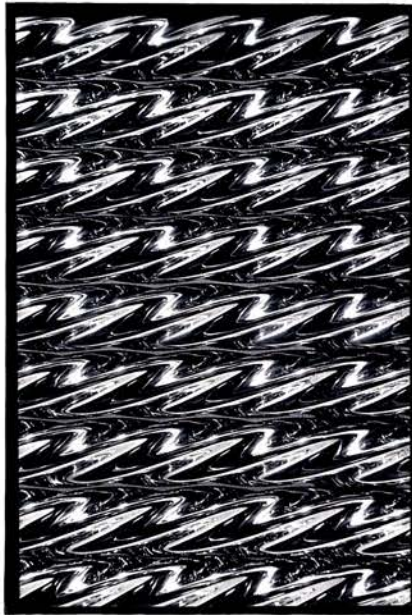


BAKER HUGHES

INCORPORATED



1989

Annual

Report



ON THE COVER

Horizontal drilling requires downhole motors and computer controls to achieve the desired profile. Baker Hughes Drilling System's drilling motor rotors and a CRT display of a desired hole profile are shown.

CORPORATE PROFILE

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

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2. Letter to Stockholders
4. Operations Review
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SUMMARY OF SELECTED FINANCIAL DATA*Baker Hughes Incorporated**(In thousands of dollars except per share amounts)**Years Ended September 30,*

	1989	1988
<i>Sales</i>	\$1,763,329	\$1,775,346
<i>Services and rentals</i>	<u>564,666</u>	<u>540,805</u>
<i>Total revenues</i>	2,327,995	2,316,151
<i>Net income</i>	85,023	103,247
<i>Net income per share</i>	.66	.82
<i>Working capital</i>	620,017	592,134
<i>Total assets</i>	2,065,920	2,117,526
<i>Net property, plant and equipment</i>	660,592	647,788
<i>Capital expenditures</i>	92,702	62,048
<i>Depreciation and amortization</i>	110,344	122,178
<i>Long-term debt</i>	417,045	440,007
<i>Stockholders' equity</i>	1,003,380	961,488
<i>Cash dividends per share of common stock</i>	<u>.46</u>	<u>.46</u>
<i>Number of shares (000)</i>		
<i>Average during year</i>	119,091	117,919
<i>Outstanding at end of year</i>	120,435	118,419
<i>Number of employees</i>	20,400	21,500

**TO
OUR
STOCKHOLDERS**

Fiscal year 1989 was a good year for Baker Hughes Incorporated. Although worldwide drilling activity was much lower than we expected, revenues and earnings benefited from a favorable mix of offshore and gas drilling activity as well as from increased demand for the products and services of Baker Hughes Process Equipment.

Revenues for 1989 were \$2.33 billion, essentially unchanged from \$2.32 billion in 1988. Net income was \$85.0 million or \$.66 per share compared to \$103.2 million or \$.82 per share in 1988. Pretax operating income for the year was \$117.6 million as compared to the prior year's \$77.2 million, which excludes the impact of net unusual credits and nonrecurring gains. This \$40.4 million increase represents an improvement of 52% in pretax operating income on flat revenues.

The improvement in Baker Hughes' quality of revenues is attributable in large measure to increased levels of drilling for natural gas. The cost of drilling the average gas well in the United States is about 60% greater than the cost of drilling an average oil well. During 1988, 35.7% of the rotary rigs drilling in the U.S. were searching for natural gas, while in 1989, the percentage of rigs drilling for gas increased to an average of 44.6% and

exceeded 50% toward the end of the year. We expect to see gas drilling account for approximately half of the U.S. drilling activity over the near term.

In addition to the much improved operating earnings which Baker Hughes enjoyed in 1989, the year was also marked by significant acquisition and divestiture activity which will have a meaningful impact on the future performance of the Company. Strategically, Baker Hughes wants businesses that produce good operating margins based on a strong technological position and, secondly, businesses that occupy the number one or two market share position in their respective product niches. Our activities over the past year kept these two strategies firmly in mind. In July, we sold our Mining Equipment group to Oy Tampella AB, a Finnish company. While we had invested significant resources in attempting to improve the overall profitability of these companies which serve the underground mining equipment market, the group lacked the critical mass in the marketplace to achieve the type of returns acceptable to Baker Hughes. Proceeds from the sale approximated \$130 million, an amount near the net carrying value of the assets sold.

On the acquisition side, we acquired three businesses that will add substantially to existing core product lines. In March, we added the business of Vetco Services to our existing tubular inspection business and in the process became the world leader in oil-field tubular inspection. In May, we acquired the business of EDECO Petroleum Services, an Aberdeen, Scotland based distributor for Brown liner hangers and Centrilift electric submersible pumps, which brings under our direct control the sales of these two product

lines in this critical oilfield market. Finally in June, we purchased the assets of Bird Machine Company, a leading supplier of centrifugal solid/liquid separation equipment which will enhance our already leading position in this market through EIMCO Process Equipment Company.

The Mining Equipment group was operating slightly above the break-even profit level, while the three businesses acquired are expected to generate pretax operating income of approximately \$20 million. Thus we have significantly upgraded the quality of our revenue stream.

Also, during 1989, we have continued Baker Hughes' commitment to research and development, investing \$30 million. Several new products were introduced during the past year which are covered in the operations review section of this report.

Outlook

We expect 1990 to bring a modest increase in the number of rotary rigs drilling worldwide with a continuation of the trend toward a more favorable drilling mix. Anticipated higher prices for natural gas in the United States and increased offshore drilling, particularly in the U.S. Gulf of Mexico and the Far East, should be key drivers in 1990.

The oil field service industry in general appears to be in the final stages of consolidation arising from the tremendous turmoil

of the last several years. We will continue to diligently pursue acquisition opportunities that enhance our oil field business.

Baker Hughes' 1989 revenues from sales of environmental equipment and services exceeded \$250 million or about 10.8% of total revenues. The bulk of these revenues was generated by the Process Equipment group. With continued emphasis on the protection of our environment and the enactment of more stringent clean air and acid rain legislation, spending by industry and governmental agencies in these areas will accelerate. We intend to pursue opportunities to broaden our participation in these environmental markets through development of new applications of our existing technologies as well as acquisitions.

We thank our 20,400 employees for their dedicated efforts in getting us over the dislocations and uncertainties of the past years and our stockholders for having continuing confidence in our industry and in our Company. We have worked hard to position the Company to take advantage of the growth opportunities that lie ahead and we feel our efforts will be rewarded.

We extend our sincere appreciation for a job well done to two of our directors who will be retiring this year, Henry LeMieux and Dan Krausse. Both of these directors have served the stockholders well and we will miss their input and guidance.



J. D. Woods
Chairman, President
and Chief Executive Officer



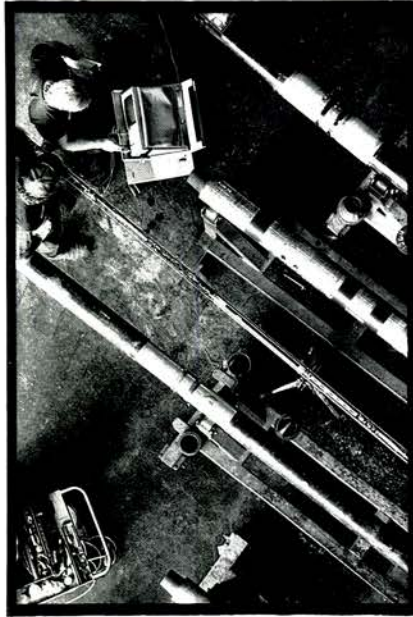
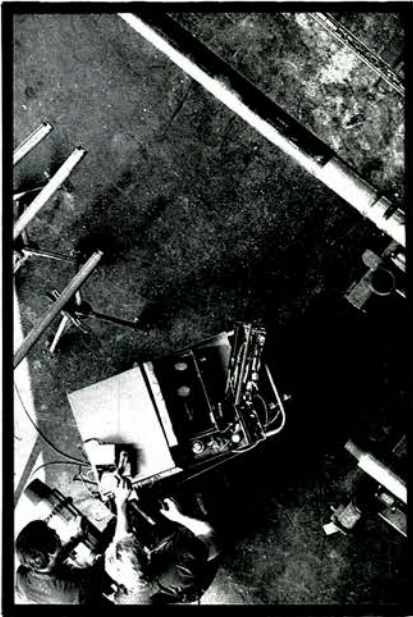
BAKER

HUGHES

DRILLING

EQUIPMENT:

EXLOG



New, next generation
modular measurement-
while-drilling tools
are tested in EXLOG's
headquarter's laboratory
in Houston. High
technology in downhole
packaging.



BAKER

HUGHES

DRILLING

EQUIPMENT

R Revenues for Baker Hughes Drilling Equipment (BHDE) in 1989 were \$728.6 million, 2.9% below 1988 levels, although worldwide drilling activity, as measured by the active rig count, was 14% lower. The acquisition of Vetco Services in March 1989 contributed 4.2% to revenues, but the improved quality of drilling, i.e. offshore and gas, generally made up for the lower number of rigs working. Pretax operating income for the year was \$50.0 million, 5.7% above the previous year, despite the revenue decline, reflecting continuing cost containment which is improving margins. Net capital employed was \$508 million, a 9.7% increase from 1988, and includes \$37 million for the Vetco Services acquisition.

The strategic emphasis of BHDE continues the focus of lowering the real cost of access to oil and gas reserves for our customers. The principle path for such emphasis is through technology, efficiency and reduced risk. Increasing the rate of penetration during the drilling operation has a powerful effect on drilling costs, and BHDE has multi-pronged programs aimed at achieving significant improvement. Improved drill bits, both roller cone and poly-crystalline diamond compact (PDC), are under continuous development at Hughes Tool Company, while joint research between Hughes and Milpark is directed at non-hydrocarbon based drilling fluids that enhance the drilling efficiency of PDC bits. At EXLOG, new systems for drilling information management have been developed to enhance efficiency and expedite decision making, while a new technology (Adams), licensed exclusively from ARCO by EXLOG, is directed at optimizing energy transfer to the bit through the drillstring from the drilling rig.

Acquiring more oil from a single hole is possible through reservoir engineering application of horizontal drilling. This exciting process is growing rapidly, and Baker Hughes Drilling Systems is in the forefront of new, improved technology to accomplish the desired result. Additionally, BHDE has programs to reduce operator risk while coupling the products and services of several Baker Hughes divisions. Risk sharing is a new concept and this packaged program is receiving growing attention by customer and trade press. Risk reduction is also the focus of Baker Hughes Tubular Services and Tri-State. Tubulars, the largest tangible asset in a well, must be competent for their intended service, and well site inspection is one sure way to ensure that competence. The acquisition of Vetco Services at mid-year places Baker Hughes Tubular Services as the world leader in pipe inspection. Similarly, lost time removing or milling-out lost or broken tools in wells is very expensive, so Tri-State is increasing research and development significantly to improve fishing and milling technology. The very successful Tri-State "Metal Muncher" is a current result of just such emphasis. This product line has been so successful it has attracted a host of imitators. The strategic emphasis of BHDE is paying off handsomely as individual divisions improve what they do best and work together with other divisions to improve the overall process of drilling wells. The synergism will continue to produce benefits for our customers.

1990 looks like a year of continued financial improvement as well. Worldwide drilling will increase with horizontal drilling increasing substantially. The positioning and technical advancements as well as the superior people in Baker Hughes Drilling Equipment will yield improved results for our stockholders.

The financial data presented in the Operations Review (pages 5-10) is on a current organizational basis and excludes any corporate or unusual items. It is not intended to correspond directly with the accompanying Consolidated Financial Statements and Notes thereto.

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PRODUCTION

TOOLS

Baker Hughes Production Tools had a very successful 1989, as revenue grew 5% to \$673.4 million while pretax operating income increased 21% to \$84.1 million. Net capital employed declined 9.5% to \$347.8 million, principally due to working capital reduction and the disposition of several unprofitable product lines.

Accomplishments of significance during 1989 were technical developments which are key to Baker Hughes Production Tools' strategic focus to lead the industry in well completions, while lowering our customers' cost of producing oil and gas, and remedial treatment. Included were: complex horizontal-well completions including gravel packing and zonal isolation in up to five separate sections of the horizontal portion; patents on processes to accomplish such completions; through-tubing apparatus to provide workover possibilities with a small coil-tubing rig instead of a large workover rig; significant progress in the development of an electromagnetic controlled safety valve which can be opened and closed by a radio signal from the surface with no mechanical, hydraulic or electrical connection to the valve; and a new liner hanger which is less costly, especially when premium casing material is needed. These steps all have the elements of enhancing our technological leadership while lowering our customers' costs. Additional strategic emphasis is niche acquisition in core-market segments. During 1989, just such a key acquisition was made. EDECO Petroleum Services was acquired by Baker Service Tools.

EDECO is the leading marketer of electric submersible pumps and liner hangers in the North Sea, thereby improving the marketing capacity for two of our core product lines.

Looking forward to 1990, we see improving conditions for our products and services. In the U.S., gas well completions should increase in number, since gas well drilling in 1989 has been higher than in previous years. Gas wells significantly benefit our completion products divisions. Also, horizontal well completions will increase rapidly worldwide. This is a technology where we are the unquestioned leader, and interest in this new and exciting technology is growing quickly. Additionally, a significant change for 1990 will be the improvement in the markets for our remedial well services and products. Near year-end, stable oil prices began to stimulate well workovers in the U.S., and 1990 should see a continuation of that trend.

Another key indicator of future opportunity is the rising drilling and workover activity in the Gulf of Mexico. Wells currently being drilled will be completed during 1990, providing substantial opportunity for Baker Hughes Production Tools.

Outside the U.S., the future looks equally bright. The British and Norwegian North Sea fields are continuing big areas for Baker Hughes as is the Middle East. West Africa and the Pacific Rim are also active areas where the Company's long-established presence has placed us in excellent position for continued market share leadership. 1990 should be an improved year for revenues and profitability.

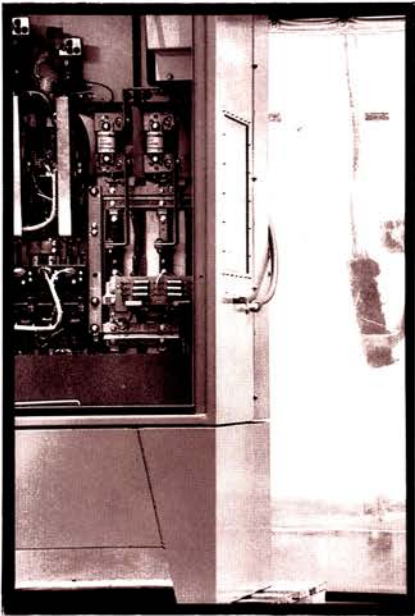
BAKER

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PRODUCTION

TOOLS:

CENTRILIFT



Electric submersible pumps

at Centrilift's test

facility undergo rigorous

evaluation before

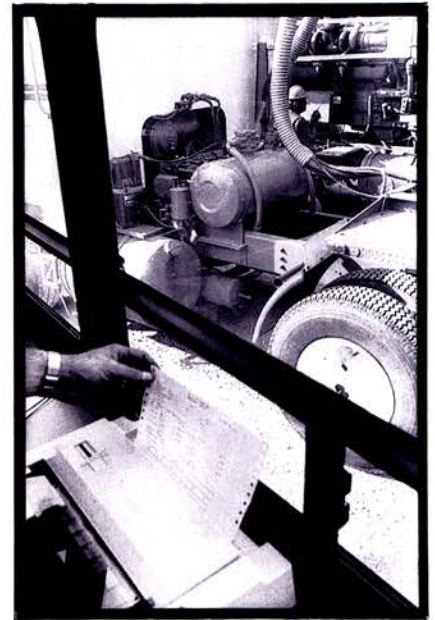
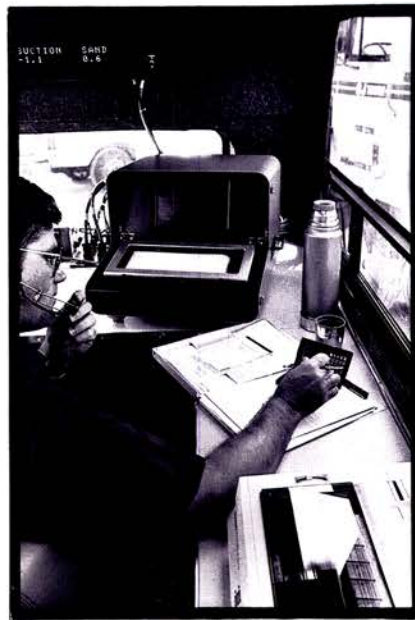
being sent to the ultimate

test well; a customer's.



BJ TITAN

SERVICES



The technology of
hydraulic fracturing continues
to advance, taking
advantage of computers to
evaluate and control
the blending and pumping
process continuously.



The Pumping Services division continued its financial turnaround in 1989. Despite lower drilling activity worldwide and the resulting revenue decline of 5.5%, pretax operating profits were up significantly to \$27.4 million, a 53% increase from 1988.

Balance sheet management also continued to reflect working capital improvement of \$10 million as net capital employed was further reduced from \$135 million in 1988 to \$129 million in 1989.

Stability in the division's key markets of Alaska, the North Sea, Indonesia and Venezuela was a significant factor in offsetting activity declines in other regions. Coupled with continued personnel efficiencies and consolidation benefits derived from the combining of domestic and international operations in late 1988, the BJ division was able to continue on track with its earnings and return enhancement objectives.

Coinciding with the earnings improvement, the division was able to accomplish several technical advancements as well. Of particular interest was the successful introduction of the Liquid-Frac-Concentrate system resulting in lower cost and reduced environmental concerns to our customers. When coupled with the division's computerized blenders and "3600" monitoring systems,

the BJ division is well positioned to participate in the increasing gas-fracturing markets of the U.S.

Along with the equipment advancements, BJ has placed a much higher emphasis on its most critical resource, its employees. Several new training programs were introduced and will continue into 1990 with an emphasis on job performance and safety. Coupled with enhanced employee communication tools, BJ's customers and employees will recognize the benefits of a company committed to providing quality services, safely.

Looking forward to 1990, BJ is cautiously optimistic about renewed gas activity in the U.S. Expansion of BJ's patented RAM cementing system and introduction of the newly field tested 3305 cement monitoring system will strengthen the division's share position in the offshore drilling markets worldwide. As activity rebounds, the division's focus will be on restoring equitable prices for its services and continuing to strengthen its share positions through technology and performance in those markets providing attractive returns.

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PROCESS

EQUIPMENT

Fiscal 1989 was a very good year for our process equipment businesses as continued strength in base metal prices coupled with growing emphasis in industrial wastewater served to stimulate growth. Revenues reached \$435.7 million, a 19.8% increase, while pretax operating income grew 35.1% to \$44.6 million. Net capital employed was \$157.7 million compared to \$96 million in 1988.

During 1989, our process businesses were enhanced by the addition to the group of Bird Machine Company. Bird, located in South Walpole, Massachusetts, is the premier manufacturer of continuous process centrifuges. Acquired in the summer of 1989, Bird contributed slightly to the year to year growth in performance, but the real effects of this fine organization will come as our participation in process flow sheets is increased with centrifugal technology provided by Bird.

During the year the group continued to build on the strength of its markets. Of particular emphasis is the approximately 60% of the group's revenue which relates to the treatment of water for safe disposal. Cutting across all industry lines, regulatory, economic and social pressures influence our customers to use our technology to separate solids and/or undesirable liquids from the water used in their various processes. Whether in municipal sewage treatment, mine tailings processing, pulp and paper production or petroleum refining, increased

attention to treatment of effluents is adding to the business opportunities worldwide for EIMCO Process Equipment, BGA, WEMCO, Bird Machine, and Lewis Pumps. It is clear that the environment is a top priority, and that Baker Hughes' process technology is a leader in wastewater processing, regardless of the industry segment in which the water is used. This area of our business will continue to grow as the forces affecting it strengthen.

Other businesses of particular strength include instrumentation markets, where our new X-ray diffraction analytical instrument is meeting superior success in acceptability. This is such a truly remarkable technological achievement that Research and Development Magazine awarded it their top 100 R&D Achievement award. This is the second successive such award that Ramsey Technology's TN division has received. Ramsey's other instrument lines continue to grow as high speed weighing, packaging and sampling of dry materials benefit from their sophisticated electronic and electro-mechanical systems. Our leadership position in mining drill bits through Baker Hughes Mining Tools also remains secure.

Looking forward, the general economic environment for our process business remains favorable. As we continue our focus on technological advancement and adaptation to new applications, with selected niche acquisitions, the future of Baker Hughes Process Equipment looks bright indeed.

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PROCESS

EQUIPMENT:

EIMCO

PROCESS EQUIPMENT



EPEC is a leading supplier of

municipal sewage

treatment equipment, a

primary part of BHPE's

strategic emphasis on waste-

water processing.



Baker Hughes Incorporated

FINANCIAL

INFORMATION

FINANCIAL AND ORGANIZATIONAL REVIEW

Baker Hughes Incorporated

FINANCIAL REVIEW

Baker Hughes Incorporated's revenues in 1989 were \$2.33 billion, virtually flat with last year's results despite the fact that drilling activity in the United States, as measured by the active rig count, was down 15% during the year. Drilling activity outside the United States was down 13% year to year.

Although revenues were flat, pretax operating profit, excluding net unusual credits and pension gains, increased \$40.4 million or 52% to \$117.6 million. This significant improvement is attributable to improved quality of revenue, modest price increases in our products and services, effective cost control of operating expenses and reduced net interest expense. Cost of sales, services and rentals was \$1.51 billion, down 1.7% from last year, improving as a percent of revenues to 65.0% from 66.5% in 1988. This improvement reflects the impact of the slightly higher prices for our products and services and a better revenue mix. Marketing and field services expenses rose 1.7% to \$431.4 million and increased very modestly as a percent to revenues to 18.5% from 18.3% in 1988. General and administrative expenses increased 1.6% to \$212.8 million, but remained relatively flat with the prior year as a percent to revenue at 9.1%. Net interest expense declined to \$51.2 million in 1989 from \$61.5 million in 1988, a reduction of \$10.3 million or 16.6%. This decline reflects both the impact of the reduction in outstanding debt during 1989 and the increase in interest income earned on cash and short-term investments.

Prior year results include net unusual credits of \$47.5 million resulting from the settlement of two patent infringement lawsuits partially offset by unusual charges. Smith International, Inc. settled with the Company for \$95 million, principally in cash, and Dresser Industries, Inc. settled for \$23 million in cash and their minority interest ownership in B-J

Revenues
(Dollars in billions)

Net Income (Loss)
(Dollars in billions)

Earnings (Loss) Per Share
(Dollars)

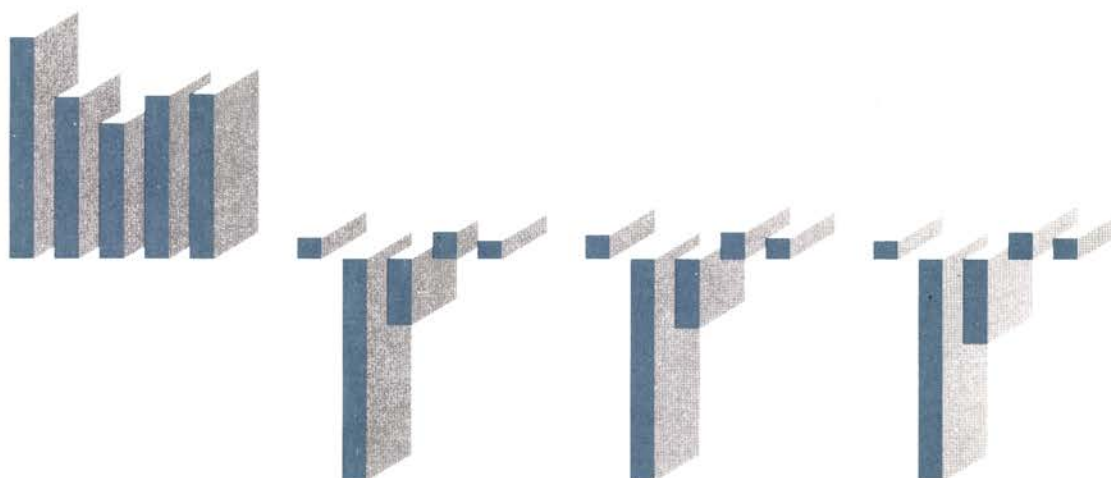
Return on Revenues
(Percent)
After-tax profit margin

85 86 87 88 89
3.17 2.31 1.92 2.32 2.33

85 86 87 88 89
.092 (.805) (.255) .103 .085

85 86 87 88 89
.80 (7.00) (2.22) .82 .66

85 86 87 88 89
2.9 (34.8) (13.2) 4.5 3.7



Titan. The value of the B-J Titan interest brought the settlement to \$55.2 million. Offsetting these credits were charges to operations of \$102.7 million resulting from the Company's determination that certain of its assets had been permanently impaired due to changes in market conditions and operating strategies and that disposal of certain product lines and continued consolidation of geographic operations was necessary.

Earnings per share declined from \$.82 per share in 1988 to \$.66 per share in 1989. This decline reflects the impact of the net unusual credits and the pension gains included in net income in 1988.

CAPITAL RESOURCES AND LIQUIDITY

During 1989, operational profitability and the sale of the Company's Mining Equipment group provided cash flow in excess of dividend requirements. Cash dividends on common stock amounted to \$54.8 million and \$7.0 million on preferred stock. A management objective to continue to strengthen the balance sheet and improve liquidity was met. At year-end, the Company had cash and cash equivalents of \$115.7 million, an increase of \$47.9 million from the prior year-end. Working capital increased by \$27.9 million during the year to \$620.0 million and the current ratio improved from 1.97 at the end of last year to 2.14 at the end of 1989. Total debt outstanding was reduced from \$487.9 million at the end of 1988 to \$445.2 million at the end of 1989, a reduction of \$42.7 million, or 8.8%. The debt to equity ratio improved from .507 to .444.

Earnings on Assets
(Percent)
Based on average total assets
and income before gross interest
expense and taxes

85	86	87	88	89
7.5	(26.3)	(6.4)	10.8	10.1

Return on Equity
(Percent)
Based on year-end
stockholders' equity

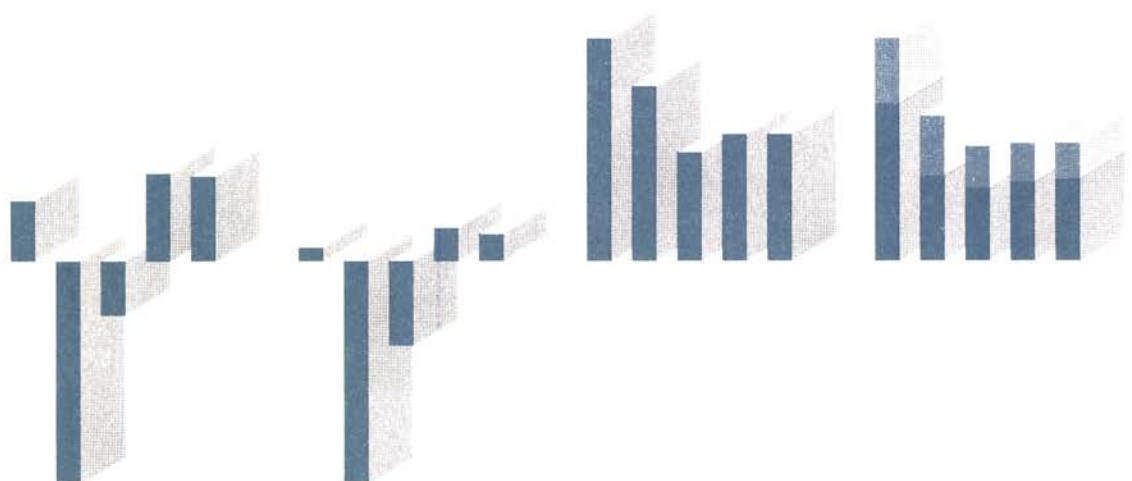
85	86	87	88	89
4.7	(75.0)	(27.8)	10.7	8.5

Common Stock Dividends Paid
(Per share)

85	86	87	88	89
.80	.64	.39	.46	.46

Stockholders' Equity and Debt
(Dollars in billions)
Includes long and short-term debt

85	86	87	88	89
.78	.73	.54	.49	.45
1.95	1.07	.92	.96	1.00



Demonstrating the Company's commitment to the future, \$92.7 million of capital was put in place during the year, up \$30.7 million from last year's total of \$62.0 million. The bulk of the Company's capital expenditures, both this year and last, were to enhance productivity and to address new technological areas.

ORGANIZATION

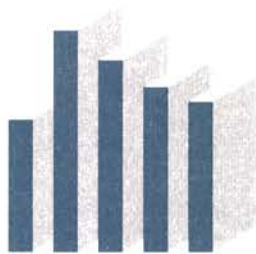
During the year several acquisitions and dispositions were effected to further strengthen the Company. The most significant event was the sale of the Company's Mining Equipment operations to Oy Tampella AB of Finland for \$130 million. The Company also acquired three key operations during the year, EDECO Petroleum Services, Vetco Services and Bird Machine Company.

MANAGEMENT

Subsequent to year-end, Joel V. Staff, formerly the president of Baker Hughes Production Tools, was named president of Baker Hughes Drilling Equipment, and Max L. Lukens, formerly Senior Vice President and Chief Financial Officer of Baker Hughes, was named president of Baker Hughes Production Tools. Mr. Staff and Mr. Lukens remain Senior Vice Presidents of Baker Hughes. Thomas W. Cason, formerly president of Milpark Drilling Fluids, was promoted to Senior Vice President and Chief Financial Officer of Baker Hughes.

Debt/Equity Ratio
Includes long and short-term debt

85	86	87	88	89
399	681	590	507	444



Incremental Asset Investment
(Dollars in millions)

- Capital expenditures
- Net additional working capital

85	86	87	88	89
178	91	45	62	93
(9)	(568)	(134)	91	28



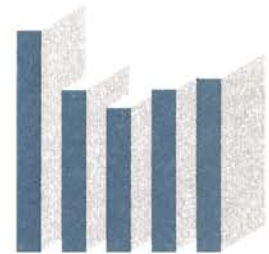
Interest Coverage
Pretax income plus gross interest expense divided by gross interest expense

85	86	87	88	89
2.00	(6.75)	(1.25)	2.30	2.25



Current Ratio

85	86	87	88	89
2.67	1.97	1.73	1.97	2.14



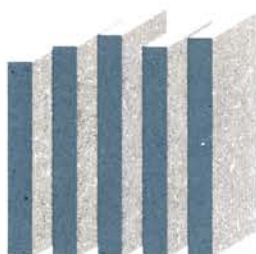
In the operating divisions several new presidents were named including, Tim L. Davis at Bird Machine Company, Edwin C. Howell at Baker Service Tools, Tim J. Probert at Milpark Drilling Fluids, Chris A. Snyder at Develco, and Andrew J. Szescila at Hughes Tool Company.

OUTLOOK

Baker Hughes is well positioned to take advantage of the opportunities presented by the 1990's. The desire for cleaner energy sources should continue to strengthen demand for natural gas, a market where the Company's products and services are well respected and in demand. Worldwide drilling for crude oil should continue its gradual trend upward in this decade as demand continues to grow. As a result of technological improvements and greater selectivity in determining drilling prospects, U.S. finding costs have continued to decline. This fact coupled with improving worldwide demand should serve to stimulate U.S. drilling activity. The organizational and product restructurings in our oilfield operations over the last several years will allow the Company to benefit greatly in these markets. Emphasis on the environment and high precious and base metal prices indicate continuing strong performance for our process businesses. We are confident that the Company will be successful in meeting both the opportunities and challenges of the new decade.

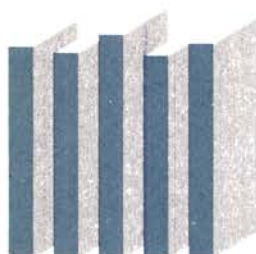
Non U.S. Revenues
As a percent of total

'85	'86	'87	'88	'89
49.1	53.4	55.5	53.3	57.1



Service and Rental Revenue
As a percent of total

'85	'86	'87	'88	'89
24.0	23.7	25.5	23.3	24.3



MANAGEMENT REPORT OF FINANCIAL RESPONSIBILITIES

Baker Hughes Incorporated

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

In fulfilling its responsibilities for the integrity of financial information, management maintains and relies on the Company's system of internal control. This system includes written policies, an organizational structure providing division of responsibilities, the selection and training of qualified personnel and a program of financial and operational reviews by a professional staff of corporate auditors and the independent public accountants. The system is designed to provide reasonable assurance that assets are safeguarded, transactions are executed in accordance with management's authorization and accounting records are reliable as a basis for the preparation of the consolidated financial statements. Management believes that, as of September 30, 1989, the Company's internal control system provides reasonable assurance that material errors or irregularities will be prevented or detected within a timely period and is cost effective.

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

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



J. D. Woods
Chairman, President
and Chief Executive Officer



Thomas W. Cason
Senior Vice President and
Chief Financial Officer



G. S. Finley
Controller

INDEPENDENT AUDITORS' REPORT

Stockholders of Baker Hughes Incorporated:

We have audited the consolidated statements of financial position of Baker Hughes Incorporated and its subsidiaries as of September 30, 1989 and 1988 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1989. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Baker Hughes Incorporated and its subsidiaries at September 30, 1989 and 1988 and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1989 in conformity with generally accepted accounting principles.

Deloitte Haskins & Sells

*Houston, Texas
November 15, 1989*

CONSOLIDATED STATEMENTS OF OPERATIONS

Baker Hughes Incorporated

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

	1989	1988	1987
REVENUES:			
Sales	\$1,763,329	\$1,775,346	\$1,432,138
Services and rentals	564,666	540,805	491,460
Total	<u>2,327,995</u>	<u>2,316,151</u>	<u>1,923,598</u>
COSTS AND EXPENSES:			
Cost of sales, services and rentals	1,513,374	1,540,078	1,392,280
Marketing and field service	431,368	424,102	401,171
General and administrative	212,811	209,522	197,147
Interest expense-net	51,229	61,462	77,161
Pension gains-net		(6,000)	(76,765)
Unusual charges (credits)-net		(47,475)	
Combination and divestiture costs			140,000
Loss in Vetco Gray Inc.			68,223
Total	<u>2,208,782</u>	<u>2,181,689</u>	<u>2,199,217</u>
Income (loss) before income taxes, minority interest and extraordinary items	119,213	134,462	(275,619)
Income taxes	34,837	71,235	(14,100)
Income (loss) before minority interest and extraordinary items	84,376	63,227	(261,519)
Minority interest in (income) loss of subsidiaries	(1,625)	(3,836)	6,697
Income (loss) before extraordinary item	82,751	59,391	(254,822)
Extraordinary item—Reduction of income taxes arising from carryforward of prior years' U.S. operating losses	2,272	43,856	
Net income (loss)	<u>\$ 85,023</u>	<u>\$ 103,247</u>	<u>\$ (254,822)</u>
Income (Loss) Per Share of Common Stock:			
Income (loss) before extraordinary item	\$.64	\$.45	\$ (2.22)
Extraordinary item	.02	.37	
Net income (loss)	<u>\$.66</u>	<u>\$.82</u>	<u>\$ (2.22)</u>

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

Baker Hughes Incorporated

(In thousands of dollars)

September 30,

1989

1988

ASSETS:

Current Assets:

Cash and short-term investments, at cost, which approximates market value \$ 115,686 \$ 67,823

Receivables-less allowance for doubtful accounts: 1989, \$41,985; 1988, \$44,557 488,825 480,815

Inventories:

Finished goods 336,028 417,304

Work in process 62,568 79,367

Raw materials 135,703 120,996

Total inventories 534,299 617,667

Prepaid expenses and deferred income taxes 26,199 36,000

Total current assets 1,165,009 1,202,305

Property:

Land 55,220 52,591

Buildings 338,718 330,848

Machinery and equipment 1,160,990 1,117,002

Rental tools and equipment 347,515 331,203

Total property 1,902,443 1,831,644

Accumulated depreciation (1,241,851) (1,183,856)

Property—net 660,592 647,788

Other Assets:

Property held for disposal 71,604 78,658

Investments 43,911 41,911

Long-term notes receivable 28,939 55,600

Other assets 28,886 39,795

Excess costs arising from acquisitions-less accumulated amortization: 1989, \$13,707; 1988, \$10,080 66,979 51,469

Total other assets 240,319 267,433

Total \$2,065,920 \$2,117,526

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

Baker Hughes Incorporated

(In thousands of dollars)
September 30,

1989

1988

LIABILITIES:

Current Liabilities:

Accounts payable-trade	\$ 221,246	\$ 217,892
Short-term borrowings	15,806	37,463
Current portion of long-term debt	12,319	10,384
Accrued employee compensation and benefits	116,784	115,727
Income taxes	36,383	35,785
Accruals relating to combination and divestiture and unusual charges	9,488	27,802
Taxes other than income	21,847	24,160
Accrued insurance	34,860	37,798
Accrued interest	20,902	22,579
Other accrued liabilities	55,357	80,581
<i>Total current liabilities</i>	<u>544,992</u>	<u>610,171</u>
Long-term debt	417,045	440,007
Deferred income taxes	69,581	73,373
Other long-term liabilities	18,436	21,485
Minority interest	12,486	11,002

STOCKHOLDERS'

EQUITY:

Stockholders' Equity:

Preferred stock, \$1 par value (authorized 15,000,000 shares; outstanding 1,999,000 shares in 1989, and 2,000,000 shares in 1988 of \$3.50 convertible exchangeable preferred stock, \$1 par value \$50 liquidation preference per share)	1,999	2,000
Common stock, \$1 par value (authorized 400,000,000 shares; outstanding 120,435,000 shares in 1989, and 118,419,000 shares in 1988)	120,435	118,419
Capital in excess of par value	918,044	895,758
Retained earnings	52,000	28,761
Cumulative foreign currency translation adjustment	(89,098)	(83,450)
<i>Total stockholders' equity</i>	<u>1,003,380</u>	<u>961,488</u>
<i>Total</i>	<u>\$2,065,920</u>	<u>\$2,117,526</u>

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Baker Hughes Incorporated

(In thousands of dollars) For the three years ended September 30, 1989	\$3.50 Convertible Exchangeable Preferred Stock (\$1 Par Value)	Common Stock (\$1 Par Value)	Capital In Excess of Par Value	Retained Earnings (Deficit)	Cumulative Foreign Currency Translation Adjustment	Total
BALANCE, SEPTEMBER 30, 1986		\$ 115,279	\$ 765,073	\$ 262,833	\$ (71,036)	\$ 1,072,149
Net loss				(254,822)		(254,822)
Cash and accrued dividends on \$3.50 convertible exchangeable preferred stock (\$1.14 per share)				(2,275)		(2,275)
Cash dividends on common stock (\$.39 per share)				(45,836)		(45,836)
Issuance of \$3.50 convertible exchangeable preferred stock	\$2,000		95,400			97,400
Adjustment to conform fiscal year of Hughes Tool Company				26,874		26,874
Foreign currency translation adjustment					(3,649)	(3,649)
Stock issued pursuant to employee stock plans		1,097	14,959			16,056
Other		1,114	8,509			9,623
BALANCE, SEPTEMBER 30, 1987	2,000	117,490	883,941	(13,226)	(74,685)	915,520
Net income				103,247		103,247
Cash and accrued dividends on \$3.50 convertible exchangeable preferred stock (\$3.50 per share)				(7,000)		(7,000)
Cash dividends on common stock (\$.46 per share)				(54,260)		(54,260)
Foreign currency translation adjustment					(8,765)	(8,765)
Stock issued pursuant to employee stock plans		777	8,569			9,346
Other		152	3,248			3,400
BALANCE, SEPTEMBER 30, 1988	2,000	118,419	895,758	28,761	(83,450)	961,488
Net income				85,023		85,023
Cash and accrued dividends on \$3.50 convertible exchangeable preferred stock (\$3.50 per share)				(7,000)		(7,000)
Cash dividends on common stock (\$.46 per share)				(54,784)		(54,784)
Foreign currency translation adjustment					(5,648)	(5,648)
Stock issued pursuant to employee stock plans		1,857	20,544			22,401
Other	(1)	159	1,742			1,900
BALANCE, SEPTEMBER 30, 1989	<u>\$ 1,999</u>	<u>\$ 120,435</u>	<u>\$ 918,044</u>	<u>\$ 52,000</u>	<u>\$(89,098)</u>	<u>\$ 1,003,380</u>

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

Baker Hughes Incorporated

		(In thousands of dollars)		
		Years ended September 30.		
		1989	1988	1987
CASH FLOWS FROM OPERATING ACTIVITIES:	Net income (loss)	\$ 85,023	\$ 103,247	\$(254,822)
	Adjustments to reconcile net income to net cash provided from operating activities:			
	Depreciation and amortization of:			
	Property	92,951	102,615	128,728
	Debt discount and other assets	17,393	19,563	17,990
	Unusual charges and combination and divestiture costs		102,682	140,000
	Deferred pension items		(3,715)	14,436
	Minority interest	1,625	3,836	(6,697)
	(Gain) loss on disposal of assets	(8,559)	3,721	(2,114)
	Noncash proceeds from settlements of litigation		(42,100)	
	Loss in Vetco Gray, Inc.			68,223
	Change in receivables	(18,880)	(9,159)	29,569
	Change in accounts payable-trade	15,007	(1,614)	8,317
	Change in inventories	7,486	12,277	53,095
	Changes in other current assets and liabilities	(29,694)	(66,238)	(86,328)
Changes in other noncurrent assets and liabilities	(1,598)	(82,057)	(24,265)	
Foreign currency translation loss, net	17,442	6,876	2,271	
	Net cash flows from operating activities	<u>178,196</u>	<u>149,934</u>	<u>88,403</u>
CASH FLOWS FROM INVESTING ACTIVITIES:	Property additions	(92,702)	(62,048)	(45,298)
	Proceeds from disposal of assets	44,200	79,979	63,282
	Cash proceeds from disposition of the Mining Equipment group	114,905		
	Acquisitions of businesses, net of cash acquired	<u>(95,159)</u>	<u>(2,772)</u>	<u>(34,979)</u>
	Net cash flows from investing activities	<u>(28,756)</u>	<u>15,159</u>	<u>(16,995)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:	Proceeds from borrowings	44,888	96,529	79,433
	Reduction of borrowings	(99,302)	(149,662)	(268,237)
	Proceeds from issuance of preferred stock			97,400
	Proceeds from exercise of stock options and stock purchase grants	22,401	9,346	16,056
	Cash dividends	<u>(61,784)</u>	<u>(61,260)</u>	<u>(47,294)</u>
	Net cash flows from financing activities	<u>(93,797)</u>	<u>(105,047)</u>	<u>(122,642)</u>
	Adjustment to conform fiscal year of Hughes Tool Company			<u>26,874</u>
	Effect of exchange rate changes on cash	<u>(7,780)</u>	<u>(3,584)</u>	<u>(8,142)</u>
	Increase (decrease) in cash and short-term investments	47,863	56,462	(32,502)
	Cash and short-term investments, beginning of year	<u>67,823</u>	<u>11,361</u>	<u>43,863</u>
	Cash and short-term investments, end of year	<u>\$ 115,686</u>	<u>\$ 67,823</u>	<u>\$ 11,361</u>

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Baker Hughes Incorporated

ONE

BASIS OF PRESENTATION:

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

The Combination was accounted for as a pooling-of-interests and, accordingly, the consolidated financial statements for years prior to 1988 have been prepared on a basis that includes the accounts of Baker and Hughes. Information concerning common stock, employee stock plans, and per share data for years prior to 1988 has been restated on an equivalent share basis.

TWO

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of consolidation: The consolidated financial statements include the accounts of Baker Hughes Incorporated and all majority-owned subsidiaries and partnerships. All significant intercompany accounts and transactions have been eliminated in consolidation.

Income (loss) per share: Income (loss) per share amounts are based on the weighted average number of shares outstanding during the respective years (119,091,000 in 1989, 117,919,000 in 1988, and 115,791,000 in 1987) and excludes in 1989 and 1988 the negligible dilutive effect of shares issuable in connection with employee stock plans. Income (loss) is adjusted for the cash and accrued dividends on preferred stock.

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

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

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

Excess costs arising from acquisitions: Excess costs arising from acquisitions of businesses are amortized on the straight-line method over the lesser of expected useful life or forty years.

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

Statement of cash flows: The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

THREE

ACQUISITIONS AND DISPOSITIONS:

The Company closed on the sale of five of the six business units comprising its Mining Equipment group, which manufactures and services underground mining equipment, on July 31, 1989 and received approximately \$115,000,000 in cash. At that time, an agreement was also reached for the sale of the one remaining business unit. Terms of the agreement provide that the Company will receive \$15,000,000 in cash plus interest when sale of this unit has been completed. Revenues and pretax operating income of the Mining Equipment group for the ten months ended July 31, 1989 are included in the Company's consolidated results of operations and amounted to \$192,000,000 and \$2,263,000, respectively. The loss recognized on disposition was not significant.

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

During the fourth quarter of 1987, the Company evaluated its investment in V-G and determined that V-G did not fit into the Company's long-term strategic plan. The Company advised C-E that it had no intention of funding the future operations of V-G, nor was it required to do so under the stockholder agreement between C-E, V-G and the Company. On September 30, 1987, the Company wrote off its remaining investment in V-G and recognized estimated liabilities of \$3,000,000 related to the disposition of its interest in V-G.

In June 1988, the Company sold, with no significant effect on the consolidated financial statements, 87.5% of its 80.1% common stock interest in V-G to Bain Venture Capital. At September 30, 1989, the Company remains contingently liable for certain bank notes issued by V-G amounting to \$15,595,000. These bank notes may be reduced by payments by V-G

Baker Hughes Incorporated

or through the sale of certain assets of V-G and its subsidiaries pledged to the banks. In addition, the Company is contingently liable for \$6,594,000 of performance bond letters of credit made by the Company on behalf of V-G. The Company does not expect the ultimate resolution of these contingencies to have a significant effect on the Company's financial position or results of operations.

The V-G common stock held by C-E is exchangeable, through warrants, for 1,146,823 shares of the Company's common stock commencing on the later of October 1, 1991 or the date on which at least one share of V-G's preferred stock has been redeemed. The Company has options to purchase any shares of its common stock issued pursuant to the warrants and the V-G common stock held by C-E.

During 1987 and 1988, the Company acquired and disposed of several businesses, none of which, individually or in the aggregate, had a significant effect on the Company's results of operations for any of the periods presented. During 1989, the Company acquired several businesses for approximately \$97,000,000 in cash. Proforma results of operations as if the businesses were acquired at the beginning of 1988 have not been presented as they do not have a significant effect on the Company's results of operations.

FOUR

COMBINATION AND DIVESTITURE COSTS; UNUSUAL CHARGES (CREDITS) — NET:

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

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

During 1988, the Company settled two patent infringement lawsuits against Smith International, Inc. ("Smith") and Dresser Industries, Inc. ("Dresser"). In December 1987, the Company received \$89,750,000 in cash and a \$10,000,000 note (bearing interest at the prime rate of the Chase Manhattan Bank plus 1.5% per annum) from Smith. Of the proceeds, \$95,000,000 has been recorded as an unusual credit and \$4,750,000 has been recorded as interest income in accordance with the terms of the settlement agreement. In July 1988, the Company received from Dresser \$23,000,000 in cash and Dresser's 27.7% interest in B-J Titan Services Company Partnership of which the Company already owned the remaining 72.3%. Accordingly, an unusual credit of \$55,157,000 was recorded in the fourth quarter of 1988. As a result, excess costs arising from acquisitions increased \$15,794,000.

During 1988, the Company determined that certain of its assets had been permanently impaired due to changes in market conditions and operating strategies and that disposal of certain product lines and the continued consolidation of geographic operations was necessary. Accordingly, the Company recognized charges to operations totalling \$102,682,000. Of these charges, \$30,300,000 related to the impairment of assets of part of the Company's pumping services operations

in Latin America, and \$26,200,000 related to the writedown of mining equipment inventory and a provision for consolidation of certain businesses, which resulted from the strategic restructuring of the Company's mining equipment operations and was recorded in the fourth quarter of 1988.

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

FIVE

CHANGE IN ACCOUNTING ESTIMATE:

During 1989, the Company revised the estimated remaining useful lives of certain rental tools and equipment to more closely reflect expected remaining lives. The effect of this change in accounting estimate resulted in an increase in the Company's net income before extraordinary item of \$2,220,000 or \$.02 per common share, and net income of \$2,822,000, or \$.02 per common share, for 1989.

SIX

INDEBTEDNESS:

Long-term debt at September 30, 1989 and 1988 consisted of the following:

<i>(In thousands of dollars)</i>	1989	1988
Zero Coupon Guaranteed Notes due 1992 with an effective interest rate of 14.48%, net of unamortized discount of \$22,320 (\$37,616 in 1988)	\$ 55,515	\$ 61,419
6% Debentures due 2002 with an effective interest rate of 14.66%, net of unamortized discount of \$110,833 (\$113,910 in 1988)	114,167	111,090
4.125% Swiss Franc 200 million Bonds due 1996 (principal and interest payments hedged through a currency swap at an effective interest rate of 7.82%)	103,851	103,177
9% Debentures due November 1, 2008	18,029	36,459
9.5% Convertible Subordinated Debentures due December 15, 2006 convertible into common stock at \$58.91 per share	98,239	99,171
Convertible Subordinated Debentures due through 1995 with an interest rate at September 30, 1989 of prime on \$247 and LIBOR + 3/8% on \$11,272	11,519	11,032
Other indebtedness with an average interest rate of 9.44% at September 30, 1989	15,725	17,659
Total long-term debt	<u>\$417,045</u>	<u>\$440,007</u>

In July 1989, the Company entered into revolving credit agreements aggregating \$300,000,000 with twenty foreign and domestic banks. The agreements have a maturity date of July 17, 1994. The rate of interest on borrowings under these arrangements is 3/8% in excess of the London Interbank Offered Rate (LIBOR) for U.S. dollar deposits. At September 30, 1989, there were no borrowings outstanding under these agreements. The provisions of the revolving credit agreements require a commitment fee of 1/8% per annum on the unused portion.

Additional bank lines of credit at September 30, 1989 include \$67,500,000 of short-term money market lines available on an as-offered basis. There are no requirements for commitment fees or compensating balances in connection with these agreements. At September 30, 1989, there were no borrowings outstanding under these agreements.

Baker Hughes Incorporated

Redemption of the Zero Coupon Notes due 1992 and the 6% Debentures due 2002 may be made at the option of the Company, in whole or in part, at any time at par plus accrued interest. Furthermore, the Zero Coupon Notes due 1992 may be redeemed prior to maturity at prices (expressed as a percentage of principal amount) of 65.74% at September 30, 1989 and scaling upward over time to 86.95% (in each case together with accrued amortization of original issue discount) in the event of certain changes affecting United States or Netherlands Antilles taxation.

The 9% Debentures due November 1, 2008 have a \$2,400,000 per annum sinking fund requirement which has been satisfied through 2005. These debentures may be redeemed by paying a premium which decreases proportionally from 4.48% until it is eliminated in 2003. The 9.5% Debentures due December 15, 2006 have a \$5,000,000 per annum sinking fund requirement beginning December 15, 1992 and may be redeemed by paying a premium which decreases proportionally from 2.59% at December 15, 1989 until it is eliminated in 1992. Optional payments, not to exceed the amounts of the mandatory sinking funds requirements, may be made in addition to the mandatory payments. During 1989 the Company repurchased \$18,743,000 of its 9% Debentures due 2008 and \$21,200,000 principal amount of its Zero Coupon Guaranteed Notes due 1992. The net loss on these transactions was not significant.

The provisions of the bonds and unsecured credit agreements have an effect on the ability of the Company to, among other things, incur borrowings, sell certain assets, pay cash dividends, acquire other businesses and purchase the Company's capital stock. At September 30, 1989, the Company could pay dividends and purchase the Company's common stock up to an amount not exceeding \$121,063,000.

At September 30, 1989, long-term debt was due in aggregate annual installments of \$12,319,000; \$3,704,000; \$59,004,000; \$7,111,000; and \$11,103,000 in each of the five years in the period ending September 30, 1994.

During 1989 and 1988, the maximum aggregate short-term borrowings outstanding at any month-end were \$55,469,000 and \$62,396,000, respectively; the average aggregate short-term borrowings outstanding based on quarter-end balances were \$39,974,000 and \$47,110,000, respectively; and the weighted average interest rates were 18.8% and 16.6%, respectively. The average interest rates on short-term borrowings outstanding at September 30, 1989 and 1988 were 20.9% and 15.5%, respectively. Throughout the year, and at September 30, 1989, substantially all of the Company's short-term borrowings were outside of the United States and denominated in currencies other than the U.S. dollar. A significant portion of such borrowings were in high inflation rate countries in Latin America where such borrowings are incurred as a hedge of a net asset position.

SEVEN

\$3.50 CONVERTIBLE EXCHANGEABLE PREFERRED STOCK:

In June 1987, the Company issued 2,000,000 shares of \$3.50 convertible exchangeable preferred stock (\$1 par value per share and \$50 liquidation preference per share). The preferred stock is convertible at the option of the holder at any time into the Company's common stock at a conversion price of \$25.50 per share (equivalent to a conversion rate of 1.96 shares of common stock for each share of preferred stock), subject to adjustment in certain events.

The preferred stock is not redeemable prior to May 15, 1990 unless the closing price of the common stock shall have equalled or exceeded 150% of the then effective conversion price for a specified period ending prior to the date notice of redemption is given. The preferred stock will otherwise be redeemable at the option of the Company, in whole or in part, at \$52.80 per share if redeemed prior to May 15, 1990, and at prices decreasing ratably annually to \$50 per share from and after May 15, 1997, in each case plus accrued dividends to the date fixed for redemption. Dividends on the preferred stock are cumulative at the rate of \$3.50 per share per annum from the date of original issuance. Such dividends are payable quarterly as declared by the Board of Directors.

Each share of the preferred stock is also exchangeable in whole, but not in part, at the option of the Company on any dividend payment date for \$50 in principal amount of the Company's 7% Convertible Subordinated Debentures due 2007.

EIGHT

EMPLOYEE STOCK PLANS:

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

The stock option activity for the Company during 1989, 1988 and 1987 was as follows:

Number of Shares (In thousands)	1989	1988	1987
Stock options outstanding, beginning of year	4,469	5,685	6,069
Changes during the year:			
Granted (per share):			
1989, \$12.88 to \$15.00	1,092		
1988, \$11.75 to \$15.375		876	
1987, \$10.25 to \$20.30			1,078
Exercised (per share):			
1989, \$10.25 to \$21.88	(1,283)		
1988, \$10.25 to \$20.375		(423)	
1987, \$12.99 to \$25.78			(386)
Exchanged (net)			(839)
Expired	(676)	(1,669)	(237)
Stock options outstanding, end of year (per share: \$10.25 to \$54.03 at September 30, 1989)	<u>3,602</u>	<u>4,469</u>	<u>5,685</u>

At September 30, 1989, options were exercisable for 2,567,000 shares, and 4,725,000 shares were available for future option grants.

Additionally, the Company has a plan which provides for the sale of convertible debentures to certain officers and certain key employees. An aggregate of \$30,000,000 principal amount of debentures may be issued under the plan which are convertible into shares of common stock after one year. At September 30, 1989, a total of \$12,223,000 principal amount of debentures are outstanding and convertible into 1,017,000 shares of common stock at \$10.25 to \$21.88 per share.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Baker Hughes Incorporated

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

The Company also has two Employee Stock Purchase Plans (the "Plan") under which there remained authorized and available for sale to employees an aggregate of 648,000 shares of the Company's common stock. The maximum number of shares subject to each option under the Plan is determined on the date of grant and equals the sum of the payroll deductions authorized by each participating employee (up to 10 percent of regular pay) divided by 85 percent of the fair market value of a share of common stock at the date of grant. Based on the market price of common stock on the date of grant, the Company estimates that approximately 521,000 shares will be purchased under the Plan on July 31, 1990, at \$17.00 per share. Under the plan, 573,000, 354,000 and 711,000 shares were issued at \$13.18, \$13.18 and \$7.86 per share during 1989, 1988 and 1987, respectively.

NINE

INCOME TAXES:

The geographical sources of income (loss) before income taxes, minority interest and extraordinary item for the three years ended September 30, 1989 were as follows:

(In thousands of dollars)	1989	1988	1987
United States	\$ (7,832)	\$111,160	\$(263,627)
Foreign	127,045	23,302	(11,992)
Total income (loss) before income taxes, minority interest and extraordinary item	<u>\$119,213</u>	<u>\$134,462</u>	<u>\$(275,619)</u>

The provisions (credits) for income taxes for the three years ended September 30, 1989 are summarized as follows:

(In thousands of dollars)	1989	1988	1987
Currently payable (refundable):			
United States	\$ 245	\$ 3,412	\$(3,524)
Foreign	32,268	23,713	12,032
Total currently payable	<u>32,513</u>	<u>27,125</u>	<u>8,508</u>
Deferred:			
United States		(2,695)	
Foreign	52	2,949	(22,608)
Total deferred	<u>52</u>	<u>254</u>	<u>(22,608)</u>
Utilization of prior years' U.S. operating losses	2,272	43,856	
Total provision (credit) for income taxes	<u>\$34,837</u>	<u>\$71,235</u>	<u>\$(14,100)</u>

The consolidated effective income tax rates for the three years ended September 30, 1989 varied from the United States statutory income tax rate for the reasons set forth below:

% of Income (Loss) Before Taxes	1989	1988	1987
Statutory income tax rate	34.0	34.0	(43.0)
Goodwill write-off and amortization	.4	.3	
Effect of U.S. operating loss (before minority interest and extraordinary items) for which no carryback or other benefit is recognizable			18.3
State taxes based on income—net of U.S. income tax benefit	.1	.4	.1
Foreign earnings at varying tax rates	(5.6)	18.4	6.0
Loss in Vetco Gray Inc.			8.6
Excise tax on pension reversion gain			1.6
Other—net	.3	(.1)	3.3
Effective income tax rate	<u>29.2</u>	<u>53.0</u>	<u>(5.1)</u>

The sources and amounts of deferred taxes for the three years ended September 30, 1989 were as follows:

(In thousands of dollars)	1989	1988	1987
Reversal of deferred taxes due to net operating loss			\$ (2,874)
Depreciation expense	\$(2,047)	\$(3,910)	(16,595)
Inventory valuations-net	(3,036)	491	1,378
Unusual charges	3,248	142	1,861
Other-net	1,887	3,531	(6,378)
Total deferred tax provision (credit)	<u>\$ 52</u>	<u>\$ 254</u>	<u>\$(22,608)</u>

In 1989, the Company utilized approximately \$6,682,000 of U.S. operating loss carryforwards for financial reporting purposes and the related tax benefit of \$2,272,000 has been reflected as an extraordinary credit in the accompanying consolidated statements of operations. At September 30, 1989, the Company had approximately \$344,693,000 of U.S. operating loss carryforwards remaining for financial reporting purposes, which expire in varying amounts between 2001 and 2002. For federal income tax purposes, the net operating loss carryforwards are approximately \$238,592,000, expiring in varying amounts between 1998 and 2004. In addition, the Company had capital loss carryforwards of approximately \$48,764,000, which expire in varying amounts between 1992 and 1993.

At September 30, 1989, the Company had approximately \$12,484,000 in investment tax credits available to offset future payments of federal income taxes. The investment tax credits expire in varying amounts between 1994 and 2001. The investment tax credit carryforwards have not been recognized for financial reporting purposes. The Company had approximately \$29,568,000 of foreign tax credits available to offset future payments of federal income taxes at September 30, 1989. If not used, the foreign tax credits expire in varying amounts between 1990 and 1994 for federal income tax purposes. The Company has recognized approximately \$5,665,000 of its foreign tax credits for financial reporting purposes. At September 30, 1989, the Company had approximately \$23,903,000 of foreign tax credit carryforwards remaining for financial reporting purposes, which expire in varying amounts between 1990 and 1993.

Baker Hughes Incorporated

The Company has not recorded deferred income taxes applicable to undistributed earnings of foreign subsidiaries that are indefinitely reinvested in foreign operations. Undistributed earnings of approximately \$344,417,000 at September 30, 1989, if remitted, would not result in any additional U.S. income taxes because of available foreign tax credits and net operating losses.

The Company intends to adopt Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, in 1990 without restatement of prior years. Under this standard, the provisions of enacted tax laws are applied to the assets and liabilities of the Company to measure the amount of taxes payable or refundable currently or in future years as a result of all events that have been recognized in the financial statements. Due to the Company's operating loss carryforwards from prior years, the Company does not anticipate that the new method of income tax accounting will have a significant effect on its financial statements. In accordance with FAS 96, beginning in 1990, the Company's utilization of net operating loss carryforwards will no longer be reflected as an extraordinary item.

TEN

INDUSTRY SEGMENT AND GEOGRAPHIC INFORMATION:

The Company operates principally in four industry segments, three of which provide equipment and services to the petroleum industry. In 1989, the Company changed its method of grouping products and services into industry segments for financial reporting purposes to be consistent with the Company's internal reporting system. Previously reported 1988 and 1987 operations by industry segment have been restated to conform to the revised industry segment grouping.

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

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

Pumping Services: Provision of hydraulic horsepower for the placement in wells of cement and formation stimulation products.

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

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

Summarized financial information concerning the industry segments and geographic areas in which the Company operated at September 30, 1989, 1988, and 1987 and for each of the years then ended is shown in the following tables:

(In thousands of dollars)	Drilling	Production	Pumping Services	Total Petroleum	Mining and Process	Eliminations	Total
Operations by Industry Segment:							
1989							
Revenues from unaffiliated customers:							
Sales	\$482,300	\$519,281	\$172,871	\$1,174,452	\$588,877		\$1,763,329
Services and rentals	241,483	143,382	143,576	528,441	36,225		564,666
Intersegment sales	3,804	10,732	542	15,078	3,106	\$ (18,184)	
Total revenues	\$727,587	\$673,395	\$316,989	\$1,717,971	\$628,208	\$ (18,184)	\$2,327,995
Operating income	\$ 49,350	\$ 83,320	\$ 27,228	\$ 159,898	\$ 46,830		\$ 206,728
Identifiable assets	\$745,481	\$545,804	\$214,759	\$1,506,044	\$307,690	\$ (6,962)	\$1,806,772
Capital expenditures	\$ 39,025	\$ 24,117	\$ 13,040	\$ 76,182	\$ 14,993	\$ 1,527	\$ 92,702
Depreciation and amortization	\$ 42,932	\$ 28,623	\$ 11,778	\$ 83,333	\$ 12,043	\$ 3,238	\$ 98,614
1988							
Revenues from unaffiliated customers:							
Sales	\$542,053	\$479,192	\$191,277	\$1,212,522	\$562,824		\$1,775,346
Services and rentals	219,061	153,892	143,703	516,656	24,149		540,805
Intersegment sales	9,592	8,107	2,480	20,179	3,894	\$ (24,073)	
Total revenues	\$770,706	\$641,191	\$337,460	\$1,749,357	\$590,867	\$ (24,073)	\$2,316,151
Operating income (loss)	\$183,190	\$ 54,550	\$ (4,706)	\$ 233,034	\$ (3,596)		\$ 229,438
Identifiable assets	\$735,898	\$575,692	\$214,350	\$1,525,940	\$387,009	\$ (588)	\$1,912,361
Capital expenditures	\$ 24,380	\$ 14,212	\$ 11,978	\$ 50,570	\$ 11,388	\$ 90	\$ 62,048
Depreciation and amortization	\$ 50,304	\$ 34,041	\$ 18,125	\$ 102,470	\$ 11,515	\$ 254	\$ 114,239
1987							
Revenues from unaffiliated customers:							
Sales	\$413,363	\$401,016	\$137,572	\$ 951,951	\$480,187		\$1,432,138
Services and rentals	195,166	161,753	112,559	469,478	21,982		491,460
Intersegment sales	4,498	6,858	1,865	13,221	986	\$ (14,207)	
Total revenues	\$613,027	\$569,627	\$251,996	\$1,434,650	\$503,155	\$ (14,207)	\$1,923,598
Operating income (loss)	\$ (36,462)	\$ (16,095)	\$ (16,411)	\$ (68,968)	\$ 2,446	\$ 2,930	\$ (63,592)
Identifiable assets	\$862,669	\$547,647	\$272,133	\$1,682,449	\$386,984	\$ (11,098)	\$2,058,335
Capital expenditures	\$ 13,655	\$ 10,913	\$ 6,198	\$ 30,766	\$ 14,116	\$ 416	\$ 45,298
Depreciation and amortization	\$ 59,168	\$ 40,087	\$ 20,137	\$ 119,392	\$ 12,804	\$ 2,292	\$ 134,488

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Baker Hughes Incorporated

(In thousands of dollars)	Western Hemisphere		Eastern Hemisphere		Eliminations	Total
	United States	Other	Europe	Other		
Operations by Geographic Area:						
1989						
Revenues from unaffiliated customers:						
Sales	\$ 899,694	\$296,855	\$291,182	\$275,598		\$1,763,329
Services and rentals	274,069	75,027	124,701	90,869		564,666
Transfer between geographic areas	98,252	3,767	3,237	7,069	\$(112,325)	
Total revenues	<u>\$1,272,015</u>	<u>\$375,649</u>	<u>\$419,120</u>	<u>\$373,536</u>	<u>\$(112,325)</u>	<u>\$2,327,995</u>
Operating income	<u>\$ 40,357</u>	<u>\$ 37,443</u>	<u>\$ 65,735</u>	<u>\$ 63,193</u>		<u>\$ 206,728</u>
Identifiable assets	<u>\$1,241,781</u>	<u>\$244,297</u>	<u>\$284,376</u>	<u>\$173,258</u>	<u>\$(136,940)</u>	<u>\$1,806,772</u>
Export sales of U.S. companies		<u>\$ 64,227</u>	<u>\$ 15,924</u>	<u>\$ 95,617</u>		<u>\$ 175,768</u>
1988						
Revenues from unaffiliated customers:						
Sales	\$ 954,939	\$313,169	\$271,279	\$235,959		\$1,775,346
Services and rentals	306,875	80,806	81,876	71,248		540,805
Transfer between geographic areas	91,903	18,984	15,268	12,710	\$(138,865)	
Total revenues	<u>\$1,353,717</u>	<u>\$412,959</u>	<u>\$368,423</u>	<u>\$319,917</u>	<u>\$(138,865)</u>	<u>\$2,316,151</u>
Operating income (loss)	<u>\$ 193,390</u>	<u>\$ (5,606)</u>	<u>\$ 27,894</u>	<u>\$ 13,760</u>		<u>\$ 229,438</u>
Identifiable assets	<u>\$1,092,423</u>	<u>\$392,217</u>	<u>\$306,261</u>	<u>\$221,788</u>	<u>\$(100,328)</u>	<u>\$1,912,361</u>
Export sales of U.S. companies		<u>\$ 45,495</u>	<u>\$ 34,795</u>	<u>\$ 99,131</u>		<u>\$ 179,421</u>
1987						
Revenues from unaffiliated customers:						
Sales	\$ 757,617	\$247,417	\$237,802	\$189,302		\$1,432,138
Services and rentals	283,293	74,697	67,482	65,988		491,460
Transfer between geographic areas	65,801	12,687	20,457	14,585	\$(113,530)	
Total revenues	<u>\$1,106,711</u>	<u>\$334,801</u>	<u>\$325,741</u>	<u>\$269,875</u>	<u>\$(113,530)</u>	<u>\$1,923,598</u>
Operating income (loss)	<u>\$ (71,077)</u>	<u>\$ 7,174</u>	<u>\$ (3,574)</u>	<u>\$ 955</u>	<u>\$ 2,930</u>	<u>\$ (63,592)</u>
Identifiable assets	<u>\$1,176,109</u>	<u>\$465,050</u>	<u>\$326,063</u>	<u>\$222,801</u>	<u>\$(131,688)</u>	<u>\$2,058,335</u>
Export sales of U.S. companies		<u>\$ 49,500</u>	<u>\$ 25,159</u>	<u>\$110,016</u>		<u>\$ 184,675</u>

Intersegment sales and transfers between geographic areas are priced at the estimated fair value of the products or services negotiated between the selling and receiving units. Operating income (loss) is total revenues less costs and expenses (including combination and divestiture costs and unusual charges (credits)-net) but before deduction of general corporate expenses, loss in Vetco Gray Inc., and net interest expense totalling \$87,515,000, \$94,976,000 and \$212,027,000 in 1989, 1988 and 1987, respectively, and excluding the extraordinary item in 1989 and 1988. Identifiable assets are those assets that are used by the Company's operations in each industry segment or are identified with the Company's operations in each geographic area. Corporate assets consist principally of cash, receivables, prepaid expenses, leasehold improvements, office furniture and assets held for disposal which amount to \$259,148,000, \$205,165,000 and \$130,297,000 at September 30, 1989, 1988 and 1987, respectively.

EMPLOYEE BENEFIT PLANS:

The Company has several noncontributory defined benefit pension plans covering various domestic and foreign employees. Additionally, virtually all employees not covered under one of the Company's pension plans are eligible to participate in the Company sponsored Thrift Plan. Pension expense for these plans was \$1,150,000, \$3,000,000 and \$3,429,000 for 1989, 1988 and 1987, respectively. Generally, the Company makes annual contributions to the plans in an amount necessary to meet ERISA's minimum funding requirements.

During 1988 and 1987, the Company settled and curtailed certain defined benefit pension plans resulting in gains of \$6,000,000 and \$76,765,000, respectively.

The net domestic pension expense for 1989, 1988 and 1987 included the following components (in thousands of dollars):

	1989	1988	1987
Service cost—benefits earned during the period	\$ 544	\$ 1,435	\$ 2,929
Interest cost on projected benefit obligation	1,682	3,588	3,030
Actual return on assets	(1,176)	455	(4,254)
Net amortization and deferral	100	(2,478)	1,724
Net pension expense	<u>\$ 1,150</u>	<u>\$ 3,000</u>	<u>\$ 3,429</u>

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

	1989	1988	1987
Discount rate	9.5%	9.5%	8.5%
Rates of increase in compensation levels	5.0%	5.0%	5.0%
Expected long-term rate of return on assets	9.0%	9.0%	9.0%

The following table sets forth the domestic plans' funded status and amounts recognized in the Company's consolidated statements of financial position at September 30, 1989 and 1988 (in thousands of dollars):

	1989		1988	
	Overfunded Plans	Underfunded Plans	Overfunded Plans	Underfunded Plans
Actuarial present value of benefit obligations:				
Vested benefit obligation	<u>\$ 4,554</u>	<u>\$ 7,583</u>	<u>\$ 5,762</u>	<u>\$ 13,370</u>
Accumulated benefit obligation	<u>\$ 4,594</u>	<u>\$ 7,648</u>	<u>\$ 5,783</u>	<u>\$ 14,595</u>
Projected benefit obligation	4,857	11,986	5,783	17,447
Plan assets at fair value	<u>7,085</u>	<u>4,990</u>	<u>9,922</u>	<u>10,312</u>
Projected benefit obligation (in excess of) less than plan assets	2,228	(6,996)	4,139	(7,135)
Unrecognized prior service cost	109	135	13	207
Unrecognized net (gain) loss	(2,104)	827	(2,647)	638
Unrecognized net (asset) liability at transition	(229)	1	2,084	(1,272)
Prepaid pension cost (pension liability)	<u>\$ 4</u>	<u>\$ (6,033)</u>	<u>\$ 3,589</u>	<u>\$ (7,562)</u>

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Baker Hughes Incorporated

The Company's foreign defined benefit plans are not required to report under ERISA and the Company has not determined the actuarial value of accumulated plan benefits. The Company intends to adopt Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, for its foreign defined benefit plans in fiscal 1990. The Company has not determined the effect this adoption will have on its financial statements.

The Company's Thrift Plan allows eligible employees to elect to contribute from 2% to 10% of their salaries to an investment trust. Employee contributions are matched by the Company at the rate of \$.50 per \$1.00 up to 6% of the employee's salary. In addition, the Company contributes for all eligible employees between 2% and 5% of their salary depending on the employee's age as of January 1 each year. Company contributions become fully vested to the employee after five years of employment or, if employed less than five years, at the close of the second plan year after the year in which contributions are made. Supplemental employee contributions are allowed. The Company's contributions to defined contribution plans including the Thrift Plan amounted to \$16,080,000, \$14,746,000 and \$8,853,000 in 1989, 1988 and 1987, respectively.

The Company also provides certain health care (primarily in the U.S.) and life insurance benefits for retired employees. Substantially all employees may become eligible for these benefits if they reach normal retirement age while working for the Company. Costs related to benefits provided for retired employees are expensed as incurred, and for 1989, 1988 and 1987 totalled \$6,675,000, \$4,585,000 and \$5,838,000, respectively.

TWELVE

STOCKHOLDER RIGHTS AGREEMENT AND OTHER MATTERS:

In 1988, the Company adopted a Stockholder Rights Agreement to protect against coercive takeover tactics. Pursuant to the Plan, the Company distributed to its stockholders one Right for each outstanding share of common stock. Each Right entitles the holder to purchase from the Company .01 of a share of the Series One Junior Participating Preferred Stock and, under certain circumstances, securities of the Company or an acquiring entity at 1/2 market value. The Rights are exercisable only if a person or group either acquires 20% or more of the Company's outstanding common stock or makes a tender offer for 30% or more of the Company's common stock. The Rights may be redeemed by the Company at a price of \$.03 per Right at any time prior to a person or group acquiring 20% or more of the Company's common stock. The Rights will expire on March 23, 1998.

Supplemental income statement information is as follows (in thousands of dollars):

	1989	1988	1987
Maintenance and repairs	\$60,410	\$66,655	\$56,008
Operating leases (generally transportation equipment and warehouse facilities)	39,077	41,965	57,160
Research and development	30,140	26,065	29,572
Taxes other than payroll and income tax	26,549	29,782	29,629
Income taxes paid (refunded)	36,522	14,180	(4,990)
Interest paid	54,961	65,875	75,190
Net foreign exchange translation losses	17,442	6,876	2,271

At September 30, 1989, the Company had long-term operating leases covering certain facilities and equipment on which minimum annual rental commitments for each of the five years in the period ending September 30, 1994 were \$34,009,000, \$26,360,000, \$17,465,000, \$13,379,000 and \$11,679,000, respectively, and \$83,541,000 in the aggregate thereafter. The Company has not entered into any significant capital leases.

THIRTEEN

COMMITMENTS AND CONTINGENCIES:

At September 30, 1989, there were no contingencies, claims or lawsuits against the Company which, in the opinion of management, could have a significant effect on its financial position or results of operations.

FOURTEEN

QUARTERLY DATA (UNAUDITED):

Summarized quarterly financial data for the years ended September 30, 1989 and 1988 are shown in the table below:

(In thousands of dollars, except per share amounts)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Fiscal Year Total
Fiscal Year 1989:*					
Revenues	\$ 566,291	\$ 568,554	\$ 588,953	\$ 604,197	\$2,327,995
Gross Profit**	88,895	86,785	94,020	113,553	383,253
Income before income tax and extraordinary item	23,431	23,719	25,646	44,792	117,588
Income before extraordinary item	15,560	15,770	15,746	35,675	82,751
Extraordinary item	1,803	(1,048)	967	550	2,272
Net income	17,363	14,722	16,713	36,225	85,023
Earnings per share amounts:					
Income before extraordinary item	.12	.12	.12	.28	.64
Extraordinary item	.01	(.01)	.01	.01	.02
Net income	.13	.11	.13	.29	.66
Dividends per share	.115	.115	.115	.115	.46
Fiscal Year 1988:*					
Revenues	\$ 546,269	\$ 538,022	\$ 564,142	\$ 667,718	\$2,316,151
Gross Profit**	72,331	79,845	87,029	112,766	351,971
Income before income tax and extraordinary item	35,152	12,618	22,765	60,091	130,626
Income before extraordinary item	16,830	4,780	9,756	28,025	59,391
Extraordinary item	16,240	3,733	3,742	20,141	43,856
Net income	33,070	8,513	13,498	48,166	103,247
Earnings per share amounts:					
Income before extraordinary item	.13	.03	.07	.22	.45
Extraordinary item	.14	.03	.03	.17	.37
Net income	.27	.06	.10	.39	.82
Dividends per share	.115	.115	.115	.115	.46

* See Notes 4 and 9 for information regarding unusual charges (credits)-net and extraordinary item.

** Represents revenues less (i) cost of sales, services and rentals and (ii) marketing and field service expense.

Baker Hughes Incorporated

**FISCAL 1989
COMPARED TO
FISCAL 1988**

Revenues in 1989 were \$2.3 billion, a slight increase from 1988. The year-to-year change in revenues has been affected by the acquisition of several businesses during the year which added \$74.5 million of revenues during 1989 as well as the disposition of the Mining Equipment group in the last quarter of 1989 which resulted in a decrease in revenues of \$34.9 million from 1988. Excluding the impact of acquisitions and dispositions in both 1988 and 1989, consolidated revenues have remained stable at \$2.3 billion and revenues from the Company's three oil and gas related groups decreased \$54.1 million, or 3.1%. This decrease from the prior year results primarily from decreased worldwide drilling activity as evidenced by the 15% and 13% decreases in the U.S. and non-U.S. active rig counts, respectively. Foreign revenues for the oil and gas related groups improved from 1988, despite the reduced rig count, as a result of the weakened U.S. dollar, market share improvements and activity increases in certain oilfield markets. Excluding the impact of acquisitions, revenues from the Company's Process Equipment group improved \$47.0 million from last year resulting from continued strength in the markets served by this group. The Process Equipment group provides products and services to the mineral, industrial continuous process industries and wastewater treatment markets. Overall, the Company's foreign revenues accounted for 57.1% of revenues in 1989, compared to 53.3% of revenues in 1988.

Costs and expenses, exclusive of net interest expense, net unusual credits and net pension gains, decreased \$16.1 million from 1988. The decrease was primarily in cost of sales, services and rentals and reflects continuing cost containment and a better revenue mix. General and administrative expense includes gains and losses resulting from the translation of foreign currencies. The Company incurred net foreign exchange translation losses of \$17.4 million and \$6.9 million in 1989 and 1988, respectively. The year-to-year increase is due to fluctuating strength of the U.S. dollar and the weakening of certain foreign currencies, particularly in South America, where the Company has substantial operations.

Net interest expense decreased 16.6% in 1989 to \$51.2 million from \$61.5 million in 1988. The decrease was primarily due to a decline in average debt outstanding and an increase in earnings on the increased average level of cash and short-term investments on hand during the year.

On an operational basis, income for the year (income before income taxes, minority interest, net unusual credits and net pension gains) was \$119.2 million compared to \$81.0 million in 1988. The \$38.2 million, or 47.2% improvement results primarily from the decreases in cost of sales, services and rentals and net interest expense.

The effective tax rate for 1989 was 29.2% as compared to 53.0% for 1988. The decrease in the tax rate is primarily attributable to unusual charges recorded in 1988 which related to foreign tax jurisdictions where no tax benefit was available.

During 1989 and 1988, the Company recorded extraordinary items of \$2.3 million and \$43.9 million, respectively, relating to the reduction of income taxes arising from the carryforward of prior years' U.S. operating losses.

The Company will adopt Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, in 1990 without restatement of prior years. Due to the Company's net operating loss carryforwards from prior years, the Company does not anticipate that the new method of income tax accounting will have a significant effect on its financial statements. In accordance with FAS 96, beginning in 1990, the Company's utilization of net operating loss carryforwards will no longer be reflected as an extraordinary item.

**CAPITAL
GENERATION
AND LIQUIDITY:**

At September 30, 1989, the Company had cash and short-term investments of \$115.7 million, an increase of \$47.9 million from September 30, 1988. This increase results primarily from the \$115 million of cash received from the disposition of the Mining Equipment group as well as cash generated from operations. The Company used cash during the year to acquire businesses, repurchase long-term debt, purchase machinery and equipment and pay dividends.

Total debt outstanding as of September 30, 1989 was \$445.2 million, a decrease of \$42.7 million from September 30, 1988. The debt to equity ratio at the end of 1989 was .444 compared to .507 at the end of 1988. The debt less cash and short-term investments to equity ratio was .328 at September 30, 1989 as compared to .437 at September 30, 1988.

The Company has bank credit lines aggregating \$300 million with a group of twenty foreign and domestic banks as well as \$67.5 million of short-term money market lines of credit. There were no borrowings against these agreements at September 30, 1989.

In July 1989, the Company sold its Mining Equipment group to Oy Tampella AB, a Finnish company. Proceeds from the disposition consisted of \$115 million in cash for five of the six business units. At that time, an agreement was also reached for the sale of the one remaining business unit. The sales agreement with Tampella provides for payment of \$15 million in cash plus interest when the sale of the remaining unit is completed. A portion of the cash proceeds from the sale of these business units was used to retire \$55.0 million outstanding under the short-term money market lines of credit used to provide interim financing for the Company's acquisitions in 1989 as well as to reduce other short and long-term borrowings.

During 1989, the Company purchased Bird Machine Company for \$47.5 million, Vetco Services for \$37 million and EDECO Petroleum Services for \$12.1 million. The acquisitions were funded entirely by cash on hand and borrowings on a short-term money market line which were retired by September 30, 1989.

The Company maintains a continuous process of evaluating acquisition and disposition candidates to better increase stockholder value. Cash on hand and bank credit lines are available to provide funding for potential acquisitions as well as to increase capital investment.

In 1989, capital expenditures were \$92.7 million compared to \$62.0 million in 1988. The ratio of capital expenditures to depreciation increased to 99.7% in 1989 as compared to 60.5% in 1988. The Company expects this reinvestment ratio to continue to increase over the next year. Funds provided from operations and outstanding lines of credit are expected to be more than adequate to meet future capital expenditure requirements.

Working capital at September 30, 1989 was \$620.0 million, an increase of \$27.9 million from September 30, 1988. In the Company's opinion, the current ratio of 2.14 indicates an acceptable level of liquidity.

Baker Hughes Incorporated

**FISCAL 1988
COMPARED TO
FISCAL 1987**

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

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

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

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

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

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

During 1988, the Company recorded an extraordinary item of \$43.9 million relating to the reduction of income taxes arising from the carryforward of prior years' U.S. operating losses.

The Company anticipates adopting Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, in 1990 without restatement of prior years. Under this standard, the provisions of enacted tax laws are applied to the assets and liabilities of the Company to measure the amount of taxes payable or refundable currently or in future years as a

result of all events that have been recognized in the financial statements. Due to the Company's operating loss carry-forwards from prior years, the Company does not anticipate that the new method of income tax accounting will have a significant effect on its financial statements.

**CAPITAL
GENERATION
AND LIQUIDITY:**

Total debt outstanding as of September 30, 1988 was \$487.9 million, a decrease of \$52.8 million from September 30, 1987. This decrease is primarily due to the repurchase of long-term debt and a reduction of short-term borrowings. The debt to equity ratio at September 30, 1988 was .507 compared to .590 at September 30, 1987. The debt less cash and short-term investments to equity ratio was .437 at September 30, 1988 as compared to .578 at September 30, 1987.

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

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

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

**STOCK PRICES
BY QUARTER**

The following table sets forth the quarterly high and low sales price per share of the Company's common stock on the New York Stock Exchange Composite Tape:

		Baker Hughes Incorporated Common Stock	
		High	Low
1988	Quarter Ended		
	12-31-87	\$26.13	\$11.13
	3-31-88	18.38	13.50
	6-30-88	19.88	14.63
	9-30-88	15.88	12.88
1989	12-31-88	14.25	12.13
	3-31-89	17.50	13.63
	6-30-89	20.00	16.63
	9-30-89	23.00	18.50

CONDENSED COMPARATIVE CONSOLIDATED FINANCIAL INFORMATION

Baker Hughes Incorporated

(In thousands of dollars except per share amounts)

	1989	1988	1987	1986	1985
SUMMARY OF OPERATIONS:					
Total revenues	<u>\$2,327,995</u>	<u>\$2,316,151</u>	<u>\$1,923,598</u>	<u>\$2,312,678</u>	<u>\$3,165,244</u>
Cost and expenses:					
Cost and expenses applicable to revenues	1,944,742	1,964,180	1,793,451	2,158,537	2,610,503
General and administrative	212,811	209,522	197,147	234,131	293,833
Interest expense—net	51,229	61,462	77,161	95,757	119,457
Pension gains—net		(6,000)	(76,765)		
Unusual charges (credits)—net		(47,475)		919,198	
Combination and divestiture costs			140,000		
Loss in Vetco Gray Inc.			68,223	11,670	
Total costs and expenses	<u>2,208,782</u>	<u>2,181,689</u>	<u>2,199,217</u>	<u>3,419,293</u>	<u>3,023,793</u>
Income (loss) before income taxes, minority interest and extraordinary items	119,213	134,462	(275,619)	(1,106,615)	141,451
Income taxes	34,837	71,235	(14,100)	(144,494)	52,304
Income (loss) before minority interest and extraordinary items	<u>84,376</u>	<u>63,227</u>	<u>(261,519)</u>	<u>(962,121)</u>	<u>89,147</u>
Minority interest in (income) loss of subsidiaries	(1,625)	(3,836)	6,697	68,916	2,683
Income (loss) before extraordinary items	<u>82,751</u>	<u>59,391</u>	<u>(254,822)</u>	<u>(893,205)</u>	<u>91,830</u>
Extraordinary items—net	2,272	43,856		88,608	
Net income (loss)	<u>\$ 85,023</u>	<u>\$ 103,247</u>	<u>\$ (254,822)</u>	<u>\$ (804,597)</u>	<u>\$ 91,830</u>
Net income (loss) per share	<u>\$.66</u>	<u>\$.82</u>	<u>\$ (2.22)</u>	<u>\$ (7.00)</u>	<u>\$.80</u>
Dividends per share of common stock	<u>\$.46</u>	<u>\$.46</u>	<u>\$.39</u>	<u>\$.64</u>	<u>\$.80</u>
FINANCIAL POSITION:					
Cash and short-term investments	\$ 115,686	\$ 67,823	\$ 11,361	\$ 43,863	\$ 35,196
Working capital	\$ 620,017	\$ 592,134	\$ 500,755	\$ 634,818	\$1,202,391
Total assets	\$2,065,920	\$2,117,526	\$2,188,632	\$2,511,054	\$3,765,269
Long-term debt	\$ 417,045	\$ 440,007	\$ 460,767	\$ 638,557	\$ 669,008
Stockholders' equity	\$1,003,380	\$ 961,488	\$ 915,520	\$1,072,149	\$1,947,822

CORPORATE ORGANIZATION

Baker Hughes Incorporated

Baker Hughes Drilling
Equipment
Joel V. Staff, President

Baker Hughes Production Tools
Max L. Lukens, President

Baker Hughes Process
Equipment
*Stephen T. Harcrow,
President*

BJ Titan Services
Houston, Texas
J. Wm. Stewart, President

DIVISIONS

Hughes Tool Company
Houston, Texas
Andrew J. Szescila, President

Milpark Drilling Fluids
Houston, Texas
Tim J. Probert, President

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

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

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

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

DIVISIONS

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

Baker Service Tools
Houston, Texas
Edwin C. Howell, President

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

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

Baker CAC
Houston, Texas
*Chris K. Monauni,
President*

Centrilift
Claremore, Oklahoma
Joseph F. Brady, President

Develco
San Jose, California
Chris A. Snyder, President

DIVISIONS

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

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

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

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

Bird Machine
South Walpole, Massachusetts
*Tim L. Davis,
President*

WEMCO
Egham, England
James E. Furman, President

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

CORPORATE ORGANIZATION

Baker Hughes Incorporated

OFFICERS

James D. Woods
*Chairman, President and Chief
Executive Officer*

Thomas W. Cason
*Senior Vice President and
Chief Financial Officer*

Stephen T. Harcrow
*Senior Vice President and
President of Baker Hughes
Process Equipment*

Max L. Lukens
*Senior Vice President and
President of Baker Hughes
Production Tools*

Joel V. Staff
*Senior Vice President and
President of Baker Hughes
Drilling Equipment*

Isaac C. Kerridge, Jr.
Vice President

Eric L. Mattson
Vice President and Treasurer

Franklin Myers
*Vice President, Secretary
and General Counsel*

Phillip A. Rice
*Vice President, Human
Resources*

Ronald G. Turner
Vice President

G. S. Finley
Controller

BOARD OF DIRECTORS

Lester M. Alberthal, Jr.*
*Chairman, President and
Chief Executive Officer of
EDS (Electronics)*

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

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

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

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

Joe B. Foster*
*Chairman of the Board and
Chief Executive Officer of
Newfield Exploration Company
(Oil & Gas)*

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

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

David D. Lybarger
Petroleum Consultant

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

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

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

*Nominee to be presented to
Annual Meeting of Stockholders.
January 24, 1990

CORPORATE INFORMATION

Transfer Agent and Registrar:
*First Chicago Shareholder
Services Trust Company
New York, New York*

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

Independent Accountants:
*Deloitte Haskins & Sells
Houston, Texas*

Form 10-K:
*A copy of the Company's
Annual Report to the
Securities and Exchange
Commission (Form 10-K) is
available by writing to:
Ronald G. Turner, Vice
President, Baker Hughes
Incorporated, P.O. Box
4740, Houston, Texas
77210-4747*

Annual Meeting:
*The Company's Annual
Meeting of Stockholders
will be held at 2 p.m.
on January 24, 1990 at
The Doubletree Hotel
at Post Oak
2001 Post Oak Boulevard
Houston, Texas*

Baker Hughes Incorporated
Corporate Offices Location:
*3900 Essex Lane
Houston, Texas 77027*

Corporate Offices
Mailing Address:
*P.O. Box 4740
Houston, Texas 77210-4740
Telephone: (713) 439-8600*

