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Corporate Profile

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

Summary of Selected Financial Data

Years Ended September 30	1987	1986
	(In thousands of dollars except per share amount)	
Sales	\$1,432,138	\$1,764,085
Services and rentals	491,460	548,593
Total revenues	1,923,598	2,312,678
Net loss	(254,822)	(804,597)
Net loss per share	(2.22)	(7.00)
Working capital	500,755	634,818
Total assets	2,188,632	2,511,054
Net property, plant and equipment	737,102	904,067
Capital expenditures	45,298	90,641
Depreciation and amortization	146,718	198,744
Long-term debt	460,767	638,557
Stockholders' equity	915,520	1,072,149
Cash dividends per share of common stock	.39	.64
Number of common shares (000)		
Average during year	115,791	114,921
Outstanding at end of year	117,490	115,279
Number of employees	21,191	22,728

To Our Stockholders

This annual report is the first for our new Company, Baker Hughes Incorporated, which was formed through the combination of two quality companies, Baker International Corporation and Hughes Tool Company. Fiscal 1987, which ended September 30, 1987, resulted in a \$2.22 loss per share for Baker Hughes. However, since the combination of Baker and Hughes on April 3, 1987, the markets for our products and services have improved and we have steadily reduced operational losses. We have operated as a combined company for only six months but the financial statements are presented as if the two companies had always been combined. The financial statements present a low point in our history and do not tell the entire story of Baker Hughes. A brief review of what led to our combination and what has happened since is appropriate.

The 1986 downturn in oil prices led to a major contraction in the revenues for Baker and Hughes. By late spring 1986 two principal conclusions could be drawn. First, the industry would weather the storm and the oilfield service business would remain viable in the long-term. Second, the key to survival in the interim was the reduction in surplus capacity to deliver both products and services. Both companies recognized these facts and the combination of Baker Hughes ensued.

When the legal combination was completed we began the process of combining two oilfield operations while striving to achieve the \$70 million cost savings estimated in the planning of the combination. You now have a right to ask "How have you done?". We think the report card is a good one due to the diligent efforts of our employees working together to fulfill the merger objectives. Here are a few salient facts which we believe to be of interest to you.

- We have already taken actions which should produce annual savings of over \$50 million. These actions include the closing of plants and the reduction of payroll costs. By consolidating operations and by lowering interest expense we have made substantial progress toward our cost reduction goals and we believe the balance of the projected savings will be achieved.
- At September 30, 1987, debt is \$541 million or 59% of equity, a significant improvement in the strength of our balance sheet since the date of the combination.

- We have maintained an investment grade credit rating on our debt.
- We have maintained the quarterly cash dividend which Baker International previously paid and are optimistic that the dividend will be continued.
- We have a court approved settlement agreement with respect to the Smith patent lawsuit. Under the terms of the settlement agreement we expect to receive a total of \$95 million from Smith in fiscal year 1988.

Addressing the outlook for the future, we believe the operating environment in which we will be working will be better in 1988 than in 1987, both in the U.S. and overseas. We expect oil prices to stabilize near their current levels and result in improved drilling and workover activity. The low levels of drilling activity in 1986 and 1987 have brought natural gas supply and demand closer into balance resulting in a renewed concern regarding the availability of supplies. We expect an increased effort to replenish gas reserves commencing in 1988, and accelerating in 1989. The coal and mineral markets, having contracted much like the oil and gas business, should show modest improvement in 1988.

We expect to return to profitability in early fiscal year 1988 as we projected at the time of our merger. This profitability results from the overall recovery of drilling and workover activity and is greatly enhanced by the benefits of the merger. This annual report is designed to acquaint you with the organizational structure and market segments of Baker Hughes, giving you an overview of the divisions that make up our Company. We are convinced that we are in the right markets, have excellent presence in those markets, and are well positioned to participate in the industry recovery.



E. H. Clark, Jr.

Chairman of the Board



J. D. Woods

President and Chief Executive Officer

Baker Hughes Drilling Equipment

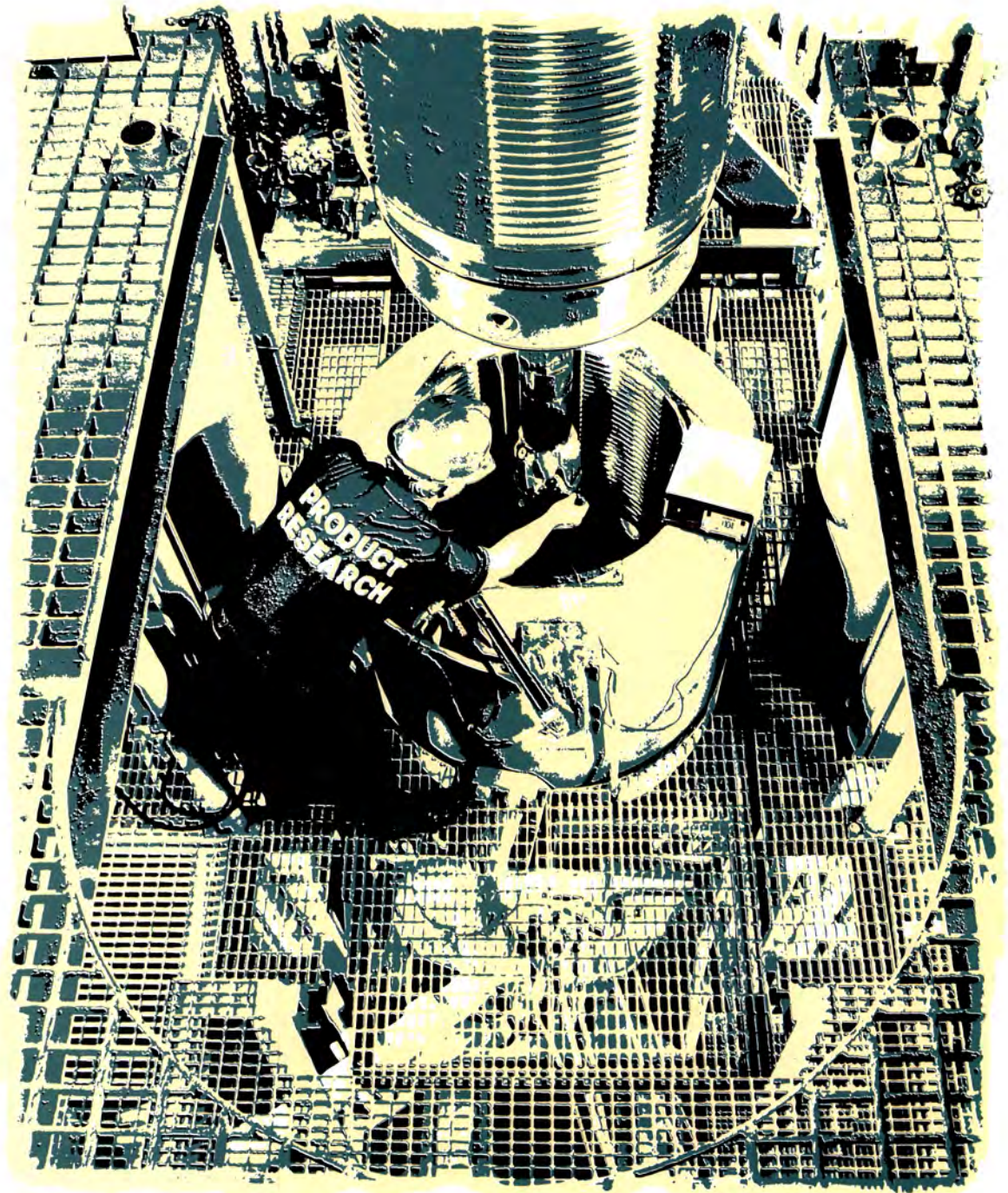
Baker Hughes Drilling Equipment provides products and services for the drilling of oil and gas wells. The five divisions that constitute BHDE are all major participants in their respective market segments, leaders not only in market position, but in technology as well. With flat or lower oil prices, lowering the access cost to hydrocarbon resources becomes an even more pressing requirement. Additionally, resource deposits become increasingly more difficult to reach, requiring improved technology to successfully produce. Incremental improvement in the process of drilling has been, and continues to be, the goal which drives Baker Hughes Drilling Equipment. Lowering real drilling costs through technological development is the highest priority for our research resources.

Hughes Tool Company

The leader in rock bit technology, Hughes Tool Company continues the tradition that was the basis of its foundation. Since Howard R. Hughes Sr. invented the rolling cone drill bit shortly after the turn of the century, Hughes has been the leader in drill bit innovation and has, as a result, maintained worldwide leadership in drill bit sales. The most recent innovation in rolling cone bit technology is the ATM high speed journal bearing seal design. This design allows tungsten carbide insert journal bearing bits to drill near the speed of steel tooth roller bearing bits, while retaining the wear characteristics of tungsten carbide teeth. Just one more incremental innovative step which, like those that have kept Hughes Tool Company in the leader's role in the past, promises to enhance that leadership in the future.

Baker Hughes Tubular Services

Tubular goods are the largest tangible asset in the investment of a well and drill pipe represents a significant portion of a useful rig. The world leader in the production of tool joints for connecting lengths of drill pipe, Baker Hughes Tubular Services also provides sophisticated inspection services, corrosion protection through specialized plastic coatings and the threading of premium connections for production casing and tubing.



Drill bit technology is advanced continuously at Hughes Tool Company

in the world's most complete test laboratory designed for that purpose.

It's no accident that Hughes is the world leader.

Baker Hughes Drilling Equipment

Tri-State Oil Tools

When equipment breaks or gets lost in an oil or gas well, a "fishing job" is required. Located all over the world, Tri-State is ready and able to perform this specialized service. Tri-State also provides oilfield machine shop services and rental tools throughout the world. By almost any measure, Tri-State is the leader in innovative service related to solving those unexpected and costly problems our customers sometimes experience.

Exlog/TOTCO

The combination of two fine oilfield names, Exlog/TOTCO furnishes a wide variety of products and services to enhance the drilling process. Instruments and services related to measuring pertinent rig parameters and how much the drilled hole is varying from its intended path as well as computer-enhanced interpretation of rig data and downhole geological information is the special business in which Exlog/TOTCO is engaged.

Milpark Drilling Fluids

One of the world's largest suppliers of drilling fluids, and the acknowledged technical leader in both water based polymer and oil based drilling fluids, Milpark continues to lead the pack in the drilling fluids business. A drilling fluid must have all of the classical properties providing lubrication, cuttings carrying and suspension capacity, cooling and wall building. It is vital that these properties are maintained in whatever environment exists. Milpark provides tailored fluid systems for the myriad of different drilling conditions encountered throughout the world taking into consideration the total economic environment including not only physical drilling variables but also ecological effects. Milpark can design the specially tailored drilling fluid system of the right characteristics to get the job done.



Drilling fluids can make a significant difference in drilling efficiency.

The mud engineer is a key part of the technology of Milpark, making the

right choices to protect the drilled hole while enhancing the process.

Baker Hughes Production Tools

After the drilling process is complete, the hole in the earth, if it encounters economic quantities of hydrocarbons, must be made ready for its long-term production, a process called "completing" the well. Also, during its productive life a well requires care and maintenance until it becomes uneconomical to produce. It is then "abandoned." Baker Hughes Production Tools is a major participant in completion, production, maintenance and abandonment of oil and gas wells.

Baker Oil Tools

The acknowledged leader in well completions, Baker Oil Tools supplies a complete array of completion products worldwide. Primary cementing equipment, well packers and accessories, flow control devices and safety equipment are the principal products provided. Accompanying the wide variety of premium products is a technical service organization whose quality is unsurpassed in the oilfield.

Baker Service Tools

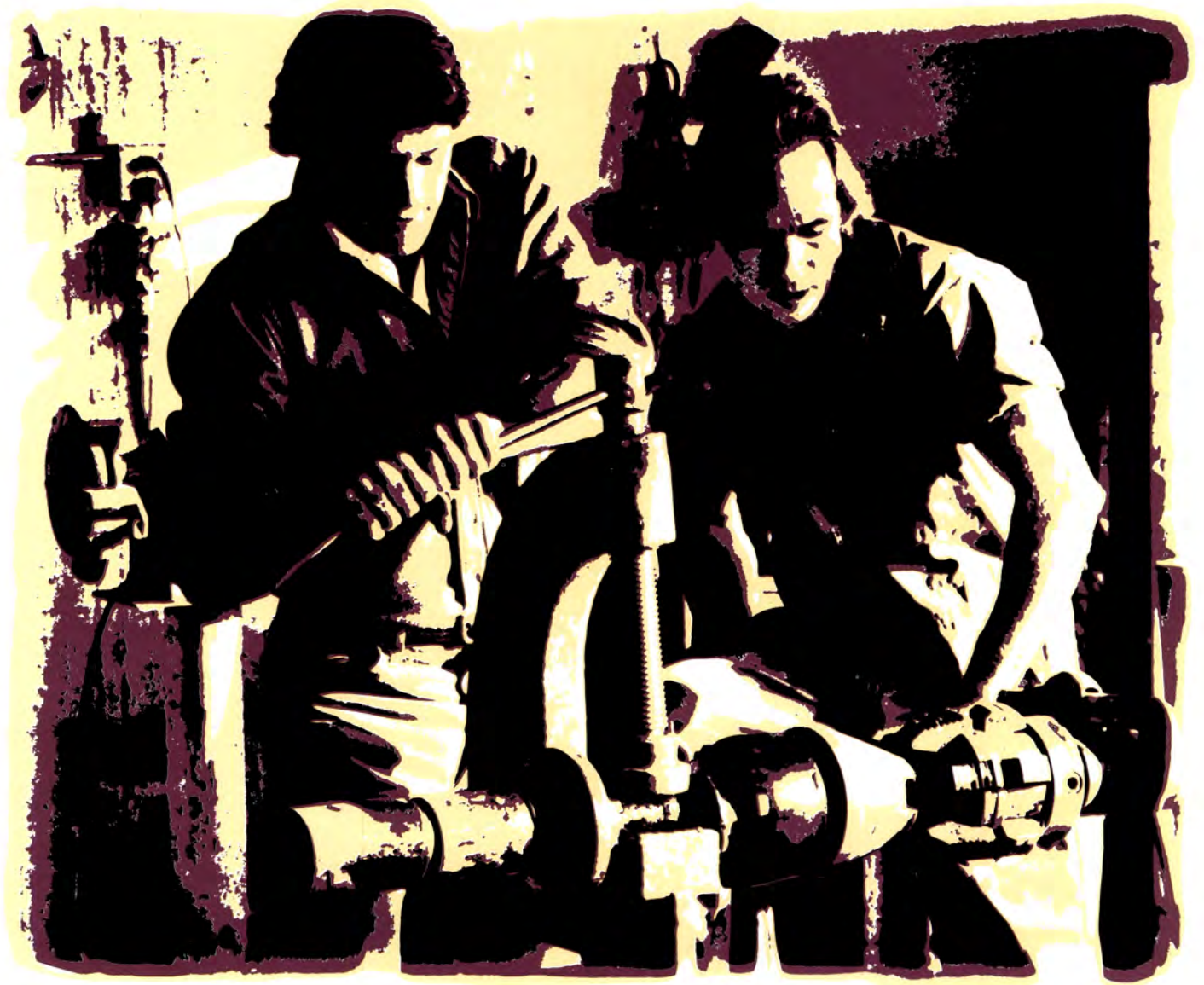
Most oil wells, during their productive lifetime, require maintenance work to restore or improve production. This remedial work is a prime market segment for Baker Service Tools. Combining superior tools with highly skilled service specialists provides the well operator with an unequalled capability to rework his oil well. Liner hangers, drillstem tests and tubing anchors are also part of Baker Service Tools' array of products and services.

Baker Sand Control

Chartered to specialize in the control of loose unconsolidated formation sand in oil and gas wells, Baker Sand Control has achieved the stature of world leader in this specialized well completion area. Now expanded into well perforating and production testing, Baker Sand Control continues to contribute technological advances in the oil and gas industry.

Baker CAC

The resulting entity from the combination of Baker CAC, Baker Torqmaster and what was retained from Baker Lift Systems, Baker CAC now markets valve operators to remotely open and close well head and manifold valves, along with control panels, to safely



Baker Oil Tools' packers and accessories fill every well completion

need. Whether for oil or gas or for production or injection, Baker covers

the entire spectrum of well completion needs.

Baker Hughes Production Tools

produce oil and gas. Large, special geometry rod pumps and controllers to sense conditions and automatically turn pumps on and off round out the product profile of Baker CAC.

Baker Performance Chemicals

Most activities associated with drilling and production involve the use of chemicals. Drilling fluid properties are achieved or enhanced by the use of specialty chemicals, while stimulation is also a prime user of chemicals. In the production phase, emulsion breakers, corrosion and scale inhibitors and various water clarifiers and biocides are essential to efficient and ecologically safe production. As a major supplier of all oilfield chemicals, Baker Performance Chemicals is among the leaders in the field.

Centrilift

When high liquid volumes need to be lifted to the surface, an electrically powered submersible pump is generally the equipment of choice. Centrilift manufactures and services pumps, electric cables and controllers of various types for the producers of large quantities of oil and/or water. For efficiency and serviceability, as well as market share, Centrilift is a leader in the electric submersible pump market segment.

Hughes Services International

Hughes Services International provides pumping services outside the United States and Canada. Hydraulic horsepower for cementing, acidizing and fracturing requires sophisticated land and offshore equipment including pumps, materials, mixing and blending equipment and computerized planning systems.

Develco

The latest addition to Baker Hughes is Develco, a high tech oilfield instrument company specializing in very sophisticated magnetic technology and low frequency radio wave communication through the earth. This technology provides new ways to perform downhole functions exciting oil producers and tool designers alike.



Centrilift's electric submersible pumps are highly sophisticated machines, where motor and pump must fit in the confinement of a well bore.

Precision parts are meticulously finished before use.

Baker Hughes Mining Equipment

Baker Hughes Mining Equipment (BHME) serves the worldwide mining and process industries. The organizational structure of BHME is similar to those of the oilfield operations with eleven operating divisions, five of which comprise the mining equipment group. The remaining six are autonomous entities. These divisions supply products and services for initial exploration, development, production and processing of all major mined commodities, including coal, gold, copper, iron ore, lead, zinc and many more. BHME operates all over the world.

Many of BHME's products have application in other industries; for example, food processing, solid/liquid separation for municipal requirements, chemicals and petrochemicals.

BGA International

BGA International manufactures, services and repairs a complete range of slurry pumps and related valves and other associated products for the minerals industry as well as other industrial markets. Ranging in size from 1 1/2" to 22", BGA pump product lines include horizontal and vertical, elastomer and hard alloy-lined centrifugal pumps. International in scope, BGA has facilities and expertise to serve mining markets not only in the U.S. but also Europe, Africa, Australia, Asia and South America.

Ramsey Technology, Inc.

Ramsey Technology provides monitoring, analysis and control equipment for process streams or bulk materials. Along with its Texas Nuclear and ICORE subsidiaries, Ramsey is involved in the advanced technology of measurement and control, with microprocessor based systems for liquid flow measurement, metal detection, bulk weight integration on conveyors and coal sampling. Ongoing research and development is an integral part of Ramsey's strategic growth.

Baker Hughes Mining Tools

Baker Hughes Mining Tools manufactures and sells rock bits and big hole cutters to the mining industry. Originally the outgrowth of the oilfield rock bit business, Baker Hughes Mining Tools now stands alone with a complete manufacturing capability



Large centrifugal pumps are part of the product line of BGA International. Used for pumping abrasive slurries found in mining and other applications, these high quality machines are standards of the industry.

Baker Hughes Mining Equipment

focused on the mining industry. Drilling bits, specialty drill stems, stabilizers and large cutters for tunneling and boring are all part of the product inventory.

Chas. S. Lewis

Chas. S. Lewis manufactures pumps and valves for the special market of pumping and controlling sulphuric acid and molten sulphur, plus other highly corrosive liquids. Lewmet is a patented alloy from which Lewis manufactures its premium line of pumps and valves.

WEMCO

WEMCO is one of the premier suppliers of flotation cells, heavy media separators, pumps, and classifiers for the beneficiation and recovery of mineral ores, salts, sands, and industrial gems. They are also a leading manufacturer of centrifuges for coal dewatering, oil/water separators to clean industrial wastewaters and produced-water from oil production, and non-clogging, solids-handling pumps for municipal wastewater treatment. WEMCO pioneered many of their products and is the acknowledged leader in most of their market segments.

EIMCO Process Equipment

EIMCO Process Equipment manufactures and markets a wide variety of equipment and systems for liquid/solid separation, solid/solid separation, and specialized pumping operations. This equipment is used in minerals beneficiation, continuous industrial processing and water and wastewater treatment by the metallurgical, chemical, municipal, pulp and paper and other worldwide process industries.

EIMCO Mining Equipment Group

The EIMCO Mining Equipment Group is composed of EIMCO Jarvis Clark, EIMCO Coal Machinery Division, EIMCO Great Britain, EIMCO Secoma, and Baker Mine Services divisions. These divisions design, manufacture and market a broad range of load-haul-dumps, scoops, drilling and roof-bolting jumbos, trucks, and auxiliary vehicles. The group provides manufacturing, assembly, repair, reconditioning and after market service support to the mining industry throughout the world through its wholly owned facilities in six major countries.



**Mined products, coal and other minerals, need to be moved from
the mine face to collection and transportation sites. EIMCO Jarvis Clark**

is the world's largest manufacturer of these machines.

Financial and Organizational Review

Baker Hughes revenues for fiscal 1987 were \$1.924 billion, down 16.8% from the prior year as oilfield drilling activity continued to decline from the depressed levels of 1986. The low drilling activity levels had an adverse affect on the price of the Company's products and services, further depressing revenues. Mining activity was also depressed in U.S. markets, however, non-U.S. mining revenues continued to increase in fiscal 1987.

The loss after taxes and the loss per share amounts for fiscal 1987 and 1986 were \$254.8 million or \$2.22 per share, and \$804.6 million or \$7.00 per share, respectively. Both years were impacted by non-operational items. It is appropriate to look at fiscal 1987 operational performance to get a proper perspective of how the Company is coping with the market environments in which it operates. During the second fiscal quarter of 1987, the Company charged to operations \$140.0 million related to the combination of Baker and Hughes. Included in the charge were losses related to the divestiture of several of Baker's businesses, which were required by the Department of Justice to allow the combination to proceed. The charge also included amounts for the consolidation of facilities and workforce reductions. During the fourth fiscal quarter of 1987, the Company evaluated its investment in Vetco Gray and determined that it no longer fit into the Company's long-term strategic plan. As a result of this evaluation and other factors, the Company has written off its investment in Vetco Gray, has deconsolidated Vetco Gray's results from those of the Company and is working on an agreement to reduce its interest in Vetco Gray. The total impact of Vetco Gray's operational losses and the write-off of the investment in fiscal 1987 was \$68.2 million. Also, during fiscal 1987 the Company settled three defined benefit pension plans through the purchase of nonparticipating annuity contracts, resulting in a \$76.8 million gain. Excluding these non-operational items the Company had an operational loss (before income taxes and minority interest) for fiscal year 1987 of \$144.2 million.

Cost of sales, services and rentals were 72.4% of revenues in fiscal 1987, approximately the same as in fiscal 1986. The significantly low gross margin in both years results from the adverse pricing environment in which the Company has been operating. Marketing and field service expense declined 18.6% from the prior year, which is at a rate higher than the decrease in revenues, due to cost containment programs and consolidation savings resulting from the combination. General and administrative expense declined 15.8% from fiscal 1986, a rate in-line with the decrease in revenues. Net interest expense was reduced by 19.4%, primarily due to a decline in average debt outstanding and a decrease in interest rate levels on the Company's floating rate debt.

Pattern of Growth

In the fourth fiscal quarter the Company's worldwide oilfield markets reflected improvement resulting in an increase in revenues of 14.7% from the third fiscal quarter. This improvement was attributable to an increase in the average domestic rig count to 1,001 rigs in the fourth fiscal quarter and the stabilization of the price of crude oil to \$18 to \$20 per barrel. The Company anticipates that the oilfield operational environment in the fourth fiscal quarter will carry through to fiscal 1988. The coal and minerals markets are expected to show modest improvement in 1988.

Capital Generation and Application

Balance sheet improvement was a major goal for the Company from the outset of the combination. Since the date of the combination, April 3, 1987, when the combined debt levels of Baker and Hughes had reached \$714.8 million, debt has been reduced such that at year-end debt was \$540.6 million. In June, 1987, the Company sold \$100 million in convertible exchangeable preferred stock providing funds to pay down debt. At September 30, 1987, the debt to equity ratio was .590, a significant improvement since the date of the combination.

Revenues

(Dollars in billions)

87	86	85	84	83
1.92	2.31	3.17	3.05	2.99

**Net Income (Loss)**

(Dollars in billions)

87	86	85	84	83
(.255)	(.805)	.092	(.063)	(.154)

**Earnings (Loss) Per Share**

(Dollars)

87	86	85	84	83
(2.22)	(7.00)	.80	(.55)	(1.35)

**Return on Revenues**

(Percent)

After-tax profit margin				
87	86	85	84	83
(13.2)	(34.8)	2.9	(2.1)	(5.2)

**Return on Assets**

(Percent)

Based on average total assets and income before gross interest expense and taxes

87	86	85	84	83
(6.4)	(26.3)	7.5	2.1	(2.6)

**Return on Equity**

(Percent)

Based on year-end

Stockholders' equity

87	86	85	84	83
(27.8)	(75.0)	4.7	(3.2)	(7.1)

**Common Stock****Dividends Paid**

(Per share)

87	86	85	84	83
.39	.64	.80	.88	.97



Capital spending for the year was \$45.3 million, considerably below the level of depreciation, due to restructuring of existing capacity and because a significant portion of the Company's capacity is relatively new.

Subsequent to the combination the Company purchased the other half of the Hughes Drilling Fluids joint venture from the W. R. Grace Company. Also, the drilling fluids operations of CKS, a French company operating in France and Africa, were purchased during the year.

Develco, a high technology oilfield instrumentation company, was acquired in 1987 and is now operated as a division of Baker Hughes Production Tools.

Organization and Management

As part of the combination of Baker and Hughes, James D. Woods was appointed as President and Chief Executive Officer. Under Mr. Woods' direction, the ongoing operations of Baker Hughes have been organized into three operating organizations that contain virtually all of the Company's operations.

Howard I. Bull is the President of Baker Hughes Drilling Equipment (BHDE) and a Senior Vice President of Baker Hughes Incorporated. BHDE is comprised of Hughes Tool Company (rock bits and rig tools), Milpark (drilling fluids), Exlog/TOTCO (drilling instruments and geological evaluations), Tri-State Oil Tools (fishing and rental tools) and Baker Hughes Tubular Services (tool joints, premium threading of casing and tubing, tubular inspection services and corrosion protection coating).

Joel V. Staff is the President of Baker Hughes Production Tools (BHPT) and a Senior Vice President of Baker Hughes Incorporated. BHPT is comprised of Baker Oil Tools (completion products), Baker Service Tools (remedial and stimulation tools, liner hangers and drillstem testing), Baker Sand Control (gravel packing, perforating and well testing), Centrilift (electric submersible pumps and cables), Baker Performance Chemicals (production chemicals), Baker CAC (beam pumps, valve operators and control panels), Hughes Services International (pumping services outside the U.S. and Canada) and Develco (high technology oilfield instrumentation).

John F. Schaefer is the President of Baker Hughes Mining Equipment (BHME) and a Senior Vice President of Baker Hughes Incorporated. BHME is comprised of BGA International (pumps for mining and other industries), Ramsey Technology (measurement and sampling equipment), Chas. S. Lewis (special alloy valves and pumps), Baker Hughes Mining Tools (bits for mining), EIMCO Process Equipment Company (special equipment for separating minerals and other substances), WEMCO (mineral beneficiation equipment) and EIMCO Mining Equipment Group (five divisions around the world providing underground mining equipment including after market repair and service to the mining industry).

Reporting directly to the Chief Executive Officer of Baker Hughes Incorporated is B-J Titan, a majority owned partnership between Baker Hughes and Dresser Industries providing oilfield pumping services in the U.S. and Canada.

Outlook for 1988

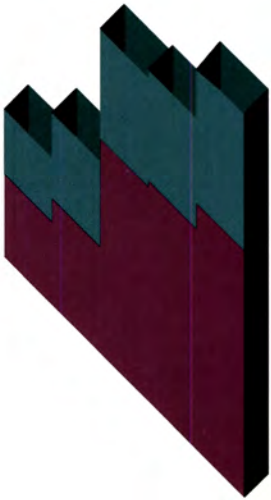
The Company expects a slight improvement in activity in its markets in 1988 as oil prices remain stable and natural gas and mineral prices move up slightly. Coupled with ongoing cost containment programs, fiscal 1988 should be a profitable year. The Company also expects to receive the negotiated patent lawsuit settlement from Smith International in fiscal 1988. This settlement is expected to provide \$95 million to Baker Hughes.

Stockholders' Equity and Debt

(Dollars in billions)

Includes long and short-term debt

	87	86	85	84	83
■ Debt	.54	.73	.78	.95	1.21
■ Equity	.92	1.07	1.95	1.98	2.17



Debt/Equity Ratio

Includes long and short-term debt

	87	86	85	84	83
	.590	.681	.399	.482	.557



Incremental Asset Investment

(Dollars in millions)

	87	86	85	84	83
■ Capital expenditures	45	91	178	126	193
■ Net additional working capital	(134)	(568)	(9)	(199)	(223)



Interest Coverage

Pretax plus gross interest times gross interest expense covered

	87	86	85	84	83
	(1.25)	(6.75)	2.00	.46	(.67)



Current Ratio

	87	86	85	84	83
	1.73	1.97	2.67	2.55	2.87



Cash Flow

(Dollars in millions)

Net income plus depreciation and amortization

	87	86	85	84	83
	(108)	(606)	346	191	120



Non U.S. Revenues

As a percent of total

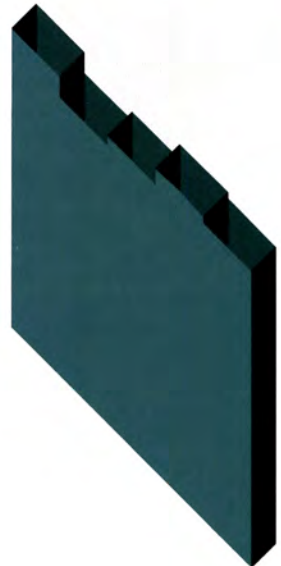
	87	86	85	84	83
	55.5	53.4	49.1	45.5	48.2



Service and Rental Revenue

As a percent of total

	87	86	85	84	83
	25.5	23.7	24.0	24.8	24.6



Consolidated Statements of Financial Position

September 30,	1987	1986
(In thousands of dollars)		
Assets:		
Current Assets:		
Cash and short-term investments, at cost, which approximates market value	\$ 11,361	\$ 43,863
Receivables — less allowance for doubtful accounts: 1987, \$46,695; 1986, \$54,498	474,405	478,898
Refundable income taxes (Note 9)		12,364
Inventories (Note 2):		
Finished goods	418,725	419,441
Work in process	80,848	123,478
Raw materials	165,479	176,535
Total inventories	665,052	719,454
Prepaid expenses and deferred income taxes (Note 9)	33,439	33,618
Total current assets	1,184,257	1,288,197
Property (Note 2):		
Land	53,176	52,178
Buildings	355,264	403,274
Machinery and equipment	1,188,279	1,264,826
Rental tools and equipment	341,144	340,031
Total property	1,937,863	2,060,309
Accumulated depreciation	(1,200,761)	(1,156,242)
Property — net	737,102	904,067
Other Assets (Note 2):		
Property held for disposal	88,301	86,119
Investments, including investments in unconsolidated subsidiaries	36,197	88,287
Noncurrent receivables	39,623	63,308
Other assets	63,986	60,881
Excess costs arising from acquisitions — less accumulated amortization: 1987, \$8,068; 1986, \$7,449 (Note 4)	39,166	20,195
Total other assets	267,273	318,790
Total	\$2,188,632	\$2,511,054

September 30, 1987 1986

 (In thousands of dollars)

Liabilities:

Current Liabilities:		
Accounts payable— trade	\$ 214,759	\$ 202,248
Short-term borrowings (Note 6)	46,791	61,096
Current portion of long-term debt (Note 6)	33,056	30,293
Accrued employee compensation and benefits	124,991	111,519
Income taxes (Note 9)	20,191	61,721
Accruals relating to combination and divestiture and unusual charges (Note 4)	74,810	45,996
Taxes other than income	28,424	38,013
Accrued insurance	39,312	29,888
Accrued interest	28,963	17,945
Other accrued liabilities	72,205	54,660
<u>Total current liabilities</u>	<u>683,502</u>	<u>653,379</u>
Long-term debt (Note 6)	460,767	638,557
Deferred income taxes (Note 9)	73,407	84,542
Other long-term liabilities	28,350	17,766
Minority interest	27,086	44,661

Stockholders' Equity:

Stockholders' Equity (Notes 2, 3, 6, 7 and 8):		
Preferred stock, \$1 par value, authorized 15,000,000 shares; issued: 2,000,000 shares of \$3.50 convertible exchangeable preferred stock, \$1 par value \$50 liquidation preference per share	2,000	
Common stock, \$1 par value (authorized 400,000,000 shares; outstanding 117,490,000 shares in 1987, and 115,279,000 shares in 1986)	117,490	115,279
Capital in excess of par value	883,941	765,073
Retained earnings (deficit)	(13,226)	262,833
Cumulative foreign currency translation adjustment	(74,685)	(71,036)
<u>Total stockholders' equity</u>	<u>915,520</u>	<u>1,072,149</u>
Total	<u>\$2,188,632</u>	<u>\$2,511,054</u>

Consolidated Statements of Operations

Years Ended September 30,		1987	1986	1985
		(In thousands of dollars, except per share amounts)		
Revenues:	Sales	\$1,432,138	\$1,764,085	\$2,405,826
	Services and rentals	491,460	548,593	759,418
	Total	1,923,598	2,312,678	3,165,244
Costs and Expenses:	Cost of sales, services and rentals	1,392,280	1,665,891	2,054,409
	Marketing and field service	401,171	492,646	556,094
	General and administrative	197,147	234,131	293,833
	Pension reversion gain (Note 11)	(76,765)		
	Unusual charges (Note 4)		919,198	
	Combination and divestiture costs (Note 4)	140,000		
	Loss in Vetco Gray Inc. (Note 3)	68,223	11,670	
	Interest expense — net	77,161	95,757	119,457
	Total	2,199,217	3,419,293	3,023,793
Income:	Income (loss) before income taxes, minority interest and extraordinary items	(275,619)	(1,106,615)	141,451
	Income taxes (Note 9)	(14,100)	(144,494)	52,304
	Income (loss) before minority interest and extraordinary items	(261,519)	(962,121)	89,147
	Minority interest	6,697	68,916	2,683
	Income (loss) before extraordinary items	(254,822)	(893,205)	91,830
	Extraordinary Items:			
	Gain on pension reversion (Note 11)		96,923	
	Loss on early extinguishment of debt (Note 5)		(8,315)	
	Net extraordinary gain		88,608	
	Net income (loss)	\$ (254,822)	\$ (804,597)	\$ 91,830
	Income (Loss) Per Share of Common Stock (Note 2):			
	Income (loss) before extraordinary items	\$ (2.22)	\$ (7.77)	\$.80
	Extraordinary items		.77	
	Net income (loss)	\$ (2.22)	\$ (7.00)	\$.80

Consolidated Statements of Stockholders' Equity

For The Three Years Ended September 30, 1987 (In thousands of dollars)

	\$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, 1984		\$115,420	\$777,969	\$1,143,989	\$(62,304)	\$1,975,074
Fiscal year ended September 30, 1985:						
Net income				91,830		91,830
Cash dividends on common stock (\$0.80 per share)				(91,676)		(91,676)
Foreign currency translation adjustment					(9,841)	(9,841)
Other	(779)	(16,650)	(136)			(17,565)
Balance, September 30, 1985		114,641	761,319	1,144,007	(72,145)	1,947,822
Fiscal year ended September 30, 1986:						
Net loss				(804,597)		(804,597)
Cash dividends on common stock (\$0.64 per share)				(73,766)		(73,766)
Foreign currency translation adjustment					1,109	1,109
Other	638	3,754	(2,811)			1,581
Balance, September 30, 1986		115,279	765,073	262,833	(71,036)	1,072,149
Fiscal year ended September 30, 1987:						
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 (\$0.39 per share)				(45,836)		(45,836)
Issuance of \$3.50 convertible exchangeable preferred stock	\$2,000		95,400			97,400
Adjustment to conform fiscal year of Hughes Tool Company (Note 1)				26,874		26,874
Foreign currency translation adjustment					(3,649)	(3,649)
Other	2,211	23,468				25,679
Balance, September 30, 1987	\$2,000	\$117,490	\$883,941	\$ (13,226)	\$(74,685)	\$ 915,520

Consolidated Statements of Changes in Financial Position

	Years Ended September 30,	1987	1986	1985
			
		(In thousands of dollars)		
Sources of working capital:	From operations:			
	Income (loss) before extraordinary items	\$(254,822)	\$(893,205)	\$ 91,830
	Loss in Vetco Gray Inc.	68,223	11,670	
	Depreciation and amortization of:			
	Property	128,728	183,609	237,257
	Debt discount and other assets	17,990	15,135	17,125
	Deferred income taxes	(15,373)	(219,177)	15,950
	Provision for writedown of noncurrent assets and other items	65,419	538,622	
	Minority interest	(6,697)	(68,916)	(2,683)
	Total from operations before extraordinary items	3,468	(432,262)	359,479
	Net extraordinary items		88,608	
	Total from operations	3,468	(343,654)	359,479
	Long-term borrowings	9,277	249,488	50,471
	Exercise of stock options, stock purchase plan grants (including related tax benefits) and other issuances	25,679	5,902	14,998
	Disposal of property and excess assets— net book value	61,168	72,919	54,659
	Proceeds from issuance of preferred stock	97,400		
	Adjustment to conform fiscal year of Hughes Tool Company	26,874		
	Receipt of income tax refund	9,572		
	(Increase) decrease in property resulting from foreign currency translation	3,945	(388)	3,419
	Net assets contributed by minority partner			96,969
	Total sources (deficiencies)	237,383	(15,733)	579,995
Applications of working capital:	Property purchases	45,298	90,641	177,509
	Cash and accrued dividends	48,111	73,766	91,676
	Reduction of long-term borrowings	199,297	294,266	190,020
	Purchase of Baker Hughes common stock		1,524	31,909
	Foreign currency translation adjustment resulting from:			
	Property, plant and equipment	3,945	(388)	3,419
	Working capital	(296)	(721)	6,422
	Acquisitions of businesses, excluding working capital:			
	Assets acquired:			
	Property, plant and equipment (net)	39,830	46,708	99,996
	Other long-term assets	8,263	1,792	10,130
	Liabilities assumed:			
	Minority interest		(23,729)	
	Long-term debt		(8,739)	(6,291)
	Other long-term liabilities		(135)	
	Excess costs arising from acquisitions	23,748		
	Working capital of Hughes Offshore contributed to Vetco Gray Inc.		41,687	
	Increase (decrease) in other assets	(1,617)	14,938	2,051
	Other — net	4,867	20,230	(18,147)
	Total applications	371,446	551,840	588,694
	Net decrease in working capital	\$(134,063)	\$(567,573)	\$ (8,699)

Years Ended September 30,	1987	1986	1985
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	(In thousands of dollars)		
Changes in working capital:			
Increase (Decrease):			
Cash and short-term investments	\$ (32,502)	\$ 8,667	\$(36,520)
Receivables	(4,493)	(265,441)	49,192
Refundable income taxes	(12,364)	(34,967)	(76,069)
Inventories	(54,402)	(310,004)	6,132
Prepaid expenses and deferred income taxes	(179)	(30,397)	(16,255)
Accounts payable — trade	(12,511)	65,945	(7,299)
Short-term borrowings and current portion of long-term debt	11,542	17,335	52,955
Accrued employee compensation and benefits	(13,472)	16,526	7,696
Income taxes	41,530	83	(15,436)
Accruals relating to combination and divestiture and unusual charges	(28,814)	(45,996)	
Taxes other than income	9,589	(1,866)	(302)
Accrued insurance	(9,424)	6,019	(21,459)
Accrued interest and other liabilities	(28,563)	6,523	48,666
Net decrease in working capital	<u>\$(134,063)</u>	<u>\$(567,573)</u>	<u>\$ (8,699)</u>

1. Basis of Presentation:

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

The Combination has been accounted for as a pooling-of-interests and, accordingly, the consolidated financial statements have been prepared on a basis that includes the accounts of Baker and Hughes. Information concerning common stock, employee stock plans, and per share data has been restated on an equivalent share basis. Consolidated financial statements as of September 30, 1986 and 1985 and for each of the years in the two year period ended September 30, 1986 include Baker's fiscal year amounts and Hughes' calendar year amounts for the respective years. Accordingly, Hughes' results of operations for the quarter ended December 31, 1986, adjusted for the pension transaction described below, are reflected in both the 1987 and 1986 consolidated statements of operations. Summarized information concerning the duplicated quarter is as follows: revenues \$165,050,000, loss before income taxes \$32,685,000 and net loss \$24,083,000. In addition, Hughes' dividends of \$2,791,000 for the quarter ended December 31, 1986, are reflected in both the 1987 and 1986 consolidated statements of stockholders' equity.

The following is a reconciliation of revenues and net income of Baker and Hughes (adjusted for the Vetco Gray Inc. deconsolidation discussed below) for the periods prior to the combination:

Years Ended September 30,	1986	1985
(In thousands of dollars)		
Revenues:		
Baker (as previously reported)	\$1,557,211	\$1,904,321
Hughes (year ended December 31)	755,467	1,260,923
Combined	<u>\$2,312,678</u>	<u>\$3,165,244</u>
Net Income (Loss):		
Baker (as previously reported)	\$ (272,987)	\$ 87,741
Hughes (year ended December 31)	(475,849)	4,089
Pension adjustment	(55,761)	
Combined	<u>\$ (804,597)</u>	<u>\$ 91,830</u>

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

2. Summary of Significant Accounting Policies:

Principles of consolidation: The consolidated financial statements include the accounts of Baker Hughes Incorporated and all majority-owned subsidiaries and partnerships, except for the Company's investment in Vetco Gray Inc., which is accounted for under the cost method (see Note 3). All significant intercompany accounts and transactions have been eliminated in consolidation.

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Income (loss) per share: Income (loss) per share amounts are based on the weighted average number of shares outstanding during the respective years (115,791,000 in 1987, 114,921,000 in 1986, and 115,154,000 in 1985) and excludes in 1985 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 (see Note 4). The Company manufactures a substantial portion of its rental tools and equipment, and the cost of these items represents direct and indirect manufacturing costs.

Property held for disposal: Property held for disposal is stated at estimated net realizable value.

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

Foreign currency translation: Gains and losses resulting from balance sheet translation of foreign operations where a foreign currency is the functional currency are included as a separate component of stockholders' equity. Net exchange gains and losses resulting from the translation of foreign currencies in 1987, 1986 and 1985 included in the determination of net income for each year are not material.

3. Acquisitions and Dispositions:

In the fourth quarter of fiscal 1986, the Company acquired from Combustion Engineering, Inc. ("C-E") the Vetco Gray Group, a worldwide supplier of drilling equipment and systems for 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 is now part of a subsidiary, Vetco Gray Inc., ("V-G") of which the Company owns 80.1% of the common stock and to which the Company has 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.

In the event of a change of control of the Company, the V-G preferred stock is exchangeable for equivalent shares of the Company's preferred stock. In the event of certain defaults by V-G, holders of the preferred stock will be entitled to elect a majority of the V-G directors. The V-G common stock held by C-E is exchangeable, through warrants, for 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.

The acquisition was originally accounted for as a purchase. However, due to the events described below, unaudited pro forma results of operations for the periods preceding the acquisition are not presented.

During the fourth quarter of fiscal 1987, the Company evaluated its investment in V-G and determined that V-G no longer fits into the Company's long-term strategic plan. This decision was based, in part, on the occurrence of events subsequent to the acquisition of V-G. The Company has advised C-E that it has no intention of funding the future operations of V-G, nor is it required to do so under the stockholder agreement between C-E, V-G and the Company. The Company is pursuing opportunities to dispose of all or substantially all of its common stock interest in V-G. Such disposition will require the consent of C-E.

As a result of these factors, the Company believes that its control over the financial and operating activities of V-G is temporary and that the consolidation of V-G is no longer appropriate. Accordingly, the consolidated financial statements for fiscal year 1986 have been restated to deconsolidate V-G and to

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 account for the Company's investment in V-G at cost. The Company has provided for impairment of its investment in V-G through its proportionate share of losses sustained by V-G through September 30, 1987. As a result, the restatement has no effect on previously reported net income or stockholders' equity of the Company. On September 30, 1987, the Company wrote off its remaining investment in V-G and recognized estimated liabilities of \$3,000,000 related to the disposition of its interest in V-G. At September 30, 1987, the Company is contingently liable for certain bank notes issued by V-G amounting to \$23.7 million. These bank notes may be reduced by payments by V-G or through the sale of certain assets of V-G and its subsidiaries pledged to the banks. In addition, the Company is contingently liable for \$6,000,000 of performance bond letters of credit made by the Company on behalf of V-G. The Company does not expect the ultimate disposition of V-G to have any further significant effect on the Company's financial position or results of operations.

In October 1987, the Company, C-E and FMC Corporation ("FMC") signed a letter of intent to combine certain businesses of FMC with V-G. Pursuant to this combination, FMC will become a minority stockholder with the option to ultimately acquire majority ownership of V-G at no further cost. The Company will not have control over the financial and operating activities of the combined company. Completion of the transaction is subject to government approval and the negotiation and approval of definitive agreements by the boards of directors of FMC, C-E and the Company.

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

In April 1985, the Company contributed its U.S. and Canadian oilfield pumping services net assets, amounting to \$254,000,000, to a partnership which the Company controls.

During each of the three years in the period ended September 30, 1987, the Company acquired and disposed of several other businesses, none of which, individually or in the aggregate, had a material effect in any of the periods presented on the Company's financial position or results of operations.

**4. Combination and
 Divestiture Costs;
 Unusual Charges:**

In connection with the combination discussed at 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. Proforma financial information for the Company reflecting the effects of the divestitures of the Business Units, which were completed in the third quarter, has not been presented because such information does not differ materially from the historical information. In addition, the Company performed a review of its combined inventories, facilities and workforce levels to identify redundancies resulting from the combination and recognized a charge to operations of \$92,000,000 attributable principally to consolidation of production facilities and staff reductions.

During the fiscal year ended September 30, 1986, the Company, in response to falling oil prices and the resultant decline in the level of activity in worldwide oil and gas markets, reviewed in detail its asset and workforce levels. The likelihood of continued depressed market conditions led the Company to take a series of actions designed to enhance its ability to operate in the rapidly changed market environment. Such actions included the scaling down of capacity of certain of its manufacturing plants and the planned disposal of certain property, plant and equipment, which was written down to estimated net

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realizable value. Several of the Company's product lines were streamlined, sold or discontinued, and assets related to these lines were written down to estimated net realizable value. Inventories were written down to better reflect current and anticipated market conditions. Compensation accruals were established for severance and early retirement based on significant workforce reductions. Additionally, the Company wrote off substantially all of the excess costs arising from prior acquisitions (including those related to mining operations) and established additional reserves for accounts receivable to reflect current industry conditions. The financial impact of the actions described above, substantially all of which were of a noncash nature, amounted to an unusual charge of \$919,198,000 (\$744,925,000 or \$6.48 per share, after income taxes and minority interest), as follows:

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

5. Extraordinary Loss on Early Extinguishment of Debt:

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

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

6. Indebtedness:

Long-term debt at September 30, 1987 and 1986 consisted of the following:

	1987	1986
	(In thousands of dollars)	
Commercial paper with an effective interest rate of 7.56% at September 30, 1987, effectively due, because of unused lines of credit, through 1990	\$ 4,475	\$ 3,000
Zero Coupon Guaranteed Notes due 1992 with an effective interest rate of 14.48%, net of unamortized discount of \$49,026 (\$56,553 in 1986)	57,695	50,168
6.00% Debentures due 2002 with an effective interest rate of 14.66%, net of unamortized discount of \$116,573 (\$118,899 in 1986)	108,427	106,101
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%)	102,503	101,828
9% Debentures due July 15, 2000	1,675	25,813
9% Debentures due November 1, 2008	47,375	59,178
9.5% Convertible Subordinated Debentures due December 15, 2006 convertible into common stock at \$58.91 per share	99,125	99,081
14.25% Notes due December 15, 1988		99,560
9.25% Senior Notes due through 1994		7,897
Convertible Subordinated Debentures due through 1993 with an interest rate at September 30, 1987 of prime on \$2,083 and LIBOR + 5/8% on \$7,628 (see Note 8)	9,711	22,009
Other indebtedness with an average interest rate of 7.7% at September 30, 1987	29,781	63,922
Total long-term debt	<u>\$460,767</u>	<u>\$638,557</u>

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At September 30, 1987, the Company's principal U.S. bank credit agreements provide for borrowings of up to \$100,000,000 as revolving credit with a maturity date of April 6, 1990. The rate of interest on borrowings under these arrangements is, at the Company's option, the prime rate or $\frac{1}{2}\%$ in excess of the London Interbank Offered Rate (LIBOR) for U.S. dollar deposits or $\frac{5}{8}\%$ in excess of the Domestic Certificate of Deposit Rate. At September 30, 1987, there were no borrowings outstanding under these agreements. The provisions of the revolving credit agreements require a commitment fee of $\frac{1}{4}\%$ per annum on the unused portion. Additional bank lines of credit at September 30, 1987, include the following:

- \$81,000,000 as revolving credit which bears interest at $\frac{1}{2}\%$ over LIBOR, has no requirement for compensating balances and is repayable in 1990. A commitment fee is payable at a rate of $\frac{1}{8}\%$ per annum on the unused portion. At September 30, 1987, there were no borrowings outstanding under this agreement.
- \$69,000,000 of short-term money market lines of credit available on an as-offered basis. There are no requirements for commitment fees or compensating balances in connection with these agreements. At September 30, 1987, there were no borrowings outstanding under these agreements.

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

Redemption of the Zero Coupon Notes due 1992 and the 6% Debentures due 2002 may be made at the option of the Company, in whole or in part, at any time at par plus accrued interest. Furthermore, the Zero Coupon Notes due 1992 may be redeemed prior to maturity at prices (expressed as a percentage of principal amount) of 49.7% at September 30, 1987, 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 9.0% Debentures due July 15, 2000, currently have a \$2,000,000 per annum sinking fund requirement and may be redeemed by paying a premium which decreases proportionally from 3.4% at July 15, 1987, until it is eliminated in 1995. The 9% Debentures due November 1, 2008, have a \$2,400,000 per annum sinking fund requirement beginning November 1, 1989, and may be redeemed by paying a premium which decreases proportionally from 5.12% at November 1, 1987, 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 4.32% at December 15, 1987, 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. The 14.25% Notes due in 1988 were redeemed at par on May 4, 1987. The 9.25% Senior Notes due through 1994 were redeemed at \$101.65 on November 20, 1986, the loss on which was not material.

The provisions of the notes, debentures, bonds and unsecured credit agreements have an effect on the ability of the Company to, without prior written consent, among other things, incur borrowings, sell certain assets, pay cash dividends, acquire other businesses and purchase the Company's capital stock. At September 30, 1987, the Company could pay dividends and purchase the Company's common stock up to an amount not exceeding \$73,926,000.

At September 30, 1987, long-term debt was due in aggregate annual installments of \$33,056,000; \$5,216,000; \$11,756,000; \$4,827,000; and \$63,757,000 in each of the five years in the period ending September 30, 1992.

During 1987 and 1986, the maximum aggregate short-term borrowings outstanding at any month-end were \$104,847,000 and \$107,924,000, respectively; the average aggregate short-term borrowings outstanding based on quarter-end balances were \$63,660,000 and \$88,297,000, respectively; and the weighted average interest rates were 22.6% and 27.9%, respectively. The average interest rates on short-term borrowings outstanding at September 30, 1987 and 1986 were 17.6% and 25.3%, respectively. Throughout the year and at September 30, 1987, 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.

In addition, the Company has guaranteed \$9,000,000 of debt of an unconsolidated subsidiary.

7. \$3.50 Convertible Exchangeable Preferred Stock:

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

The preferred stock is not redeemable prior to May 15, 1990, unless the closing price of the common stock shall have equalled or exceeded 150% of the then effective conversion price for a specified period ending prior to the date notice of redemption is given. The preferred stock will otherwise be redeemable at the option of the Company, in whole or in part, at \$53.50 per share if redeemed prior to May 15, 1988, and at prices decreasing ratably annually to \$50.00 per share from and after May 15, 1997, in each case plus accrued dividends to the date fixed for redemption. Dividends on the preferred stock are cumulative at the rate of \$3.50 per share per annum from the date of original issuance. Such dividends are payable quarterly commencing August 15, 1987, as declared by the Board of Directors.

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

8. Employee Stock Plans:

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

The stock option activity for the Company during 1987, 1986 and 1985 was as follows:

Number of Shares	1987	1986	1985
		(In thousands)	
Stock options outstanding, beginning of year	6,069	5,774	5,496
Changes during the year:			
Granted or assumed (per share):			
1987, \$10.25 to \$20.30	1,078		
1986, \$13.75 to \$16.75		1,265	
1985, \$16.00 to \$17.75			1,057
Exercised (per share):			
1987, \$12.99 to \$25.78	(386)		
1986, \$11.09 to \$16.00		(165)	
1985, \$11.09 to \$15.75			(344)
Exchanged — (net)	(839)		
Expired	(237)	(805)	(435)
Stock options outstanding, end of year (per share: \$10.25 to \$64.75 at September 30, 1987)	5,685	6,069	5,774

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 At September 30, 1987, options were exercisable for 2,543,000 shares, and 6,471,000 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, 1987, a total of \$9,711,000 principal amount of debentures are outstanding and convertible into 835,000 shares of common stock at \$10.25 to \$21.88 per share.

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

The Company also has Employee Stock Purchase Plans (the "Plan") under which there remained authorized and available for sale to employees an aggregate of 1,600,000 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 479,000 shares will be purchased under the Plan on July 31, 1988, at \$22.31 per share. Under a pre-existing plan, 711,000, 455,000, and 714,000 shares were issued at \$7.86, \$7.86 and \$13.28 per share during 1987, 1986 and 1985, respectively.

9. Income Taxes:

The geographical sources of income (loss) before income taxes, minority interest and extraordinary items for the three years ended September 30, 1987 were as follows:

	1987	1986	1985
	(In thousands of dollars)		
United States	\$(263,627)	\$ (980,012)	\$ (31,559)
Foreign	(11,992)	(126,603)	173,010
Total income (loss) before income taxes, minority interest and extraordinary items	<u>\$(275,619)</u>	<u>\$(1,106,615)</u>	<u>\$141,451</u>

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The provisions (credits) for income taxes for the three years ended September 30, 1987 are summarized as follows:

	1987	1986	1985
	(In thousands of dollars)		
Currently payable (refundable):			
United States	\$ (3,524)	\$ 2,922	\$(26,782)
Foreign	12,032	20,414	44,634
Total currently payable	8,508	23,336	17,852
Deferred:			
United States		(156,747)	21,864
Foreign	(22,608)	(11,083)	12,588
Total deferred	(22,608)	(167,830)	34,452
Total provision (credit) for income taxes	\$(14,100)	\$(144,494)	\$ 52,304

The consolidated effective income tax rates for the three years ended September 30, 1987 varied from the United States statutory income tax rate for the reasons set forth below:

% of Income (Loss) Before Taxes	1987	1986	1985
Statutory income tax rate	(43.0)	(46.0)	46.0
Goodwill write-off and amortization		3.4	1.1
Effect of U.S. operating loss (before minority interest and extraordinary items) for which no carryback or other benefit is recognizable	18.3	19.0	
State taxes based on income — net of United States income tax benefit	.1		1.1
United States taxes not provided on Foreign, DISC, and FSC earnings	6.0	7.2	(8.1)
United States investment tax credits (flow through method)		2.7	(3.3)
Loss in Vetco Gray Inc.	8.6		
Excise tax on pension reversion gain	1.6	.7	
Other — net	3.3		.2
Effective income tax rate	(5.1)	(13.0)	37.0

The sources and amounts of deferred taxes for the three years ended September 30, 1987 were as follows:

	1987	1986	1985
	(In thousands of dollars)		
Reversal of deferred taxes due to net operating loss	\$ (2,874)	\$(159,209)	
Depreciation expense	(16,595)	8,199	\$37,391
United States income tax on:			
Foreign earnings			9,660
DISC earnings			4,076
Tax carryforwards (foreign tax, investment credit, etc.)			(43,921)
Inventory valuations — net	1,378	(1,871)	1,257
Unusual charges	1,861	(9,831)	13,184
Original issue discount			4,566
Accrued liabilities and allowances			1,984
Other — net	(6,378)	(5,118)	6,255
Total deferred tax provision (credit)	\$(22,608)	\$(167,830)	\$34,452

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At September 30, 1987, the Company had approximately \$489,402,000 of net operating loss carryforwards 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 \$264,121,000, expiring in varying amounts between 2000 and 2002.

At September 30, 1987, the Company had approximately \$13,925,000 in investment tax credits available to offset future payments of federal income taxes. The investment tax credits expire in varying amounts between 1993 and 2001. The Company had approximately \$21,652,000 of foreign tax credits available to offset future payments of federal income taxes at September 30, 1987. If not used, the foreign tax credits expire in varying amounts between 1989 and 1992. These tax credit carryforwards have not been recognized for financial reporting purposes.

The Company accrues United States income taxes on foreign earnings expected to be repatriated. If such earnings are not repatriated as planned, the taxes previously accrued are credited against the provision for United States income taxes on foreign earnings. Repatriation of all accumulated foreign earnings at September 30, 1987, would have resulted in a tax liability of approximately \$29,499,000. In conjunction with the reversal of deferred tax credits in fiscal 1986 and considering the existence of U.S. net operating loss carryforwards, the Company reversed all previously accrued United States income taxes on unrepatriated foreign earnings.

The Tax Reform Act of 1986 has no impact on the Company's deferred income taxes in the near future as all existing U.S. deferred income taxes associated with timing differences were reversed due to the existence of U.S. net operating loss carryforwards. In addition, the amount of investment tax credit carryforwards as reduced by the Tax Reform Act of 1986 is reflected in the amounts disclosed herein.

10. Industry Segment and Geographic Information:

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

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

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

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

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

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

Summarized financial information concerning the industry segments and geographic areas in which the Company operated at September 30, 1987, 1986, and 1985 and for each of the years then ended is shown in the following tables:

	Drilling	Completion, Remedial and Production	Total Petroleum	Mining Industry	Other Industries	Eliminations	Total
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(In thousands of dollars)

Operations by Industry Segment:

1987

Revenues from unaffiliated customers:							
Sales	\$ 406,700	\$ 508,021	\$ 914,721	\$345,533	\$171,884		\$1,432,138
Services and rentals	152,734	314,897	467,631	18,648	5,181		491,460
Intersegment sales	2,365	2,452	4,817	12,721	39	\$(17,577)	
Total revenues	\$ 561,799	\$ 825,370	\$1,387,169	\$376,902	\$177,104	\$(17,577)	\$1,923,598
Operating income (loss)	\$ (40,903)	\$ (36,019)	\$ (76,922)	\$ (2,070)	\$ 5,686	\$ 2,930	\$ (70,376)
Identifiable assets	\$ 857,143	\$ 814,656	\$1,671,799	\$306,042	\$170,917	\$(18,270)	\$2,130,488
Capital expenditures	\$ 14,567	\$ 15,581	\$ 30,148	\$ 11,710	\$ 3,440		\$ 45,298
Depreciation and amortization	\$ 55,928	\$ 63,080	\$ 119,008	\$ 10,430	\$ 5,050		\$ 134,488

1986

Revenues from unaffiliated customers:							
Sales	\$ 549,067	\$ 716,198	\$1,265,265	\$322,313	\$176,507		\$1,764,085
Services and rentals	166,405	343,557	509,962	11,216	27,415		548,593
Intersegment sales	7,519	2,226	9,745	64	1,018	\$(10,827)	
Total revenues	\$ 722,991	\$1,061,981	\$1,784,972	\$333,593	\$204,940	\$(10,827)	\$2,312,678
Operating loss	\$ (486,438)	\$ (437,261)	\$ (923,699)	\$ (18,296)	\$ (8,729)	\$ (1,335)	\$ (952,059)
Identifiable assets	\$ 921,113	\$ 950,014	\$1,871,127	\$341,167	\$122,000	\$(3,642)	\$2,330,652
Capital expenditures	\$ 41,292	\$ 36,501	\$ 77,793	\$ 8,500	\$ 4,348		\$ 90,641
Depreciation and amortization	\$ 80,038	\$ 94,131	\$ 174,169	\$ 10,584	\$ 4,617		\$ 189,370

1985

Revenues from unaffiliated customers:							
Sales	\$ 946,846	\$ 984,027	\$1,930,873	\$306,554	\$168,399		\$2,405,826
Services and rentals	228,147	497,827	725,974	10,441	23,003		759,418
Intersegment sales	4,358	1,439	5,797		642	\$(6,439)	
Total revenues	\$1,179,351	\$1,483,293	\$2,662,644	\$316,995	\$192,044	\$(6,439)	\$3,165,244
Operating income	\$ 101,969	\$ 166,356	\$ 268,325	\$ 11,881	\$ 18,614	\$ (181)	\$ 298,639
Identifiable assets	\$1,635,721	\$1,488,221	\$3,123,942	\$333,278	\$134,049	\$(3,888)	\$3,587,381
Capital expenditures	\$ 73,402	\$ 78,719	\$ 152,121	\$ 20,798	\$ 4,590		\$ 177,509
Depreciation and amortization	\$ 100,263	\$ 126,446	\$ 226,709	\$ 10,926	\$ 5,764		\$ 243,399

Notes to Consolidated Financial Statements (Continued)

	Western Hemisphere		Eastern Hemisphere		Eliminations	Total
	United States	Other	Europe	Other		
(In thousands of dollars)						
Operations by Geographic Area:						
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	\$1,106,711	\$334,801	\$325,741	\$269,875	\$(113,530)	\$1,923,598
Operating income (loss)	\$ (77,861)	\$ 7,174	\$ (3,574)	\$ 955	\$ 2,930	\$ (70,376)
Identifiable assets	\$1,248,262	\$465,050	\$326,063	\$222,801	\$(131,688)	\$2,130,488
Export sales of U.S. companies		\$ 49,500	\$ 25,159	\$110,016		\$ 184,675
1986						
Revenues from unaffiliated customers:						
Sales	\$ 985,762	\$278,752	\$316,776	\$182,795		\$1,764,085
Services and rentals	328,034	64,990	68,515	87,054		548,593
Transfer between geographic areas	131,948	6,662	11,215	17,175	\$(167,000)	
Total revenues	\$1,445,744	\$350,404	\$396,506	\$287,024	\$(167,000)	\$2,312,678
Operating loss	\$ (848,174)	\$ (22,797)	\$ (38,275)	\$ (41,478)	\$ (1,335)	\$ (952,059)
Identifiable assets	\$1,383,611	\$479,677	\$330,035	\$224,864	\$(87,535)	\$2,330,652
Export sales of U.S. companies		\$ 76,635	\$ 23,443	\$135,688		\$ 235,766
1985						
Revenues from unaffiliated customers:						
Sales	\$1,501,595	\$354,216	\$302,804	\$247,211		\$2,405,826
Services and rentals	486,471	88,171	71,048	113,728		759,418
Transfer between geographic areas	178,307	15,643	28,198	28,411	\$(250,559)	
Total revenues	\$2,166,373	\$458,030	\$402,050	\$389,350	\$(250,559)	\$3,165,244
Operating income	\$ 95,586	\$ 94,561	\$ 61,094	\$ 47,579	\$ (181)	\$ 298,639
Identifiable assets	\$2,369,925	\$561,082	\$417,001	\$358,022	\$(118,649)	\$3,587,381
Export sales of U.S. companies		\$ 94,369	\$ 38,506	\$243,303		\$ 376,178

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 in 1987 and 1986) but before deduction of general corporate expenses, loss in Vetco Gray Inc., and net interest expense of \$205,243,000, \$154,556,000 and \$157,188,000 in 1987, 1986 and 1985, respectively and excluding extraordinary items in 1986. Identifiable assets are those assets that are used by the Company's operations in each industry segment or are identified with the Company's operations in each geographic area. Corporate assets consist principally of cash, receivables, prepaid expenses, leasehold improvements, office furniture, assets held for disposal, and intangible assets and amounted to \$58,144,000, \$180,402,000 and \$177,888,000 at September 30, 1987, 1986 and 1985, respectively.

11. Employee Benefit Plans:

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The Company and its subsidiaries have several noncontributory, pay and non-pay related 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.

Effective October 1, 1986, the Company adopted Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions for its domestic defined benefit plans. Accordingly, the method of determining pension cost in 1987 is not comparable with prior years. The effect of this change was to decrease pension cost in 1987 by \$2,066,000. Pension expense for these plans was \$3,429,000, \$14,881,000 and \$10,635,000 for 1987, 1986 and 1985, respectively. The 1986 pension expense includes \$4,772,000 relating to an early retirement option offered to eligible employees over 55 years of age who were participants in the terminated plans. Generally, the Company makes annual contributions to the plans to the extent they are tax deductible in that year and, at a minimum, the amount necessary to meet ERISA's minimum funding requirements.

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

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

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

Assumptions used in determining the 1987 net pension expense were:

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

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 The following table sets forth the plans' funded status and amounts recognized in the Company's balance sheet at September 30, 1987.

	Overfunded Plans	Underfunded Plans
	(In thousands of dollars)	
Actuarial present value of benefit obligations:		
Vested benefit obligation	\$10,652	\$ 11,780
Accumulated benefit obligation	<u>\$11,323</u>	<u>\$ 15,480</u>
Projected benefit obligation	\$12,783	\$ 32,386
Plan assets at fair value	19,283	11,798
Projected benefit obligation (in excess of) less than plan assets	6,500	(20,588)
Unrecognized prior service cost		164
Unrecognized net (gain)	(3,178)	(436)
Unrecognized net (asset) liability at transition	(3,168)	2,188
Prepaid pension cost (pension liability) recognized in the balance sheet	<u>\$ 154</u>	<u>\$(18,672)</u>

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

The following information for the Company's domestic defined benefit plans, as reported in 1986 in accordance with APB Opinion No. 8, was determined from the most recent actuarial valuation data available. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was between 7% and 8%.

	1986
Actuarial present value of accumulated plan benefits:	
Vested	\$167,616
Non-vested	12,127
Total	<u>\$179,743</u>
Net assets available for benefits	<u>\$263,671</u>

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

The Company's Thrift Plan allows eligible employees to elect to contribute from 2% to 10% of their salaries to an investment trust. Employee contributions are matched by the Company at the rate of \$.50 per \$1.00 up to 4% of the employee's salary. In addition, beginning on January 1, 1987, the Company began contributing for all eligible employees between 2% and 5% of their salary depending on the employee's age as of January 1 each year. Company contributions become fully vested to the employee at the close of the second plan year after the year in which contributions are made. In addition, the Company provides defined contribution Savings Plans for certain U.S. employees. Participating employees contribute 2% or 4% of their basic compensation. The Company contributes either 50% or 75% of the first 2% to 4% of basic employee contributions depending on the specific plan and employee contributions. Supplemental employee contributions are allowed. The Company's contributions to the Thrift Plan and the Savings Plans amounted to \$8,853,000, \$5,597,000 and \$5,453,000 in 1987, 1986 and 1985, 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 1987, 1986 and 1985 totalled \$5,838,000, \$3,418,000 and \$4,193,000, respectively.

12. Other Matters:

Information as to maintenance and repairs, operating leases, research and development, and other tax expenditures is summarized as follows:

Years Ended September 30,	1987	1986	1985
	(In thousands of dollars)		
Maintenance and repairs	\$56,008	\$70,230	\$94,350
Operating leases (generally transportation equipment and warehouse facilities)	57,160	73,450	81,130
Research and development	29,572	38,337	51,333
Taxes other than payroll and income tax	29,629	37,620	40,065

At September 30, 1987, 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, 1992 were \$45,205,000, \$37,959,000, \$29,049,000, \$17,356,000 and \$12,158,000, respectively, and \$69,690,000 in the aggregate thereafter. The Company has not entered into any significant capital leases.

13. Litigation:

In prior years the Company brought patent infringement lawsuits against Smith International, Inc. ("Smith") and Dresser Industries, Inc. ("Dresser").

As a result of the suit against Smith, the Company was awarded \$205 million in damages and interest. Both the Company and Smith appealed the judgment and currently there are cross-appeals pending in the Court of Appeals for the Federal Circuit (the "Cross-Appeals"). Subsequent to the entry of the judgment against it, Smith filed a petition for reorganization under Chapter 11 of the Bankruptcy Code, which is pending in the U.S. Bankruptcy Court for the Central District of California (the "Bankruptcy Court").

On July 21, 1987, Smith filed a plan of reorganization incorporating the terms of an agreement it had reached with the Company compromising the judgment (the "Plan"). Under this agreement, the Company is to receive by December 31, 1987, under a Smith plan of reorganization, a total payment of \$95 million, of which \$85 million will be in cash and \$10 million in short-term notes. In addition, interest at the rate of 10% per annum will be paid on the entire amount from July 1, 1987, until payment of the \$85 million in cash to the Company. It is expected that this interest payment will be approximately \$5 million. After that time, the short-term notes will bear interest at the prime rate of The Chase Manhattan Bank plus 1 1/2 percent per annum. In anticipation of consummation of the Plan by December 31, 1987, the parties have moved to stay the Cross-Appeals until January 5, 1988.

On November 12, 1987, the Bankruptcy Court confirmed Smith's Plan and overruled the one objection to the Plan that had been filed. The objection was brought by the holders of certain contingent, unliquidated claims relating to a suit by the Environmental Protection Agency (the "EPA Claimants"). The order confirming the Plan is subject to possible appeal by the EPA Claimants. The settlement will be recognized in the consolidated financial statements upon receipt of payment from Smith.

As a result of the lawsuit against Dresser, the Company has been awarded a \$121,500,000 judgment. The United States Court of Appeals for the Federal Circuit has upheld the validity of the Company's patent and the infringement by Dresser, but has remanded the case to the Federal District Court for a redetermination of damages. Because of the uncertainty surrounding this award, no recognition has been given to it in the accompanying consolidated financial statements.

**14. Quarterly Data
(Unaudited):**

Summarized quarterly financial data for the years ended September 30, 1987 and 1986 are shown in the table below:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Fiscal Year Total
(In thousands of dollars, except per share amounts)					
Fiscal Year 1987: *					
Revenues	\$462,792	\$455,165	\$468,350	\$537,291	\$1,923,598
Gross profit**	21,217	33,087	28,370	47,473	130,147
Loss before income tax	(12,857)	(167,618)	(40,429)	(48,018)	(268,922)
Net loss	(7,701)	(163,923)	(41,241)	(41,957)	(254,822)
Net loss per share	(.07)	(1.42)	(.36)	(.38)	(2.22)
Dividends per share of common stock	.09	.07	.115	.115	.39
Fiscal Year 1986: *					
Revenues	\$689,738	\$621,448	\$507,276	\$494,216	\$2,312,678
Gross profit**	76,444	36,146	13,351	28,200	154,141
Loss before extraordinary items	(3,971)	(785,699)	(58,109)	(45,426)	(893,205)
Extraordinary Items:					
Gain on pension reversion		85,000	5,000	6,923	96,923
Loss on early extinguishment of debt				(8,315)	(8,315)
Net loss	(3,971)	(700,699)	(53,109)	(46,818)	(804,597)
Earnings per share amounts:					
Loss before extraordinary items	(.03)	(6.84)	(.51)	(.39)	(7.77)
Extraordinary items		.74	.05	(.02)	.77
Net loss	(.03)	(6.10)	(.46)	(.41)	(7.00)
Dividends per share of common stock	.20	.20	.15	.09	.64

*See Notes 1, 4, 5, and 11 for information regarding combination and divestiture costs, unusual charges and extraordinary items.
**Represents revenues less cost of sales, services and rentals and marketing and field service expense.

Stock Prices by Quarter

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

Fiscal years 1986-1987	Quarter Ending	Baker International Corporation Common Stock	
		High	Low
Pre-Combination 1986	12-31-85	\$18.13	\$14.13
	3-31-86	17.88	12.50
	6-30-86	15.38	12.63
	9-30-86	13.13	8.88
1987	12-31-86	\$12.13	\$ 9.88
	3-31-87	18.25	12.13
	Through 4-03-87	18.63	17.38
		Baker Hughes Incorporated Common Stock	
	Quarter Ending	High	Low
Post-Combination 1987	6-30-87	\$23.38	\$16.13
	9-30-87	27.38	22.50

Approximate number of Stockholders at November 30, 1987: 25,700

Auditors' Opinion

**To the Stockholders of
Baker Hughes Incorporated:**

.....
We have examined the consolidated statements of financial position of Baker Hughes Incorporated and its subsidiaries as of September 30, 1987 and 1986, and the related consolidated statements of operations, stockholders' equity, and changes in financial position for each of the three years in the period ended September 30, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such consolidated financial statements present fairly the financial position of Baker Hughes Incorporated and its subsidiaries at September 30, 1987 and 1986, and the results of their operations and the changes in their financial position for each of the three years in the period ended September 30, 1987, in conformity with generally accepted accounting principles consistently applied during the period, after restatement for the change, with which we concur, in the consolidation policy described in Note 2 to the consolidated financial statements, except for the change, with which we concur, in 1987 in the method of accounting for pension costs as described in Note 11 to the consolidated financial statements.

Deloitte Haskins & Sells

Houston, Texas
November 18, 1987

Fiscal 1987 Compared to Fiscal 1986

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

Cost of sales, services and rentals decreased 16.4% to \$1.4 billion from the 1986 level of \$1.7 billion. The decrease was at a rate comparable to the decrease in revenues due to cost containment programs. In the 1987 fourth fiscal quarter cost of sales, services and rentals increased 9.0% from the third fiscal quarter on the 14.7% fourth fiscal quarter revenue increase discussed above. This cost increase is at a rate substantially less than the increase in revenues and is attributable to an improvement in the prices of the Company's products and services and continuing cost containment programs.

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

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

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

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

In October 1987, the Company, Combustion Engineering, Inc. ("C-E") and FMC Corporation ("FMC") signed a letter of intent to combine certain businesses of FMC with V-G. Pursuant to this combination, FMC will become a minority stockholder with the option to ultimately acquire majority ownership of V-G at no further cost. The Company will not have control over the financial and operating activities of the combined Company. Completion of the transaction is subject to government approval and the negotiation and approval of definitive agreements by the boards of directors of FMC, C-E and the Company (see Note 3 of Notes to Consolidated Financial Statements).

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

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

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

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

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

Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

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

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

On June 5, 1987, the Company reached an agreement with Smith International, Inc. regarding the settlement of the patent infringement suit outstanding between the companies, whereby the Company will receive \$95 million plus interest at 10% per annum from July 1, 1987, until payment is received (see Note 13 of Notes to Consolidated Financial Statements).

Fiscal 1986 Compared to Fiscal 1985

Results of Operations: Revenues in fiscal 1986 were \$2.3 billion, a decrease of 26.9% from fiscal 1985. During fiscal 1986, the Company's worldwide oilfield markets were adversely affected by a decline in drilling activity, excess manufacturing capacity, instability in the price of crude oil and price pressure on products and services. The decrease in oilfield revenues was partially off-set by an increase in non-U.S. mining revenues. Foreign revenues for the Company's combined oilfield and mining markets accounted for 53.4% of revenues in 1986, compared to 49.1% in 1985.

Cost of sales, services and rentals decreased 18.9% from the 1985 level of \$2.1 billion. The decrease was at a rate less than the decrease in revenues due to continuing price pressure on products and services, partially off-set by cost containment programs.

Marketing and field service expense and general and administrative expense declined significantly due to cost containment programs and the consolidation and restructuring of the oilfield divisions. Marketing and field service expense decreased 11.4% to \$492.6 million from \$556.1 million in 1985. General and administrative expense includes net foreign exchange gains and losses resulting from the translation of foreign currencies. The Company incurred net foreign exchange losses of \$1.5 million and \$9.8 million in fiscal years 1986 and 1985, respectively. General and administrative expense was \$234.1 million in 1986, a decrease of 20.3% from the 1985 level of \$293.8 million.

In the second fiscal quarter of 1986, the Company provided an unusual charge of \$919.2 million (\$744.9 million, or \$6.48 per share after income taxes and minority interest) which resulted from the Company's review of its asset and work force levels in view of continuing depressed worldwide oil and gas markets. This examination resulted in a write-down of assets to net realizable value or to the estimated net present value of future cash flows from operations. In addition, reserves were established for severance and early retirement payments. These actions brought the Company's balance sheet in line with current and anticipated industry outlooks (see Note 4 of Notes to Consolidated Financial Statements). The tax benefit from the unusual charge was limited, as a substantial portion of the unusual charge was incurred in the U.S. where tax benefits available to the Company were limited by net operating loss carryforwards.

Net interest expense decreased 19.8% in fiscal year 1986 to \$95.8 million compared to \$119.5 million in fiscal year 1985. The decrease was primarily due to a decline in average debt outstanding and a decrease in interest rate levels on the Company's floating rate debt.

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In fiscal 1986, the Company recorded an extraordinary gain of \$96.9 million or \$.84 per share, in connection with the termination of two of its major pension plans. The Company recorded an extraordinary loss of \$8.3 million, or \$.07 per share, due to a premium paid on the early retirement of debt (see "Capital Generation and Liquidity" below and Notes 5 and 11 of Notes to Consolidated Financial Statements).

The income (loss) on an operational basis (before unusual charges, income taxes, minority interest, loss in V-G and extraordinary items) was \$(175.7 million) in fiscal 1986 and \$141.5 million in fiscal 1985.

Capital Generation and Liquidity: Total debt outstanding as of September 30, 1986, was \$729.9 million, a decrease of \$47.8 million from September 30, 1985. During fiscal 1986, the Company was able to restructure a portion of its debt by issuing \$102.0 million of ten year bonds with a 7.82% effective interest rate. The proceeds of such issuance were used to retire several other debt issues, including \$60.0 million of 10.20% Notes due in 1990 and \$30.4 million of Zero Coupons due in 1992.

In September 1986, the Company received \$96.9 million of cash from the pension reversion (see "Results of Operations" above and Note 11 of Notes to Consolidated Financial Statements). These funds were used to retire a portion of the Company's floating rate indebtedness and for general corporate purposes.

In fiscal 1986, capital expenditures were \$90.6 million compared to \$177.5 million in fiscal year 1985. The ratio of capital expenditures to depreciation decreased to 49.4% in fiscal 1986 as compared to 74.8% in fiscal 1985. The Company has spent less than the level of depreciation primarily due to overcapacity and because a significant portion of its capacity is relatively new.

Working capital at September 30, 1986, was \$634.8 million, a decrease of \$567.6 million from fiscal year 1985. The current ratio of 1.97 at September 30, 1986, indicates an acceptable level of liquidity.

Condensed Comparative Consolidated Financial Information *

	1987	1986	1985	1984	1983
	(In thousands of dollars except per share amounts)				
Summary of operations:					
Total revenues	\$1,923,598	\$2,312,678	\$3,165,244	\$3,049,439	\$2,994,928
Cost and expenses:					
Cost and expenses applicable to revenues	1,793,451	2,158,537	2,610,503	2,515,109	2,567,693
General and administrative	197,147	234,131	293,833	270,922	324,834
Loss in Vetco Gray Inc.	68,223	11,670			
Unusual charges		919,198		198,300	246,937
Combination and divestiture costs	140,000				
Pension reversion gain	(76,765)				
Interest expense—net	77,161	95,757	119,457	166,657	146,703
Total costs and expenses	2,199,217	3,419,293	3,023,793	3,150,988	3,286,167
Income (loss) before income taxes, minority interest and extraordinary items	(275,619)	(1,106,615)	141,451	(101,549)	(291,239)
Income taxes	(14,100)	(144,494)	52,304	(38,335)	(136,848)
Income (loss) before minority interest and extraordinary items	(261,519)	(962,121)	89,147	(63,214)	(154,391)
Minority interest	6,697	68,916	2,683		
Income (loss) before extraordinary items	(254,822)	(893,205)	91,830	(63,214)	(154,391)
Extraordinary items—net		88,608			
Net income (loss)	\$ (254,822)	\$ (804,597)	\$ 91,830	\$ (63,214)	\$ (154,391)
Net income (loss) per share	\$ (2.22)	\$ (7.00)	\$.80	\$ (.55)	\$ (1.35)
Dividends per share of common stock	\$.39	\$.64	\$.80	\$.88	\$.97
Financial position:					
Cash and short-term investments	\$ 11,361	\$ 43,863	\$ 35,196	\$ 71,716	\$ 66,739
Working capital	\$ 500,755	\$ 634,818	\$1,202,391	\$1,211,090	\$1,410,085
Total Assets	\$2,188,632	\$2,511,054	\$3,765,269	\$3,869,554	\$4,257,832
Long-term debt	\$ 460,767	\$ 638,557	\$ 669,008	\$ 791,239	\$1,004,182
Stockholders' equity	\$ 915,520	\$1,072,149	\$1,947,822	\$1,975,074	\$2,169,436

Corporate Organization

Baker Hughes Drilling Equipment

Howard I. Bull, *President*

Divisions

Hughes Tool Company
Houston, Texas

Dale E. Boyer, *President*

Milpark Drilling Fluids
Houston, Texas

Thomas W. Cason, *President*

Tri-State Oil Tools
Bossier City, Louisiana

Charles G. Phillips, *President*

Exlog/TOTCO

*Houston, Texas

John F. Lauletta, *President*

Baker Hughes Tubular
Services

Houston, Texas

David L. Daniel, *President*

*Scheduled for Spring, 1988.

Baker Hughes Production Tools

Joel V. Staff, *President*

Divisions

Baker Oil Tools

Houston, Texas

Gerald M. Hage, *President*

Baker Service Tools

Houston, Texas

A. W. Preusch, *President*

Baker Sand Control

Houston, Texas

A. G. Avant, *President*

Baker Performance Chemicals

Houston, Texas

M. Glen Bassett, *President*

Baker CAC

*Houston, Texas

Joseph F. Brady, *President*

Centrilift

Claremore, Oklahoma

J. L. Cox, *President*

Hughes Services International

Houston, Texas

Andrew J. Szescila, *President*

Develco

San Jose, California

L. H. Rorden, *President*

B-J Titan

Houston, Texas

J. Wm. Stewart, *President*

Baker Hughes Mining Equipment

John F. Schaefer, *President*

Divisions

BGA International

Salt Lake City, Utah

Stephen T. Harcrow, *President*

Ramsey Technology, Inc.

St. Paul, Minnesota

Donald L. Babbitt, *President*

Chas. S. Lewis

St. Louis, Missouri

William M. Stuart, *President*

EIMCO Process Equipment

Salt Lake City, Utah

Raymond H. Aldrich, *President*

WEMCO

Sacramento, California

James E. Furman, *President*

Baker Hughes Mining Tools

Grand Prairie, Texas

William S. Price, *President*

EIMCO Mining Equipment
Group

EIMCO Coal Machinery

Division

Fairmont, West Virginia

Larry G. Marteney, *President*

EIMCO Great Britain

Gateshead, England

Allan M. McKay, *Managing*

Director

EIMCO Jarvis Clark

Burlington, Ontario

Christopher J. Keogh,

President

EIMCO Secoma

Lyon, France

Gerard Bruere-Dawson,

President

Baker Mine Services

Meadowlands, Pennsylvania

Christopher E. Yunkun,

President

Corporate Organization

Officers

E. H. Clark, Jr.
Chairman of the Board

James D. Woods
President and Chief Executive Officer

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

Max L. Lukens
Senior Vice President and Chief Financial Officer

John F. Schaefer
Senior Vice President and President of Baker Hughes Mining Equipment

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

Isaac C. Kerridge, Jr.
Vice President

Phillip A. Rice
Vice President, Human Resources

Ronald G. Turner
Vice President

Eric L. Mattson
Treasurer

G. S. Finley
Controller

Board of Directors

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

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

E. H. Clark, Jr.
Chairman of the Board of Baker Hughes Incorporated

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

Don D. Jordan
President and Chief Executive Officer of Houston Industries Incorporated (Diversified Energy)

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

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

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

Ben F. Love
Chairman of the Board and Chief Executive Officer of Texas Commerce Bancshares, Inc. (Banking)

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)

Morton M. Winston
Winston & Associates (Business Development Consultants)

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

*New nominee to be presented to Annual Meeting of Stockholders, January 27, 1988

Corporate Information

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

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

Corporate Counsel:
Latham & Watkins
Los Angeles, California

Independent Accountants:
Deloitte Haskins & Sells
Houston, Texas

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

Annual Meeting:
The Company's Annual Meeting
of Stockholders will be held at
2 p.m. on January 27, 1988, at the
Westin Oaks Hotel
5060 Westheimer
Houston, Texas

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

Corporate Offices Mailing
Address:
P.O. Box 4740
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