters of 1998, the Company experienced a decline in demand for its products and services as a result of a significant decrease in the price of oil and natural gas. The decline in customer demand materialized quickly from the previous high growth rates. As a result of this sharp decline in demand and to adjust to the lower level of activity, the Company assessed its overall operations and recorded charges of $549.0 million in the September quarter and $40.5 million in the December quarter as summarized below:

	Total	Amounts paid in 1998	Accrued Balance at December 31, 1998
Cash charges:			
Severance for approximately 5,300 employees	$ 64.3	$ 26.6	$ 37.7
Integration costs, abandoned leases and other contractual obligations	40.0	14.7	25.3
Environmental reserves	8.8	4.3	4.5
Other cash costs (includes litigation reserves)	21.4	4.7	16.7
Subtotal cash charges	134.5	$ 50.3	$ 84.2
Noncash charges – write-down of:			
Inventory and rental tools	173.2		
PetroAlliance Services Company Limited	83.2		
Property and other assets	80.1		
Oil and gas properties (ceiling-test)	69.3		
Intangible assets	21.5		
Real estate held for sale	17.0		
Investments in affiliates	10.7		
Subtotal noncash charges	455.0		
Total cash and noncash charges	$ 589.5		

The above charges were reflected in the following captions of the consolidated statement of operations:

	Total
Costs of revenues	$ 305.0
Selling, general and administrative	68.7
Unusual charge	215.8
Total	$ 589.5

The amount accrued for severance is based upon the Company's written severance policy and the positions eliminated. The accrued severance does not include any portion of the employees' salaries through their severance dates. Based upon current severance dates, the Company expects that of the accrued severance remaining at December 31, 1998, $27.0 million will be paid during the first quarter of 1999 and the remaining $10.7 million will be paid during the second quarter of 1999 when the employees leave the Company.

The Company accrued $40.0 million to combine operations and consolidate facilities. Such accrual includes costs to settle leases on idled facilities based upon lease agreements; to shut-down oil and gas operations in certain countries based upon management's decision to abandon operations; to terminate a rig contract based upon the terms of the agreement; and other collocation costs based upon the estimated exit costs for approved plans. The accrual does not include any portion of the costs before actual abandonment of the facilities or ceasing of the operations. The Company expects to spend approximately $9.4 million of the accrued balance as of December 31, 1998 during the first quarter of 1999 and, except for amounts payable under terms of leases and other contracts, the remaining amounts accrued will be paid during the remainder of 1999.

The impairment of inventory and rental tool assets of $173.2 million impacted virtually all operating divisions and was due to advances in technology that have obsoleted certain product lines, as well as a decline in market demand that has resulted in an excess supply of certain products. The product lines most affected were completion products, drilling and evaluation systems and tools, tricone and diamond drill bits, and filtration systems. Much of the obsolete and excess inventory will be scrapped and has been written off completely. The remaining assets have been written down to their estimated value based on the Company's inventory and rental tool obsolescence policy.

In the third quarter of 1998, the Company recorded an $83.2 million write-down of PetroAlliance Services Company Limited ("PAS"), a former consolidated joint venture operating in the former Soviet Union. The write-down of the joint venture was based upon the Company's estimated value of assets ultimately received in consideration of the sale of the PAS investment in November 1998. The Company received as consideration for the sale of PAS a seismic vessel, other seismic and well-logging assets, certain PAS assets in Kazakhstan and Turkmenistan, certain customer receivables and a $33.0 million note from the purchasers. The write-down included $10.7 million for equipment, $22.0 million of goodwill, and $50.5 million of net current assets.

The impairment of property and other assets of $80.1 million includes an $18.1 million write-down to reduce the carrying value of a portion of the Company's drilling equipment; a $12.6 million write-off of obsolete solid and oil-filled streamer sections used on seismic vessels; a $14.9 million write-down of surplus well-logging equipment; a $9.5 million write-off of prepaid royalties

on an abandoned product line; and $25.0 million of assets written down to fair market value. The write-down of these assets was determined based on internally developed valuations using a variety of methods.

A $69.3 million charge results from the application of the ceiling test prescribed for oil and gas properties accounted for under the full cost method. With the sharp decline in price of both oil and natural gas, the carrying value of the Company's oil and gas interests were required to be written down.

The write-off of intangible assets of $21.5 million includes $2.7 million for capitalized software costs for product lines abandoned as a result of recent acquisitions; $5.3 million for capitalized development costs for software systems that are being replaced by the Company's implementation of SAP R/3; and $13.5 million for goodwill associated with a discontinued business and a subsidiary held for sale.

The write-down of real estate held for sale of $17.0 million is for a specific property and the charge reduces the carrying value to the property's appraised value.

The $10.7 million charge is to write-off investments in joint ventures in both Russia and Indonesia and also includes a loss on the sale of Tracor Europa, a discontinued subsidiary.

1997

During 1997, the Company recorded unusual charges of $52.1 million. This included charges in connection with the acquisitions of Petrolite and Drilex of $35.5 million and $7.1 million, respectively, to combine the acquired operations with those of the Company. An additional $9.5 million charge was recorded as a result of the decision to discontinue a low margin, oilfield product line in Latin America and to sell the Tracor Europa subsidiary, a computer peripherals operation. This resulted in a write-down of the investment in Tracor Europa to net realizable value. Cash provisions of the unusual charge totaled $19.4 million. The Company spent $5.5 million during 1997 and $1.6 million during the Transition Period. The Company spent substantially all of the remaining $12.3 million in 1998. Such expenditures relate to specific plans and clearly defined actions and were funded from operations and available credit facilities.

1996

During 1996, the Company recorded an unusual charge of $39.6 million. The charge consisted of the write-off of $8.5 million of oilfield operations patents that no longer protected commercially significant technology, a $5.0 million impairment of a Latin America joint venture due to changing market conditions in the region in which it operates, restructuring charges totaling $24.1 million, and $2.0 million of other charges. The restructuring charges included the downsizing of Baker Hughes INTEQ's Singapore and Paris operations, a reorganization of EIMCO Process Equipment's Italian operations, and the consolidation of certain Baker Oil Tools manufacturing operations. Noncash provisions of the charge totaled $25.3 million and consisted primarily of the write-down of assets to net realizable value. The remaining $14.3 million of the charge represents expected cash expenditures related to severance under existing benefit arrangements, abandoned leases, and the relocation of people and equipment. The Company spent $4.2 million of the cash during 1996, $6.3 million during 1997 and the remaining $3.8 million during the Transition Period.

Acquired In-process Research and Development

The acquisition of Petrolite in 1997 was accounted for as a purchase. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair market values at the date of the acquisition. In accordance with generally accepted accounting principles, the $118.0 million allocated to in-process research and development has been recorded as a charge in the consolidated statement of operations as of the acquisition date because the technological feasibility of the projects in-process had not been established and there was no alternative future use at that date.

There were 26 individual research and development projects that were in development at the time of the acquisition that were classified as in-process research and development. The products under development were valued using a discounted cash flow analysis at a 14 percent discount factor. The cash flows were projected for a 20-year period and included additional research and development and capital expenditures required to

complete the projects. The gross margins used for these products were generally consistent with those of other chemical products sold by the Company. The 14 percent discount factor used considered the time value of money, inflation and the risk inherent in the projects under development. In aggregate, the remaining completion costs for these products were projected to exceed $7.2 million with completion periods varying from 90 days to two years. Significant cash inflows from these products in total were expected to commence during 1999. During 1998, 16 of these products generated commercial sales, five had product sales on a trial basis only, and five were determined not to be viable products.

Interest Expense

Interest expense in 1998 increased $57.6 million compared to 1997. Interest expense in 1997 increased $3.5 million compared to 1996. These increases were due to higher debt levels that funded acquisitions, capital expenditures, and working capital.

Spin-off Related Costs

Costs related to the Spin-off of UNOVA of $8.4 million were charged to continuing operations during 1997.

Gain on Sale of Varco Stock

In May 1996, the Company sold 6.3 million shares of Varco International, Inc. ("Varco") common stock, representing its entire investment in Varco. The Company received net proceeds of $95.5 million and recognized a pretax gain of $44.3 million. The Company's investment in Varco was accounted for using the equity method. Equity income included in the Consolidated Statement of Operations for 1996 was $1.8 million.

Income Taxes

A significant portion of the Merger related costs and the unusual and other nonrecurring charges recorded in 1998 are not deductible for tax purposes in any jurisdiction. In addition, the Company operates in certain jurisdictions that assess tax on a deemed profit or turnover basis. As a result, the Company provided $16.3 million of income taxes on the net loss of $297.4 million in 1998. The effective tax rates before Merger and acquisition related costs, Spin-off related costs, unusual, and other nonrecurring items were 35.5 percent, 37.9 percent, 35.2 percent and 40.0 percent for the periods ended December 31, 1998, December 31, 1997, September 30, 1997 and September 30, 1996, respectively.

CAPITAL RESOURCES AND LIQUIDITY

Operating Activities

Net cash inflows from operating activities of continuing operations were $809.7 million, $141.1 million, $713.5 million and $636.6 million in 1998, the Transition Period, 1997 and 1996, respectively. The increase in operating cash flow in each successive period resulted from the increasing business levels from period to period.

Investing Activities

Net cash outflows from investing activities of continuing operations were $1,675.8 million in 1998, $319.2 million in the Transition Period, $971.8 million in 1997 and $485.4 million in 1996.

Property additions in 1998 increased as the Company added capacity to meet increased market demand and due to an increase in the acquisition of multiclient seismic data. In light of the more recent activity decline, the Company reviewed significant capital projects and currently expects 1999 capital expenditures to be approximately $600.0 million (excluding acquisitions), a significant reduction from 1998 capital spending. Funds provided from operations and outstanding lines of credit are expected to be adequate to meet future capital expenditure requirements.

Proceeds from the disposal of assets generated $100.0 million in 1998, $20.5 million in the Transition Period, $66.3 million in 1997 and $98.3 million in 1996.

The Company obtained $68.7 million of cash from the two stock acquisitions of Petrolite Corporation and Drilex that occurred in 1997. In July 1997, the Company sold all of the marketable securities it obtained from Wm. S. Barnickel & Company in association with the Petrolite acquisition for $48.5 million. In May 1996, the Company sold its entire investment in Varco receiving net proceeds of $95.5 million.

In 1998 the Company used short-term borrowings to purchase various businesses including WEDGE for $218.4 million, net of

cash acquired, 3-D for $117.5 million and Western Rock Bit for $31.4 million. In the Transition Period, the Company used short-term borrowings to purchase various businesses, including Oilfield Dynamics Inc. for $34.2 million. In 1997, the Company used existing cash on hand and short-term borrowings to purchase various businesses, including Environmental Technology Divisions of Deutz AG for $52.2 million, net of cash acquired. In 1996, the Company acquired Vortoil Separation Systems and KTM Process Equipment Inc. for a total of $32.7 million, net of cash acquired.

During the June 1997 quarter, the Company began a multi-year initiative designed to develop and implement an enterprise-wide software system. The initiative, named "Project Renaissance," will utilize SAP R/3 as its software platform across the entire Company and is expected to cost in excess of $300 million over a four-year period.

The words "expected" and "expects" are intended to identify Forward-Looking Statements in "Investing Activities." See "Forward-Looking Statements" and "Business Environment" above for a description of risk factors related to these Forward-Looking Statements.

Financing Activities

Net cash inflows (outflows) from financing activities of continuing operations were $838.6 million, $173.7 million, $462.3 million and ($133.9) million in 1998, the Transition Period, 1997 and 1996, respectively.

Total debt outstanding at December 31, 1998 was $2,770.7 million, compared to $1,782.6 million at December 31, 1997 and $1,589.5 million and $1,179.1 million at September 30, 1997 and 1996, respectively. The increase in debt is primarily due to increased borrowings from commercial paper and revolving credit facilities that funded acquisitions, capital expenditures and increases in working capital. The debt-to-equity ratio was 0.87 at December 31, 1998 compared to 0.51 at December 31, 1997.

Cash dividends in 1998 increased due to the increase in the number of shares of common stock outstanding. On an annualized basis the cash dividend of $0.46 per share of common stock will require approximately $150.0 million of cash which compares to an annual requirement of approximately $80.0 million before the Merger.

At December 31, 1998, the Company had $2,237.4 million of credit facilities with commercial banks, of which $1,000.0 million was committed. These facilities are subject to normal banking terms and conditions that do not signifcantly restrict the Company's activities.

Subsequent to December 31, 1998, the Company issued $400 million of 6.875 percent Notes due January 2029, $325 million of 6.25 percent Notes due January 2009, $200 million 6.0 percent Notes due February 2009 and $100 million of 5.8 percent Notes due 2003 with effective interest rates of 7.07 percent, 6.36 percent, 6.09 percent and 6.01 percent, respectively. The proceeds were used to repay current portions of long-term debt, commercial paper, and other short-term borrowings.

ACCOUNTING STANDARDS

Derivative and Hedge Accounting

In June 1998, the FASB issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities that require an entity to recognize all derivatives as an asset or liability measured at its fair value. Depending on the intended use of the derivative, changes in its fair value will be reported in the period of change as either a component of earnings or a component of other comprehensive income.

SFAS No. 133 is effective for all quarters of fiscal years beginning after June 15, 1999. Retroactive application to periods prior to adoption is not allowed. The Company will adopt the standard in the first quarter of 2000. The Company has not quantified the impact of the adoption of SFAS No. 133 on its consolidated financial statements.

QUANTITATIVE AND QUALITATIVE MARKET RISK DISCLOSURES

The Company is exposed to certain market risks that are inherent in the Company's financial instruments arising from transactions that are entered into in the normal course of business. The Company may enter into derivative financial instrument transactions to manage or reduce market risk; that is, the Company does not enter into derivative financial instrument transactions for speculative

purposes. A discussion of the Company's primary market risk exposure in financial instruments is presented below.

Long-term Debt

The Company is subject to interest rate risk on its long-term fixed interest rate debt. Commercial paper borrowings, other short-term borrowings and variable rate long-term debt do not give rise to significant interest rate risk because these borrowings have maturities of less than three months or have variable interest rates. All other things being equal, the fair market value of debt with a fixed interest rate will increase, and the amount required to retire the debt today will increase, as interest rates fall and the fair market value will decrease as interest rates rise. This exposure to interest rate risk is managed by borrowing money that has a variable interest rate or using interest rate swaps to change fixed interest rate borrowings to variable interest rate borrowings. Generally, the Company desires to maintain between 45 percent and 65 percent of total borrowings at variable interest rates.

The following table sets forth, as of December 31, 1998 and 1997, the Company's principal cash flows for its long-term debt obligations, which bear a fixed rate of interest and are denominated in U.S. dollars, and the related weighted average interest rates by expected maturity dates. Additionally, the table sets forth the notional amounts and weighted average interest rates of the Company's interest rate swaps by expected maturity.

	1998	1999	2000	2001	2002	2003	Thereafter	Total
As of December 31, 1998:								
Long-term debt [4]		$152.0	$95.1	$1.5	$9.2		$885.1[1]	$1,142.9
Weighted average interest rates		7.61%	8.55%	6.77%	6.77%		6.10%	6.51%
Fixed to variable swaps [5]			$93.0					
Pay rate			7.76%[2]					
Receive rate			8.59%					
As of December 31, 1997:								
Long-term debt [4]	$49.1	$150.0	$93.0				$890.6[1]	$1,182.7
Weighted average interest rates	5.65%	7.73%	8.59%				6.11%	6.48%
Fixed to variable swaps [5]	$230.5		$93.0					
Pay rate	3.55%[3]		7.82%[2]					
Receive rate	3.50%		8.59%					

[1] Includes a zero-coupon instrument with an accreted value of $275.5 million and $265.7 million at December 31, 1998 and 1997, respectively.

[2] Six-month LIBOR plus 2 percent settled semi-annually, maturing in January 2000.

[3] 30-day commercial paper minus 1.96 percent settled at maturity in May 1998.

[4] Fair value of long-term debt is $1,114.8 million and $1,257.9 million at December 31, 1998 and 1997, respectively.

[5] Fair value of the interest rate swaps is $1.6 million and $2.8 million at December 31, 1998 and 1997, respectively.

Included in the table above in the "Thereafter" column is the Company's Liquid Yield Option Notes ("LYONS") which are convertible into Company common stock at the option of the holder. As such, the fair value of the LYONS is determined, in addition to changes in interest rates, by changes in the market price of the Company's common stock. Holding interest rates constant, a 20 percent decline in the market price of the Company's common stock would not cause the fair value of the LYONS at December 31, 1998 to decrease by a comparable percentage amount because the LYONS currently trade more like a debt instrument than an equity instrument. This occurs because the market price of the Company's common stock at December 31, 1998 of $17.625 was significantly below the LYONS conversion price of $38.88.

Investments

The Company's investment in common stock and common stock warrants of Tuboscope, Inc. ("Tuboscope") is subject to equity price risk as the common stock of Tuboscope is traded on the New York Stock Exchange. Warrants to buy shares of Tuboscope common stock derive their value, in part, from the market value of Tuboscope common stock. This investment is classified as available for sale and, consequently, is reflected in the consolidated statement of financial position at fair value with unrealized gains and losses reported as a separate component of comprehensive income within stockholders' equity. The Company has no current intention of acquiring more shares of, or disposing of its interest in, Tuboscope; however, the Company's intentions may change in light of facts and circumstances that may arise in future dealings in the marketplace or other events affecting Tuboscope or the Company.

At December 31, 1998 and 1997, the fair value of the Company's investment in common stock and common stock warrants of Tuboscope was $26.9 million and $91.4 million, respectively. The Tuboscope common stock was valued at the closing price at December 31, 1998 and 1997, as reported on the New York Stock Exchange, and the warrants were valued using the Black-Scholes option-pricing model. No actions have been taken by the Company to hedge this market risk exposure. A 20 percent decline in the market price of Tuboscope common stock would cause the fair value of the investment in common stock and common stock warrants of Tuboscope to decrease $5.9 million at December 31, 1998.

Foreign Currency

The Company's operations are conducted around the world in a number of different currencies. As such, there is exposure to future earnings due to changes in foreign currency exchange rates when transactions are denominated in currencies other than the Company's functional currencies, which are the primary currencies in which the Company conducts its business in various jurisdictions. As a general rule, the Company hedges all or part of the future earnings exposure when it believes the risk of loss is greater than the cost of the associated hedge.

At December 31, 1998 and 1997, the Company had Norwegian Krone denominated commitments of $81.4 million and $84.0 million, respectively, to purchase two seismic vessels. The Company entered into forward exchange contracts with notional amounts of $88.9 million as of December 31, 1998 and 1997 to hedge these commitments. At December 31, 1998, the fair market value of these contracts was $80.8 million resulting in an unrealized loss of $8.1 million. At December 31, 1997, the unrealized loss was not significant. Also at December 31, 1998, the Company had Australian Dollar denominated commitments of $32.6 million primarily related to a long-term equipment purchase commitment for which the Company entered into forward exchange contracts with notional amounts of $29.1 million to hedge the majority of this commitment. At December 31, 1998, the fair market value of these contracts was $30.2 million resulting in an unrealized gain of $1.1 million. The notional amounts are used to express the volume of these transactions and do not represent exposure to loss. The fair market value of these contracts was based on year end quoted market prices for contracts with similar terms and maturity dates. The carrying value of the contracts was not significant. Foreign currency gains and losses for such purchases are deferred and become part of the bases of the assets. The counterparties to the Company's forward contracts are major financial institutions. The credit ratings and concentration of risk of these financial institutions are monitored on a continuing basis and, in management's opinion, present no significant credit risk to the Company. In the unlikely event that the counterparties fail to meet the terms of a foreign currency contract, the Company's exposure is limited to the foreign currency spot rate differential.

Certain borrowings of the Company are denominated in currencies other than its functional currency. At December 31, 1998, these nonfunctional currency borrowings totaled $28.5 million where the primary exposure was between the U.S. Dollar and the British Pound. At December 31, 1997, the Company's nonfunctional currency short-term borrowings totaled $8.7 million where the primary exposure was between the U.S. Dollar and the French Franc. A 10 percent appreciation of the U.S. Dollar against these currencies would not have a significant effect on the future earnings of the Company.

YEAR 2000 ISSUE

Forward-Looking Statements Regarding the Year 2000 Issue

The words "expect," "believe," "will," "estimate," "target" and similar expressions are intended to identify Forward-Looking Statements in "Year 2000 Issue." Although the Company expects that it will complete various phases of its Year 2000 Program Plan (the "Program Plan") as described below, including (without limitation) the specific remedial and corrective aspects of the program or the contingency plans described below, there can be no assurance that the Company will be successful in completing each and every aspect of the Program Plan and, if successful, within the expected schedules described below. Factors that could affect the Company's implementation of its Program Plan include unforeseen difficulties in remediating a

specific problem due to the complexity of hardware and software, the inability of third parties to adequately address their own year 2000 issues, including vendors, contractors, financial institutions, U.S. and foreign governments and customers, the delay in completion of a phase of the Program Plan necessary to begin a later phase, the discovery of a greater number of hardware and software systems or technologies with material year 2000 issues than the Company presently anticipates, and the lack of alternatives that the Company previously believed existed.

Overview

Many computer hardware and software products have not been engineered with internal calendars or date-processing logic capable of accommodating dates after December 31, 1999. In most cases, the problem is due to the hardware or software application storing the year as a two-digit field. In applications where this year 2000 ("Y2K") problem exists, the year 2000 will appear as 00, and current applications could interpret the year as 1900 or some other date rather than 2000. The same error may exist for years later than 2000 because the application cannot distinguish which century the date represents. These errors could negatively affect the Company's business application systems, manufacturing, engineering and process control systems, products sold to customers, equipment used in providing services, facilities equipment and information technology ("IT") infrastructure. Additionally, Y2K issues impacting suppliers and customers could have an indirect negative impact on the Company.

Year 2000 Program Plan

Baker Hughes has developed a Year 2000 Program Plan for identifying, assessing and correcting its Y2K problems. This Program Plan strives to achieve a consistent approach to the Y2K issue throughout the Company. The Program Plan has the following aspects: program management, inventory and risk assessment, remediation, testing and implementation, contingency planning, and quality assurance.

The Company is currently completing an inventory of all hardware and software that the Company incorporates in its products or utilizes to support its operations or provide services to its customers. The Company is also determining whether the inventoried items have Y2K problems. If a Y2K problem exists, the Company will assess the risks associated with the problem.

At December 31, 1998, the Company had inventoried well over half of its hardware and software. All inventories and assessments are in progress and expected to be substantially complete by mid-March. Since the inventory and assessment phase is still in progress, the Company could identify additional hardware and software that has Y2K problems.

Baker Hughes has adopted the British Standards Institute Year 2000 Conformity Guidelines as a reasonable standard for determining whether software and hardware are not materially affected by Y2K problems. When meeting these guidelines, the Company has deemed that hardware and software are not materially affected by Y2K problems and, thus, are "in Y2K compliance."

The Company's remediation efforts include the correction or replacement of noncompliant hardware and software and are scheduled to be completed by mid to late 1999 for all material noncompliant hardware and software that the Company has identified to date. Both the Company's employees and outside vendors are performing this work. The Company has established a target date of June 30, 1999 for the completion of the work on a majority of its material noncompliant systems and technologies. The Company expects to complete its development of contingency plans prior to the end of 1999 for any material systems and technologies not remediated by June 1999.

The Company is unable to reasonably estimate the absolute dollar effect on the Company's results of operation, liquidity or financial condition if its remediation efforts are unsuccessful, although the Company believes the effect would be material.

Baker Hughes has performed testing and validation of the compliance status for all critical hardware and software as the Company has completed each remediation project. Hardware and software that is not critical may not be tested and validated. The Company is currently testing and validating, among other hardware and software, its seismic data acquisition and analysis systems, surface data acquisition and logging systems, wireline logging systems, certain filtration and separation equipment that has been customized with program logic controllers, and certain motor controllers that include embedded chips and internal clocks. The

Company's employees and, in some cases, third-party contractors have performed the testing and validation work. Near the completion of the inventory and risk assessment phase, the Company expects to use external resources to evaluate the Company's program management and the adequacy and completeness of its risk assessment, testing and validation.

Year 2000 Program Plan Costs

Baker Hughes has approximately 80 full-time equivalent employees ("FTEs") involved in the Y2K effort, which the Company estimates has an associated annual cost of approximately $5.6 million. Generally, these FTEs are full-time employees who are devoting some portion of their schedule to the Y2K effort.

In addition to the payroll and payroll-related costs, Baker Hughes estimates spending approximately $48.0 million in the Y2K compliance effort, of which approximately $35.0 million would be capitalized as replacement hardware and software equipment. Of the $48.0 million, the Company has spent approximately $26 million through December 31, 1998. The Company has funded, and expects to continue to fund, these expenditures from cash that it generates from operating activities or existing credit facilities. These cost estimates could change materially based upon the completion of the inventory and risk assessment phase of the Program Plan.

Third-Party Issues

The failure of third-parties, which have a material relationship with the Company, to address their Y2K problems could negatively and materially impact the Company. To address this risk, the Company is assessing the effect of Y2K on key vendor and contractor relationships and has begun to do the same with respect to key customer relationships. This assessment includes key relationships with parties with which the Company interfaces electronically and with which the Company has entered into strategic alliances.

The Company is evaluating vendors that the Company believes are material to its operations and assessing the business risk of Y2K noncompliance on their part. Based upon this assessment, the Company is seeking to obtain written confirmation from key vendors and contractors that they are adequately addressing their Y2K issues. Additionally, the Company seeks to review the Y2K statements of these vendors and contractors to the extent they exist. Where the Company cannot obtain satisfactory confirmation from these vendors, the purchasing departments of each operating division of the Company intend to identify alternate sources, if available, for vendors if those sources are needed because of an inability to perform due to Y2K noncompliance. The Company expects to complete this assessment by May 1999.

Known Material Y2K Noncompliant Hardware and Software

INTEQ and Baker Oil Tools are implementing SAP R/3 for domestic operations during 1999. INTEQ has delayed remediation of its existing payroll system, and Baker Oil Tools has delayed remediation for certain other business applications, in each case, pending the implementation of SAP R/3. Contingencies for these operational areas are being evaluated, and the Company expects to implement a contingency plan if the SAP implementation is not timely.

Older versions of INTEQ's PC-based surface data acquisition systems are not Y2K compliant. The software is in the process of being remediated. The noncompliant PC hardware cannot be economically remediated, and the purchase of new, higher grade personal computers is required to replace the noncompliant equipment. This remediation began in 1997 with the replacement of personal computers being phased in and is expected to be completed by late 1999. The Company estimates that as of December 31, 1998, it was 60 percent complete in the replacement of the noncompliant personal computer hardware and software for the surface data acquisition systems.

Baker Atlas is rewriting its bonded inventory control module that tracks assets that are used in international waters that may be exempt from import duties. The upgrade is expected to be in place by June 1999.

The Company's Western Geophysical operating division relies heavily upon Global Positioning System ("GPS") equipment that the U.S. Navy operates. The noncompliance of this equipment is a known problem outside the control of the Company that affects other businesses, the government, the military services and individuals that rely upon GPS services, including most of the

Company's seismic business competitors. Based upon information obtained from the U.S. government, the Company believes that the government is adequately addressing its GPS Y2K noncompliance problem and expects this system to be compliant in early 1999. However, there can be no assurance that any Y2K noncompliance with respect to the government's GPS equipment or the equipment of its contractors and subcontractors will be corrected on schedule. The Company is not aware of any contingency system that its GPS receivers can utilize if the government's GPS equipment is not made Y2K compliant. A failure to correct the Y2K problems of this equipment could have a material adverse impact on the Company's results of operations.

Western Geophysical uses a seismic acquisition synchronizer as part of its marine seismic acquisition services. This product is not Y2K compliant, and its noncompliance would have a material impact on the Company's marine seismic acquisition revenues if not corrected. The Company is discussing the issue with the manufacturer to complete an upgrade remediation plan. Western Geophysical anticipates that this software will be Y2K compliant by June 1999. A seismic acquisition system that Western Geophysical uses is also not Y2K compliant. The manufacturer has informed Western Geophysical that it intends to make the system Y2K compliant in the first quarter of 1999. Finally, Western Geophysical has a prospect data logger software system that is not Y2K compliant. Western Geophysical is internally generating software upgrades for this system.

Baker Process is implementing a new business application system to replace its existing systems, which are not Y2K compliant. This system includes financial, purchasing, inventory management and manufacturing functionality. The Company expects Baker Process to complete the implementation of the new system by late 1999.

The Baker Process operating division provides mechanical equipment that, in some cases, has been customized at the request of the customer to include control panels and circuit boards. The Company obtained these control panels and circuit boards from third-party vendors at the request of various customers. The Company is researching the Y2K compliance status of these boards. This status is often dependent upon the purchase date and serial number of the product. The warranties from the Company or its subcontractors have, in many instances, lapsed with respect to these panels and circuit boards. The Company expects to have completed its investigation of these systems by mid 1999. Pending the results of this evaluation, there could be a material noncompliance issue with these products.

EURO CONVERSION

A single European currency ("the Euro") was introduced on January 1, 1999, at which time the conversion rates between legacy currencies and the Euro were set for 11 participating member countries. However, the legacy currencies in those countries will continue to be used as legal tender through January 1, 2002. Thereafter, the legacy currencies will be canceled, and Euro bills and coins will be used in the eleven participating countries.

Transition to the Euro creates a number of issues for the Company. Business issues that must be addressed include pricing policies and ensuring the continuity of business and financial contracts. Finance and accounting issues include the conversion of accounting systems, statutory records, tax books and payroll systems to the Euro, as well as conversion of bank accounts and other treasury and cash management activities.

The Company is assessing and addressing these transition issues. The Company does not presently anticipate that the transition to the Euro will have a significant impact on its results of operations, financial position or cash flows. The word "anticipate" is intended to identify a Forward-Looking Statement in "Euro Conversion." Baker Hughes' anticipation regarding the lack of significance of the Euro introduction on Baker Hughes' operations is only its forecast regarding this matter. This forecast may be substantially different from actual results, which are affected by factors substantially similar to those described in "Year 2000 Issue – Forward-Looking Statements Regarding the Year 2000 Issue" above.

Independent Auditors' Report

Stockholders of Baker Hughes Incorporated:

We have audited the accompanying consolidated statements of financial position of Baker Hughes Incorporated and its subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for the year ended December 31, 1998, the three month period ended December 31, 1997 and for each of the two years in the period ended September 30, 1997. 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 December 31, 1998 and 1997, and the results of their operations and their cash flows for the year ended December 31, 1998, the three month period ended December 31, 1997 and for each of the two years in the period ended September 30, 1997 in conformity with generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of accounting for impairment of long-lived assets to be disposed of effective October 1, 1996 to conform with Statement of Financial Accounting Standards No. 121.

Deloitte & Touche LLP

February 17, 1999
Houston, Texas

Consolidated Statements of Operations

(In millions, except per share amounts)	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Revenues	$ 6,311.9	$ 1,572.9	$ 5,343.6	$ 4,445.8
Costs and expenses:				
Costs of revenues	4,710.9	1,045.7	3,676.9	3,062.8
Selling, general and administrative	1,301.8	324.6	1,036.1	889.2
Merger related costs	219.1			
Unusual charge	215.8		52.1	39.6
Acquired in-process research and development			118.0	
Total	6,447.6	1,370.3	4,883.1	3,991.6
Operating income (loss)	(135.7)	202.6	460.5	454.2
Interest expense	(149.0)	(24.5)	(91.4)	(87.9)
Interest income	3.6	1.1	3.6	4.9
Spin-off related costs			(8.4)	
Gain on sale of Varco stock				44.3
Income (loss) from continuing operations before income taxes and cumulative effect of accounting change	(281.1)	179.2	364.3	415.5
Income taxes	(16.3)	(68.0)	(163.4)	(169.1)
Income (loss) from continuing operations before cumulative effect of accounting change	(297.4)	111.2	200.9	246.4
Cumulative effect of accounting change:				
Impairment of long-lived assets to be disposed of (net of $6.0 income tax benefit)			(12.1)	
Income (loss) from continuing operations	(297.4)	111.2	188.8	246.4
Discontinued operations, net of tax		2.8	(154.9)	55.7
Net income (loss)	$ (297.4)	$ 114.0	$ 33.9	$ 302.1
Basic earnings per share:				
Income (loss) from continuing operations before cumulative effect of accounting change	$ (0.92)	$ 0.35	$ 0.67	$ 0.86
Cumulative effect of accounting change			(0.04)	
Discontinued operations		0.01	(0.52)	0.19
Net income (loss)	$ (0.92)	$ 0.36	$ 0.11	$ 1.05
Diluted earnings per share:				
Income (loss) from continuing operations before cumulative effect of accounting change	$ (0.92)	$ 0.34	$ 0.66	$ 0.85
Cumulative effect of accounting change			(0.04)	
Discontinued operations		0.01	(0.51)	0.19
Net income (loss)	$ (0.92)	$ 0.35	$ 0.11	$ 1.04

See Notes to Consolidated Financial Statements

Consolidated Statements of Financial Position

(In millions, except par value)	December 31, 1998	December 31, 1997
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 16.6	$ 41.9
Receivables-less allowance for doubtful accounts:		
December 31, 1998, $50.1; December 31, 1997, $54.4	1,422.3	1,519.4
Inventories	1,065.7	1,145.0
Other current assets	219.9	213.5
Total current assets	2,724.5	2,919.8
Property-net	2,292.3	1,979.0
Goodwill and other intangibles - less accumulated amortization:		
December 31, 1998, $285.5; December 31, 1997, $ 238.4	1,898.4	1,537.2
Multiclient seismic data and other assets	895.6	794.6
Total assets	$ 7,810.8	$ 7,230.6
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 560.5	$ 601.5
Short-term borrowings and current portion of long-term debt	44.4	177.3
Accrued employee compensation	284.3	287.0
Other accrued liabilities	420.7	351.3
Total current liabilities	1,309.9	1,417.1
Long-term debt	2,726.3	1,605.3
Deferred income taxes	156.5	283.8
Deferred revenue and other long-term liabilities	418.7	405.4
Commitments and contingencies		
Stockholders' equity:		
Common stock, $1 par value (shares authorized - 400.0; outstanding -		
327.1 at December 31, 1998 and 316.8 at December 31, 1997)	327.1	316.8
Capital in excess of par value	2,931.8	2,834.0
Retained earnings	100.4	494.1
Cumulative foreign currency translation adjustment	(155.4)	(160.5)
Unrealized gain (loss) on securities available for sale	(0.1)	38.1
Pension liability adjustment	(4.4)	(3.5)
Total stockholders' equity	3,199.4	3,519.0
Total liabilities and stockholders' equity	$ 7,810.8	$ 7,230.6

See Notes to Consolidated Financial Statements

Consolidated Statements of Stockholders' Equity

(In millions, except per share amounts)	Common Stock	Capital In Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income: Foreign Currency Translation Adjustment	Accumulated Other Comprehensive Income: Unrealized Gain (Loss) on Securities Available for Sale	Accumulated Other Comprehensive Income: Pension Liability Adjustment	Treasury Stock	Total
BALANCE, SEPTEMBER 30, 1995 as previously reported	$ 142.2	$ 1,342.3	$ 140.1	$ (107.7)	$ (3.4)	$ —	$ —	$ 1,513.5
Western Atlas pooling of interests	143.6	1,039.0	165.8	8.4				1,356.8
BALANCE, SEPTEMBER 30, 1995	285.8	2,381.3	305.9	(99.3)	(3.4)	—	—	2,870.3
Comprehensive income								
Net income			302.1					
Other comprehensive income:								
Foreign currency translation adjustment, net of $.5 tax				(7.0)				
Unrealized gain adjustment, net of $12.2 tax					22.7			
Total comprehensive income								317.8
Cash dividends on common stock ($.46 per share)			(65.9)					(65.9)
Stock issued pursuant to employee stock plans	3.7	67.1						70.8
Treasury stock purchase							(2.1)	(2.1)
BALANCE, SEPTEMBER 30, 1996	289.5	2,448.4	542.1	(106.3)	19.3	—	(2.1)	3,190.9
Comprehensive income								
Net income			33.9					
Other comprehensive income:								
Foreign currency translation adjustment, net of $1.1 tax				(29.8)				
Unrealized gain adjustment, net of $22.3 tax					41.4			
Pension adjustment, net of $1.9 tax						(3.5)		
Total comprehensive income								42.0
Drilex pooling of interests	2.7	46.9	5.7					55.3
Spin-off of UNOVA (See Note 3)		(513.1)	(77.9)	(8.8)				(599.8)
Cash dividends on common stock ($.46 per share)			(69.6)					(69.6)
Petrolite and other acquisitions	20.2	758.4						778.6
Stock issued pursuant to employee stock plans	4.1	87.9					13.5	105.5
Treasury stock purchase							(11.4)	(11.4)
BALANCE, SEPTEMBER 30, 1997	316.5	2,828.5	434.2	(144.9)	60.7	(3.5)	—	3,491.5
Comprehensive income								
Net income			114.0					
Other comprehensive income:								
Foreign currency translation adjustment, net of $1.6 tax				(15.6)				
Unrealized gain adjustment, net of $10.3 tax					(22.6)			
Total comprehensive income								75.8
Cash dividends on common stock ($.115 per share)			(19.5)					(19.5)
Stock issued pursuant to employee stock plans	0.3	5.5						5.8
Adjustment for change in year end			(34.6)					(34.6)
BALANCE, DECEMBER 31, 1997	316.8	2,834.0	494.1	(160.5)	38.1	(3.5)	—	3,519.0
Comprehensive income								
Net loss			(297.4)					
Other comprehensive income:								
Foreign currency translation adjustment, net of $.5 tax				5.1				
Unrealized loss adjustment, net of $22.5 tax					(38.2)			
Pension adjustment, net of $.5 tax						(.9)		
Total comprehensive income								(331.4)
Cash dividends on common stock ($.46 per share)			(96.3)					(96.3)
Stock issued pursuant to employee stock plans	10.3	97.8						108.1
BALANCE, DECEMBER 31, 1998	$ 327.1	$ 2,931.8	$ 100.4	$ (155.4)	$ (0.1)	$ (4.4)	$ —	$ 3,199.4

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

(In millions)	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Cash Flows From Operating Activities:				
Income (loss) from continuing operations	$ (297.4)	$ 111.2	$ 188.8	$ 246.4
Adjustments to reconcile income (loss) from continuing operations to net cash flows from operating activities:				
Depreciation, depletion and amortization	758.3	141.7	554.9	465.0
Provision (benefit) for deferred income taxes	(107.0)	(4.2)	(3.9)	28.6
Noncash portion of nonrecurring charges	513.2		32.7	25.3
Acquired in-process research and development			118.0	
Gain on sale of Varco stock				(44.3)
Gain on disposal of assets	(32.0)	(12.0)	(20.7)	(38.0)
Cumulative effect of accounting changes			12.1	
Change in receivables	99.5	(84.4)	(209.2)	(132.1)
Change in inventories	(39.5)	(58.2)	(110.1)	(79.4)
Change in accounts payable	(59.8)	8.5	82.9	43.6
Change in other assets and liabilities	(25.6)	38.5	68.0	121.5
Net cash flows from continuing operations	809.7	141.1	713.5	636.6
Net cash flows from discontinued operations		10.5	12.1	22.3
Net cash flows from operating activities	809.7	151.6	725.6	658.9
Cash flows from investing activities:				
Expenditures for capital assets and multiclient seismic data	(1,318.2)	(296.6)	(1,047.7)	(657.7)
Proceeds from disposal of assets	100.0	20.5	66.3	98.3
Cash obtained in stock acquisitions			68.7	
Proceeds from sale of businesses				12.1
Acquisition of businesses, net of cash acquired	(457.6)	(43.1)	(107.6)	(33.6)
Proceeds from sale of investments			48.5	95.5
Net cash flows from continuing operations	(1,675.8)	(319.2)	(971.8)	(485.4)
Net cash flows from discontinued operations		(0.6)	(406.3)	9.6
Net cash flows from investing activities	(1,675.8)	(319.8)	(1,378.1)	(475.8)
Cash flows from financing activities:				
Net borrowings (payments) from commercial paper and revolving credit facilities	977.3	(29.0)	471.0	(19.4)
Repayment of indebtedness	(69.5)	(21.4)	(128.7)	(111.6)
Proceeds from issuance of common stock	27.1	13.6	80.0	60.1
Dividends	(96.3)	(19.5)	(69.6)	(65.9)
Payment from UNOVA, Inc.		230.0	109.6	2.9
Net cash flows from continuing operations	838.6	173.7	462.3	(133.9)
Net cash flows from discontinued operations		13.1	210.4	(44.5)
Net cash flows from financing activities	838.6	186.8	672.7	(178.4)
Adjustment for change in year end		(17.3)		
Effect of foreign exchange rate changes on cash	2.2	(1.5)	(2.1)	(0.7)
Increase (decrease) in cash and cash equivalents	(25.3)	(0.2)	18.1	4.0
Cash and cash equivalents, beginning of year	41.9	42.1	24.0	20.0
Cash and cash equivalents, end of year	$ 16.6	$ 41.9	$ 42.1	$ 24.0

See Notes to Consolidated Financial Statements

NOTE 1.
BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Baker Hughes Incorporated and all majority-owned subsidiaries (the "Company" or "Baker Hughes"). In the Notes to Consolidated Financial Statements, all dollar amounts in tabulations are in millions of dollars unless otherwise indicated.

Change in Year-end

On August 27, 1998, the Board of Directors of Baker Hughes approved a change in the fiscal year-end of the Company from September 30 to December 31, effective with the calendar year beginning January 1, 1998. A three-month transition period from October 1, 1997 through December 31, 1997 (the "Transition Period") precedes the start of the 1998 fiscal year. "1997" and "1996" refer to the respective years ended September 30, the Transition Period refers to the three months ended December 31, 1997 and "1998" refers to the twelve months ended December 31, 1998.

Merger

On August 10, 1998, Baker Hughes completed a merger (the "Merger") with Western Atlas Inc. ("Western Atlas") by issuing 148.6 million shares of Baker Hughes common stock for all of the outstanding common stock of Western Atlas. Each share of Western Atlas common stock was exchanged for 2.7 shares of Baker Hughes common stock. Western Atlas, the common stock of which was previously publicly traded, is a leading supplier of oilfield services and reservoir information technologies for the worldwide oil and gas industry. It specializes in land, marine and transition-zone seismic data acquisition and processing services, well-logging and completion services, and reservoir characterization and project management services.

The Merger was accounted for as a pooling of interests and, accordingly, all prior period consolidated financial statements of Baker Hughes have been restated to include the results of operations, financial position and cash flows of Western Atlas. Information concerning common stock, employee stock plans and per share data has been restated on an equivalent share basis. The consolidated financial statements as of September 30, 1997 and for each of the two years in the period ended September 30, 1997 include Baker Hughes' previous September 30 fiscal year amounts and Western Atlas' December 31 calendar year amounts for the corresponding fiscal years of Baker Hughes. Consolidated financial statements for the three months ended December 31, 1997 include amounts for Baker Hughes and Western Atlas for the three months ended December 31, 1997. As a result, Western Atlas' results of operations for the three months ended December 31, 1997 are included in both the consolidated financial statements for the year ended September 30, 1997 and for the Transition Period. Included in the consolidated statement of stockholders' equity is a $34.6 million adjustment for the change in year end which represents Western Atlas' results of operations for the three months ended December 31, 1997 that is included in both 1997 and the Transition Period.

The reconciliations of revenue, income from continuing operations and net income (loss) of Baker Hughes and Western Atlas for the periods prior to the combination are as follows:

	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Revenues:			
Baker Hughes	$ 1,133.4	$ 3,685.4	$ 3,027.7
Western Atlas	439.5	1,658.2	1,418.1
Combined	$ 1,572.9	$ 5,343.6	$ 4,445.8
Income from continuing operations:			
Baker Hughes	$ 79.4	$ 97.0	$ 176.4
Western Atlas	31.8	91.8	70.0
Combined	$ 111.2	$ 188.8	$ 246.4
Net income (loss):			
Baker Hughes	$ 79.4	$ 97.0	$ 176.4
Western Atlas	34.6	(63.1)	125.7
Combined	$ 114.0	$ 33.9	$ 302.1

There were no material adjustments required to conform the accounting policies of the two companies. Certain amounts of Western Atlas have been reclassified to conform to the reporting practices of Baker Hughes.

In connection with the Merger, in 1998 the Company recorded merger related costs of $219.1 million. The categories of costs

incurred, the actual cash payments made in 1998 and the accrued balances at December 31, 1998 are summarized below:

	Total	Amounts paid in 1998	Accrued Balance at December 31, 1998
Cash costs:			
Transaction costs	$ 51.5	$ 46.9	$ 4.6
Employee costs	87.7	66.7	21.0
Other Merger integration costs	21.7	9.8	11.9
Subtotal cash cost	160.9	$123.4	$ 37.5
Noncash	58.2		
Total	$ 219.1		

Transaction costs of $51.5 million include banking, legal and printing fees and other costs directly related to the Merger. The Company had contracted for and incurred most of the cost of the services for the remaining accrual, however, such amounts had not been paid. The Company expects that all amounts accrued for transaction costs will be paid by June 30, 1999.

Employee related costs of $87.7 million consist of payments made to certain officers of Western Atlas and Baker Hughes pursuant to change in control provisions and severance benefits paid to terminated employees whose responsibilities were deemed redundant as a result of the Merger. Accrued employee costs, other than retirement benefits, at December 31, 1998 of $12.8 million are scheduled to be paid to the employees upon leaving the Company during the first quarter of 1999. The remaining accrued employee costs at December 31, 1998 of $8.2 million represent retirement benefits of certain employees that will be paid, in accordance with the terms of the agreements, over the lives of the covered employees.

Other integration costs include the costs of changing legal registrations in various jurisdictions, terminating a joint venture as a result of the Merger, changing signs and logos at the Company's major facilities around the world and other integration costs. The Company expects that the remaining balance of $11.9 million for other integration costs will be paid by June 30, 1999.

The noncash charge of $58.2 million consists of a charge of $45.3 million related to the triggering of change of control rights contained in certain Western Atlas employee stock option plans that were not converted to Baker Hughes options concurrent with the Merger; a charge of $3.9 million for the issuance of the Company's common stock pursuant to certain stock plans as a result of the change in control; and a $9.0 million charge recorded to write-off the carrying value of a product line that was discontinued as a result of the Merger.

NOTE 2.
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation: The consolidated financial statements include those of the Company and all majority owned subsidiaries. Investments in which the Company owns 20 percent to 50 percent and exercises significant influence over operating and financial policies are accounted for using the equity method. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue recognition: Revenue from product sales are recognized upon delivery of products to the customer. Revenue from services and rentals are recorded when such services are rendered.

Cash equivalents: The Company considers all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents.

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. The Company manufactures a substantial portion of its rental tools and equipment, and the cost of these items includes direct and indirect manufacturing costs.

The Company is developing and implementing SAP R/3 as an enterprise-wide software system. External direct costs of con-

sulting services and payroll related cost of employees who work full-time on implementation of the enterprise-wide software system are capitalized. Costs associated with business process reengineering are expensed as incurred.

The Company uses the full-cost method of accounting for its investment in oil and gas properties. Under this method, the Company capitalizes all acquisition, exploration, and development costs incurred for the purpose of finding oil and gas reserves. Depreciation, depletion, and amortization of oil and gas properties is computed using the unit-of-production method based upon production and estimates of proved reserves. Due to ceiling test limitations, the Company had write-downs of $69.3 million, $12.5 million and $7.0 million during 1998, 1997 and 1996, respectively.

Multiclient Seismic Data: Costs incurred in the creation of Company-owned multiclient seismic data are capitalized and amortized over the estimated revenue that the Company expects to receive from the licensing of such data. Cash prepayments received from customers for specific contracts are included in deferred revenue until earned.

Impairment of assets: The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, effective October 1, 1996. The statement sets forth guidance as to when to recognize an impairment of long-lived assets, including goodwill, and how to measure such an impairment. The methodology set forth in SFAS No. 121 is not significantly different from the Company's prior policy and, therefore, the adoption of SFAS No. 121 did not have a significant impact on the consolidated financial statements as it relates to impairment of long-lived assets used in operations. The accounting for long-lived assets to be disposed of requires these assets to be carried at the lower of cost or fair market value as determined by a discounted cash flow analysis, rather than the lower of cost or net realizable value, the method that was previously used by the Company. The Company recognized a charge to income of $12.1 million ($.04 per share-diluted), net of a tax benefit of $6.0 million, in 1997 as the cumulative effect of a change in accounting.

Investments: Investments in debt and equity securities, other than those accounted for by the equity method, are classified as available for sale and reported at fair value with unrealized gains or losses, net of tax, recorded as a separate component of comprehensive income within stockholders' equity.

Goodwill: Goodwill arising from acquisitions is amortized on the straight-line method over the lesser of its expected useful life or 40 years.

Income taxes: Deferred income taxes are determined utilizing an asset and liability approach. This method gives consideration to the future tax consequences associated with differences between the financial accounting and tax bases of assets and liabilities.

Environmental matters: Remediation costs are accrued based on estimates of known environmental remediation exposure. Such accruals are recorded even if significant uncertainties exist over the ultimate cost of the remediation. Ongoing environmental compliance costs, including maintenance and monitoring costs, are expensed as incurred. Where the Company has been identified as a potentially responsible party in a Federal Superfund site, the Company accrues its share of the estimated remediation costs of the site based on the ratio that the estimated volume of waste contributed to the site by the Company bears to the total volume of waste at the site.

Stock-based compensation: The intrinsic value method of accounting is used for stock-based employee compensation whereby no compensation expense is recognized when the exercise price of an employee stock option is equal to, or greater than, the market price of the Company's common stock on the grant date.

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 comprehensive income within 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.

Financial instruments: The Company uses forward exchange contracts and currency swaps to hedge certain firm commitments and transactions denominated in foreign currencies. Gains and losses on forward contracts are deferred and offset against foreign exchange gains or losses on the underlying hedged item. The

Company uses interest rate swaps to manage interest rate risk. The interest differentials from interest rate swaps are recognized as an adjustment to interest expense. The Company's policies do not permit financial instrument transactions for speculative purposes.

NOTE 3. DISCONTINUED OPERATIONS

In May 1997, the Western Atlas Board of Directors approved, in principle, a plan to distribute (the "Spin-off") to Western Atlas shareholders all of the outstanding common stock of UNOVA, Inc. ("UNOVA"), a wholly owned subsidiary of Western Atlas, organized to conduct Western Atlas' industrial automation systems business. Pursuant to the Spin-off, on October 31, 1997 each Western Atlas shareholder received an equivalent number of shares of UNOVA common stock in a tax-free transaction. As explained in Note 1, the fiscal year financial information for Baker Hughes for the year ended September 30, 1997 includes Western Atlas' results for calendar year 1997. Hence, on the statements of consolidated stockholders' equity, the Spin-off of UNOVA is included in the year ended September 30, 1997.

Income (loss) from discontinued operations includes interest expense allocated on the basis of debt levels assumed in the Spin-off. Corporate, general and administrative costs of Western Atlas were not allocated to UNOVA for any of the periods presented. Concurrent with the Spin-off, UNOVA repaid Western Atlas for intercompany indebtedness totaling $230.0 million.

Discontinued operations of UNOVA are as follows:

	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Revenue	$ 107.0	$ 1,201.1	$ 1,164.7
Allocated interest expense	1.7	17.2	11.5
Allocated interest income		2.7	4.4
Income (loss) before income taxes	4.7	(122.7)	92.9
Provision for income taxes	(1.9)	(32.2)	(37.2)
Discontinued operations	$ 2.8	$ (154.9)	$ 55.7

The UNOVA results of operations in 1997 include a $203.0 million charge for acquired in-process research and development activities related to UNOVA's acquisition of Norand Corporation and United Barcode Industries in 1997.

The net assets of UNOVA as of the distribution date were as follows:

Current assets	$ 752.7
Noncurrent assets	586.9
Total assets	1,339.6
Current liabilities	(652.2)
Noncurrent liabilities	(87.6)
Total liabilities	(739.8)
Net assets of UNOVA	$ 599.8

NOTE 4. EARNINGS PER SHARE

The Company adopted SFAS No. 128, "Earnings per Share," in the Transition Period. SFAS No. 128 establishes new standards for computing and presenting earnings per share ("EPS"), and requires all prior periods to be restated. Reconciliation of the numerators and denominators of the basic and diluted EPS computations for income from continuing operations is as follows:

	Year Ended December 31, 1998		Three Months Ended December 31, 1997	
	(Loss)	Shares	Income	Shares
Basic	$ (297.4)	321.7	$ 111.2	316.2
Effect of dilutive securities, net of tax:				
Stock plans				6.2
Liquid Yield Option Notes			1.7	7.2
Diluted	$ (297.4)	321.7	$ 112.9	329.6

	Year Ended September 30, 1997		Year Ended September 30, 1996	
	Income	Shares	Income	Shares
Basic	$ 200.9	299.5	$ 246.4	287.7
Effect of dilutive securities, net of tax:				
Stock plans		5.2		2.9
Liquid Yield Option Notes			6.0	7.2
Diluted	$ 200.9	304.7	$ 252.4	297.8

Securities excluded from the computation of diluted EPS for the year ended December 31, 1998 that could potentially dilute basic EPS in the future were options to purchase 13.3 million shares, Liquid Yield Option Notes convertible into 7.2 million shares and 1.6 million shares estimated to be issued under the Company's employee stock purchase plan. Since the Company incurred a loss for 1998, such dilutive securities were excluded as they would be anti-dilutive to basic EPS.

NOTE 5. INVENTORIES

Inventories are comprised of the following:

	December 31, 1998	December 31, 1997
Finished goods	$ 855.2	$ 911.5
Work in process	83.2	138.2
Raw materials	127.3	95.3
Total	$ 1,065.7	$ 1,145.0

NOTE 6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is comprised of the following:

	December 31, 1998	December 31, 1997
Land	$ 86.0	$ 73.0
Buildings	613.3	534.3
Machinery and equipment	2,313.6	1,983.6
Rental tools and equipment	906.5	820.0
Oil and gas properties, full cost method	225.1	114.8
Total property	4,144.5	3,525.7
Accumulated depreciation and depletion	1,852.2	1,546.7
Property–net	$ 2,292.3	$ 1,979.0

NOTE 7. ACQUISITIONS AND DISPOSITIONS

In addition to the acquisitions discussed separately below, the Company made several smaller acquisitions in each respective year with an aggregate purchase price of $119.2 million during 1998, $74.3 million during the Transition Period, $98.4 million in 1997 and $32.9 million in 1996. These acquisitions were accounted for using the purchase method of accounting. Accordingly, the cost of each acquisition has been allocated to assets acquired and liabilities assumed based on their estimated fair market values at the date of the acquisition. The operating results of these acquisitions are included in the consolidated statements of operations from their respective acquisition date. Pro forma results of these acquisitions have not been presented as the pro forma revenue, income before accounting change, and earnings per share would not be materially different from the Company's actual results.

1998

WEDGE and 3-D

In April 1998, the Company acquired all the outstanding stock of WEDGE DIA-Log, Inc. ("WEDGE") for $218.5 million in cash. WEDGE specializes in cased-hole logging and pipe recovery services. Also in April 1998, the Company acquired 3-D Geophysical, Inc. ("3-D") for $117.5 million in cash. 3-D is a supplier of primarily land-based seismic data acquisition services. The purchase method of accounting was used to record both of these acquisitions. Pro forma results of these two acquisitions have not been presented as the pro forma revenue, net income, and earnings per share would not be materially different from the Company's actual results.

1997

Petrolite

In July 1997, the Company acquired Petrolite Corporation ("Petrolite") and Wm. S. Barnickel & Company ("Barnickel"), the holder of 47.1 percent of Petrolite's common stock, for 19.3 million shares of the Company's common stock having a value of $730.2 million in a three-way business combination. The purchase method of accounting was used to record these acquisitions. Additionally, the Company assumed Petrolite's outstanding vested and unvested employee stock options which were converted into the right to acquire 1.0 million shares of the Company's common stock. Such assumption of Petrolite options by the Company had a fair market value of $21.0 million resulting in total consideration in the acquisitions of $751.2 million. Petrolite, the shares of which were previously publicly traded, is a manufacturer and marketer of specialty chemicals used in the petroleum and process industries. Barnickel was a privately held company that owned marketable securities, which were sold after the acquisition, in addition to its investment in Petrolite.

The acquisition of Petrolite in 1997 was accounted for as a purchase. Accordingly, the purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair market values at the date of the acquisition. In accordance with generally accepted accounting principles, the $118.0 million

allocated to in-process research and development has been recorded as a charge in the consolidated statement of operations as of the acquisition date because the technological feasibility of the projects in-process had not been established and there was no alternative future use at that date.

There were 26 individual research and development projects that were in development at the time of the acquisition that were classified as in-process research and development. The products under development were valued using a discounted cash flow analysis at a 14 percent discount factor. The cash flows were projected for a 20-year period and included additional research and development and capital expenditures required to complete the projects. The gross margins used for these products were generally consistent with those of other chemical products sold by the Company. The 14 percent discount factor used considered the time value of money, inflation, and the risk inherent in the projects under development. In aggregate, the remaining completion costs for these products were projected to exceed $7.2 million with completion periods varying from 90 days to two years. Significant cash inflows from these products in total were expected to commence during 1999. During 1998, 16 of these products generated commercial sales, five had product sales on a trial basis only, and five were determined not to be viable products.

The Company incurred certain liabilities as part of the plan to combine the operations of Petrolite with those of the Company. These liabilities relate to the Petrolite operations and include severance of $13.8 million for redundant marketing, manufacturing, and administrative personnel, relocation of $5.8 million for moving equipment and transferring marketing and technology personnel, primarily from St. Louis to Houston, and environmental remediation of $16.5 million for redundant properties and facilities that were to be sold. Cash spent during 1998, the Transition Period, and 1997 totaled $12.9 million, $2.1 million and $7.7 million, respectively.

Drilex

In July 1997, the Company acquired Drilex International Inc. ("Drilex"), a provider of products and services used in the directional and horizontal drilling and workover of oil and gas wells, for 2.7 million shares of the Company's common stock. The acquisition was accounted for using the pooling of interests method of accounting. Under this method of accounting, the historical cost bases of the assets and liabilities of the Company and Drilex are combined at recorded amounts and the results of operations of the combined companies for 1997 are included in the 1997 consolidated statement of operations. The historical results of the separate companies for years prior to 1997 are not combined because the retained earnings and results of operations of Drilex are not material to the consolidated financial statements of the Company.

Norand and United Barcode Industries

The Company acquired Norand Corporation ("Norand") on March 3, 1997, and United Barcode Industries ("UBI") on April 4, 1997. These companies were integrated into the Company's industrial automation systems operations and included in the Spin-off of UNOVA. The purchase method of accounting was used to record these acquisitions; and, accordingly, the acquisition costs of $280.0 million and $107.0 million for Norand and UBI, respectively, were allocated to the net assets acquired based upon their relative fair values. In accordance with generally accepted accounting principles, such allocation assigned a combined value for the two acquisitions of $203.0 million to in-process research and development activities, which was expensed in 1997 because its technological feasibility had not been established and it had no alternative future use at the date of acquisition.

1996

In May 1996, the Company sold 6.3 million shares of Varco International, Inc. ("Varco") common stock, representing its entire investment in Varco. The Company received net proceeds of $95.5 million and recognized a pretax gain of $44.3 million. The Company's investment in Varco was accounted for using the equity method. Equity income included in the consolidated statement of operations for 1996 was $1.8 million.

NOTE 8.
UNUSUAL AND OTHER NONRECURRING CHARGES

1998

The Company had experienced high growth levels for its products and services from 1994 through the second quarter of 1998. During the third and fourth quarters of 1998, the Company experienced a decline in demand for its products and services as a result of a significant decrease in the price of oil and natural gas. The decline in customer demand materialized quickly from the previous high growth rates. As a result of this sharp decline in demand and to adjust to the lower level of activity, the Company assessed its overall operations and recorded charges of $549.0 million in the September quarter and $40.5 million in the December quarter as summarized below:

	Total	Amounts paid in 1998	Accrued Balance at December 31, 1998
Cash charges:			
Severance for approximately 5,300 employees	$ 64.3	$ 26.6	$ 37.7
Integration costs, abandoned leases and other contractual obligations	40.0	14.7	25.3
Environmental reserves	8.8	4.3	4.5
Other cash costs (includes litigation reserves)	21.4	4.7	16.7
Subtotal cash charges	134.5	$ 50.3	$ 84.2
Noncash charges – write-down of:			
Inventory and rental tools	173.2		
PetroAlliance Services Company Limited	83.2		
Property and other assets	80.1		
Oil and gas properties (ceiling-test)	69.3		
Intangible assets	21.5		
Real estate held for sale	17.0		
Investments in affiliates	10.7		
Subtotal noncash charges	455.0		
Total cash and noncash charges	$ 589.5		

The above charges were reflected in the following captions of the consolidated statement of operations:

Costs of revenues	$ 305.0
Selling, general and administrative	68.7
Unusual charge	215.8
Total	$ 589.5

The amount accrued for severance is based upon the Company's written severance policy and the positions eliminated. The accrued severance does not include any portion of the employees' salaries through their severance dates. Based upon current severance dates, the Company expects that of the accrued severance remaining at December 31, 1998, $27.0 million will be paid during the first quarter of 1999 and the remaining $10.7 million will be paid during the second quarter of 1999 when the employees leave the Company.

The Company accrued $40.0 million to combine operations and consolidate facilities. Such accrual includes costs to settle leases on idled facilities based upon lease agreements; to shut-down oil and gas operations in certain countries based upon management's decision to abandon operations; to terminate a rig contract based upon the terms of the agreement; and other collocation costs based upon the estimated exit costs for approved plans. The accrual does not include any portion of the costs before actual abandonment of the facilities or ceasing of the operations. The Company expects to spend approximately $9.4 million of the accrued balance as of December 31, 1998 during the first quarter of 1999 and, except for amounts payable under terms of leases and other contracts, the remaining amounts accrued will be paid during the remainder of 1999.

The impairment of inventory and rental tool assets of $173.2 million impacted virtually all operating divisions and was due to advances in technology that have obsoleted certain product lines, as well as a decline in market demand that has resulted in an excess supply of certain products. The product lines most affected were completion products, drilling and evaluation systems and tools, tricone and diamond drill bits, and filtration systems. Much of the obsolete and excess inventory will be scrapped and has been written off completely. The remaining assets have been written down to their estimated value based on the Company's inventory and rental tool obsolescence policy.

In the third quarter of 1998, the Company recorded an $83.2 million write-down of PetroAlliance Services Company Limited ("PAS"), a former consolidated joint venture operating in the former Soviet Union. The write-down of the joint venture was based upon the Company's estimated value of assets ultimately received in consideration of the sale of the PAS investment in November 1998. The Company received as consideration for the

sale of PAS a seismic vessel, other seismic and well-logging assets, certain PAS assets in Kazakhstan and Turkmenistan, certain customer receivables and a $33.0 million note from the purchasers. The write-down included $10.7 million for equipment, $22.0 million of goodwill, and $50.5 million of net current assets.

The impairment of property and other assets of $80.1 million includes an $18.1 million write-down to reduce the carrying value of a portion of the Company's drilling equipment; a $12.6 million write-off of obsolete solid and oil-filled streamer sections used on seismic vessels; a $14.9 million write-down of surplus well-logging equipment; a $9.5 million write-off of prepaid royalties on an abandoned product line; and $25.0 million of assets written down to fair market value. The write-down of these assets was determined based on internally developed valuations using a variety of methods.

The write-off of intangible assets of $21.5 million includes $2.7 million for capitalized software costs for product lines abandoned as a result of recent acquisitions; $5.3 million for capitalized development costs for software systems that are being replaced by the Company's implementation of SAP R/3; and $13.5 million for goodwill associated with a discontinued business and a subsidiary held for sale.

The write-down of real estate held for sale of $17.0 million is for a specific property and the charge reduces the carrying value to the property's appraised value.

The $10.7 million charge is to write-off investments in joint ventures in both Russia and Indonesia and also includes a loss on the sale of Tracor Europa, discontinued subsidiary.

1997

During the year ended September 30, 1997, the Company recognized a $52.1 million unusual charge consisting of the following:

Baker Petrolite:	
Severance for 140 employees	$ 2.2
Relocation of people and equipment	3.4
Environmental	5.0
Abandoned leases	1.5
Integration costs	2.8
Inventory write-down	11.3
Write-down of other assets	9.3
Drilex:	
Write-down of property and other assets	4.1
Banking and legal fees	3.0
Discontinued product lines:	
Severance for 50 employees	1.5
Write-down of inventory, property and other assets	8.0
Total	$ 52.1

In connection with the acquisitions of Petrolite, accounted for as a purchase, and Drilex, accounted for as a pooling of interests, the Company recorded unusual charges of $35.5 million and $7.1 million, respectively, to combine the acquired operations with those of the Company. The charges include the cost of closing redundant facilities, eliminating or relocating personnel and equipment and rationalizing inventories which required disposal at amounts less than cost. A $9.5 million charge was recorded as a result of the decisions to: 1) discontinue a low margin, oilfield product line in Latin America; and, 2) sell the Tracor Europa subsidiary, a computer peripherals distributor, which was written down to net realizable value. Cash provisions of the unusual charge totaled $19.4 million. The Company spent $12.3 million in 1998, $1.6 million during the Transition Period, and $5.5 million during 1997.

1996

During the year ended September 30, 1996, the Company recognized a $39.6 million unusual charge consisting of the following:

Patent write-off	$ 8.5
Impairment of joint venture	5.0
Restructurings:	
Severance for 360 employees	7.1
Relocation of people and equipment	2.3
Abandoned leases	2.8
Inventory write-down	1.5
Write-down of assets	10.4
Other	2.0
Total	$ 39.6

The Company recorded a $24.1 million restructuring charge, which includes costs associated with the downsizing of Baker Hughes INTEQ's Singapore and Paris operations, a reorganization of EIMCO Process Equipment's Italian operations, and the consolidation of certain Baker Oil Tools manufacturing operations. The Company had certain oilfield operations patents which no longer protected commercially significant technology resulting

in a write-off of $8.5 million. A $5.0 million impairment of a Latin America joint venture was recorded due to changing market conditions in the region in which it operates. Cash provisions of the charge totaled $14.3 million. The Company spent $3.8 million during the Transition Period, $6.3 million during 1997 and $4.2 million during 1996.

NOTE 9. INDEBTEDNESS

Total debt consisted of the following:

	December 31, 1998	December 31, 1997
Short-term debt with an average interest rate of 5.72% at December 31, 1998	$ 943.3	$ 355.8
Commercial Paper with an average interest rate of 5.28% at December 31, 1998	759.1	370.3
Liquid Yield Option Notes ("LYONS") due May 2008 with a yield to maturity of 3.5% per annum, net of unamortized discount of $109.6 at December 31, 1998 ($119.5 at December 31, 1997)	275.5	265.7
7.625% Notes due February 1999 with an effective interest rate of 7.73%, net of unamortized discount of $.3 at December 31, 1997	150.0	149.7
8% Notes due May 2004 with an effective interest rate of 8.08%, net of unamortized discount of $.8 at December 31, 1998 ($.9 at December 31, 1997)	99.2	99.1
7.875% Notes due June 2004 with an effective interest rate of 8.13%, net of unamortized discount of $2.2 at December 31, 1998 ($2.6 at December 31, 1997)	247.8	247.4
8.55% Debentures due June 2024 with an effective interest rate of 8.80%, net of unamortized discount of $2.8 at December 31, 1998 ($2.9 at December 31, 1997)	147.2	147.1
8.59% Debentures due January 2000 with an effective interest rate of 6.75%	93.0	93.0
5.65% Notes due 1998		48.5
Other debt with an effective interest rate of 6.08% at December 31, 1998	55.6	6.0
Total debt	2,770.7	1,782.6
Less short-term debt and current maturities	44.4	177.3
Long-term debt	$2,726.3	$ 1,605.3

At December 31, 1998, the Company had $2,237.4 million of credit facilities with commercial banks, of which $1,000.0 million was committed. The committed facilities mature as follows: $250.0 million in 2000 and $750.0 million in 2003. The Company's policy is to classify commercial paper and short-term borrowings as long-term debt, to the extent of its committed facilities and to the extent of its intent to refinance the short-term obligations, since the Company has the ability under certain credit agreements, and the intent, to maintain these obligations for longer than one year.

The Liquid Yield Option Notes ("LYONS") are convertible into the Company's common stock at a conversion price of $38.88 per share, as of December 31, 1998, which increases at an annual rate of 3.5 percent. At the option of the Company, the LYONS may be redeemed for cash at a redemption price equal to the issue price plus accrued original issue discount through the date of redemption. At the option of the holder, the LYONS may be redeemed for cash on May 5, 2003, for a redemption price equal to the issue price plus accrued original issue discount through the date of redemption.

Subsequent to December 31, 1998, the Company issued $400 million of 6.875 percent Notes due January 2029, $325 million of 6.25 percent Notes due January 2009, $200 million 6.0 percent Notes due February 2009 and $100 million of 5.8 percent Notes due 2003 with effective interest rates of 7.07 percent, 6.36 percent, 6.09 percent and 6.01 percent, respectively. The proceeds were used to repay $150.0 million of the 7.625 percent Notes due February 1999, commercial paper and other short-term borrowings. Accordingly, such amounts are presented as long-term debt in the accompanying consolidated statement of financial position.

Maturities of debt at December 31, 1998 after consideration of the refinancing subsequent to year end as discussed above are as follows: 1999-$44.4 million; 2000-$185.1 million; 2001-$1.5 million, 2002-$9.2 million, 2003-$849.3 million and $1,681.2 million thereafter.

NOTE 10.
FINANCIAL INSTRUMENTS

Interest Rate Swaps

At December 31, 1998, the Company was party to an interest rate swap agreement for a notional amount of $93.0 million on which the Company pays interest at a rate of LIBOR plus 2 percent and receives interest at a rate of 8.59 percent. The interest rate swap settles semi-annually and terminates on January 27, 2000. In the unlikely event that the counterparty fails to meet the terms of the interest rate swap agreement, the Company's exposure is limited to the interest rate differential.

Subsequent to December 31, 1998, the Company entered into an interest rate swap with a notional amount of $325.0 million. The Company will receive interest at a rate of 6.25 percent and pay interest at a rate equal to the average of 6 month LIBOR for Yen, Euro and Swiss Franc plus a 3.16 percent spread. The interest rate swap will settle semi-annually and terminate in January 2009. In the unlikely event that the counterparty fails to meet the terms of the interest rate swap agreement, the Company's exposure is limited to the interest rate differential.

Foreign Currency Contracts

At December 31, 1998, the Company had entered into foreign currency forward contracts with notional amounts of $88.9 million to hedge the commitment to purchase two seismic vessels and $29.1 million to hedge equipment purchases under a long-term purchase agreement. The fair value of these contracts, based on year-end quoted market prices for contracts with similar terms and maturity dates, was $80.8 million and $30.2 million, respectively. Foreign currency gains and losses for such purchases are deferred and will become part of the cost of the assets. The counterparties to the Company's forward contracts are major financial institutions. The credit ratings and concentration of risk of these financial institutions are monitored on a continuing basis and, in management's opinion, present no significant credit risk to the Company.

Fair Value of Financial Instruments

The Company's financial instruments include cash and short-term investments, receivables, long-term investments, payables, debt and interest rate, and foreign currency contracts. Except as described below, the estimated fair values of such financial instruments at December 31, 1998 and 1997 approximate their carrying value as reflected in the consolidated statements of financial position. The fair value of the Company's debt and interest rate and foreign currency contracts has been estimated based on quoted market prices and the Black-Scholes option-pricing model.

The estimated fair value of the Company's debt at December 31, 1998 and 1997 was $2,818.7 million and $1,913.8 million, respectively, which differs from the carrying amounts of $2,770.7 million and $1,782.6 million, respectively, included in the consolidated statements of financial position. The fair value of the Company's interest rate swap contracts at December 31, 1998 and 1997 was $1.6 million and $2.8 million, respectively.

Concentration of Credit Risk

The Company sells its products and services to various companies in the oil and gas industry. Although this concentration could affect the Company's overall exposure to credit risk, management believes that the Company is exposed to limited risk since the majority of its business is conducted with major companies within the industry. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral for its accounts receivables. In some cases, the Company will require payment in advance or security in the form of a letter of credit or bank guarantee.

The Company maintains cash deposits with major banks which from time to time may exceed federally insured limits. The Company periodically assesses the financial condition of the institutions and believes that any possible loss is minimal.

NOTE 11. EMPLOYEE STOCK PLANS

The Company has stock option plans that provide for granting of options for the purchase of common stock to officers and other key employees. These stock options may be granted subject to terms ranging from one to 10 years at a price equal to or greater than the fair market value of the stock at the date of grant.

Stock option activity for the Company was as follows:

(Shares in thousands)	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding at September 30, 1995	12,758	$ 15.30
Granted	2,803	20.75
Exercised	(2,965)	15.89
Forfeited	(403)	18.45
Outstanding at September 30, 1996	12,193	16.30
Granted	3,237	30.15
Options assumed in acquisitions	2,324	16.04
Spin-off adjustment	2,387	
Exercised	(3,590)	16.04
Forfeited	(204)	21.32
Outstanding at September 30, 1997	16,347	16.54
Granted	3,173	47.81
Exercised	(818)	12.26
Forfeited	(4)	30.83
Adjustment for change in year end	528	
Outstanding at December 31, 1997	19,226	21.66
Granted	6,233	21.29
Exercised	(1,661)	10.90
Forfeited	(655)	28.30
Change in control rights converted	(9,811)	
Outstanding at December 31, 1998	13,332	$ 27.24

The Merger with Western Atlas triggered change in control rights contained in certain Western Atlas employee stock option plans. Conversion of 9.8 million options with these change in control rights resulted in the issuance of 7.5 million shares of the Company's common stock.

In connection with the Spin-off, all employee and director options of Western Atlas outstanding immediately prior to the Spin-off were adjusted by increasing the number of shares subject to the option and decreasing the exercise price per share so as to preserve the difference between the aggregate exercise price of the option and the aggregate market value of the shares subject to the option.

Under the terms of the Baker Hughes and Western Atlas stock option plans, all outstanding options at August 10, 1998 vested as a result of the Merger. At December 31, 1998, 4.6 million shares were available for future option grants.

The fair market value of the options granted in 1998, the Transition Period, 1997 and 1996 was $7.79, $14.47, $11.18 and $6.49, respectively, using the following assumptions for those respective years in the Black-Scholes option-pricing model: dividend yield of 2.2 percent, 0.96 percent, 1.5 percent and 2.2 percent; expected volatility of 49.4 percent, 36.4 percent, 33.5 percent and 26.7 percent; risk-free interest rate of 4.2 percent, 5.6 percent, 6.2 percent and 6.2 percent; and expected life of each option of 4.3 years, 3.2 years, 4.6 years and 4.6 years.

The following table summarizes information for stock options outstanding at December 31, 1998 (shares in thousands):

	Outstanding			Exercisable	
Range of Exercise Prices	Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
$ 0.61 - 14.86	872	6.45	$ 10.49	578	$ 10.94
16.74 - 20.50	1,720	6.51	19.07	1,650	19.15
21.00 - 27.85	6,733	9.18	21.19	725	22.77
28.50 -38.69	1,020	7.25	35.13	952	35.08
39.88 - 47.81	2,987	8.73	47.75	2,975	47.78
Total	13,332	8.41	$ 27.24	6,880	$ 33.43

The following table summarizes pro forma disclosures assuming the Company had used the fair market value method of accounting for its stock based compensation plans:

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Pro forma net income (loss)	$ (318.0)	$ 99.2	$ 16.2	$ 294.0
Pro forma EPS - basic	(0.99)	0.31	0.05	1.02
Pro forma EPS - diluted	(0.99)	0.31	0.05	1.01

The effects of applying the fair market value method of accounting in the above pro forma disclosure may not be indicative of future amounts since the pro forma disclosure does not apply to options granted prior to 1996 and additional awards in future years are anticipated.

NOTE 12. INCOME TAXES

The geographic sources of income (loss) from continuing operations before income taxes and cumulative effect of accounting changes are as follows:

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
United States	$ (293.1)	$ 40.9	$ 52.9	$ 149.6
Foreign	12.0	138.3	311.4	265.9
Total	$ (281.1)	$ 179.2	$ 364.3	$ 415.5

The provision for income taxes is comprised of:

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Current:				
United States	$ 35.9	$ 32.2	$ 54.6	$ 42.7
Foreign	87.4	40.0	112.7	97.8
Total current	123.3	72.2	167.3	140.5
Deferred:				
United States	(74.7)	(14.1)	2.7	19.1
Foreign	(32.3)	9.9	(6.6)	9.5
Total deferred	(107.0)	(4.2)	(3.9)	28.6
Provision for income taxes	$ 16.3	$ 68.0	$ 163.4	$ 169.1

Tax benefits of $16.1 million, $1.4 million, $11.0 million, and $5.1 million associated with the exercise of employee stock options were allocated to equity in the periods ended December 31, 1998, December 31, 1997, September 30, 1997 and September 30, 1996, respectively.

The provision for income taxes differs from the amount computed by applying the U.S. statutory income tax rate to income before income taxes and cumulative effect of accounting changes for the reasons set forth below:

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Statutory income tax at 35%	$ (98.4)	$ 62.7	$ 127.5	$ 145.4
Merger and acquisition related costs	55.8		41.3	
IRS audit agreement and refund claims	(18.4)		(11.4)	
Nondeductible goodwill amortization	13.7	2.0	6.1	7.0
State income taxes - net of U.S. tax benefit	4.0	2.1	4.6	1.6
Incremental effect of foreign operations	25.4	6.5	(6.7)	8.9
Foreign losses with no tax benefit	36.0		1.7	4.9
Utilization of operating loss carryforwards		(0.6)	(4.2)	(3.3)
Other-net	(1.8)	(4.7)	4.5	4.6
Provision for income taxes	$ 16.3	$ 68.0	$ 163.4	$ 169.1

The effective tax rates before Merger and acquisition related costs, Spin-off related costs, unusual and other nonrecurring items were 35.5 percent, 37.9 percent, 35.2 percent and 40.0 percent for the periods ended December 31, 1998, December 31, 1997, September 30, 1997 and September 30, 1996, respectively.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting for income tax purposes, and of operating loss and tax credit carryforwards. The tax effects of the Company's temporary differences and carryforwards are as follows:

	December 31, 1998	December 31, 1997
Deferred tax liabilities:		
Property	$ 90.4	$ 95.6
Other assets	55.6	153.8
Excess costs arising from acquisitions	72.5	68.1
Undistributed earnings of foreign subsidiaries	39.3	41.3
Other	41.1	43.4
Total	298.9	402.2
Deferred tax assets:		
Receivables	12.4	3.0
Inventory	126.7	99.1
Employee benefits	26.1	24.2
Other accrued expenses	75.6	52.6
Operating loss carryforwards	19.1	10.8
Tax credit carryforwards	55.3	15.5
Other	8.6	40.5
Subtotal	323.8	245.7
Valuation allowances	(32.3)	(12.6)
Total	291.5	233.1
Net deferred tax liability	$ 7.4	$ 169.1

A valuation allowance is recorded when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability to generate sufficient taxable income of the appropriate character in the future. The Company has reserved the operating loss carryforwards in certain non-U.S. jurisdictions where its operations have decreased, currently ceased or the Company has withdrawn entirely.

Provision has been made for U.S. and additional foreign taxes for the anticipated repatriation of certain earnings of foreign subsidiaries of the Company. The Company considers the undistributed earnings of its foreign subsidiaries above the amount already provided to be permanently reinvested. These additional foreign earnings could become subject to additional tax if remitted, or deemed remitted, as a dividend; however, the additional amount of taxes payable is not practicable to estimate.

At December 31, 1998, the Company had approximately $47.5 million of foreign tax credits, $6.5 million of general business credits, and $1.3 million of alternative minimum tax credits available to offset future payments of federal income taxes, expiring in varying amounts between 2003 and 2009. The alternative minimum tax credits may be carried forward indefinitely under current U.S. law.

NOTE 13. SEGMENT AND RELATED INFORMATION

The Company's nine business units have separate management teams and infrastructures that offer different products and services. The business units have been aggregated into two reportable segments—oilfield and process—since the long-term financial performance of these reportable segments is affected by similar economic conditions.

Oilfield: This segment consists of eight business units - Baker Atlas, Baker Hughes INTEQ, Baker Oil Tools, Baker Petrolite, Centrilift, E&P Solutions, Hughes Christensen and Western Geophysical - that manufacture and sell equipment and provide services used in the drilling, completion, production and maintenance of oil and gas wells and in reservoir measurement and evaluation. The principal markets for this segment include all major oil and gas producing regions of the world including North America, Latin America, Europe, Africa, the Middle East and the Far East. Customers include major multinational, independent and national or state-owned oil companies.

Process: This segment consists of one business unit—Baker Process —that manufactures and sells process equipment for separating solids from liquids and liquids from liquids through filtration, sedimentation, centrifugation and floatation processes. The principle markets for this segment include all regions of the world where there are significant industrial and municipal wastewater applications and base metals activity. Customers include municipalities, contractors, engineering companies and pulp and paper, minerals, industrial, and oil and gas producers.

The accounting policies of the reportable segments are the same as those described in Note 2 of Notes to Consolidated Financial Statements. The Company evaluates the performance of its operating segments based on income before income taxes, accounting changes, nonrecurring items, and interest income and expense. Intersegment sales and transfers are not significant.

Summarized financial information concerning the Company's reportable segments is shown in the following table. The "Other" column includes corporate-related items, results of insignificant operations and, as it relates to segment profit (loss), income and expense not allocated to reportable segments.

	Oilfield	Process	Other	Total
1998				
Revenues	$5,801.8	$490.2	$19.9	$6,311.9
Segment profit (loss)	737.7	24.1	(1,042.9)	(281.1)
Total assets	6,969.2	425.4	416.2	7,810.8
Capital expenditures	1,258.5	17.2	42.5	1,318.2
Depreciation, depletion and amortization	729.7	12.9	15.7	758.3
Transition period				
Revenues	$1,441.6	$124.1	$7.2	$1,572.9
Segment profit (loss)	215.2	9.0	(45.0)	179.2
Total assets	6,314.8	375.3	540.5	7,230.6
Capital expenditures	279.0	1.6	16.0	296.6
Depreciation, depletion and amortization	135.7	2.7	3.3	141.7
1997				
Revenues	$4,942.3	$386.1	$15.2	$5,343.6
Segment profit (loss)	676.8	36.3	(348.8)	364.3
Total assets	6,222.2	363.7	501.1	7,087.0
Capital expenditures	1,013.0	6.4	28.3	1,047.7
Depreciation, depletion and amortization	529.9	8.4	16.6	554.9
1996				
Revenues	$4,065.4	$352.8	$27.6	$4,445.8
Segment profit (loss)	518.9	31.2	(134.6)	415.5
Total assets	4,429.7	258.9	1,108.0	5,796.6
Capital expenditures	646.4	6.6	4.7	657.7
Depreciation, depletion and amortization	436.5	6.7	21.8	465.0

The following table presents the details of "Other" segment profit (loss).

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Corporate expenses	$ (88.9)	$ (21.6)	$ (61.8)	$ (59.2)
Interest expense–net	(145.4)	(23.4)	(87.8)	(83.0)
Unusual charge	(215.8)		(52.1)	(39.6)
Acquired in-process research and development			(118.0)	
Nonrecurring charges to costs of revenues and SG&A	(373.7)		(21.9)	
Gain on sale of Varco stock				44.3
Merger related costs	(219.1)			
Spin-off related costs			(8.4)	
Other			1.2	2.9
Total	$(1,042.9)	$ (45.0)	$(348.8)	$(134.6)

The following table presents consolidated revenues by country based on the location of the use of the product or service.

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
United States	$2,196.4	$ 545.6	$1,849.0	$1,479.3
United Kingdom	572.2	117.8	426.6	383.1
Venezuela	350.4	107.5	383.0	246.8
Norway	269.7	64.2	222.8	185.4
Canada	257.8	87.6	266.3	203.9
Other countries (approximately 65 countries)	2,665.4	650.2	2,195.9	1,947.3
Total	$6,311.9	$1,572.9	$5,343.6	$4,445.8

The following table presents long-lived assets by country based on the location of the asset.

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
United States	$ 929.0	$ 879.2	$ 823.7	$ 547.4
United Kingdom	242.0	204.2	192.7	118.9
Venezuela	70.1	70.8	54.8	45.6
Nigeria	86.9	41.4	38.9	30.4
Norway	50.0	37.2	32.0	45.5
Other countries	367.9	319.6	340.6	178.8
Western Geophysical mobile assets *	546.4	426.6	426.6	324.6
Total	$2,292.3	$1,979.0	$1,909.3	$1,291.2

* These assets represent marine seismic vessels, land crews and related equipment that are mobile and move frequently between countries. Data processing centers, land and buildings have been included in the countries where these assets are located.

NOTE 14.
EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plans And Postretirement Benefits Other Than Pensions

The Company adopted SFAS No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits, which is effective for the Company for the year ended December 31, 1998. The statement revises the required disclosures about pensions and postretirement benefit plans.The Company has several noncontributory

defined benefit pension plans covering various domestic and foreign employees. Generally, the Company makes annual contributions to the plans in amounts necessary to meet minimum governmental funding requirements.

The Company has a defined benefit postretirement plan that provides certain health care and life insurance benefits for substantially all U.S. employees who retire having met certain age and service requirements.

	Pension Benefits		Postretirement Benefits Other Than Pensions	
	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended December 31, 1998	Three Months Ended December 31, 1997
Change in benefit obligation:				
Benefit obligation at beginning of year	$ 184.6	$ 178.3	$ 115.7	$ 116.0
Service cost	5.0	1.2	1.6	0.3
Interest cost	13.3	3.3	8.4	2.0
Plan participants' contributions	1.1			
Acquisition		2.8		
Amendments			(2.1)	0.2
Actuarial (gain)/loss	24.5	1.8	7.0	
Curtailment loss	2.5		2.1	
Settlement gain	(6.7)			
Benefits paid	(9.0)	(1.9)	(9.0)	(2.8)
Exchange rate adjustment	2.5	(0.9)		
Benefits obligation at end of year	217.8	184.6	123.7	115.7
Change in plan assets:				
Fair value of plan assets at beginning of year	269.3	260.3		
Actual return on plan asssets	2.0	7.3		
Employer contribution	2.0	0.3		
Settlement	(6.7)			
Plan participants' contributions	1.1			
Acquisition		3.4		
Benefits paid	(7.4)	(1.7)		
Exchange rate adjustment	1.9	(0.3)		
Fair value of plan assets at end of year	262.2	269.3	—	—
Funded status	44.4	84.7	(123.7)	(115.7)
Unrecognized actuarial (gain)/loss	23.0	(17.0)	(4.2)	(10.3)
Unrecognized prior service cost	0.7	0.4	(2.2)	(0.1)
Net amount recognized	68.1	68.1	(130.1)	(126.1)
Benefits paid - October to December 1998	0.5		2.8	
Net amount recognized	$ 68.6	$ 68.1	$ (127.3)	$ (126.1)

	Pension Benefits		Postretirement Benefits Other Than Pensions	
	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended December 31, 1998	Three Months Ended December 31, 1997
Amounts recognized in the statement of financial position consist of:				
Prepaid benefit cost	$ 96.2	$ 87.2		
Accrued benefit liability	(34.9)	(24.7)	$ (127.3)	$ (126.1)
Intangible asset	0.5	0.2		
Accumulated other comprehensive income	6.8	5.4		
Net amount recognized	$ 68.6	$ 68.1	$ (127.3)	$ (126.1)

Pension Benefits	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Weighted-average assumptions:				
Discount rate	6.54%	7.51%	7.56%	7.90%
Expected return on plan assets	8.68%	8.92%	8.92%	8.81%
Rate of compensation increase	3.95%	3.89%	3.73%	4.73%
Components of net periodic benefit cost:				
Service cost	$ 5.0	$ 1.2	$ 3.9	$ 3.0
Interest cost	13.3	3.3	7.7	5.2
Expected return on plan assets	(22.5)	(5.4)	(9.9)	(6.1)
Amortization of transition (asset)/obligation			(0.1)	(0.4)
Recognized actuarial (gain)/loss	(0.1)	(0.2)	0.3	0.1
Net periodic benefit cost	(4.3)	(1.1)	1.9	1.8
Curtailment effect recognized	2.5			
Total net periodic benefit cost	$ (1.8)	$ (1.1)	$ 1.9	$ 1.8

Postretirement Benefits Other Than Pensions	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Weighted-average assumptions:				
Discount rate	6.75%	7.50%	7.48%	7.50%
Components of net periodic benefit cost:				
Service cost	$ 1.6	$ 0.3	$ 1.3	$ 1.3
Interest cost	8.4	2.0	7.6	7.4
Recognized actuarial (gain)/loss	.3		.1	
Net periodic benefit cost	$ 10.3	$ 2.3	$ 9.0	$ 8.7

The projected benefit obligation, accumulated benefit obligation, and fair value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were $43.8 million, $39.0 million and $11.0 million as of December 31, 1998, and $30.7 million, $26.3 million and $4.5 million as of December 31, 1997.

The assumed health care cost trend rate used in measuring the accumulated benefit obligation for postretirement benefits other than pensions as of December 31, 1998 was 6.50% for 1999 declining gradually each successive year until it reaches 5% in 2002. Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	1-Percentage Point Increase	1-Percentage Point Decrease
Effect on total service and interest cost components	$ 426.0	$ (411.0)
Effect on postretirement benefit obligation	5,237.0	(5,103.0)

Defined Contribution Plans

During the periods reported, generally all Baker Hughes U.S. employees (other than those employed at the time by Western Atlas) not covered under one of the Baker Hughes pension plans were eligible to participate in the Baker Hughes sponsored Thrift Plan. The Thrift Plan allows eligible employees to elect to contribute from 2 percent to 15 percent of their salaries to an investment trust. Employee contributions are matched by the Company at the rate of $1.00 per $1.00 employee contribution for the first 2 percent and $.50 per $1.00 employee contribution for the next 4 percent of the employee's salary. In addition, the Company contributes for all eligible employees between 2 percent and 5 percent of their salary depending on the employee's age as of January 1 each year. Such contributions become fully vested to the employee after five years of employment. Baker Hughes' contribution to the Thrift Plan and other defined contribution plans amounted to $51.0 million, $10.6 million, $35.9 million and $30.0 million in 1998, the Transition Period, 1997 and 1996, respectively.

During the periods reported, most of Western Atlas' U.S. employees were covered by a defined contribution plan. Western Atlas contributed an amount based on its consolidated pretax earnings in accordance with the provisions of such plan. This plan includes a voluntary savings feature that is intended to qualify under Section 401(k) of the Internal Revenue Code and is designed to enhance the retirement programs of participating employees. Under this feature, Western Atlas matches up to 67 percent of a certain portion of participants' contributions. Western Atlas' contributions to this plan were $31.4 million, $10.5 million, $39.0 million, and $32.8 million in 1998, the Transition Period, 1997 and 1996, respectively.

Postemployment Benefits

During the periods reported, the Company provided certain postemployment disability and medical benefits to substantially all qualifying former or inactive Baker Hughes U.S. employees (other than those employed at the time by Western Atlas) following employment but before retirement. Disability income benefits ("Disability Benefits"), available at the date of hire, are provided through a qualified plan which has been funded by contributions from the Company and employees. The primary asset of the plan is a guaranteed insurance contract with an insurance company which currently earns interest at 7.2 percent. The actuarially determined obligation is calculated at a discount rate of 6.5 percent. Disability Benefits expense was $2.9 million, $.5 million and $1.1 million in 1998, the Transition Period and 1997, respectively. Disability Benefits income was $.1 million in 1996. The continuation of medical, life insurance and Thrift Plan benefits while on disability, and the service related salary continuance benefits ("Continuation Benefits") were provided through a nonqualified, unfunded plan until April 1997. The continuation of the medical benefit portion of the plan was merged into the disability income benefits plan beginning in April 1997. Expense for Continuation Benefits,

which is primarily interest cost on the projected benefit obligation, was $3.8 million, $.7 million, $3.3 million and $2.9 million for 1998, the Transition Period, 1997 and 1996, respectively.

The following table sets forth the funded status and amounts recognized in the Company's consolidated statements of financial position for Disability Benefits and Continuation Benefits:

	December 31, 1998	December 31, 1997
Actuarial present value of accumulated benefit obligation	$ (46.3)	$ (40.2)
Plan assets at fair value	15.1	15.0
Accumulated benefit obligation in excess of plan assets	(31.2)	(25.2)
Unrecognized net loss	8.9	5.7
Postemployment liability	$ (22.3)	$ (19.5)

Health care cost assumptions used to measure the Continuation Benefits obligation are similar to the assumptions used in determining the obligation for postretirement health care benefits. Additional assumptions used in the accounting for Continuation Benefits were a discount rate of 6.5 percent in 1998, 7.0 percent in the Transition Period and 1997, and increases in compensation of 5.0 percent for all periods presented.

NOTE 15. LITIGATION

The Company is sometimes named as a defendant in litigation relating to the products and services it provides. The Company insures against these risks to the extent deemed prudent by its management, but no assurance can be given that the nature and amount of such insurance will in every case fully indemnify the Company against liabilities arising out of pending and future legal proceedings relating to its ordinary business activities. Many of these policies contain self insured retentions in amounts the Company deems prudent.

NOTE 16. ENVIRONMENTAL MATTERS

The Company's past and present operations include activities which are subject to extensive federal and state environmental regulations. The Company has been identified as a potentially responsible party ("PRP") in remedial activities related to various "Superfund" sites. Applicable federal law imposes joint and several liability on each PRP for the cleanup of these sites leaving the Company with the uncertainty that it may be responsible for the remediation cost attributable to other PRPs who are unable to pay their share of the remediation costs. Generally, the Company has estimated its share of such total cost based on the ratio that the number of gallons of waste estimated to have been contributed to the site by the Company bears to the total number of gallons of waste estimated to have been disposed at the site. The Company has accrued what it believes to have been its pro rata share of the total cost of remediation of these Superfund sites based upon such a volumetric calculation. No accrual has been made under the joint and several liability concept since the Company believes that the probability that it will have to pay material costs above its volumetric share is remote. The Company believes there are other PRPs who have greater involvement on a volumetric calculation basis, who have substantial assets and who may be reasonably expected to pay their share of the cost of remediation. In some cases, the Company has insurance coverage or contractual indemnities from third parties to cover the ultimate liability.

At December 31, 1998 and 1997, the Company had accrued $26.4 million, and $23.7 million, respectively, for remediation costs, including the Superfund sites referred to above. The measurement of the accruals for remediation costs is subject to uncertainty, including the evolving nature of environmental regulations and the difficulty in estimating the extent and type of remediation activity that will be utilized. The Company believes that the likelihood of material losses in excess of those amounts recorded is remote.

NOTE 17.
OTHER MATTERS

Supplemental consolidated statement of operations information is as follows:

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Year Ended September 30, 1997	1996
Rental expense (generally transportation equipment and warehouse facilities)	$ 190.4	$ 40.5	$154.2	$114.6
Research and development	128.4	31.8	118.7	98.8
Income taxes paid	134.5	64.7	148.7	84.2
Interest paid	150.3	33.1	92.4	90.0

NOTE 18.
COMMITMENTS AND CONTINGENCIES

At December 31, 1998, the Company had commitments outstanding for capital expenditures under purchase orders and contracts of approximately $214.2 million. Of this amount, $145.1 million related primarily to construction of two seismic vessels. The cost of the vessels and related equipment is currently estimated to be $204.0 million, excluding capitalized interest. Completion of the vessels, including all related seismic equipment, is now expected for the year 2000.

At December 31, 1998, 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 December 31, 2003 are $61.5 million, $45.2 million, $26.4 million, $16.6 million and $7.4 million, respectively, and $40.9 million in the aggregate thereafter. The Company has not entered into any significant capital leases.

For the purpose of governing certain relationships between UNOVA and the Company after the Spin-off, UNOVA and the Company entered into various agreements including a Distribution and Indemnity Agreement, a Tax-Sharing Agreement, a Benefits Agreement and an Intellectual Property Agreement.

NOTE 19. QUARTERLY DATA (UNAUDITED)

(Per share amounts in dollars)	Fiscal Year 1998 *					Three Months Ended December 31, 1997*	Fiscal Year 1997*				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Fiscal Year	Transition Period	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Fiscal Year
Revenues	$ 1,648.1	$ 1,659.7	$ 1,584.9	$ 1,419.2	$ 6,311.9	$ 1,572.9	$1,206.7	$1,268.7	$1,337.5	$1,530.7	$5,343.6
Gross profit **	531.0	513.9	160.1	396.0	1,601.0	527.2	365.9	386.2	428.4	486.2	1,666.7
Income (loss) from continuing operations before cumulative effect of accounting change	112.9	118.1	(534.5)	6.1	(297.4)	111.2	67.6	74.6	109.8	(51.1)	200.9
Net income (loss)	112.9	118.1	(534.5)	6.1	(297.4)	114.0	70.2	(111.9)	123.9	(48.3)	33.9
Per share of common stock:											
Income (loss) from continuing operations before cumulative effect of accounting change											
Basic	0.36	0.37	(1.65)	0.02	(0.92)	0.35	0.23	0.25	0.37	(0.16)	0.67
Diluted	0.35	0.36	(1.65)	0.02	(0.92)	0.34	0.23	0.25	0.36	(0.16)	0.66
Net income (loss)											
Basic	0.36	0.37	(1.65)	0.02	(0.92)	0.36	0.24	(0.38)	0.42	(0.15)	0.11
Diluted	0.35	0.36	(1.65)	0.02	(0.92)	0.35	0.24	(0.36)	0.41	(0.15)	0.11
Common stock market prices:											
High	$ 44.13	$ 44.00	$ 34.94	$ 23.88		$ 49.63	$ 38.88	$ 41.25	$ 40.13	$ 47.25	
Low	$ 34.88	$ 33.13	$ 17.75	$ 15.00		$ 39.00	$ 29.50	$ 34.13	$ 32.63	$ 38.38	

* See Note 2 for accounting changes; see Note 3 for discontinued operations; see Note 7 for acquisitions and dispositions; see Note 8 for unusual charges.

** Represents revenues less costs of revenues.

Corporate Information

Corporate Officers:

Max L. Lukens
Chairman, President, and Chief Executive Officer

Thomas R. Bates, Jr.
Senior Vice President

Eric L. Mattson
Senior Vice President and Chief Financial Officer

G. Stephen Finley
Senior Vice President and Chief Administrative Officer

Andrew J. Szescila
Senior Vice President

Ray A. Ballantyne
Vice President Marketing, Technology, and Business Development

Douglas C. Doty
Vice President and Treasurer

Arthur T. Downey
Vice President, Government Affairs

James W. Harris
Vice President, Tax and Controller

John A. O'Donnell
Vice President, Business Process Development

Lawrence O'Donnell, III
Vice President and General Counsel

Linda J. Smith
Corporate Secretary

M. Glen Bassett
Vice President and President, Baker Petrolite Corporation

Joseph F. Brady
Vice President and President, Centrilift

Matthew G. Dick
Vice President and President, Baker Process

Gerald M. Gilbert
Vice President and President, E&P Solutions

Edwin C. Howell
Vice President and President, Baker Oil Tools

Gary E. Jones
Vice President and President, Baker Atlas

Timothy J. Probert
Vice President and President, Baker Hughes INTEQ

Douglas J. Wall
Vice President and President, Hughes Christensen Company

Richard C. White
Vice President and President, Western Geophysical

Board of Directors:

Lester M. Aberthal, Jr.
Retired Chairman of the Board of EDS

Victor G. Beghini
Vice Chairman - Marathon Group, USX Corporation and President, Marathon Oil Company

Alton J. Brann
Chairman and Chief Executive Officer of UNOVA, Inc.

Joseph T. Casey
Retired Vice Chairman and Chief Financial Officer of Western Atlas Inc.

Eunice M. Filter
Vice President, Secretary, and Treasurer of Xerox Corporation

Joe B. Foster
Chairman and Chief Executive Officer of Newfield Exploration Company

Claire W. Gargalli
Former Vice Chairman, Diversified Search and Diversified Health Search Companies

Richard D. Kinder
Chairman and Chief Executive Officer of Kinder Morgan Energy Partners, L.P.

Max L. Lukens
Chairman, President, and Chief Executive Officer of Baker Hughes Incorporated

John F. Maher*
Retired President and Chief Executive Officer of Great Western Financial Corporation

James F. McCall
Lt. General, U.S. Army (Retired), Executive Director of the American Society of Military Comptrollers

H. John Riley, Jr.
Chairman, President, and Chief Executive Officer of Cooper Industries, Inc.

John R. Russell
Retired President of Baker Hughes Incorporated and Former President and Chief Executive Officer of Western Atlas Inc.

Charles L. Watson
Chairman and Chief Executive Officer of Dynegy, Inc.

Max P. Watson, Jr.
Chairman, President, and Chief Executive Officer of BMC Software, Inc.

* Will retire at the Annual Meeting of Stockholders to be held on April 28, 1999.

Shareholder Information:

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Ridgefield Park NJ 07660
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Independent Accountants
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Stock Exchange Listings
Ticker Symbol "BHI"
New York Stock Exchange,
Pacific Exchange, Inc.,
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Investor Relations Office
Gary R. Flaharty
Director Investor Relations
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gary.flaharty@bakerhughes.com

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 Baker Hughes Investor Relations.

Annual Meeting
The Company's Annual Meeting of Stockholders will be held at 11:00 AM on April 28, 1999 at the offices of the company: 3900 Essex Lane, Suite 210, Houston, Texas.

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Houston, Texas 77027
Telephone (713) 439-8600
P.O. Box 4740
Houston, Texas 77210-4740

Website
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Baker Hughes Information System
1 (800) 969-7447

Glossary

A glossary of selected oilfield terms

Completion — technology used to bring a well on production. Matched to the reservoir and formation for optimum production, completion technology includes perforating, gravel packing, and flow control equipment (such as packers, inflatable tools, and sliding sleeves).

Deepwater — operations in water depths that exceed 1500 ft.

Depth migration — special seismic data processing used to focus subsurface events to their proper locations in depth. Prestack depth migration, a computing-intensive process, has been highly successful for complex imaging, including subsalt formations.

Directional drilling — the method of guiding a well along a predetermined path to a specific target. A directional drilling company provides technology and rig site supervision to efficiently meet directional drilling objectives.

Downhole Factory™ — a Baker Hughes concept for the future in which many tasks associated with hydrocarbon production are performed in the wellbore instead of on the surface. Downhole oil/water separation and automated well maintenance are examples.

Downhole oil/water separation — a system comprising a downhole hydrocyclone and electrical submersible pump that separates oil from water downhole, reinjects water, and produces oil to the surface.

Drill-in fluid — a specialty drilling fluid designed to minimize formation damage in the reservoir.

Drilling fluid — fluid used in the wellbore to lubricate and cool the bit, control bottomhole pressures, and remove cuttings.

Electrical submersible pump (ESP) — a system comprised of a downhole pump, a downhole electric motor, cabling, and surface controller to lift larger quantities of fluids from wells that do not flow under their own pressure.

Fishing — tools and services that perform specialty and repair work downhole. Fishing activities include retrieving lost tools and repairing wellbore damage.

Geophone — a microphone-like sensor that transforms seismic reflections into an electrical signal.

Geosteering — a subset of horizontal drilling in which measurements of formation properties are used to place the wellbore in specific geologic targets.

Gravel pack — a completion technique used to control production of sand from loosely consolidated formations.

Horizontal drilling — a subset of directional drilling in which the angle of deviation of the wellbore reaches 90 degrees, maximizing the length of wellbore exposed to the formation.

Hydrocyclone — a device for separating mixed liquids (e.g. oil and water).

Hydrophone — a pressure-sensitive sensor used to detect seismic reflections during marine surveys.

Intelligent completions — a completion technology in which formation property measurements are made and the completion dynamically adjusts itself to maximize production from the well.

Logging-while-drilling (LWD) — a variation of measurement-while-drilling in which the LWD tool gathers information about the formation while the well is being drilled.

Measurement-while-drilling (MWD) — measuring directional information (azimuth, inclination, and tool orientation) downhole to adjust the drilling process and guide the wellbore to a specific target.

Multicomponent seismic — a survey conducted using 3-component (3-C) geophones for sensing seismic reflections in the vertical, horizontal, and crossline directions. In the marine environment, a hydrophone is included to acquire 4-component (4-C) data.

Multidimensional seismic (2-D, 3-D, 4-D) — seismic data are used to map subsurface formations. A 2-D survey reveals a crosssection of the subsurface. In a 3-D survey, seismic data are collected in the inline and crossline directions to create a three-dimensional image of the subsurface. In a 4-D or time-lapse 3-D survey, 3-D surveys are repeated over time to track fluid movement in the reservoir.

Multilateral well — a well in which two or more branches are drilled from a single main wellbore. Various levels of completion systems can be installed in a multilateral well to enable it to produce from several zones simultaneously.

Oilfield chemicals — chemicals used to treat produced fluids and control corrosion and deposition in producing wells.

Packer — open and cased-hole devices used to create seals to control fluid flow.

PDC drill bits — use fixed position polycrystalline diamond compact cutters that shear the formation instead of grinding it. In many applications, PDC bits offer higher penetration rates and longer life than tricone bits.

Permeability — a measure of the ease in which a fluid can pass through the pore spaces of a formation.

Resistivity — a measurement of a formation's resistance to electrical current. Used to determine whether the formation holds hydrocarbons or water.

Sliding sleeve — a flow control device that can be opened or closed to allow or prevent production to flow into the well.

Sonic log — a well log of the travel time for acoustic waves per unit of distance.

Streamer — a marine cable containing regularly spaced hydrophones. During a marine seismic survey, several of these streamers are towed behind the survey vessel.

Transition zone — the region between land and deep water consisting typically of surf, swamps, and bayous.

Tricone® drill bit — a rotary drill bit employing three cones and either hardened steel teeth or tungsten carbide inserts (TCI). This bit works by grinding away at formation rock as it is turned.

Well log — a record of one or more subsurface formation measurements as a function of depth in a borehole.

Workover — maintenance procedures performed on a previously completed well to restore or stimulate production or increase the life of the well.


BAKER
HUGHES