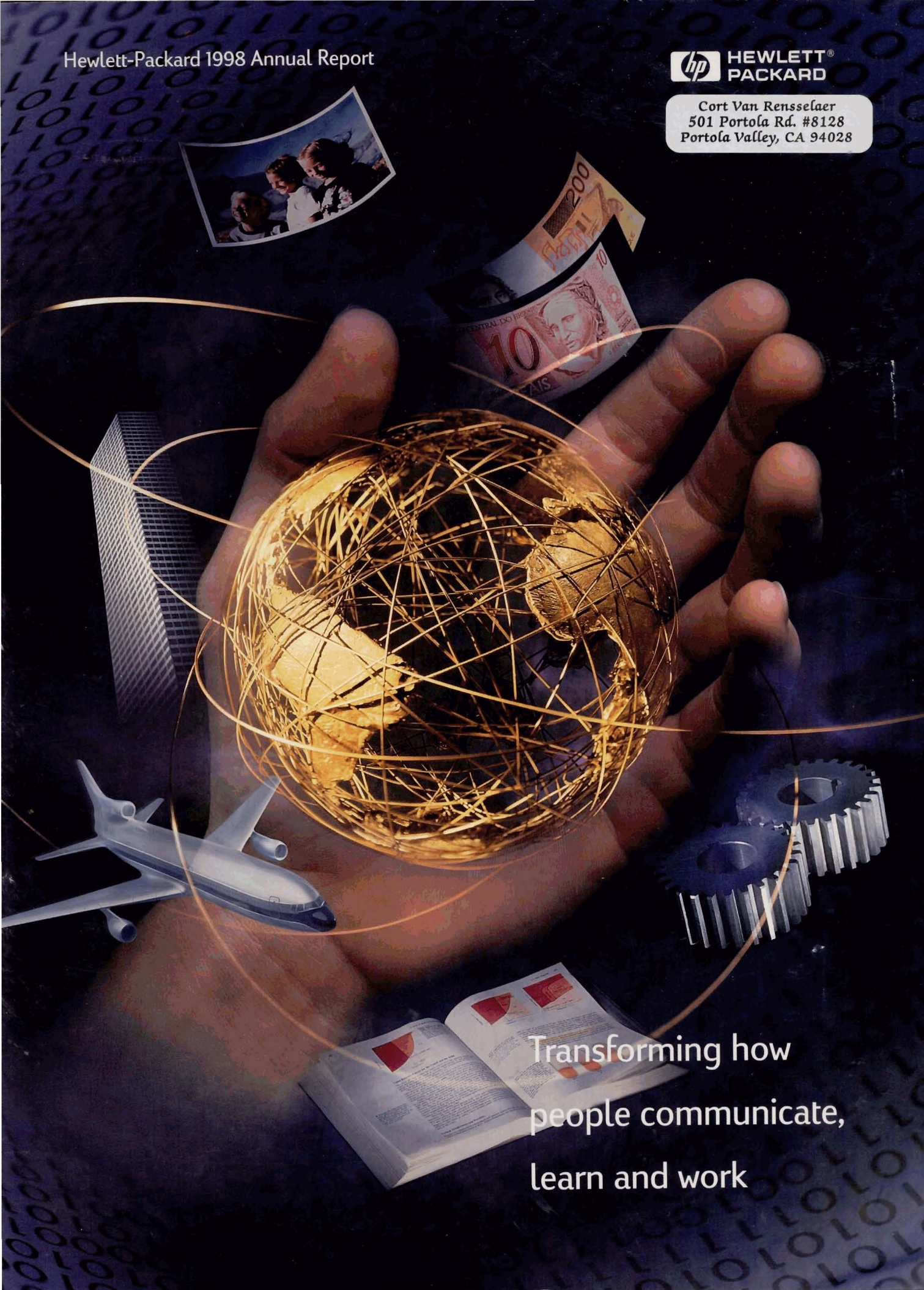
Hewlett-Packard 1998 Annual Report

HEWLETT® PACKARD



Transforming how people communicate, learn and work

Corporate Profile

Hewlett-Packard Company designs, manufactures and services products and systems for measurement, computation and communications. Our basic business purpose is to create information products that accelerate the advancement of knowledge and improve the effectiveness of people and organizations. The company's products and services are used in industry, business, engineering, science, medicine and education in more than 130 countries.

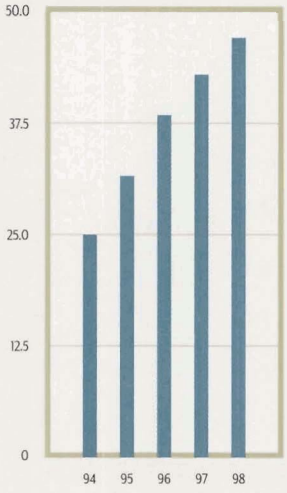
Contents

Financial Highlights

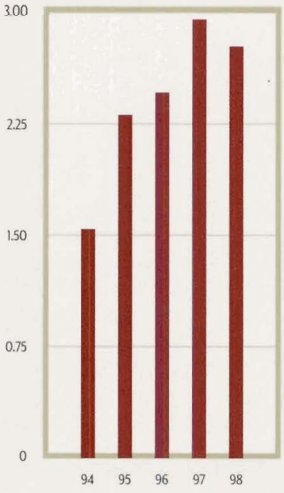
Unaudited
For the years ended October 31
In millions except per share amounts and employees

	1998	1997	Increase (Decrease)
Total orders	**$ 46,504**	$ 43,153	8%
Net revenue	**$ 47,061**	$ 42,895	10%
Earnings from operations	**$ 3,841**	$ 4,339	(11%)
Net earnings	**$ 2,945**	$ 3,119	(6%)
Net earnings per share-Diluted	**$ 2.77**	$ 2.95	(6%)
Return on assets	**8.7%**	9.8%	
Return on average equity	**17.4%**	21.1%	
At year-end:			
Shares outstanding	**1,015**	1,041	
Employees	**124,600**	121,900	

Net Revenue
In billions



Net Earnings Per Share · Diluted
In dollars



Return on Assets and Return on Average Shareholders' Equity
Percent

To Our Shareholders

We did many things well at Hewlett-Packard this year. At year's end, we were a faster, more competitive company, with an improved product and services offering, greater ability to deliver solutions and a more focused organizational structure.

However, we're clearly disappointed that earnings declined in 1998. Many factors contributed to this outcome. Among them were unacceptably high expense growth and competitive pricing pressures in PCs in the first half, and a weak macroeconomic environment in the second half.

Despite this result, we had many strategic successes this year and made real progress in some important aspects of financial performance. This year's report describes how these successes are making HP more competitive and focused. In this letter, I'll review our performance and discuss a few of our accomplishments.

The Year's Results > In the first half of the year, revenue growth was strong, but expense growth that exceeded revenue growth hurt earnings. We slowed expense growth dramatically in the second half, when revenue growth also slowed.

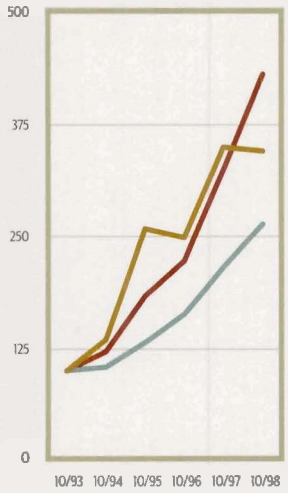
For the year, net earnings and earnings per share (EPS) both declined 6 percent compared with 1997 and were $2.9 billion and $2.77, respectively. We took charges during the year, primarily for voluntary-severance programs and manufacturing consolidations, which were among the many actions we took to improve our cost and expense structures. These charges totaled approximately $260 million and reduced EPS by about 16 cents.

Revenue grew 10 percent to $47.1 billion, with revenue from the United States up 13 percent and revenue from outside the U.S. increasing 7 percent. Europe achieved solid revenue growth, but economic turmoil in Asia Pacific resulted in a substantial revenue decline in that region.

In last year's annual report, I noted the uncertainties that were developing in Asia in the second half of 1997. Those uncertainties turned into a severe downturn this year that affected HP significantly, in part because our market presence and revenue had grown so strongly in the region over the last 10 years. The situation in Asia, which was intertwined with this year's slowdown in the semiconductor industry, affected growth across the company, with its biggest impact in our test-and-measurement business.

Cost of sales for the full year was 68.1 percent of revenue, an increase of 2.1 percentage points from a year ago. The mix effect from revenue weakness in test and measurement, whose cost of sales is well below the corporate average, put upward pressure on these costs. This year's difficult but necessary voluntary-severance programs will help cost of sales in 1999, since most of the 2,700 people who chose to leave the company are in the cost-of-sales category.

Comparison of Five-Year Cumulative Total Return*
Dollars



*$100 invested on 10/31/93 in stock or index – including reinvestment of dividends. Fiscal year ending October 31.

We did a superb job on operating expenses in the second half after a poor first half. These expenses rose 9 percent for the year — 17 percent in the first half but just 2 percent in the second half. I'm very proud of how quickly HP's people responded to the urgent need to slow spending. We took short-term steps on spending, such as a drastic cutback on travel, and addressed more structural expense issues with hiring controls and the increased use of outsourcing where it's appropriate and cost-effective. As a result, we began 1999 with a better expense structure, and we'll work hard to keep expense growth moderate.

We made excellent progress on asset management this year. As a percent of revenue, net property, plant and equipment reached an all-time low at the end of the year, due largely to aggressive control of capital spending as growth slowed. Our accounts-receivable-to-revenue ratio remained stable and at very acceptable levels, despite economic stresses in Asia Pacific.

We made great strides on inventory as well. Total inventory at the end of fiscal 1998 was nearly $600 million lower than at the end of 1997, and most of our major businesses reduced their inventory-to-sales ratios during the year. This progress was due to our ongoing work with contract manufacturers, channel partners and suppliers to improve the efficiency of our supply chains.

The outcome on inventory contributed to an excellent year for cash generation. Our cash position remained strong, with year-end cash and equivalents at more than $4 billion. This is especially noteworthy in light of our aggressive share buyback. For the full year, we repurchased approximately 43 million shares for $2.4 billion. We have substantial authorizations remaining for additional share repurchase, and our plan, as we start 1999, is to continue to be aggressive in buying back shares.

So, while our earnings fell short of our goals, we achieved a number of financial successes. In addition, despite slower revenue growth in the second half, our businesses made real strides in strengthening their competitiveness and market positions. I'd like to describe some of the ways we did this.

Business Review > Our computer activities accounted for 84 percent of our revenue in 1998, and many businesses achieved good results. Printers, software and services, high-end UNIX® systems and PCs had good growth and profitability.

Both our laser and inkjet businesses posted solid growth, achieved good profits and held or strengthened their market-share leadership in 1998. Late in the year, we introduced 20 new printing and imaging products across our LaserJet, DeskJet and ScanJet families — the largest hardcopy rollout in our

We see many opportunities for healthy growth from important trends in imaging that HP products and technologies are helping to shape.

history and an introduction that positions us very well for 1999. These products deliver on our digital workplace strategy, enabling the seamless exchange between paper and digital information. We also unveiled two inkjet printers that incorporate breakthrough technology we call the Modular Ink Delivery System.

Given our strong market position, our strategy in printing and imaging is to expand the overall market. We see many opportunities for healthy growth from important trends in imaging that HP products and technologies are helping to shape: the increasing use of color in the office, the convergence of printing and copying, and the movement of printing that has traditionally been done on offset presses to office printers. We're also working with partners to apply our inkjet technology to new categories that go beyond desktop printing.

Our software business achieved good growth and reasonable profits this year. HP OpenView, our platform for network and systems management, now has more than 120,000 installations and is a market leader. During the year we delivered exciting new HP OpenView capabilities in network and security management as well as for the Windows NT® market. Many of our other software businesses are relatively new and are targeted at Internet-related markets. They achieved good results this year.

Our customer-support business achieved growth that outpaced the market, as well as excellent profitability. Mission-critical support was an area of exceptional strength and rapid growth. In our services business, we realigned our consulting activities to provide greater global reach in fields of interest our customers care about.

It was a pretty good year in the UNIX server business. We strengthened our UNIX system offering at the high end, where robust, highly available systems are essential to customers' mission-critical applications. Our HP 9000 V-Class system won outstanding market acceptance during the year, with more than 1,500 systems ordered. We also bolstered the low end of our UNIX system family with products targeted at the growing market among Internet Service Providers (ISPs), and we are using the Internet as a primary sales medium for these systems.

Toward the end of the year, we brought together all the hardware, software and services we provide to large businesses into a new Enterprise Computing Solutions Organization. This move will help us deliver the integrated solutions that customers increasingly want from HP and our partners.

Our PC business solidified its top-tier status with unit-shipment growth of more than twice the market average this year. We had a much better second half than first half in PCs; growth and profits improved after a first half in which industry-wide oversupply in the reseller channel affected our results.

We are working hard to offer customers in all our businesses the speed, convenience and flexibility that electronic commerce offers.

We also made excellent progress in reducing our cost structures and refining our sales and distribution model in PCs. One result of this progress was a substantial reduction in PC inventory levels during the year.

Our HP Pavilion home PCs had an especially good year, with unit growth in excess of 100 percent and the No. 2 position in the U.S. retail channel at year end. We also continued to bring out innovative new products, such as the HP Jornada, a mobile PC that weighs less than three pounds, has 12-hour battery life and already has won recognition for its design and innovation.

PCs are a good example of how we have expanded the ways in which customers can do business with HP. Today, people can buy an HP Pavilion from a retailer; over the World Wide Web directly from HP; at a kiosk in more than 500 Circuit City stores in the U.S.; or over the Web via Internet resellers.

This is one example of our company-wide progress on electronic commerce in 1998; this year's annual report describes several others. We are working hard to offer customers in all our businesses the speed, convenience and flexibility that electronic commerce offers. Our goal is to match our sales and distribution systems to the buying preferences of different customers, and I'm pleased with our accomplishments in this area.

It was a challenging year overall in our measurement businesses, particularly in test and measurement, where the situation in Asia and the downturn in the semiconductor industry were key factors in a 4-percent revenue decline. Our components business also was affected by weakness in Asia, but strength in fiber-optic and optical electronics enabled the components business to achieve 8-percent revenue growth. Strength in the U.S. and Europe helped the medical business achieve an 11-percent revenue increase, while our chemical-analysis business's focus on pharmaceutical and biopharmaceutical markets was key to its 6-percent revenue growth.

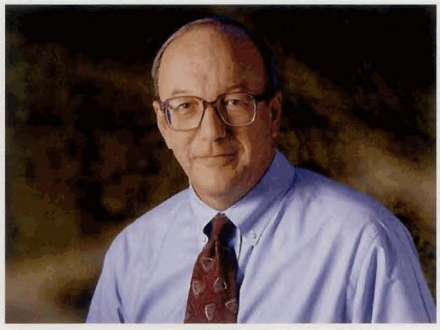
We believe our measurement businesses are fundamentally sound and have high potential for profitable growth. They are linked to major growth areas, such as the burgeoning communications and biopharmaceuticals markets. We've improved our cost structures, and we are in a very strong product cycle as we start 1999.

Looking Ahead > We begin 1999 with many strengths: an outstanding product and services portfolio, leaner expense structures and an excellent position in many promising markets. There are, however, some reasons for caution. Our caution stems largely from the macroeconomic environment, in which some forecasts are for slower growth in capital spending in a number of major economies in 1999.

There are also uncertainties surrounding the Year 2000 issue. HP's current products are ready for the new millenium, and we have our internal systems in good shape. But it's impossible to know how this issue will affect customers and key suppliers in the year ahead.

We have solid grounds for optimism as well. Our product and service offerings are stronger than they were a year ago, and we have ambitious new-product programs in place for 1999. We've made significant progress on incorporating the Internet and World Wide Web into how we work with customers and partners, and we will remain aggressive in building a powerful online presence. Our new Enterprise Computing Solutions Organization should make HP easier for enterprise customers to do business with, and should help us move more quickly to deliver comprehensive, yet focused, solutions. Finally, this year's progress on expenses has improved our ability to drive growth to the bottom line.

The title of this year's annual report expresses our belief that the information-technology industry, and technology users, are in the midst of fundamental change that is transforming every facet of our lives. This change is also transforming Hewlett-Packard in fundamental ways. The difficulties we faced in 1998 have taught us important lessons about the need for focus, better execution and improved responsiveness in the fast-moving markets in which we compete. We're determined to apply those lessons to the exciting opportunities we see across the company.



Lew Platt

Lew Platt

Chairman of the Board, President

and Chief Executive Officer

December 18, 1998

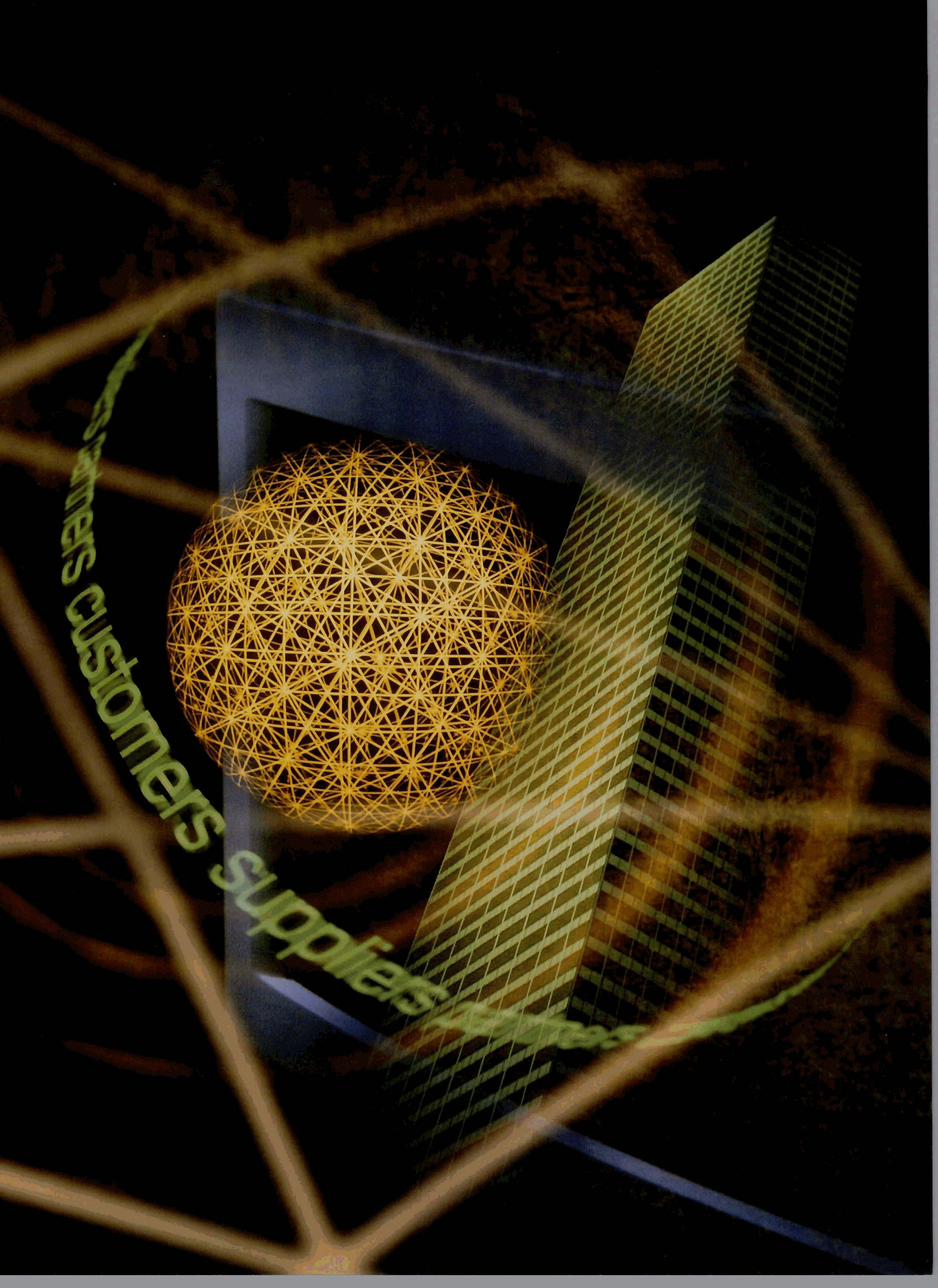
Since the early 1980s, Hewlett-Packard has worked to create a future in which computing and measurement are pervasive — that is, universally accessible and almost infinitely adaptable to users' needs.

Our early commitments to open systems and standards, our broad range of solutions that encompass products and services, and our diverse partnerships have helped fuel HP's growth and make this vision a reality.

Today, the Internet and World Wide Web are driving fundamental changes in how people communicate, learn and work. We believe that the explosive growth of the Internet and Web validates our vision and is speeding the arrival of pervasive computing and measurement.

During 1998, we helped customers, from large organizations to individuals, the power of digital technology, the Internet and the Web to work for them. We helped new businesses and industries that are springing up around the world. We helped organizations reshape what they do and how they do it. We helped people explore new ways to learn and to strengthen their ties with friends and family.

The essays that follow describe some of the ways HP helped organizations and people thrive in the emerging world of pervasive computing and measurement.


customers suppliers

A robust information infrastructure — systems, support and applications that are powerful, available, manageable and secure — is what customers expect from HP and our partners.

This infrastructure starts with powerful systems. This year we strengthened our high-end UNIX system offering with the HP 9000 V-Class 2250 Enterprise Server system, which won excellent market acceptance. We enhanced our midrange and low-end UNIX system product line with new HP 9000 K-Class, A-Class, D-Class and R-Class systems.

Our offering also includes HP NetServer systems, which are based on the Intel microprocessor architecture and support Windows NT, Novell NetWare and other industry-standard operating systems. The HP NetServer LH3 system set a new standard for midrange computing with its powerful Pentium® II processors, redundant component design and high-performance disk drives. Customers as diverse as the Los Angeles Fire Department and the Stock Exchange of Singapore are using HP NetServers as a vital part of their information infrastructures.

Complete solutions require robust storage, and this year we solidified our position as the industry-leading storage supplier among UNIX system vendors, according to the International Data Corporation, a leading research firm. Our stress-free storage initiative guarantees customers complete satisfaction with our broad range of online and off-line storage products.

High availability — that is, little or no unplanned downtime — is an essential requirement for many HP customers. This year we announced our "5nines:5minutes" initiative, an aggressive plan to maintain leadership in high availability. Our goal is to guarantee, in the year 2000, a maximum of five minutes unplanned

World Cup

On July 13, as France erupted in celebration of its team's World Cup victory, Philippe Verveer, chief information officer for the French Organizing Committee (CFO), made an announcement that sparked a celebration at HP. "Everything from HP performed flawlessly," Verveer said. "We depended on HP and other technology partners for our mission-critical applications, and we are delighted with the outcome." More than 2,000 HP PCs, 130 HP-UX[1] and NT-based servers, 1,000 networking components and 600 printers linked the CFO offices, 10 venues and the media center in Paris. HP worked with EDS, Sybase, Inc. and France Telecom to provide system hardware, networking, support, consulting and maintenance. The solution enabled printing of more than 2.5 million tickets, production of more than 130,000 accreditation badges and delivery of game information to more than 12,000 journalists and 20 million Internet surfers from 170 countries. We also provided medical and chemical-analysis equipment for the World Cup.

downtime per year, or 99.999 percent uptime, for UNIX system HP 9000 Enterprise Servers, as well as "end-to-end" for the network, database and storage devices.

We're working with Cisco Systems, Inc., a major networking supplier; EMC Corporation, a leader in system storage; and Oracle® Corporation, a leader in the database market, on end-to-end availability. We also became the first server vendor to offer a 99.9 percent uptime commitment for Intel-based servers running the Windows NT operating system.

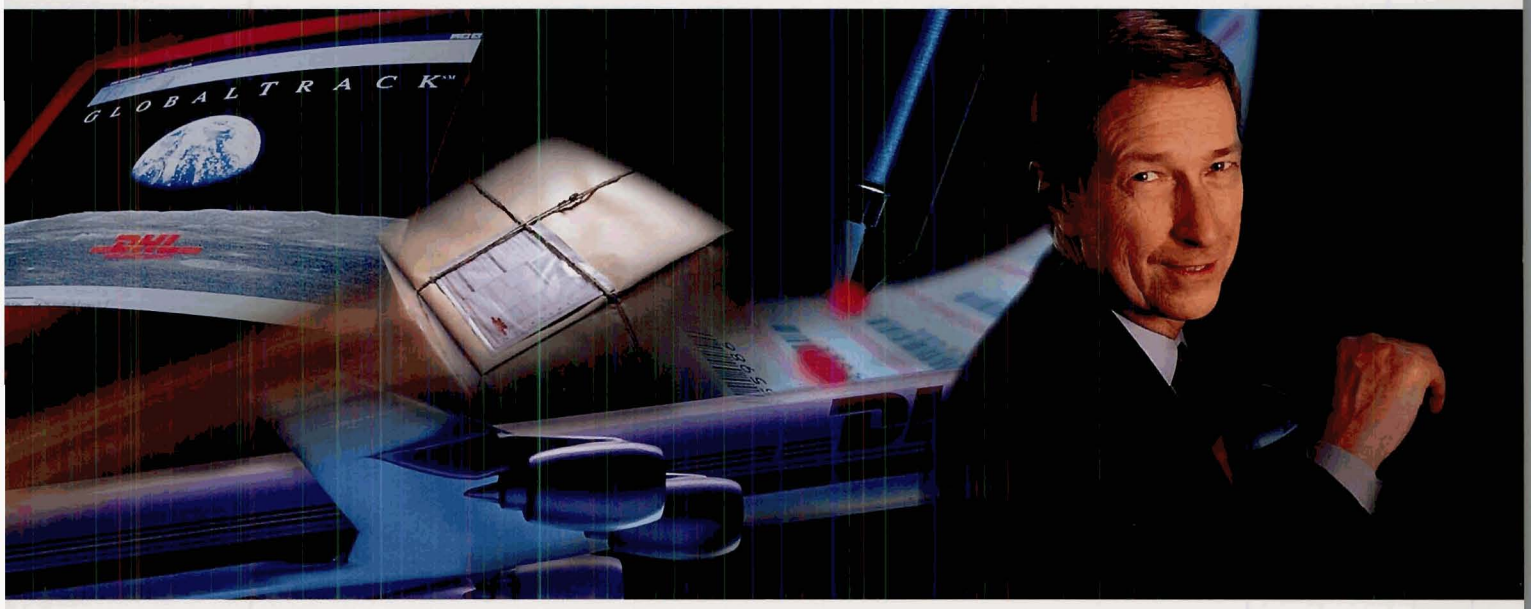
The ability to manage their infrastructures is also crucial to customers. This year, we brought out more than 40 new and enhanced HP OpenView IT management solutions. We created a dedicated sales organization for HP OpenView and worked with more than 200 partners to strengthen our offering.

Our HP Praesidium/Authorization Server is a security framework that enables organizations to collaborate electronically by identifying, authenticating and authorizing users. This year we launched the Praesidium

partner program, in which we work with independent software vendors, resellers, distributors and systems integrators to expand the market presence of our security products. In addition, our HP VerSecure encryption product received approval from the United States government for export to six countries.

The explosive growth of the Internet and World Wide Web is part of even broader growth in demand for data and voice communications capacity from businesses and individuals. In 1998, our test-and-measurement business made many contributions to the networking and service providers who are meeting the need for more bandwidth by building the next-generation, global communications infrastructure.

One example is HP Firehunter, which enables Internet Service Providers to deploy end-to-end, real-time management of their Web services with assured and verified quality. We also provided equipment for the testing and deployment of Dense Wavelength Division Multiplexing, a technology that increases the carrying capacity of existing fiber-optic networks by up to 16 times.



DHL

More than 635,000 destinations. Operations in 227 countries. More than 140 million shipments annually. As the world's largest international air-express company, DHL defines what it means to be a global company that has to be fast and efficient. HP systems, network management and support are at the heart of DHL's global network. HP 9000 Enterprise Servers run DHL's vast "Track and Trace" databases, which give customers current information on their shipments via the World Wide Web. HP OpenView performs crucial network-management functions, and we deliver around-the-clock technical support at key locations. "HP is always quick to respond to problems and challenges," says Len Hanlock, President of DHL Systems. "They've helped us streamline processes and reduce costs, and they keep an eye open for ways to help us improve our use of technology."

From payroll systems to marketing and customer contact, organizations are using digital technology and the Internet to streamline their current processes and deploy new ones.

During 1998, we delivered software solutions, services, printing, imaging and messaging capabilities that help organizations service their customers, respond to competition and expand their businesses in new ways.

We focused on our customers' internal administrative processes, supply chain and customer service, and made important strides in each.

We brought out HP Changengine 2.0 Admin Edition, the first software product based on our breakthrough Changengine technology. Admin Edition enables organizations to streamline processes such as travel requests or payroll. Because Changengine separates the business-process logic from the data and the application, organizations can change such processes without touching the application itself. We also introduced HP Changengine 3.0, a product suite that enables customers to automate, manage and integrate their business processes across internal organizational boundaries as well as beyond their enterprises.

The many processes that make up enterprise resource planning (ERP) were a key focus of our supply-chain efforts this year. Here, SAP's software infrastructure is the market leader. HP is the leading hardware platform for SAP systems, with more than 5,000 installations running on either HP-UX or NT-based systems. We also provide a rich set of services and support for SAP R/3. More customers have outsourced the management of their SAP/R3 installations to HP than to any other vendor.

Customer contact was another important focus this year. HP SmartContact software is a customer-management solution that integrates telephone-based customer service with other channels, such as the Internet, fax, kiosk and video.

HP's imaging capabilities, which have fueled our market leadership in printers, scanners and all-in-one products, also offer powerful ways for organizations to change how they communicate. Increasingly, organizations are moving to a distribute-then-print model of communications, in which documents are created in one area, distributed over the network and printed locally.

In late 1998, we launched 20 new products that give customers new capabilities in printing, copying, capturing, sending and "mopying" information in both paper-based and digital form. This introduction included three new color printers and the HP Mopier 320 network copier. A "mopier" is a printer that enables users to make multiple original prints; the HP Mopier 320 is our first network copier that also enables "walk-up" copying.

United Grain Growers

As deregulation and technology transform agriculture in Canada, United Grain Growers (UGG) is moving quickly to improve its processes. UGG, which stores, sells and ships a variety of grain products within Canada and internationally, has relied on HP 9000 Enterprise Servers for several years. Now the company is piloting HP Changengine, a software advance that enables organizations to redo business processes without rewriting applications. "We're using Changengine to speed how we implement and track any change in an employee's job, salary, work location and more," says Guy Wood, MIS director at UGG. "It enables us to get approvals faster and track the paperwork more easily than before. We're very happy with our progress, and we're looking for other ways to apply Changengine's capabilities. Our local HP people have been great as well. They really went to bat for us with the developers to make sure the software was tuned to our needs."

Peapod

Peapod, which pioneered grocery shopping on the Internet, is the highest-volume online grocery shopping and delivery service in the world. More than 100,000 customers across the United States are ordering fresh produce, quality meats, beverages, paper goods, snacks and more at Peapod's Web site. Specially trained Peapod shoppers then fill the customer's order from grocery stores and deliver it to the person's home. The company has grown very rapidly, and HP 9000 Enterprise Servers have been the backbone of Peapod's data center from the beginning. "We need a high-quality platform for our database that we and our customers can count on. That's why we chose HP," says Anne Marie Walsh, Peapod's vice president of Internet Commerce and former vice president of Information Technology.

Other new products address the knowledge-management and communications needs of today's highly mobile businesspeople. The HP CapShare information appliance is a handheld device that enables users to copy a document and send it wirelessly to a printer, fax machine or PC. We also brought out the HP 9100C Digital Sender, a desktop device that enables users to send color or black-and-white documents to an Internet e-mail address, fax number, network printer or PC. It's a cost-effective alternative to fax and courier services that integrates paper documents smoothly into today's electronic workplace.

The HP 9100C Digital Sender builds on an organization's messaging capabilities, which was another important area for us this year. We announced that we will collaborate with Microsoft to deliver end-to-end solutions that are based on Microsoft Exchange, which is that company's messaging product. These solutions will run on HP NetServer systems and will be supported by a range of project-planning, implementation and support services.


FAX
300
250
200
150
100
50
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PRODUCT A
PRODUCT B
PRODUCT C
Product Lines
Cost
List Price
http://www.earth.com

for consumers GREAT IDEAS and SMALL BUSINESSES

At home, in small offices or on the road, we're helping people be more creative, learn and communicate with an exciting array of innovative products.

We brought feature-rich PCs and printers to the home market with excellent results. All our HP Pavilion home PCs introduced in 1998 offer one-touch access to the Internet and 50 hours of Internet exploration at no charge. In addition, we backed our HP Pavilion PCs with the HP Customer Care Promise, a guarantee to answer all support calls in three minutes or less — 24 hours a day, 365 days a year.

We also made it easy for people to buy a custom-built HP Pavilion. At Circuit City, a leading U.S. retailer, customers can use an electronic kiosk to learn about and choose the microprocessor, amount of memory and disk space, monitor and other features and accessories for their HP Pavilion PCs. More than 500 Circuit City stores were participating in the program at year-end.

One result of these efforts was an improvement of more than 15 points in the repurchase rate of HP Pavilion home PCs by U.S. consumers, according to a study by ZD Market Intelligence, a leading source of information on the computer and communications industries.

Our printers also delivered exciting new capabilities this year. We brought out the HP DeskJet 895C printer, which comes with HP Instant Delivery personal publishing software. HP Instant Delivery enables people to access their favorite online publications and Internet sites without logging on to those sites. Based on a timetable the user sets, Instant Delivery "calls" a publisher's site and prints the specially formatted material unattended.

We also introduced our Printable Expressions greeting-card collections, which allow people to create and print personalized greeting cards using color inkjet printers. Each collection includes a CD-ROM with original works of art, 100 pre-written greetings and tools to create a new greeting, and a step-by-step guide with online assistance.

The home-office and small-business market was an important focus for us in 1998. Our all-in-one products combine printing, copying, scanning and faxing, and they achieved very strong growth this year. The HP OfficeJet Series 700 all-in-one is HP's first all-in-one product that enables users to send both black-and-white and color images by fax.

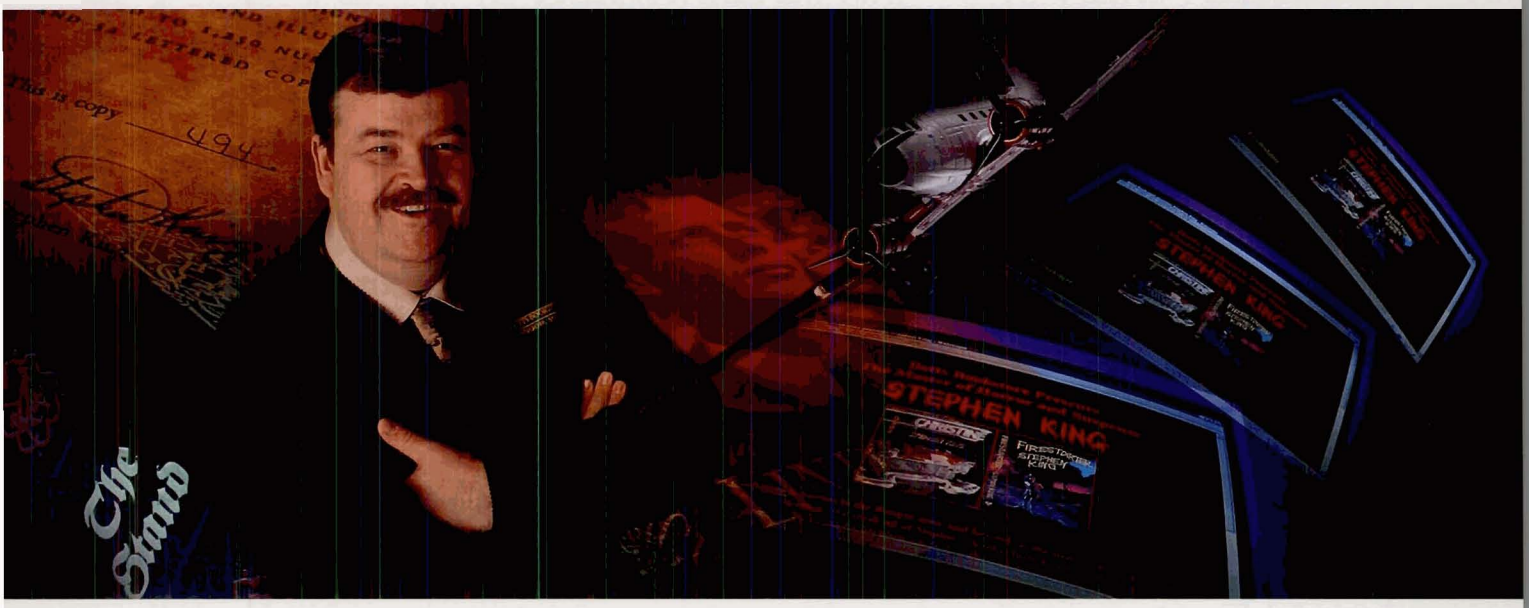
We introduced the HP LaserJet 1100 printer, the successor to the award-winning HP LaserJet 6L printer. The LaserJet 1100 features JetPath technology, which allows users to integrate copying and scanning capabilities into the printer. We also brought out the HP LaserJet 1100A printer-copier-scanner, which offers complete copying and scanning features, a wide range of reducing and enlarging capabilities, and software for managing and storing documents.

Lebanon High School

At Lebanon High School in Lebanon, Oregon, more than 1,500 students and faculty are using HP DeskJet printers and software to improve communications and learning. Kathy Brandis's chemistry class can access information on paper deadlines, test schedules and assignments on the school's intranet, which students can access at any time. "It makes keeping up with your classes a lot easier," says Jesse McDougal. The school's daily bulletin keeps students like Jesse up to speed on club meetings, sports tryouts, cafeteria menus and more. With HP's Instant Delivery software, teachers will soon be able to customize their class bulletins by incorporating topical material from the World Wide Web. "The ability to use color really helps us get the students' attention," says Brandis, "and the HP printers make color handouts about the same cost as photocopying."

Betts Bookstore

Betts Bookstore of Bangor, Maine has been in business for 60 years, and HP is helping owner Stuart Tinker carve out a distinctive niche for the '90s and beyond. The store specializes in helping readers around the world find collectibles by best-selling master of horror and suspense, Bangor resident Stephen King. Tinker uses an HP Vectra PC for accounting, online book searches and to respond to customer inquiries that come in via e-mail. The HP Vectra PC also hosts the store's Web site, which readers log on to for current information on first editions, signed copies and other King collectibles. The store's Internet and mail-order sales are growing rapidly, and Tinker credits the HP Vectra PC for fueling this growth. "I don't know a lot about computers, but the Vectra has been very easy to set up and use," Tinker says. "I can spend time running the business without getting bogged down with the technology."



A new line of HP Brio business PCs, the HP Brio 7000, debuted an industry-first subcompact, "microtower" design. The HP Brio 8000 PC series offers an Intel 400MHz Pentium processor, and powerful graphics and sound capabilities.

Customer response to our electronic store, the HP Shopping Village Web site (http://www.shopping.hp.com), was excellent. Our goal is to help make people's lives easier and to customize their shopping experiences. Since late in 1997, we have offered refurbished printers and PCs online; this year, for the first time, we made new PCs and printers available at the HP Shopping Village. Customers can now order more than 150 products from their homes, around the clock, seven days a week.

This year we also introduced important technology that will enable a wide range of devices, such as printers and cellular phones, to communicate more intelligently via the World Wide Web. These software products, sold under the brand name Chai, enable device manufacturers and independent solution providers to create innovative applications and services that take advantage of the burgeoning Internet.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During 1998, electronic commerce moved to the business mainstream. This is an exciting opportunity for HP, and we're well-positioned to succeed. Our online-commerce efforts emphasized three solution areas: the Web storefront, transaction security and electronic payments.

For the Web storefront, our goal is to help customers succeed in their electronic-commerce efforts. We want to make "virtual shopping" a compelling experience. This year we introduced our Web Quality of Service (QoS) program as a key to achieving this goal.

Web QoS combines our capabilities in servers, measurement and management to improve service-level guarantees on the Internet. We're working with our application, database and networking partners to allow businesses and consumers to prioritize demand on Web sites and to provide reliable service even during peak usage.

Our imaging capabilities are also helping customers optimize the commercial power of the Internet. This year we unveiled HP OpenPix ImageIgniter software, which enables users to zoom in on, pan and share Internet photos, and to take full advantage of HP's photographic-quality print capabilities. HP OpenPix software also enables Web site owners to track and analyze how users interact with images.

Our "ImageIgnite Your Site" program is designed to speed businesses' use of the compelling images this software makes possible. Companies from Levi Strauss and Liz Claiborne to online merchants such as fatface.com and ubarter.com are using OpenPix ImageIgniter.

We also rolled out the Electronic Solutions. Now (ESN) program, through which we are creating customized Web sites for our largest enterprise customers. ESN allows these customers to access a range of secure electronic services, including information on products and configurations, account-specific pricing, ordering,

order status and support. ESN also provides customized account information and a monthly executive-information service.

This year we also created a rich online shopping experience for HP customers. Launched in November 1997, the HP Commerce Center is a Web site at which individuals, as well as small and medium-sized businesses, can order a wide range of peripherals, PCs and PC servers. Resellers such as Avnet, Inacom and CompUSA fill the orders in the United States. Through the year we expanded both the range of products offered and the resellers in the program, and customer response has been very encouraging. We opened similar online commerce centers in Asia Pacific and Europe during the year.

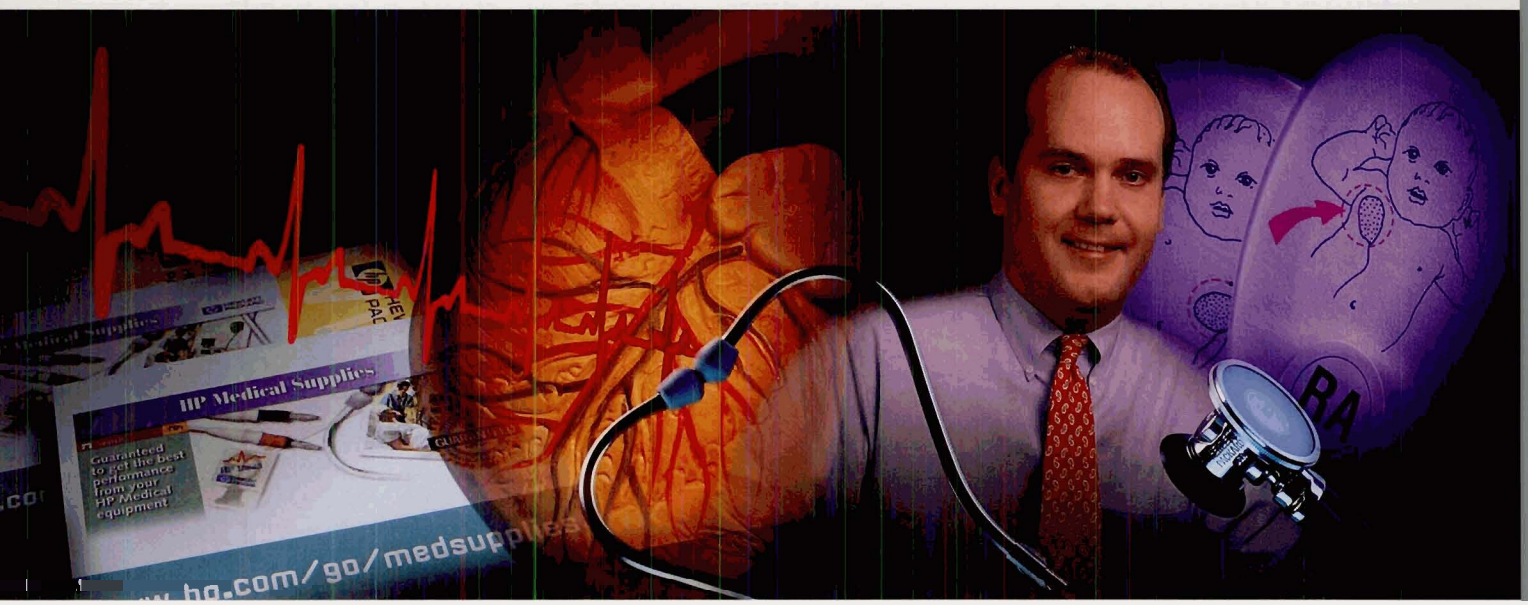
Transaction security refers to our products and technologies that make transactions secure and private for consumers and merchants. Our HP VirtualVault technology is a high-security-grade version of the HP-UX operating system that protects Web content and internal databases. During 1998, HP VirtualVault won strong market acceptance. More than 100 banks in 22 countries are using HP VirtualVault as part of their Internet security, and the product was named "Best General Security Product of 1998" by *Secure Computing* magazine, a leading trade publication.

ForeningsSparbanken AB

ForeningsSparbanken AB (Swedbank) is the largest savings-bank group in Scandinavia and a technology innovator. Working with HP VeriFone and Point AB, VeriFone's distributor in Sweden, ForeningsSparbanken AB (Swedbank) is spearheading that nation's Electronic Purse initiative. The Electronic Purse initiative enables Swedish citizens to carry cash electronically on smart cards, which they use for a wide variety of traditional cash transactions, such as paying for parking. In addition, Swedish consumers will now be able to download cash from their bank accounts to their smart cards using VeriFone's Personal Automatic Teller Machine and VeriSmart software. "The flexibility and ease of use that VeriFone make possible are critical to the success of Electronic Purse," says Jan Liden, senior vice president at ForeningsSparbanken AB (Swedbank).

BryanLGH

When Edvard Rutmanis needs to order electrodes for defibrillators, blood-pressure cuffs or hundreds of other medical supplies and accessories from HP, he logs on to a customized online ordering Web site developed for him by HP's Medical Supplies Business Unit. The site enables Edvard, a buyer for BryanLGH Medical Center in Lincoln, Nebraska, to find the items he's looking for by product number, instrument number or key-word search. The Web site also has BryanLGH's account contract price for every product. "I really like the fact that I can order what I need, when I need it, on my schedule," says Edvard. "It's also very convenient to have our prices right there on the site."



Our electronic-payment efforts are designed to enable seamless commerce across the physical and virtual worlds for merchants, financial institutions and consumers. HP VeriFone is leading our work in this area. VeriFone is the world's largest supplier of electronic-payment solutions, including point-of-sale terminals, smart-card readers and software for secure Internet payment. This year VeriFone extended its market leadership with major implementations at Blockbuster Entertainment, Rite Aid Pharmacy and CVS Drugs, as well as with the rollout of an extensive smart-card solution for McDonald's in Germany.

VeriFone also deployed secure Internet payment software to financial institutions and merchants around the world, including software that utilizes the Secure Electronic Transaction (SET) protocol developed by VISA and MasterCard.

In 1998, VeriFone was a founding member, along with EDS and HP, of the Global e-Commerce Forum, an industry group whose goal is to provide a unified voice for defining and driving a variety of electronic-commerce initiatives.

Year in Review

Test and Measurement

HP 3070 Series 3

Electronics manufacturers can test printed circuit boards faster and more effectively with as little as 50 percent electrical access and at lower cost with the HP 3070 Series 3 family of board-test systems. The same trends that benefit customers — shorter product life cycles, greater miniaturization and advanced technologies — challenge manufacturers. This family of products delivers time-saving innovations that help manufacturers tackle their toughest high-tech test problems with ease.

HP 95000 HSM

HP collaborated with semiconductor manufacturers to develop a new high-speed memory test system. It's called the HP 95000 High Speed Memory (HSM) Series and is used for high-volume production testing of a new generation of DRAMs, called RDRAM chips. These chips will exceed the speed of even the next generation of PC chips, operating at 800MHz, compared to today's 450MHz PCs. These devices require the "at-speed" testing that only HP can provide. The series offers memory-chip manufacturers the industry's smallest footprint, lowest cost of test and lowest-risk test solution.

HP Service Advisor

The HP Service Advisor is a new, low-cost "tablet" test platform for the telecom market. It accepts a variety of interchangeable modules for testing services ranging from ADSL (asymmetric digital subscriber line) to ATM transmission. As service providers accelerate the rollout of new voice and high-speed data-communications offerings for the home and office, the HP Service Advisor provides a cost-efficient and easy-to-use solution for their installers in the field.

HP 3070 Series 3

HP 95000 HSM

HP Service Advisor

VXI Microwave Synthesizer

To meet the constant equipment-test challenges in the aerospace and defense environments, HP introduced a new VXI microwave synthesizer solution. The HP E6432A is suited for a wide range of automated-test applications, including field tests, avionics, communications systems and other manufacturing-test applications.

HP 16700A and 16600 series

At the Embedded Systems Conference, HP introduced new digital-system-debug tools — which combine logic analysis and emulation — to help designers cope with hardware and software integration problems. The new tools are the HP 16700A, a modular, high-performance platform; and the HP 16600 series, a preconfigured system with built-in analysis capabilities.

HP TestBook Wireless

A new wireless-test technology for vehicle service increases technicians' productivity and reduces repair costs for customers. The HP TestBook Wireless, an integrated diagnostic solution, offers technicians centralized access to diagnostic and customer-service information in the service bay or in the field.

Medical

Heartstream ForeRunner

With this year's acquisition of Heartstream, Inc., HP offers the Heartstream ForeRunner, an automatic external defibrillator (AED) that delivers lifesaving therapy to victims

of sudden cardiac arrest. It's lightweight and portable — about the size of a hardcover novel — and enables trained users such as corporate first-aid teams, police and flight attendants to respond quickly and effectively. HP Heartstream is the official supplier of AEDs to the National Ski Patrol, and a number of airlines — including American, Delta, Aloha and Alaska — fly with ForeRunners onboard.

Computers and Peripherals

HP 3000

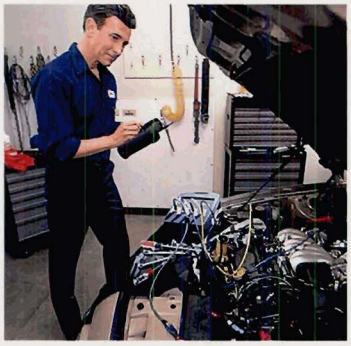
1998 marked the renaissance of the HP 3000. HP announced that the product would support the Intel Architecture (IA-64) platform, ensuring a roadmap to the future for this 26-year-old technology classic. HP also announced that it would target five new vertical markets for the HP 3000 — mail order, healthcare, manufacturing, credit unions and airlines — and subsequently acquired Open Skies, Inc., which provides reservation solutions for small and medium-sized airlines.

HP Mopier 320 network copier

The HP Mopier 320 network copier builds on HP's legacy of more than 30 million installed HP LaserJet printers. It helps users make the transition to networked copying, while continuing to accommodate their need for convenient walk-up copying. The Mopier 320 network copier is HP's first product designed to replace conventional copiers in small to medium-sized workgroups.

HP CapShare 910

HP introduced its first product based on HP CapShare page-processing technology, developed at HP Laboratories. The 12.5-ounce (355 grams) HP CapShare 910 information appliance is the size of a portable compact disc player and runs on two AA rechargeable batteries. This device gives mobile professionals the ability to capture, store and share paper documents while away from their offices. CapShare page processing re-creates the document in as little as six seconds and shows a thumbnail image of the document on a built-in liquid-crystal display. Once captured, the document can be sent directly to a printer or smart wireless handheld device via infrared port, or to a notebook or portable PC, where it can be sent as an e-mail or e-fax.



HP Testbook Wireless

Heartstream ForeRunner

HP 3000

HP Color LaserJet 4500 and 8500 printers

We strengthened our color laser printing leadership with the HP Color LaserJet 4500 and 8500 printers, which enable users to produce brilliant color documents quickly, easily and cost effectively. The HP Color LaserJet 4500 printer enables corporate workgroups to incorporate color in presentations, fliers, sales materials and reports. With the HP Color LaserJet 8500 printer, users in corporate departments can create documents, such as newsletters, brochures and posters, that were previously outsourced to commercial printers.

HP 9100C Digital Sender

The HP 9100C Digital Sender is a new product category for office communication. This compact, desktop sending device converts color, paper documents into digital information so they can be sent via e-mail, network fax, HP JetSend-enabled device, network PC

or network printer. By using the network to send information on paper, the HP 9100C Digital Sender is an efficient and cost-effective alternative to conventional paper-distribution systems such as fax and courier.

HP Vectra VL PC

HP's award-winning Vectra VL corporate PC delivers great performance, advanced PC manageability, integrated security features and long-lasting product-life stability. Based on Intel's Pentium II 450MHz processor, it provides industry-leading storage capacity, flexibility and fast data throughput for graphics and spreadsheet applications. In 1998, HP Vectra PCs won more than 20 awards conferred by some of the most influential PC publications worldwide.

HP 2000C Professional Series printer

In North America, we introduced the HP 2000C Professional Series color inkjet printer. It fills the gap between the upper end of the inkjet market and the lower end of the color-laser market. For typical desktop printing, the new printer can produce three full-page color documents in about 43 seconds. Its speed for printing black is comparable to that of personal desktop monochrome laser printers.

HP LaserJet 8100 printer series

We introduced our fastest and most versatile LaserJet printers to date, the HP LaserJet 8100 printer series. The LaserJet 8100 enables users to distribute documents they previously produced on centralized photocopiers and commercial printing presses — such as reports, forms, newsletters, brochures, catalogs, newspapers and magazines —

HP 2000C

HP LaserJet 8100 printer series

HP Kayak XU and XW PC Workstations

electronically via the Web. With this emerging "distribute-then-print" trend, customers also can print high-volume documents as needed — from their desktops — rather than storing preprinted ones.

HP Kayak XU and XW PC Workstations

In October, HP introduced the newest members of its Kayak PC Workstation family — HP Kayak XU and XW PC Workstations. The systems offer software developers, design engineers, financial analysts and multimedia-authoring professionals unparalleled speed and the industry's most advanced 2-D and 3-D graphics.

Blue lasers

HP Laboratories demonstrated a blue laser, a technology that is expected to lead to major advances in computer-storage devices, displays and laser printers. The breakthrough resulted from collaborations among researchers and scientists at HP Labs' Communications & Optics Research Laboratory (in Palo Alto, Calif. and Tokyo); Meijo University in Nagoya, Japan; and the University of California at Santa Barbara. Lasers used for fiber-optic communication links typically use infrared light with a wavelength of 780 to 850 nanometers, and lasers used for CD storage devices use red light in the 650-to-670-nanometer range. Blue lasers operate at a shorter wavelength, typically 410 to 470 nanometers, and they produce a smaller spot size (relative to infrared and red lasers). Laser printers could use blue lasers to print more dots per inch for higher resolution, and digital video discs could use them to

store more bits in the same amount of space. In addition, blue lasers can be used (with green and red lasers) in high-performance display systems.

Chemical Analysis

Lab-on-a-chip

HP and Caliper Technologies Corp. are working together on the first generation of systems for analytical instrumentation based on Caliper's lab-on-a-chip technology. These systems will integrate a large number of chemical manipulations on a single chip. Because the chips are expected to be many times faster than today's instruments, they will speed up chemical analysis and significantly reduce costs. Researchers will be able to share the digital information easily as they develop products and applications in drug discovery, bioanalytical research and medical diagnostics.

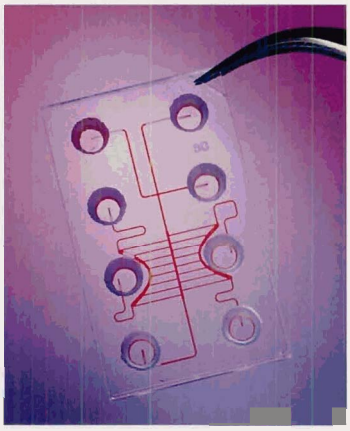
MTI Analytical Instruments acquisition

In February, HP signed a definitive agreement to acquire MTI Analytical Instruments, a manufacturer of high-speed, portable, laboratory and continuous-measurement gas chromatograph instruments. Together, we will enhance the mobile capabilities of our gas chromatographs, which will enable the testing of compounds in real time at a remote site or on the production line, rather than in a laboratory.

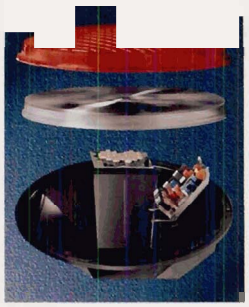
Components

LED Light Module

LumiLeds Lighting, a joint venture between Philips Lighting B.V. and HP, introduced a red LED traffic-signal module, a revolutionary package of signal components for the traffic-light industry. It provides the same brightness as 200 conventional high-brightness LEDs using only 18 HP "high-flux" LEDs. LED traffic signals save energy and eliminate the frequent replacement of incandescent lamps. High-brightness LEDs also are going into crossing signals, theater-floor lighting, illuminated signs and other places where incandescent bulbs have been used previously.



Lab-on-a-chip



LED Light Module

MT-RJ system

MT-RJ system

The MT-RJ transceiver assists in providing the next-generation fiber-optic cabling system to make fiber-to-the-desk more affordable and practical. It features small size, lower costs, and easy application and use. The MT-RJ alliance — which includes AMP, Inc., Siecor, US Conec, Fijikura and HP — recognizes the need to "future-proof" networks in preparation for future bandwidth requirements.

CMOS sensors

To meet the increasing demand for affordable, high-quality digital imaging in such applications as toys, surveillance and security cameras, and for biometric measurements, HP introduced a family of four complementary metal oxide silicon (CMOS) image sensors. HP's CMOS sensors provide higher-quality images and enable lower systems cost for these digital-imaging applications than previously available devices.

Information Storage

CD-ReWritable products

HP offers a complete line of affordable read/write CD-based solutions with the new portfolio of industry-leading

CD-ReWritable (CD-RW) products. HP CD-RW disks can hold up to 650MB of data, photos, music and video. Users can write, erase, rewrite and update all their large files on CD-RW media — using them over and over again to archive and back up their data. With CD-RW media, customers can share their data with more than 200 million CD-ROM players and 600 million audio players worldwide.

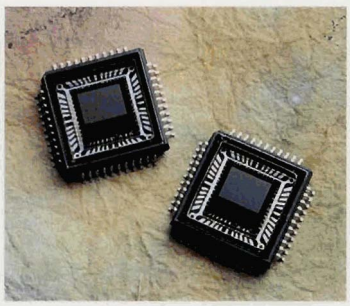
Events

HP-Cisco alliance

HP and Cisco extended their alliance into one of today's hottest markets in the communications industry. The companies announced a new communications business model for service providers and an open Internet platform for combined data, voice and video services. These are expected to change the way telecommunications is delivered and to accelerate the introduction of services such as Internet telephony, audio e-mail, and a new type of Internet shopping that offers interactive voice and data service. Service providers can offer customers combined communication solutions, enabling them to deliver services for the electronic world.

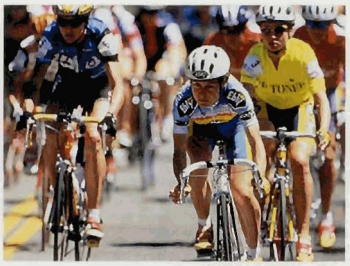
HP International Women's Challenge

The HP International Women's Challenge took place in June in Boise, Idaho. More than 125 cyclists from around the world, competing on teams of four, raced for a prize purse valued at $100,000 — the richest in women's cycling. This was the first time in its 15-year history that the event was broadcast on network television. Linda Jackson of Napean, Ontario, Canada, won the overall title and finished first in the six-day, 274-mile race.



CMOS sensors

CD-ReWritable products



HP International Women's Challenge

World AIDS Conference

HP donated cash and technical assistance — and loaned computers and printers — to the 12th World AIDS Conference, which was held in Geneva. More than 12,000 physicians, educators, public officials and others involved in HIV/AIDS-related issues, treatment and research attended the six-day conference. HP linked 250 desktop computer systems and 70 printers to serve the participating delegates. The conference organizers used the cash donation to support a hands-on computer-skills-building program during the conference. The program focused on training attendees to use computers and showing them how computers can help them improve their job efficiency.

Mission Critical Computing Conference

In October, HP and 19 partner companies held a Mission Critical Computing Conference. The goal of this collaboration was to give customers increased levels of availability in mission-critical environments. The partners believe that no one company, working alone, can make mission-critical computing a competitive advantage for customers. It takes a team to create solutions that will allow companies to grow and flourish in the 21st-century economy and truly harness the power of global information.

Citizenship

Hewlett-Packard's emphasis on corporate citizenship reflects our most basic values. We believe it's vital to contribute to communities in ways that go beyond what we do as businesspeople. This year, the company and our people gave their time, talents and financial support to diverse efforts with a common goal: to help people and to improve communities.

In fiscal 1998, we donated approximately $65 million in cash and equipment to programs and organizations of many kinds. Universities around the world continued to receive the largest portion of HP's philanthropic support, with approximately $35 million in cash and HP products donated in 1998.

Our support of education isn't limited to universities. We're working with Intel and Microsoft on the Technology in Education Initiative, whose goal is to equip teachers in middle schools and high schools with technology and training to improve their students' skills and achievement. We're supplying servers, printers, scanners and HP PhotoSmart digital camera systems for this effort, which reaches beyond the United States. HP Taiwan implemented a pilot program during the year, and similar initiatives are in place across Europe.

A bike ride 43 feet off the ground is helping the California Science Center attract tourists and reach out to local Los Angeles residents such as Ellis Anderson. The Center is using an HP equipment grant of PCs, servers and printers in its computer labs, interactive exhibits and to run the museum's administrative functions.

The E-mail Mentor program, developed at HP and recently transferred to Colorado State University, is designed to create one-to-one relationships among our employees, students in grades 5 through 12 and their teachers. The program's goal is to work with teachers to motivate students to excel in math, science and communications. During 1998, more than 1,100 students and their teachers from the United States, Canada, Australia and France participated, and we rolled out a very successful pilot program in Singapore.

This year we also helped people and groups who are addressing significant social problems. We provided computing products and services for a secured, online donation system that enables people to contribute money, via the Internet, to Second Harvest, the largest charitable hunger-relief organization in the United States. This donation system is part of a larger effort, called Networked to Fight Hunger, in which we're working with four regional food banks to streamline office operations and improve the efficiency of the food-distribution process.

In 1998, we worked hard to improve our overall environmental performance. A growing number of our manufacturing sites achieved or are pursuing certification to ISO 14001, a global standard for environmental systems management.

Our product-stewardship effort strives to prevent or minimize negative effects on the ecosystem, or to human health and safety, that may occur through the manufacture or use of an HP product. This year, a number of printers and personal computers met the stringent criteria of Germany's "Blue Angel" designation for environmentally sound products.

We also worked to use resources more efficiently. We recycled or reused more than 3.5 million pounds of old product material every month from customers and HP sites at our product-recovery centers in France, Germany and California. Over the last five years, we've also reduced the number of parts needed to build an HP Vectra PC from 1,650 to 350.

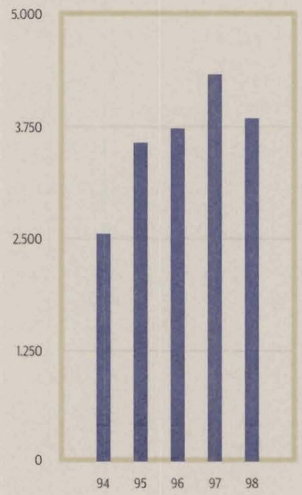
Contents

Selected Financial Data

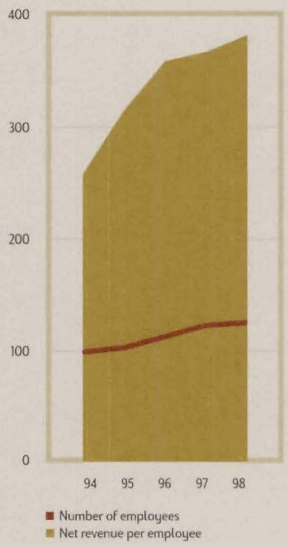
Unaudited

For the years ended October 31 In millions except per share amounts and employees	1998	1997	1996	1995	1994
U.S. orders	$ 21,338	$ 18,837	$ 17,181	$ 14,686	$ 11,692
International orders	25,166	24,316	21,708	17,999	13,658
Total orders	$ 46,504	$ 43,153	$ 38,889	$ 32,685	$ 25,350
Net revenue	$ 47,061	$ 42,895	$ 38,420	$ 31,519	$ 24,991
Earnings from operations	$ 3,841	$ 4,339	$ 3,726	$ 3,568	$ 2,549
Net earnings	$ 2,945	$ 3,119	$ 2,586	$ 2,433	$ 1,599
Per share amounts:					
Net earnings – Basic	$ 2.85	$ 3.04	$ 2.54	$ 2.38	$ 1.58
Net earnings – Diluted	$ 2.77	$ 2.95	$ 2.46	$ 2.31	$ 1.54
Cash dividends	$ .60	$ .52	$ .44	$ .35	$ .275
At year-end:					
Total assets	$ 33,673	$ 31,749	$ 27,699	$ 24,427	$ 19,567
Long-term debt	$ 2,063	$ 3,158	$ 2,579	$ 663	$ 547
Employees	124,600	121,900	112,000	102,300	98,400

Earnings from Operations
In millions

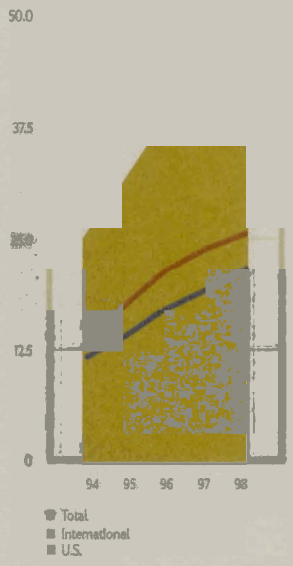


Employees and Net Revenue Per Employee
In thousands

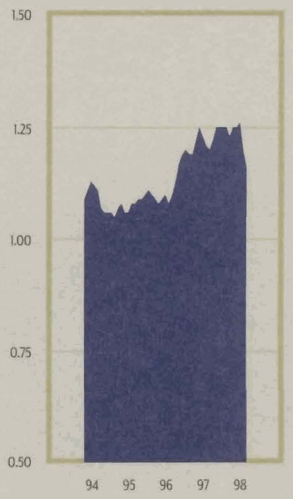


Financial Review
Unaudited

Net Revenue
In billions



U.S. Dollar Relative to Major Foreign Currencies
Fiscal 1980 equals 1.00



Results of Operations

In 1998, HP reported net revenue growth of 10 percent. The company experienced favorable market acceptance of its new products; however, continued pricing pressure on personal computer and printer products, as well as the impact of the economic downturn in Asia and other areas of the world as the year progressed, adversely impacted revenue growth and related operating margins. Revenue growth was 16 percent during the first half of 1998, but slowed to 4 percent growth in the second half, reflecting the weakening macroeconomic environment. Controls on costs and expenses implemented by the company during the second half of 1998 favorably impacted operating results, but did not fully offset the impact of the slowdown in revenue growth. As a result, full-year operating- and net-profit margins were lower than in 1997 and net earnings declined 6 percent, compared with a 21 percent increase in 1997.

Net revenue grew 10 percent in 1998 following 12 percent growth in 1997. Currency unfavorably impacted net revenue growth approximately 4 percentage points in both years. U.S. revenue grew 13 percent to $21.5 billion and international revenue grew 7 percent to $25.6 billion in 1998, following increases of 12 percent in the U.S. and 11 percent internationally in 1997. International revenue growth slowed significantly in 1997 and further in 1998 primarily as a result of weakness in the Japanese environment in 1997 followed by widespread economic weakness in Asia which became significant in mid-1998.

Revenue in the company's computer product, service and support business increased 11 percent in 1998 compared with growth of 13 percent in 1997. Strong growth in unit shipments of the company's computers, printers and storage products continued, especially HP Pavilion and Vectra PC's, CD ROM storage products, Unix servers and HP's families of DeskJet and LaserJet printers. This growth was driven primarily by increased market penetration and new product introductions in 1998 and 1997. In both years, competitive actions designed to increase or maintain market share against intense competition contributed to declines in the average selling prices for many of these products, especially PC's and Deskjet printers, resulting in unit volume growth that significantly outpaced revenue growth. Continued strong sales growth in consumable supplies for the company's printer products, reflected increased printer usage and a larger installed base.

Revenue in the company's measurement businesses increased 1 percent in 1998 from 1997, compared with revenue growth of 7 percent from 1996 to 1997. This revenue trend was primarily attributable to the company's test and measurement business, which experienced a decline in net revenue of 4 percent during 1998, compared with a 11 percent increase during 1997. The decline in test and measurement revenue in 1998 reflected the economic weakness in Asia and the worldwide semiconductor industry slowdown that began in the second half of the year.

Services such as hardware and software support and maintenance, product financing, rentals, consulting, and education, as well as systems integration and selective-outsourcing management, are an integral part of the company's offerings. Net revenue from services grew 12 percent in 1998, compared with 17 percent in 1997. The decline in revenue growth in 1998 was primarily attributable to moderating growth in the company's leasing business. Increases in the company's installed base and continued growth in the professional services business also contributed to the increase in service and support revenue in both years.

The company anticipates that net revenue growth for the full-year 1999 will be similar to the revenue growth rate experienced in 1998. Revenue growth is likely to be impacted by continuing economic uncertainties in Asia and other regions around the world and by ongoing competitive pricing pressures, particularly in the PC and printer businesses. The company anticipates that revenue growth will be slower during the first half of 1999, reflecting the current economic weakness in Asia and other areas and will increase later in the year when compared to the weaker revenue growth in the second half of 1998.

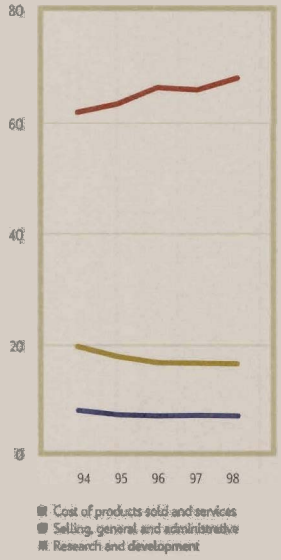
Information on orders and net revenue by groupings of similar products and services is presented on page 63 of this report.

Costs, expenses and earnings as a percentage of net revenue were as follows:

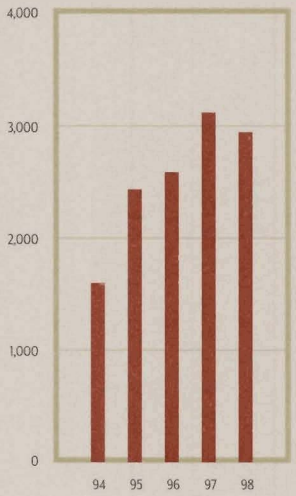
For the years ended October 31	1998	1997	1996
Cost of products sold and services	**68.1%**	66.0%	66.4%
Research and development	**7.1%**	7.2%	7.1%
Selling, general and administrative	**16.6%**	16.7%	16.8%
Earnings from operations	**8.2%**	10.1%	9.7%
Net earnings	**6.3%**	7.3%	6.7%

Cost of products sold and services as a percentage of net revenue was 68.1 percent in 1998 and increased 2.1 percentage points, compared with a 0.4 percentage point decrease in 1997. The cost of products sold and services in 1998 included $260 million of charges primarily for voluntary employee severance programs and fixed-asset writedowns related to outsourcing of certain production operations. In 1996, the company exited its disk-mechanism manufacturing business. Excluding the effect of these charges in 1998 and the exit costs in 1996, cost of products sold and services as a percentage of net revenue would have increased 1.6 percentage points in 1998 after a 0.5 percentage point increase in 1997.

Costs and Expenses
As a percentage of net revenue



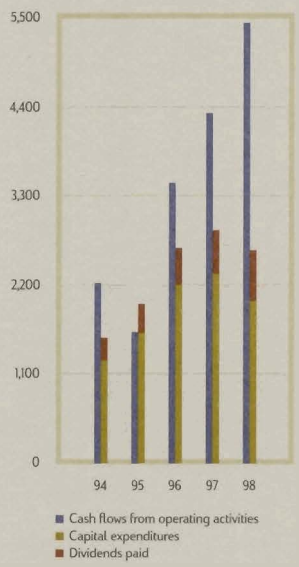
Net Earnings
In millions



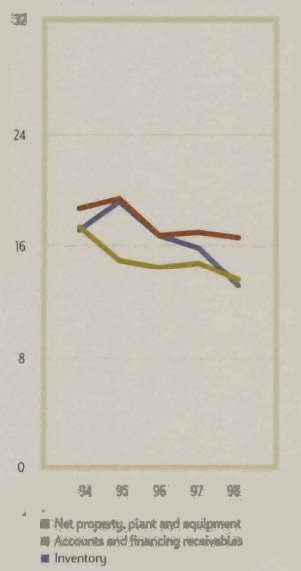
Financial Review

Unaudited

Selected Cash Flows
In millions



Operating Assets
As a percentage of net revenue



Intense price competition particularly in the PC and printer markets continued to adversely impact product revenues and gross profit margins in 1998 and 1997. Additionally, the continued shift in the mix of products sold towards lower gross-margin, high-volume product families, as well as costs associated with continuing new-product introductions, again put upward pressure on the cost of sales percentage. In both 1998 and 1997, these factors were partially offset by improving supply chain management and lower product return costs. The company expects continued upward pressure on cost of sales as a result of ongoing competitive pricing pressures and continued shifts in the mix of its business.

Research and development expenditures increased 9 percent in 1998 to $3.4 billion, versus 13 percent growth and expenditures of $3.1 billion in 1997. The ongoing increase in spending on research and development primarily reflects the company's continued investments in new microchip architectures and hardware design and development in enterprise computing products as well as new technologies for printing and imaging. Selling, general and administrative expenses grew 9 percent in 1998 and 11 percent in 1997. The growth in both years was primarily due to increased selling costs related to order and revenue growth and increased marketing program costs associated with the company's continued introduction of new products and expansion of its distribution and support capabilities. The growth rate in operating expenses slowed significantly in the second half of 1998. This decline was attributable to company-wide cost reduction programs that resulted in significant decreases in certain variable costs such as travel and discretionary marketing programs. As a percentage of net revenue, both research and development and selling, general and administrative expenses were substantially unchanged from 1997. Reducing the rate of operating expense growth below the rate of net revenue growth remains a major focus of the company.

The company's effective tax rate decreased from 30 percent in 1997 and 1996 to 28 percent in 1998 as a result of a change in the mix of earnings in different tax jurisdictions around the world. As reported, net earnings decreased 6 percent to $2.9 billion in 1998, compared with a 21 percent increase in 1997. Adjusted for the charges recorded to cost of products sold and services in 1998 and the company's exit from disk-mechanism manufacturing in 1996 , net earnings would have been essentially flat in 1998 compared with 11% growth in 1997. As a percentage of net revenue, adjusted net earnings were 6.7 percent in 1998, compared with 7.3 and 7.4 percent in 1997 and 1996.

Financial Condition and Liquidity

HP's financial position continued strong throughout 1998, as cash and cash equivalents and short-term investments were $4.1 billion at October 31, 1998 compared to $4.6 billion at October 31, 1997. During 1998, cash from operations funded $1.3 billion reductions in total borrowings and $2.4 billion in repurchases of common stock. Additionally, the company increased dividends paid per share in both 1998 and 1997.

Operating activities generated $5.4 billion in cash in 1998, compared with $4.3 billion and $3.5 billion in 1997 and 1996, respectively. The increase in cash generated in 1998 compared with 1997 primarily reflected the significant decrease in the company's inventory levels during the year. The increase in cash generated in 1997 compared with 1996 primarily reflected improved net earnings before depreciation and amortization. Inventory as a percentage of net revenue declined to 13.1 percent, a decrease of 2.7 percentage points in 1998 following the 0.9 percentage point reduction achieved in 1997. The decline in the inventory ratio in both years is attributable to continued progress in supply chain management. Accounts and financing receivables as a percentage of net revenue were 16.5 percent in 1998, 16.9 percent in 1997 and 16.7 percent in 1996.

Capital expenditures in 1998 were $2.0 billion, compared with $2.3 billion and $2.2 billion in 1997 and 1996, respectively. The company's capital expenditures declined in 1998 reflecting increased outsourcing of certain production processes, slowing capacity requirements and the company's increased spending controls. Capital expenditures in 1997 and 1996 related primarily to expansion of production capacity to accommodate higher volumes and the introduction of new products, and also included increased investments to support growth in the company's leasing business.

Long-term borrowings of $223 million in 1998 and $1.2 billion in 1997 continued the company's strategy of incurring debt to support increased investments in the company's lease finance portfolio and other interest-bearing assets. With the company's strong cash position during 1998, the company repaid approximately $580 million in long-term debt. At October 31, 1998, the company had an unused committed borrowing facility in place totaling $1 billion.

The company invests excess cash in short- and long-term investments, depending on its projected cash needs for operations, capital expenditures and other business purposes. The company also supplements its internally generated cash flow with a combination of short- and long-term borrowings. In 1998, the company repaid approximately $734 million in short-term borrowings primarily using proceeds from short-term investments.

Shares of the company's common stock are repurchased under a systematic program to manage the dilution created by shares issued under employee stock plans. In July 1998, the company announced a new authorization for beyond-zero dilution repurchases of up to $2 billion of the company's common stock in the open market or in private transactions. In 1998, 43 million shares were repurchased under both of these plans for $2.4 billion. In 1997, 13.2 million shares were repurchased at an aggregate price of $724 million under the systematic program. As of October 31, 1998, the company has remaining authorization from the Board of Directors for future repurchases under these programs of approximately $2.1 billion.

Factors That May Affect Future Results

The company encounters aggressive competition in all areas of its business activity. The company's competitors are numerous, ranging from some of the world's largest corporations to many relatively small and highly specialized firms. The company competes primarily on the basis of technology, performance, price, quality, reliability, distribution and customer service and support. Product life cycles are short, and, to remain competitive, the company will be required to develop new products, periodically enhance its existing products and compete effectively on the basis of the factors described above. In particular, the company anticipates that it will have to continue to adjust prices of many of its products to stay competitive and it will have to effectively manage financial returns with reduced gross margins.

The company's future operating results may be adversely affected if the company is unable to continue to develop, manufacture and market innovative products and services rapidly that meet customer requirements for performance and reliability. The process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers' changing needs and emerging technological trends. The company consequently must make long-term investments and commit significant resources before knowing whether its predictions will eventually result in products that achieve market acceptance. After a product is developed, the company must quickly manufacture sufficient volumes at acceptable costs. This is a process that requires accurate forecasting of volumes, mix of products and configurations. Moreover, the supply and timing of a new product or service must match customers' demand and timing for the particular product or service. Given the wide variety of systems, products and services the company offers, the process of planning production and managing inventory levels becomes increasingly difficult.

Inventory management has become increasingly complex as the company continues to sell a greater mix of products, especially printers and personal computers, through third-party commercial and retail distribution channels. Channel partners constantly adjust their ordering patterns in response to the company's and its competitors' supply into the channel and the timing of their new product introductions and relative feature sets, as well as seasonal fluctuations in end-user demand such as the back-to-school and holiday selling periods. Channel partners may increase orders during times of shortages, cancel orders if the channel is filled with currently available products, or delay orders in anticipation of new products. Any excess supply could result in price reductions and inventory writedowns, which in turn could adversely affect the company's gross margins.

The short life cycles of many of the company's products pose a challenge for the effective management of the transition from existing products to new products and could adversely affect the company's future operating results. Product development or manufacturing delays, variations in product costs, and delays in customer purchases of existing products in anticipation of new product introductions are among the factors that make a smooth transition from current products to new products difficult. In addition, the timing of introductions by suppliers and competitors of new products and services may negatively affect future operating results of the company, especially when competitive product introductions coincide with periods leading up to the company's own introduction of new or enhanced products. Furthermore, some of the company's own new products may replace or compete with certain of the company's current products.

The company generally relies upon patent, copyright, trademark and trade secret laws in the United States and in selected other countries to establish and maintain its proprietary rights in its technology and products. However, there can be no assurance that any of the company's proprietary rights will not be challenged, invalidated or circumvented, or that any such rights will provide significant competitive advantages. Moreover, because of the rapid pace of technological change in the information technology industry, many of the company's products rely on key technologies developed by others. There can be no assurance that the company will be able to continue to obtain licenses to such technologies. In addition, from time to time, the company receives notices from third parties regarding patent or copyright claims. Any such claims, with or without merit, could be time-consuming to defend, result in costly litigation, divert management's attention and resources and cause the company to incur significant expenses. In the event of a successful claim of infringement against the company and failure or inability of the company to license the infringed technology or to substitute similar non-infringing technology, the company's business could be adversely affected.

Portions of the company's manufacturing operations are dependent on the ability of suppliers to deliver quality components, subassemblies and completed products in time to meet critical manufacturing and distribution schedules. The company periodically experiences constrained supply of certain component parts in some product lines as a result of strong demand in the industry for those parts. Such constraints, if persistent, may adversely affect the company's operating results until alternate sourcing can be developed. In order to secure components for production and introduction of new products, the company at times makes advance payments to certain suppliers, and often enters into noncancellable purchase commitments with vendors for such components. Volatility in the prices of these component parts, the possible inability of the company to secure enough components at reasonable prices to build new products in a timely manner in the quantities and configurations demanded or, conversely, a temporary oversupply of these parts, could adversely affect the company's future operating results.

The company continues to expand into third-party distribution channels to accommodate changing customer preferences. As a result, the financial health of commercial and retail distribution channels, and the company's continuing relationships with them, are becoming more important to the company's success. Some of these companies are thinly capitalized and may be unable to withstand changes in business conditions. The company's financial results could be adversely affected if the financial condition of certain of these third parties substantially weakens or if the company's relationship with them deteriorates.

Sales outside the United States make up more than half of the company's revenues. In addition, a portion of the company's product and component manufacturing, along with key suppliers, are located outside the United States. Accordingly, the company's future results could be adversely affected by a variety of factors, including changes in a specific country's or region's political conditions or changes or continued weakness in economic conditions, trade protection measures, import or export licensing requirements, the overlap of different tax structures, unexpected changes in regulatory requirements and natural disasters.

The company is also exposed to foreign currency exchange rate risk inherent in its sales commitments, anticipated sales and assets and liabilities denominated in currencies other than the U.S. dollar, as well as interest rate risk inherent in the company's debt, investment and finance receivable portfolios. As more fully described in the "Off-balance-sheet foreign exchange risk" and "Borrowings" notes to the financial statements, the company's risk management strategy utilizes derivative financial instruments, including forwards, swaps and purchased options to hedge certain foreign currency and interest rate exposures, with the intent of offsetting gains and losses that occur on the underlying exposures with gains and losses on the derivative contracts hedging them. The company does not enter into derivatives for trading purposes.

The company has performed a sensitivity analysis assuming a hypothetical 10% adverse movement in foreign exchange rates and interest rates applied to the hedging contracts and underlying exposures described above. As of October 31, 1998 and 1997, the analysis indicated that such market movements would not have a material effect on the company's consolidated financial position, results of operations or cash flows. Actual gains and losses in the future may differ materially from that analysis, however, based on changes in the timing and amount of interest rate and foreign currency exchange rate movements and the company's actual exposures and hedges.

As a matter of course, the company frequently engages in discussions with a variety of parties relating to possible acquisitions, strategic alliances, joint ventures and divestitures. Although consummation of any transaction is unlikely to have a material effect on the company's results as a whole, the implementation or integration of a transaction may contribute to the company's results differing from the investment community's expectation in a given quarter. Divestitures may result in the cancellation of orders

and charges to earnings. Acquisitions and strategic alliances may require, among other things, integration or coordination with a different company culture, management team organization and business infrastructure. They may also require the development, manufacture and marketing of product offerings with the company's products in a way that enhances the performance of the combined business or product line. Depending on the size and complexity of the transaction, successful integration depends on a variety of factors, including the hiring and retention of key employees, management of geographically separate facilities, and the integration or coordination of different research and development and product manufacturing facilities. All of these efforts require varying levels of management resources, which may temporarily adversely impact other business operations.

A portion of the company's research and development activities, its corporate headquarters, other critical business operations and certain of its suppliers are located near major earthquake faults. The ultimate impact on the company, its significant suppliers and the general infrastructure is unknown, but operating results could be materially affected in the event of a major earthquake. The company is predominantly uninsured for losses and interruptions caused by earthquakes.

Certain of the company's operations involve the use of substances regulated under various federal, state, and international laws governing the environment. It is the company's policy to apply strict standards for environmental protection to sites inside and outside the U.S., even if not subject to regulations imposed by local governments. The liability for environmental remediation and related costs is accrued when it is considered probable and the costs can be reasonably estimated. Environmental costs are presently not material to the company's operations or financial position.

The profit margins realized by the company vary somewhat among its products, its customer segments and its geographic markets. Consequently, the overall profitability of the company's operations in any given period is partially dependent on the product, customer and geographic mix reflected in that period's net sales.

Although the company believes that it has the product offerings and resources needed for continuing success, future revenue and margin trends cannot be reliably predicted and may cause the company to adjust its operations, which could cause period-to-period fluctuations in operating results.

The company's stock price, like that of other technology companies, is subject to significant volatility. The announcement of new products, services or technological innovations by the company or its competitors, quarterly variations in the company's results of operations, changes in revenue or earnings estimates by the investment community and speculation in the press or investment community are among the factors affecting the company's stock price. In addition, the stock price may be affected by general market conditions and domestic and international macroeconomic factors unrelated to the company's performance. Because of the foregoing reasons, recent trends should not be considered reliable indicators of future stock prices or financial results.

Year 2000

The information provided below constitutes a "Year 2000 Readiness Disclosure" for purposes of the Year 2000 Information and Readiness Disclosure Act.

The Year 2000 ("Y2K") problem arises from the use of a two-digit field to identify years in computer programs, e.g., 85=1985, and the assumption of a single century, the 1900s. Any program so created may read, or attempt to read, "00" as the year 1900. There are two other related issues which could also lead to incorrect calculations or failure, such as (i) some systems' programming assigns special meaning to certain dates, such as 9/9/99, and (ii) the year 2000 is a leap year. Accordingly, some computer hardware and software, including programs embedded within machinery and parts, will need to be modified prior to the year 2000 in order to remain functional. The company's Y2K initiatives are focusing primarily on four areas of potential impact: internal information technology ("IT") systems, internal non-IT systems, including services and embedded chips (controllers), the company's products and services, and the readiness of significant third parties with whom the company has material business relationships.

The company expects to implement successfully the systems and programming changes necessary to address Y2K internal IT and non-IT readiness issues and, based on current estimates, does not believe that the costs associated with such actions will have a material effect on the company's results of operations or financial condition. There can be no assurance, however, that there will not be a delay in, or increased costs associated with the implementation of such changes. In addition, failure to achieve Y2K readiness for the company's internal systems could delay its ability to manufacture and ship products and deliver services, disrupt its customer service and technical support facilities, and interrupt customer access to its online products and services. The company's inability to perform these functions could have an adverse effect on future results of operations or financial condition.

Internal IT Systems. The company has established a dedicated Y2K Internal Readiness Program Office to oversee the company's worldwide Y2K internal IT application and infrastructure readiness activities. The Internal Readiness Program Office has senior executive sponsorship and provides monthly progress reports to the company's senior management. The Internal Readiness Program Office is charged with raising awareness throughout the company, developing tools and methodologies for addressing the Y2K issue, monitoring the development and implementation of business and infrastructure plans to bring non-compliant applications into compliance on a timely basis and identifying and assisting in resolving high risk issues.

The company is approaching its Y2K internal readiness program in the following four phases: (1) assessment, (2) planning, (3) preparation and (4) implementation. The assessment phase involves taking an inventory of the company's internal IT applications to prioritize risk, identifying failure dates,

defining a solution strategy, estimating repair costs and communicating across and within business units regarding the magnitude of the problem and the need to address Y2K issues. The planning phase consists of identifying the tasks necessary to ensure readiness, scheduling remediation plans for applications and infrastructure, and determining resource requirements and allocations. The third phase, preparation, involves readying the development and testing environments, and piloting the remediation process. Implementation, the last phase, consists of executing the company's plans to fix, test and implement critical applications and associated infrastructure, and putting in place contingency plans for processes that have a high impact on the company's businesses.

The company is targeting its efforts to ensure that its IT applications will be Y2K compliant by July 31, 1999. The assessment, planning and preparation phases are substantially complete. As of November 30, 1998, the implementation phase is approximately 40 percent complete.

Internal Non-IT Systems. As the company is progressing on its internal IT and product readiness efforts, it has also focused on internal non-IT systems. Non-IT systems include, but are not limited to, those systems that are not commonly thought of as IT systems, such as telephone/PBX systems, fax machines, facilities systems regulating alarms, building access and sprinklers, manufacturing equipment, and other miscellaneous systems. Y2K readiness for these internal non-IT systems is the responsibility of the company's worldwide operating units and their respective functions, e.g., facilities and manufacturing. The company's Y2K Program Office provides standardized tools and monitors the progress of these readiness efforts to ensure business continuity.

Products. The company's newly introduced products are Y2K compliant. However, certain hardware and software products currently installed at customer sites will require upgrade or other remediation. Some of these products are used in critical applications where the impact of non-performance to these customers and other parties could be significant. The company believes that its customers are responsible for costs to achieve their Y2K compliance. The company, however, is taking steps to preserve customer satisfaction and brand reputation. In 1997, the company established a dedicated Y2K Product Compliance Program Office to coordinate the company's worldwide Y2K product compliance activities. The Product Compliance Program Office is charged with developing and overseeing implementation of plans to identify all standard products delivered since January 1, 1995; test those products for compliance; identify an appropriate path to compliance for non-compliant standard products; and communicate the status and necessary customer action for non-compliant standard products. The company has an internet website dedicated to communicating Y2K issues to a broad customer base. This website includes a product compliance search page that allows customers to look up the status of the HP products they have installed. In certain areas, the company is taking additional steps to identify affected customers, raise customer awareness related to non-compliance of certain HP products and assist the customer base to assess their risks.

The costs of the readiness program for products are primarily costs of existing internal resources largely absorbed within existing engineering spending levels. These costs were incurred primarily in 1998 and earlier years and were not broken out from other product engineering costs. Historical Y2K customer satisfaction costs were not material. Future product readiness costs, including those for customer satisfaction, are not anticipated to be material. In addition, while the company is aware of the potential for legal claims against it and other companies for damages arising from products that are not Y2K compliant, management believes that reasonable customer satisfaction steps are under way so that any such claims against the company would be without merit.

It is unknown how Y2K issues may affect customer spending patterns. As customers focus their attention and capital budgets in the near term on preparing their own businesses for the Year 2000, they may either delay or accelerate purchases of new applications, services and systems from the company. Many of the company's products run custom software or connect to other systems or peripheral products that may be adversely affected by operating system or hardware upgrades. Although these factors may increase demand for certain of the company's products and services, it could also soften the demand for other offerings. As a result, these events may affect the company's future revenues and revenue patterns.

Material Third-Party Relationships. The company has developed a Y2K process for dealing with its key suppliers, contract manufacturers, distributors, vendors and partners. The process generally involves the following steps: (i) initial supplier survey, (ii) risk assessment and contingency planning, (iii) follow-up supplier reviews and escalation, if necessary, and where relevant, (iv) testing. To date, the company has received responses from a majority of its critical suppliers, most of whom have responded that they expect to address all their significant Y2K issues on a timely basis. The company is following up with those significant vendors and service providers that either did not respond initially or whose responses were unsatisfactory. In some cases, to meet Y2K readiness the company has replaced suppliers or eliminated suppliers from consideration for new business. The company has also contracted with multiple transportation companies to provide product delivery alternatives.

The company is working to identify and analyze the most reasonably likely worst case scenarios for third party relationships affected by Y2K. These scenarios could include possible infrastructure collapse, the failure of power and water supplies, major transportation disruptions, unforeseen product shortages due to hoarding of products and sub-assemblies and failures of communications and financial systems — any one of which could have a major and material effect on the company's ability to build its products and deliver services to its customers. While the company has contingency plans in place to address most issues under its control, an infrastructure problem outside of its control could result in a delay in product shipments depending on the nature and severity of the problems. The company would expect that most utilities and service providers would be able to restore service within days although more pervasive system problems involving multiple providers could last two to four weeks or more depending on the complexity of the systems and the effectiveness of their contingency plans.

Although the company is dedicating substantial resources towards attaining Y2K readiness, there is no assurance it will be successful in its efforts to identify and address all Y2K issues. Even if the company acts in a timely manner to complete all of its assessments, identify, develop and implement remediation plans believed to be adequate, and develop contingency plans believed to be adequate, some problems may not be identified or corrected in time to prevent material adverse consequences to the company. The discussion above regarding estimated completion dates, costs, risks and other forward-looking statements regarding Y2K is based on the company's best estimates given information that is currently available and is subject to change. As the company continues to progress with its Y2K initiatives, it may discover that actual results will differ materially from these estimates.

Adoption of the Euro

In 1997, the company established a dedicated task force to address the issues raised by the introduction of a European single currency (the Euro) for initial implementation as of January 1, 1999 and during the transition period through January 1, 2002. The company's primary focus has been on the changes needed to deal with a mix of Euro and local denomination transactions from the first day of changeover – January 1, 1999. At the beginning of the transition period, product prices in local currencies will be converted to Euros as required. At an appropriate point during the transition period, product prices in participating countries will be established and stored in Euros, and converted to local denominations. During the transition period, the company's financial systems located in the participating countries will be converted from local denominations to Euros.

The company has developed plans to support display and printing of the Euro character by impacted Hewlett-Packard products. Some products are currently able to perform these functions while plans are still in process for other products. Current information about the impact of the adoption of the Euro on the company's products and businesses is available at the Hewlett-Packard Euro Web site.

The company does not presently expect that introduction and use of the Euro will materially affect the company's foreign exchange and hedging activities or the company's use of derivative instruments. Management does not expect that the introduction of the Euro will result in any material increase in costs to the company and all costs associated with the introduction of the Euro will be expensed to operations as incurred. While the company will continue to evaluate the impact of the Euro introduction over time, based on currently available information, management does not believe that the introduction of the Euro currency will have a material adverse impact on the company's financial condition or overall trends in results of operations.

Consolidated Statement of Earnings

For the years ended October 31 In millions except per share amounts	1998	1997	1996
Net revenue:			
Products	**$40,105**	$36,672	$33,114
Services	**6,956**	6,223	5,306
Total net revenue	**47,061**	42,895	38,420
Costs and expenses:			
Cost of products sold	**27,477**	24,217	22,013
Cost of services	**4,595**	4,102	3,486
Research and development	**3,355**	3,078	2,718
Selling, general and administrative	**7,793**	7,159	6,477
Total costs and expenses	**43,220**	38,556	34,694
Earnings from operations	**3,841**	4,339	3,726
Interest income and other, net	**485**	331	295
Interest expense	**235**	215	327
Earnings before taxes	**4,091**	4,455	3,694
Provision for taxes	**1,146**	1,336	1,108
Net earnings	**$ 2,945**	$ 3,119	$ 2,586
Net earnings per share:			
Basic	**$ 2.85**	$ 3.04	$ 2.54
Diluted	**$ 2.77**	$ 2.95	$ 2.46
Average shares used in computing basic net earnings per share	**1,034**	1,026	1,019
Average shares and equivalents used in computing diluted net earnings per share	**1,072**	1,057	1,052

The accompanying notes are an integral part of these financial statements.

Consolidated Balance Sheet

October 31 In millions except par value and number of shares	1998	1997
Assets		
Current assets:		
Cash and cash equivalents	**$ 4,046**	$ 3,072
Short-term investments	**21**	1,497
Accounts receivable	**6,232**	6,142
Financing receivables	**1,520**	1,123
Inventory	**6,184**	6,763
Other current assets	**3,581**	2,350
Total current assets	**21,584**	20,947
Property, plant and equipment, net	**6,358**	6,312
Long-term investments and other assets	**5,731**	4,490
Total assets	**$33,673**	$31,749
Liabilities and shareholders' equity		
Current liabilities:		
Notes payable and short-term borrowings	**$ 1,245**	$ 1,226
Accounts payable	**3,203**	3,185
Employee compensation and benefits	**1,768**	1,723
Taxes on earnings	**2,796**	1,515
Deferred revenues	**1,453**	1,152
Other accrued liabilities	**3,008**	2,418
Total current liabilities	**13,473**	11,219
Long-term debt	**2,063**	3,158
Other liabilities	**1,218**	1,217
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $1 par value		
(authorized: 300,000,000 shares; issued: none)	**—**	—
Common stock and capital in excess of $0.01 par value		
(authorized: 4,800,000,000 shares; issued and outstanding: 1,015,403,000 in 1998 and 1,041,042,000 in 1997)	**10**	1,187
Retained earnings	**16,909**	14,968
Total shareholders' equity	**16,919**	16,155
Total liabilities and shareholders' equity	**$33,673**	$31,749

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Cash Flows

For the years ended October 31 In millions	1998	1997	1996
Cash flows from operating activities:			
Net earnings	**$ 2,945**	$ 3,119	$ 2,586
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	**1,869**	1,556	1,297
Deferred taxes on earnings	**(1,263)**	(232)	(284)
Changes in assets and liabilities:			
Accounts and financing receivables	**(1,019)**	(993)	(492)
Inventory	**563**	(279)	(356)
Accounts payable	**1**	775	(55)
Taxes on earnings	**1,216**	(63)	102
Other current assets and liabilities	**788**	237	520
Other, net	**342**	201	138
Net cash provided by operating activities	**5,442**	4,321	3,456
Cash flows from investing activities:			
Investment in property, plant and equipment	**(1,997)**	(2,338)	(2,201)
Disposition of property, plant and equipment	**413**	333	316
Purchase of short-term investments	**(3,297)**	(5,213)	(6,652)
Maturities of short-term investments	**4,773**	4,158	7,074
Purchase of long-term investments	**(762)**	—	(734)
Other, net	**75**	48	22
Net cash used in investing activities	**(795)**	(3,012)	(2,175)
Cash flows from financing activities:			
Change in notes payable and short-term borrowings	**(734)**	(1,194)	(1,137)
Issuance of long-term debt	**223**	1,182	1,989
Payment of long-term debt	**(580)**	(273)	(41)
Issuance of common stock under employee stock plans	**467**	419	363
Repurchase of common stock	**(2,424)**	(724)	(1,089)
Dividends	**(625)**	(532)	(450)
Other, net	**—**	—	(4)
Net cash used in financing activities	**(3,673)**	(1,122)	(369)
Increase in cash and cash equivalents	**974**	187	912
Cash and cash equivalents at beginning of year	**3,072**	2,885	1,973
Cash and cash equivalents at end of year	**$ 4,046**	$ 3,072	$ 2,885
Supplemental cash flow disclosures:			
Income taxes paid, net	**$ 1,039**	$ 1,488	$ 1,159
Interest paid	**$ 205**	$ 325	$ 267

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Shareholders' Equity

In millions except number of shares in thousands	Common stock		Retained earnings	Total
	Number of shares	Par value and capital in excess of par		
Balance October 31, 1995	1,019,910	$ 1,381	$ 10,458	$ 11,839
Acquisition via immaterial pooling	3,056	137	(162)	(25)
Shares issued	15,737	577	—	577
Shares repurchased	(24,580)	(1,081)	(8)	(1,089)
Dividends	—	—	(450)	(450)
Net earnings	—	—	2,586	2,586
Balance October 31, 1996	1,014,123	1,014	12,424	13,438
Acquisition via immaterial pooling	23,590	43	118	161
Shares issued	16,536	693	—	693
Shares repurchased	(13,207)	(563)	(161)	(724)
Dividends	—	—	(532)	(532)
Net earnings	—	—	3,119	3,119
Balance October 31, 1997	1,041,042	1,187	14,968	16,155
Shares issued	17,384	868	—	868
Shares repurchased	(43,023)	(2,045)	(379)	(2,424)
Dividends	—	—	(625)	(625)
Net earnings	—	—	2,945	2,945
Balance October 31, 1998	**1,015,403**	**$ 10**	**$16,909**	**$16,919**

The accompanying notes are an integral part of these financial statements.

Notes to Consolidated Financial Statements

Summary of Significant Accounting Policies

Principles of consolidation The consolidated financial statements include the accounts of Hewlett-Packard Company and its wholly- and majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

In July 1997, the Financial Accounting Standards Board (FASB) Emerging Issues Task force (EITF) reached a final consensus on Issue 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights." This consensus precludes investors from consolidating majority-owned investees when a minority shareholder or shareholders hold substantive participating rights, which, individually or in the aggregate, would allow such minority shareholders to participate in significant decisions made in the ordinary course of business. The company has followed the guidance in EITF 96-16 with respect to all investments made after July 24, 1997 and intends to adopt this guidance with respect to its previously existing majority-owned subsidiaries no later than the fourth quarter of fiscal year 1999. The company has not yet determined what, if any, impact this adoption will have on its financial statements.

Use of estimates The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the company's financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue recognition Revenue from product sales is generally recognized at the time the product is shipped, with provisions established for price protection programs and for estimated product returns. Upon shipment, the company also provides for the estimated cost that may be incurred for product warranties and post-sales support. Service revenue is recognized over the contractual period or as services are rendered and accepted by the customer.

Advertising Advertising costs are expensed as incurred and amounted to $1,214 million in 1998, $1,131 million in 1997 and $999 million in 1996.

Taxes on earnings Income tax expense is based on pretax financial accounting income. Deferred tax assets and liabilities are recognized principally for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts.

Net earnings per share The company adopted Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings per Share," in the first quarter of fiscal year 1998. Under SFAS 128, the company presents two earnings per share (EPS) amounts. Basic EPS is calculated based on net earnings available to common shareholders and the weighted-average number of shares outstanding during the reported period. Diluted EPS includes additional dilution from potential common stock, such as stock issuable pursuant to the exercise of stock options outstanding and the conversion of debt. All prior period EPS amounts have been presented to conform to the provisions of the statement.

In millions except per share data	1998	1997	1996
Numerator:			
Net earnings	**$2,945**	$3,119	$2,586
Adjustments for interest, net of income tax effect	**26**	—	—
Net earnings, adjusted	**$2,971**	$3,119	$2,586
Denominator:			
Weighted-average shares outstanding	**1,034**	1,026	1,019
Effect of dilutive securities:			
Dilutive options	**28**	31	33
Convertible zero-coupon notes due 2017	**10**	—	—
Dilutive potential common shares	**38**	31	33
Weighted-average shares and dilutive potential common shares	**1,072**	1,057	1,052
Basic earnings per share	**$ 2.85**	$ 3.04	$ 2.54
Diluted earnings per share	**$ 2.77**	$ 2.95	$ 2.46

Cash equivalents and short-term investments The company has classified investments as cash equivalents if the maturity of such investments is three months or less from the purchase date. Short-term investments are principally comprised of time deposits and temporary money-market instruments. Cash equivalents and short-term investments are stated at cost, which approximates market.

Inventory Inventory is valued at standard cost that approximates actual cost computed on a first-in, first-out basis, not in excess of market value.

Property, plant and equipment Property, plant and equipment are stated at cost. Additions, improvements and major renewals are capitalized. Maintenance, repairs and minor renewals are expensed as incurred. Depreciation is provided using accelerated methods, principally over 15 to 40 years for buildings and improvements and 3 to 10 years for machinery and equipment. Depreciation of leasehold improvements is provided using the straight-line method over the life of the lease or the asset, whichever is shorter.

Long-term investments The company's long-term investments are primarily comprised of debt securities which are held-to-maturity.

Foreign currency translation The company uses the U.S. dollar as its functional currency. Foreign currency assets and liabilities are remeasured into U.S. dollars at end-of-period exchange rates except for inventory, property, plant and equipment, other assets and deferred revenues, which are remeasured at historical exchange rates. Revenues and expenses are remeasured at average exchange rates in effect during each period, except for those expenses related to balance sheet amounts that are remeasured at historical exchange rates. Gains or losses from foreign currency remeasurement are included in net earnings. The effect of foreign currency exchange rate fluctuations on cash and cash equivalents denominated in foreign currencies was not material.

Recent pronouncements In June 1997, the FASB issued SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information." The statement changes standards for the way that public business enterprises identify and report operating segments in annual and interim financial statements. This statement requires selected information about an enterprise's operating segments and related disclosure about products and services, geographic areas and major customers. The company expects to report multiple segments when it adopts the standard for fiscal year-end 1999.

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement establishes accounting and reporting standards for derivative instruments and requires recognition of all derivatives as assets or liabilities in the statement of financial position and measurement of those instruments at fair value. The statement is effective for fiscal years beginning after June 15, 1999. The company will adopt the standard no later than the first quarter of fiscal year 2000 and is in the process of determining the impact that adoption will have on its consolidated financial statements.

Reclassifications Certain reclassifications of the 1997 and 1996 financial statements and related notes amounts have been made to conform with the 1998 presentation.

Acquisitions

The company acquired several companies during the last three years that were not significant to its financial position or results of operations. During 1997 and 1996, two acquisitions were accounted for using the pooling-of-interests method; however, prior period consolidated financial statements were not restated because the retroactive effects were not material. All other acquisitions were accounted for using the purchase method. Under the purchase method, the results of operations of acquired companies are included prospectively from the date of acquisition, and the acquisition cost is allocated to the acquirees' tangible and identifiable intangible assets and liabilities based upon their fair market values at the date of the acquisition, with any residual being goodwill. The company amortizes goodwill on a straight-line basis over its estimated economic life, generally 2 to 5 years. At October 31, 1998 and 1997, the net book value of goodwill associated with acquisitions was $174 million and $165 million, respectively.

Financial Instruments

Off-balance-sheet foreign exchange risk The company enters into foreign exchange contracts, primarily forwards and purchased options, to hedge against exposure to changes in foreign currency exchange rates. Such contracts are designated at inception to the related foreign currency exposures being hedged, which include committed and anticipated sales by subsidiaries and assets and liabilities that are denominated in currencies other than the U.S. dollar. To achieve hedge accounting, contracts must reduce the foreign currency exchange rate risk otherwise inherent in the amount and duration of the hedged exposures and comply with established company risk management policies. Hedging contracts generally mature within six months.

When hedging sales-related exposure, foreign exchange contract expirations are set so as to occur in the same month the hedged shipments occur, allowing realized gains and losses on the contracts to be recognized in net revenue in the same periods in which the related revenues are recognized. When hedging balance sheet exposure, realized gains and losses on foreign exchange contracts are recognized in other income and expense in the same period as the realized gains and losses on remeasurement of the foreign currency denominated assets and liabilities occur. All gains and losses related to foreign exchange contracts are included in cash flows from operating activities in the consolidated statement of cash flows.

The notional amount of foreign exchange contracts outstanding at October 31, 1998 and 1997 was $12.1 billion and $9.5 billion, respectively, and related to exposures in approximately 35 foreign currencies. The notional amount represents the future cash flows under contracts to both purchase and sell foreign currencies. Unrealized gains and losses on hedging contracts deferred under the company's hedge accounting policies amounted to $63 million and $292 million, respectively, at October 31, 1998 and $103 million and $86 million, respectively, at October 31, 1997. Unamortized premiums and realized gains deferred under currency options are not material.

Concentrations of credit risk Financial instruments that potentially subject the company to significant concentrations of credit risk consist principally of cash, investments, accounts receivable, financing receivables, and certain other financial instruments.

The company maintains cash and cash equivalents, short- and long-term investments and certain other financial instruments with various financial institutions. These financial institutions are located in many different geographies, and company policy is designed to limit exposure with any one institution. As part of its cash and risk management processes, the company performs periodic evaluations of the relative credit standing of the financial institutions. The company has not sustained material credit losses from these instruments.

The company sells a significant portion of its products through third-party resellers and, as a result, maintains individually significant receivable balances with major distributors. If the financial condition or operations of these distributors deteriorate substantially, the company's operating results could be adversely affected. The ten largest distributor receivable balances collectively represent 23 percent and 19 percent of total accounts receivable at October 31, 1998 and 1997, respectively. Credit risk with respect to other accounts receivable and financing receivables are generally diversified due to the large number of entities comprising the company's customer base and their dispersion across many different industries and geographies. The company performs ongoing credit evaluations of its third-party resellers' and other customers' financial condition, and requires collateral, such as letters of credit and bank guarantees, in certain circumstances.

Fair value of financial instruments For certain of the company's financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, financing receivables, notes payable and short-term borrowings, accounts payable and other accrued liabilities, the carrying amounts approximate fair value due to their short maturities. Long-term floating rate notes, long-term equity investments and time deposits are carried at amounts that approximate fair value. The estimated fair value of fixed rate long-term debt is primarily based on quoted market prices, as well as borrowing rates currently available to the company for bank loans with similar terms and maturities. This fair value, when adjusted for unrealized gains and losses on related interest rate swap agreements, approximates the carrying amount of long-term debt.

The estimated fair value for foreign exchange contracts is primarily based on quoted market prices for the same or similar instruments, adjusted where necessary for maturity differences. At October 31, 1998 and 1997, the estimated fair value of foreign exchange contracts amounted to $(229) million and $17 million, respectively.

The estimated fair values may not be representative of actual values of the financial instruments that could have been realized as of year end or that will be realized in the future.

Financing Receivables and Investment in Operating Leases

Financing receivables represent sales-type and direct-financing leases and installment sales resulting from the marketing of the company's and complementary third-party products. These receivables typically have terms from two to five years and are usually collateralized by a security interest in the underlying assets. The components of financing receivables, net, which are included in financing receivables and long-term investments and other assets at October 31, are:

In millions	1998	1997
Gross financing receivables	**$ 3,446**	$ 2,478
Unearned income	**(340)**	(253)
Financing receivables, net	**3,106**	2,225
Less current portion	**(1,520)**	(1,123)
Amounts due after one year, net	**$ 1,586**	$ 1,102

Contractual maturities of the company's gross financing receivables at October 31, 1998 are $1,721 million in 1999, $1,025 million in 2000, $572 million in 2001, $102 million in 2002 and $26 million thereafter. Actual cash collections may differ primarily due to customer early buy-outs and refinancings.

The company also leases its products to customers under operating leases. Equipment on operating leases was $1,377 million and $1,138 million at October 31, 1998 and 1997, respectively, and is included in machinery and equipment. Accumulated depreciation on equipment on operating leases was $606 million and $489 million at October 31, 1998 and 1997, respectively. Minimum future rentals on noncancelable operating leases with original terms of one year or longer are $608 million in 1999, $319 million in 2000, $117 million in 2001, $34 million in 2002 and $7 million thereafter.

Inventory

October 31, In millions	1998	1997
Finished goods	**$ 4,170**	$ 4,136
Purchased parts and fabricated assemblies	**2,014**	2,627
	$ 6,184	$ 6,763

Property, Plant and Equipment

October 31, In millions	1998	1997
Land	**$ 450**	$ 468
Buildings and leasehold improvements	**4,997**	4,672
Machinery and equipment	**7,123**	6,636
	12,570	11,776
Accumulated depreciation	**(6,212)**	(5,464)
	$ 6,358	$ 6,312

Taxes on Earnings

The provision for income taxes is comprised of:

In millions	1998	1997	1996
U.S. federal taxes:			
Current	$ 1,051	$ 544	$ 614
Deferred	(1,086)	(257)	(115)
Non-U.S. taxes:			
Current	1,153	965	716
Deferred	(46)	52	(169)
State taxes	74	32	62
	$ 1,146	$1,336	$1,108

The significant components of deferred tax assets, which required no valuation allowance, and deferred tax liabilities included on the balance sheet at October 31 are:

	1998		1997	
In millions	Deferred tax assets	Deferred tax liabilities	Deferred tax assets	Deferred tax liabilities
Inventory	$ 639	$ 24	$ 563	$ 16
Fixed assets	123	—	90	17
Warranty	367	—	224	15
Leasing activities	51	63	16	78
Retiree medical benefits	253	—	257	—
Other retirement benefits	—	111	—	113
Employee benefits, other than retirement	354	47	242	42
Intracompany sales	825	—	—	—
Other	182	89	228	140
	$2,794	$334	$1,620	$421

The current portion of the deferred tax asset is $2,082 million and $1,042 million at October 31, 1998 and 1997, respectively, and is included in other current assets.

Tax benefits of $157 million, $150 million and $123 million associated with the exercise of employee stock options were allocated to equity in 1998, 1997 and 1996, respectively.

The differences between the U.S. federal statutory income tax rate and the company's effective tax rate are:

	1998	1997	1996
U.S. federal statutory income tax rate	**35.0%**	35.0%	35.0%
State income taxes, net of federal tax benefit	**1.2**	0.5	1.1
Lower rates in other jurisdictions, net	**(9.7)**	(5.9)	(6.9)
Other, net	**1.5**	0.4	0.8
	28.0%	30.0%	30.0%

The domestic and foreign components of earnings before taxes are:

In millions	1998	1997	1996
U.S. operations including Puerto Rico	**$ 727**	$1,433	$1,535
Non-U.S.	**3,364**	3,022	2,159
	$4,091	$4,455	$3,694

The company has not provided for U.S. federal income and foreign withholding taxes on $7.1 billion of non-U.S. subsidiaries' undistributed earnings as of October 31, 1998, because such earnings are intended to be reinvested indefinitely. If these earnings were distributed, foreign tax credits should become available under current law to reduce or eliminate the resulting U.S. income tax liability. Where excess cash has accumulated in the company's non-U.S. subsidiaries and it is advantageous for tax or foreign exchange reasons, subsidiary earnings are remitted.

As a result of certain employment and capital investment actions undertaken by the company, income from manufacturing activities in certain countries is subject to reduced tax rates, and in some cases is wholly exempt from taxes, for years through 2012. The income tax benefits attributable to the tax status of these subsidiaries are estimated to be $435 million, $226 million and $212 million for 1998, 1997 and 1996, respectively.

The Internal Revenue Service (IRS) has completed its examination of the company's federal income tax returns filed through 1992. The IRS has commenced its examination of returns for years 1993 to 1995. The company believes that adequate accruals have been provided for all years.

Borrowings

Notes payable and short-term borrowings and the related average interest rates at October 31 are:

	1998		1997	
In millions		**Average Interest rate**		Average Interest rate
Current portion of long-term debt	**$1,007**	**5.7%**	$ 254	7.5%
Notes payable to banks	**72**	**8.5%**	834	6.7%
Other short-term borrowings	**166**	**4.9%**	138	5.9%
	$1,245		$1,226	

At October 31, 1998, the company had a committed borrowing facility in place with unused borrowing capacity totaling $1 billion.

Long-term debt and related maturities and interest rates at October 31 are:

In millions	1998	1997
U.S. dollar zero-coupon subordinated convertible notes, due 2017 at 3.13%	**$ 1,111**	$ 968
U.S. dollar notes, due 1999-2012 at 5.25%-7.90%	**1,104**	1,500
Deutschemark notes, due 2000-2002 at 4.75%-5.63%	**372**	352
Yen notes, due 1999-2002 at 1.80%-5.03%	**265**	377
British pound note, due 1999 at 7.13%	**170**	162
Other	**48**	53
Less current portion	**(1,007)**	(254)
	$ 2,063	$3,158

The company issues long-term debt in either U.S. dollars or foreign currencies based on market conditions at the time of financing. Interest rate and foreign currency swaps are then used to modify the market risk exposures under the debt to achieve primarily U.S. dollar LIBOR-based floating interest expense and to neutralize exposure to changes in foreign currency exchange rates. The swap transactions generally involve the exchange of fixed for floating interest payment obligations and, when the underlying debt is denominated in a foreign currency, exchange of the foreign currency principal and interest obligations for U.S. dollar-denominated amounts. Notional amounts and maturities under the swaps generally match those of the underlying debt. Unrealized gains and losses on currency swaps hedging foreign currency debt are recognized as other assets and other liabilities and are not material.

In November 1997 and October 1997, the company issued $200 million and $1.8 billion face value of zero-coupon subordinated convertible notes, respectively, due 2017 for proceeds of $108 million and $968 million, respectively. The notes are convertible at any time by the holders at the rate of 5.43 shares of the company's common stock for each $1,000 face value of the notes, payable in either cash or common stock at the option of the company. The notes may be redeemed by the holders on October 14, 2000 or by the company on or after that date at book value, payable in either cash or common stock at the option of the company. The notes are subordinated to all other existing and future senior indebtedness of the company.

Aggregate future maturities of long-term debt outstanding at October 31, 1998 are $1,007 million in 1999, $500 million in 2000, $208 million in 2001, $77 million in 2002, $6 million in 2003 and $1,272 million thereafter. The company occasionally repurchases its debt prior to maturity based on its assessment of current market conditions and financing alternatives.

Shareholders' Equity

Reincorporation Effective May 20, 1998, the company changed its state of incorporation from California to Delaware. As a result of the change, the par value of the company's stock was decreased from $1.00 to $0.01 per share. There was no impact on the company's financial condition or results of operations as a result of the reincorporation. The reincorporation proposal had been approved by the company's shareholders at the company's annual meeting of shareholders on February 24, 1998. An increase in the number of authorized shares of the company's common stock from 2.4 billion to 4.8 billion was also approved by the shareholders.

Employee Stock Purchase Plan Eligible company employees may generally contribute up to 10 percent of their base compensation to the quarterly purchase of shares of the company's common stock under the Employee Stock Purchase Plan. Under this plan, employee contributions to purchase shares are partially matched with shares contributed by the company, which

generally vest over two years. At October 31, 1998, approximately 107,000 employees were eligible to participate and approximately 64,000 employees were participants in the plan. During 1998, 1997 and 1996, the company contributed 2,173,000, 2,327,000 and 2,311,000 matching shares at weighted average prices of $63, $54 and $46 per share, respectively, and recognized compensation expense of $100 million, $96 million and $72 million, respectively, under the plan.

Incentive compensation plans The company has four principal stock option plans, adopted in 1979, 1985, 1990 and 1995. All plans permit options granted to qualify as "Incentive Stock Options" under the Internal Revenue Code. The exercise price of a stock option is generally equal to the fair market value of the company's common stock on the date the option is granted and its term is generally ten years. Under the 1990 and 1995 Incentive Stock Plans, the Compensation Committee, in certain cases, may choose to establish a discounted exercise price at no less than 75 percent of fair market value on the grant date. In 1998, 1997 and 1996, discounted options totaling 1,050,000, 780,000 and 1,165,000 shares, respectively, were granted. Stock compensation expense related to the discounted options was not material in each of these years. Options generally vest at a rate of 25 percent per year over a period of four years from the date of grant except for discounted options, which generally may not be exercised until the third or fifth anniversary of the option grant date, at which time such options become 100 percent vested. The plans also provide for the granting of stock appreciation rights with respect to options granted to officers. The company has not included stock appreciation rights with options granted to officers since October 31, 1991.

The following table summarizes option activity during 1998, 1997 and 1996:

	1998		1997		1996	
	Shares (000)	**Weighted-Average Exercise Price**	Shares (000)	Weighted-Average Exercise Price	Shares (000)	Weighted-Average Exercise Price
Outstanding at beginning of year	**51,250**	**$26**	49,344	$20	49,616	$15
Granted	**10,648**	**60**	8,000	51	7,237	43
Assumed via acquisitions	**—**	**—**	3,179	30	639	40
Exercised	**(8,245)**	**16**	(8,689)	14	(7,214)	12
Cancelled	**(1,580)**	**44**	(584)	33	(934)	22
Outstanding at end of year	**52,073**	**$33**	51,250	$26	49,344	$20
Options exercisable at year-end	**29,140**	**$21**	27,471	$17	25,649	$13
Weighted-average fair value of options granted during the year	**$21.67**		$20.16		$17.82	

The following table summarizes information about options outstanding at October 31, 1998:

	Options Outstanding			**Options Exercisable**	
Range of Exercise Prices	**Number Outstanding (000)**	**Weighted-Average Remaining Contractual Life**	**Weighted-Average Exercise Price**	**Number Exercisable (000)**	**Weighted-Average Exercise Price**
$ 0–25	**25,789**	**4.0 years**	**$16**	**22,461**	**$15**
$26–50	**10,701**	**7.3**	**43**	**4,489**	**43**
$51 & over	**15,583**	**8.6**	**58**	**2,190**	**55**
	52,073		**$33**	**29,140**	**$21**

Shares available for option grants at October 31, 1998 and 1997 were 50,168,000 and 59,012,000, respectively. Approximately 65,000 employees were considered eligible to receive stock options in fiscal year 1998. There were approximately 37,000 employees holding options under one or more of the option plans as of October 31, 1998.

Under the 1985 Incentive Compensation Plan and the 1990 and 1995 Incentive Stock Plans, certain key employees may be granted cash or restricted stock awards. Cash and restricted stock awards are independent of option grants and are subject to restrictions considered appropriate by the company's Compensation Committee. The majority of the shares of restricted stock outstanding at October 31, 1998 are subject to forfeiture if employment terminates prior to three years from the date of grant. During that period, ownership of the shares cannot be transferred. Restricted stock has the same dividend and voting rights as other common stock and is considered to be currently issued and outstanding. The cost of the awards, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse. Such expense was not material in 1998, 1997 or 1996. At October 31, 1998 and 1997, the company had 4,380,000 and 4,300,000 shares, respectively, of restricted stock outstanding.

Pro forma information The company applies the intrinsic-value-based method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for employee stock options. Accordingly, compensation expense is recognized only when options are granted with a discounted exercise price. Any such compensation expense is recognized ratably over the associated service period, which is generally the option vesting term.

Pro forma net earnings and earnings per share information, as required by SFAS No. 123, "Accounting for Stock-Based Compensation," has been determined as if the company had accounted for employee stock options under SFAS 123's fair value method. The fair value of these options was estimated at grant date using a Black-Scholes option pricing model with the following weighted-average assumptions for fiscal 1998, 1997 and 1996, respectively: risk-free interest rates of 5.38, 6.21 and 6.29 percent; dividend yield of 1.0 percent; expected option life of 7 years for 1998 and 6 years for 1997 and 1996; and volatility of 30 percent.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the 4-year average vesting period of the options. The company's pro forma net earnings for 1998, 1997 and 1996 were $2,891 million, $3,078 million and $2,570 million, and pro forma diluted net earnings per share were $2.70, $2.91 and $2.44, respectively. These pro forma amounts include amortized fair values attributable to options granted after October 31, 1995 only, and therefore are not representative of future pro forma amounts.

Shares reserved At October 31, 1998 and 1997, the company has reserved 116,168,000 and 131,761,000 shares, respectively, for future issuance under the employee stock plans.

Stock repurchase program Shares of the company's common stock are repurchased under a systematic program to manage the dilution created by shares issued under employee stock plans. The company repurchased 21,573,000 shares in 1998, 13,207,000 shares in 1997 and 24,580,000 shares in 1996 for an aggregate purchase price of $1,292 million, $724 million and $1,089 million, respectively. At October 31, 1998, the company had authorization for an aggregate of $1,214 million in future repurchases under this program based on certain price and volume criteria. During July 1998, the company's Board of Directors authorized a new incremental repurchase program under which up to $2 billion of the company's common stock can be repurchased in the open market or in private transactions. Under this program, the company repurchased 21,450,000 shares for an aggregate purchase price of $1,132 million. These repurchases are in addition to the company's existing systematic share-repurchase program.

Retirement Plans and Retiree Medical Benefits

Pension and deferred profit-sharing plans Substantially all of the company's employees are covered under various pension and deferred profit-sharing retirement plans. Worldwide pension and deferred profit-sharing costs were $349 million in 1998, $320 million in 1997, and $281 million in 1996.

U.S. employees who meet certain minimum eligibility criteria are provided retirement benefits under the Hewlett-Packard Company Retirement Plan (Retirement Plan). Defined benefits are based upon an employee's highest average pay rate and length of service. For eligible service through October 31, 1993, the benefit payable under the Retirement Plan is reduced by any amounts due to the employee under the company's frozen defined contribution Deferred Profit-Sharing Plan (DPS), which has since been closed to new participants.

The combined status of the Retirement Plan and DPS follows:

In millions	**1998**	1997
Fair value of plan assets	**$3,666**	$3,284
Retirement benefit obligation	**$3,845**	$3,329

Employees outside the U.S. generally receive retirement benefits under various defined benefit and defined contribution plans based upon factors such as years of service and employee compensation levels. Eligibility is generally determined in accordance with local statutory requirements.

Retiree medical plan In addition to providing pension benefits, the company sponsors a medical plan that provides defined benefits to U.S. retired employees. Substantially all of the company's current U.S. employees could become eligible for these benefits, and the existing benefit obligation relates primarily to those employees. Once participating in the plan, retirees may choose from managed-care and indemnity options, with their contributions dependent on options chosen and length of service.

401(k) plan U.S. employees of the company may participate in the Tax Saving Capital Accumulation Plan (TAXCAP), which was established as a supplemental retirement program. Beginning February 1, 1998, enrollment in the TAXCAP is automatic for employees who meet eligibility requirements unless they decline participation. Under the TAXCAP program, the company matches contributions by employees up to a maximum of 4 percent of an employee's annual compensation. The maximum combined contribution to the Employee Stock Purchase Plan and TAXCAP is 25 percent of an employee's annual base compensation subject to certain regulatory and plan limitations. At October 31, 1998, 63,000 employees were participating in TAXCAP out of 69,000 who were eligible.

Net periodic cost The company's net pension and retiree medical costs are comprised of:

	Pension								
	U.S. plan			Non-U.S. plans			U.S. retiree medical plan		
In millions	**1998**	1997	1996	**1998**	1997	1996	**1998**	1997	1996
Service cost—benefits earned during the period	**$189**	$ 159	$137	**$114**	$ 104	$ 86	**$27**	$ 25	$ 23
Interest cost on benefit obligation	**54**	40	27	**88**	82	74	**35**	34	32
Actual return on plan assets	**(87)**	(107)	(61)	**(251)**	(341)	(120)	**(56)**	(82)	(55)
Net amortization and deferral	**17**	58	25	**112**	234	36	**(9)**	27	8
Net plan cost	**$173**	$ 150	$128	**$ 63**	$ 79	$ 76	**$ (3)**	$ 4	$ 8

Funded status The funded status of the defined benefit and retiree medical plans is:

In millions	U.S. defined benefit plan 1998	U.S. defined benefit plan 1997	Non-U.S. defined benefit plans 1998	Non-U.S. defined benefit plans 1997	U.S. retiree medical plan 1998	U.S. retiree medical plan 1997
Fair value of plan assets	**$ 936**	$ 733	**$ 1,919**	$ 1,530	**$ 503**	$ 448
Benefit obligation	**(1,115)**	(778)	**(1,983)**	(1,443)	**(543)**	(475)
Plan assets in excess (less than) benefit obligation	**(179)**	(45)	**(64)**	87	**(40)**	(27)
Unrecognized net experience (gain) loss	**77**	(23)	**73**	(80)	**(255)**	(268)
Unrecognized prior service cost (benefit) related to plan changes	**39**	43	**33**	37	**(144)**	(154)
Unrecognized net transition asset*	**(15)**	(23)	**(1)**	(3)	**—**	—
Prepaid (accrued) costs	**(78)**	$ (48)	**$ 41**	$ 41	**$(439)**	$(449)
Vested benefit obligation	**$ (507)**	$(327)	**$(1,476)**	$(1,059)		
Accumulated benefit obligation	**$ (507)**	$(327)	**$(1,540)**	$(1,105)		

*Amortized over 15 years for the U.S. plan and over periods ranging from 12 to 20 years for non-U.S. plans.

Plan assets consist primarily of listed stocks and bonds. It is the company's practice to fund these costs to the extent they are tax-deductible.

Assumptions The assumptions used to measure the benefit obligations and to compute the expected long-term return on assets for the company's defined benefit and retiree medical plans are:

	1998	1997	1996
U.S. defined benefit plan:			
Discount rate	**6.5%**	7.0%	7.5%
Average increase in compensation levels	**5.0%**	5.5%	5.5%
Expected long-term return on assets	**9.0%**	9.0%	9.0%
Non-U.S. defined benefit plans:			
Discount rate	**3.0 to 6.5%**	3.5 to 8.0%	4.0 to 8.5%
Average increase in compensation levels	**3.75 to 5.0%**	3.5 to 5.5%	3.5 to 6.5%
Expected long-term return on assets	**6.5 to 8.5%**	6.0 to 9.0%	5.8 to 10.0%
U.S. retiree medical plan:			
Discount rate	**6.5%**	7.0%	7.5%
Expected long-term return on assets	**9.0%**	9.0%	9.0%
Current medical cost trend rate	**8.65%**	9.6%	10.0%
Ultimate medical cost trend rate	**5.5%**	6.0%	6.0%
Medical cost trend rate decreases to ultimate rate in year	**2007**	2007	2007
Effect of a 1% increase in the medical cost trend rate (millions):			
Increase in benefit obligation	**$116**	$101	$90
Increase in the annual retiree medical cost	**$ 17**	$ 15	$13

Commitments

The company leases certain real and personal property under noncancelable operating leases. Future minimum lease payments at October 31, 1998 are $216 million for 1999, $175 million for 2000, $129 million for 2001, $94 million for 2002, $73 million for 2003 and $240 million thereafter. Certain leases require the company to pay property taxes, insurance and routine maintenance, and include escalation clauses. Rent expense was $465 million in 1998, $388 million in 1997 and $353 million in 1996.

Contingencies and Factors That Could Affect Future Results

Contingencies The company is involved in lawsuits, claims, investigations and proceedings, including patent, commercial, and environmental matters, which arise in the ordinary course of business. There are no such matters pending that the company expects to be material in relation to its business, financial condition, or results of operations.

Factors that could affect future results A substantial portion of the company's revenues each year are generated from the development, manufacture and rapid release to market of high technology products newly introduced during the year. In the extremely competitive industry environment in which the company operates, such product generation, manufacturing and marketing processes are uncertain and complex, requiring accurate prediction of market trends and demand as well as successful management of various manufacturing risks inherent in such products. Additionally, the company's production strategy relies on certain key suppliers' ability to deliver quality components, subassemblies and completed products in time to meet critical manufacturing and distribution schedules, and its sales strategy relies on the ability of certain third-party resellers to support sales channels to the mass market effectively. In light of these dependencies, it is reasonably possible that failure to successfully manage a significant product introduction, failure of certain key suppliers to deliver as needed, or failure of certain resellers to remain customers and channel partners could have a severe near-term impact on the company's order growth, revenue growth, or results of operations.

The Company expects to implement successfully the changes necessary to address its Year 2000 (Y2K) internal readiness, product compliance, and material third-party relationship issues. Based on current estimates, the Company does not believe that the incremental costs associated with such actions will have a material effect on the Company's results of operations or financial condition. There can be no assurance, however, that there will not be a delay in, increased costs associated with, or legal claims related to the implementation of such changes. In addition, failure to achieve Y2K readiness could result in delays in the Company's ability to manufacture and ship products and deliver services, disrupt its customer service and technical support facilities, and interrupt customer access to its online products and services. The Company's inability to perform these functions could have an adverse effect on future results of operations or financial condition.

Geographic Area Information

The company, operating in a single industry segment, designs, manufactures and services products and systems for measurement, computation and communications.

Net revenue, earnings from operations and identifiable assets, classified by the major geographic areas in which the company operates, are:

In millions	1998	1997	1996
Net revenue			
United States:			
Unaffiliated customer sales	**$21,530**	$19,076	$17,041
Interarea transfers	**7,748**	7,368	7,263
	29,278	26,444	24,304
Europe:			
Unaffiliated customer sales	**16,056**	14,332	13,252
Interarea transfers	**1,814**	1,768	1,643
	17,870	16,100	14,895
Japan, Other Asia Pacific, Canada, Latin America:			
Unaffiliated customer sales	**9,475**	9,487	8,127
Interarea transfers	**5,091**	5,198	5,470
	14,566	14,685	13,597
Eliminations	**(14,653)**	(14,334)	(14,376)
	$47,061	$42,895	$38,420
Earnings from operations			
United States	**$ 1,837**	$ 2,549	$ 2,470
Europe	**1,323**	1,296	769
Japan, Other Asia Pacific, Canada, Latin America	**1,337**	1,278	1,173
Eliminations and corporate	**(656)**	(784)	(686)
	$ 3,841	$ 4,339	$ 3,726
Identifiable assets			
United States	**$16,079**	$15,665	$14,321
Europe	**11,169**	9,710	7,991
Japan, Other Asia Pacific, Canada, Latin America	**8,588**	8,549	7,200
Eliminations and corporate	**(2,163)**	(2,175)	(1,813)
	$33,673	$31,749	$27,699

Net revenue from sales to unaffiliated customers is based on the location of the customer. Interarea transfers are sales among company affiliates principally made at market price, less an allowance primarily for subsequent manufacturing and/or marketing costs. Earnings from operations and identifiable assets are classified based on the location of the company's facilities. Identifiable corporate assets, which are net of eliminations, are comprised primarily of cash and cash equivalents, property, plant and equipment, and other assets, and aggregate $4,838 million in 1998, $5,776 million in 1997 and $4,810 million in 1996.

Statement of Management Responsibility

The company's management is responsible for the preparation, integrity and objectivity of the consolidated financial statements and other financial information presented in this report. The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles and reflect the effects of certain estimates and judgments made by management.

The company's management maintains an effective system of internal control that is designed to provide reasonable assurance that assets are safeguarded and transactions are properly recorded and executed in accordance with management's authorization. The system is continuously monitored by direct management review and by internal auditors who conduct an extensive program of audits throughout the company. The company selects and trains qualified people who are provided with and expected to adhere to the company's standards of business conduct. These standards, which set forth the highest principles of business ethics and conduct, are a key element of the company's control system.

The company's consolidated financial statements have been audited by PricewaterhouseCoopers LLP, independent accountants. Their audits were conducted in accordance with generally accepted auditing standards, and included a review of financial controls and tests of accounting records and procedures as they considered necessary in the circumstances.

The Audit Committee of the Board of Directors, which consists of outside directors, meets regularly with management, the internal auditors and the independent accountants to review accounting, reporting, auditing and internal control matters. The committee has direct and private access to both internal and external auditors.

Lew Platt
Chairman of the Board, President and
Chief Executive Officer

Robert Wayman
Executive Vice President, Finance and Administration
Chief Financial Officer

Report of Independent Accountants

To the Shareholders and Board of Directors of Hewlett-Packard Company

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of earnings, cash flows and shareholders' equity present fairly, in all material respects, the financial position of Hewlett-Packard Company and its subsidiaries at October 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended October 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation.
We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

San Jose, California
November 16, 1998

Orders and Net Revenue by Groupings of Similar Products and Services

Unaudited

For the years ended October 31 In millions	1998	1997	1996
Orders			
Computer products, service and support	**$38,780**	$35,399	$31,853
Test and measurement products and service	**4,234**	4,486	4,018
Medical electronic equipment and service	**1,444**	1,339	1,292
Electronic components	**1,054**	989	831
Chemical analysis and service	**992**	940	895
	$46,504	$43,153	$38,889
Net revenue			
Computer products, service and support	**$39,466**	$35,407	$31,447
Test and measurement products and service	**4,169**	4,339	3,910
Medical electronic equipment and service	**1,408**	1,265	1,287
Electronic components	**1,052**	975	918
Chemical analysis and service	**966**	909	858
	$47,061	$42,895	$38,420

The table above provides supplemental information showing orders and net revenue by groupings of similar products and services. In fiscal year 1998, the company's Integrated Systems Division was transferred from the computer products, service and support grouping to the test and measurement products and service grouping. Fiscal years 1997 and 1996 orders and net revenue have been restated to be consistent with the new presentation. The change did not affect the company's total orders or net revenue. The company reports orders when received. The groupings are as follows:

Computer products, service and support Computer equipment and systems (hardware and software), networking products, desktop and large-format printers, desktop scanners, all-in-one and digital photography products; extended-storage products; terminals and handheld calculators; consulting and integration services; support and maintenance services; and parts and supplies.

Test and measurement products and service Instruments, systems and software to design and produce electronics; to test integrated circuits; and to test, synchronize and extract data from Internet, intranet and telephony networks; video servers; and manufacturing consultation.

Medical electronic equipment and service Clinical measurement instrumentation and information systems used for patient monitoring; point-of-care diagnostics; ultrasound imaging and diagnostic cardiology; solutions implementation and support and equipment maintenance services; and medical supplies.

Electronic components Advanced components for wireless and wired communications, image capture and display, and power lighting.

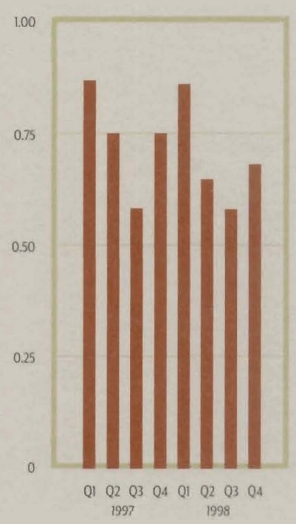
Chemical analysis and service Gas and liquid chromatographs; mass spectrometers and spectrophotometers used to analyze chemical compounds; bioscience instrument systems; laboratory data and information management systems; support and maintenance services; and consumables and supplies.

Quarterly Summary

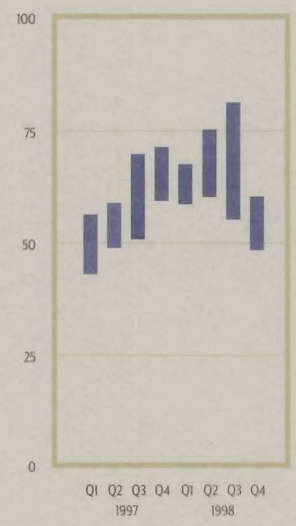
Unaudited

For the three months ended In millions except per share amounts	January 31	April 30	July 31	October 31
1998				
U.S. orders	$ 5,339	$ 5,338	$ 5,031	$ 5,630
International orders	7,052	6,276	5,423	6,415
Total orders	$12,391	$11,614	$10,454	$12,045
Net revenue	$11,816	$12,040	$10,979	$12,226
Cost of products sold and services	$ 7,837	$ 8,224	$ 7,505	$ 8,506
Earnings from operations	$ 1,304	$ 872	$ 774	$ 891
Net earnings	$ 929	$ 685	$ 621	$ 710
Per share amounts:				
Net earnings – Basic	$ .89	$ .66	$ .60	$ .69
Net earnings – Diluted	$ .86	$ .65	$ .58	$ .68
Cash dividends	$ .14	$ .14	$ .16	$ .16
Range of stock prices	$58¾-67¾	$60¼-75⅜	$55⅜-81⅝	$48 9/16-60¼
1997				
U.S. orders	$ 4,215	$ 4,586	$ 4,853	$ 5,183
International orders	6,759	5,808	5,503	6,246
Total orders	$ 10,974	$ 10,394	$ 10,356	$ 11,429
Net revenue	$ 10,295	$ 10,340	$ 10,471	$ 11,789
Cost of products sold and services	$ 6,694	$ 6,743	$ 7,053	$ 7,829
Earnings from operations	$ 1,281	$ 1,102	$ 825	$ 1,131
Net earnings	$ 912	$ 784	$ 617	$ 806
Per share amounts:				
Net earnings – Basic	$ .90	$ .77	$ .60	$ .77
Net earnings – Diluted	$ .87	$ .75	$ .58	$ .75
Cash dividends	$ .12	$ .12	$ .14	$ .14
Range of stock prices	$43⅛-56⅜	$ 49-59	$50⅞-70	$59½-71 9/16

Net Earnings Per Share - Diluted
In dollars



Range of Stock Price
In dollars per share



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Chief Executive Officer
Hewlett-Packard Company

Robert P. Wayman
Executive Vice President and
Chief Financial Officer
Hewlett-Packard Company

Emeritus Director

William R. Hewlett
Co-founder
Hewlett-Packard Company

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Keyworth (Chair), Condit, Hackborn,
Hewlett, Lawrence

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Orr (Chair), Everhart, Fery, Ginn, Lawrence

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Chief Executive Officer

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Vice President and Controller

Manuel F. Diaz
Vice President, Customer Advocacy
(Retiring February 1, 1999)

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Vice President, Customer Advocacy
(Effective February 1, 1999)

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Geographic Operations
Managing Director Americas Operations

Lawrence Tomlinson
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Professional Services Business Unit

Duane E. Zitzner*
Vice President and General Manager
Personal Systems Group

D. Craig Nordlund
Associate General Counsel and
Secretary

Ann O. Baskins
Assistant Secretary and
Senior Managing Counsel

**Executive Officer under Section 16 of the Securities and Exchange Act of 1934*

Shareholder Information

The annual meeting will be held on Tuesday, February 23, 1999 at the Flint Center for the Performing Arts. The address is 21250 Stevens Creek Boulevard, Cupertino, California, 95015-1897.

Investor Information

Current and prospective HP investors can receive the annual report, proxy statement, 10-K, earnings announcements, 10-Q and other publications at no cost by calling 800-TALK-HWP (825-5497). As a service to people with impaired vision, the 1998 annual report is available on audio cassette.

HP's home page on the World Wide Web is at http://www.hp.com

The annual report and related financial information are also available on the Web, and they can be accessed either from our home page or directly at http://www.hp.com/go/financials

HP's Web site with Year 2000 information for customers is at http://www.hp.com/year2000/index.html

Transfer Agent and Registrar

Please contact HP's transfer agent, at the phone number or address listed below, with questions concerning stock certificates, dividend checks, transfer of ownership or other matters pertaining to your stock account.

Harris Trust and Savings Bank
Shareholder Services
P.O. Box A3504
Chicago, Illinois 60690

If calling from anywhere within the United States: (800) 286-5977
From outside the United States: (312) 461-4061

Common Stock and Dividends

Hewlett-Packard is listed on the New York and Pacific stock exchanges, with the ticker symbol HWP. We've paid cash dividends each year since 1965. The current rate is $0.16 per share per quarter. As of November 30, 1998, there were 113,871 shareholders of record.

Dividend Reinvestment/Stock Purchase

Dividend reinvestment and stock purchase are available through Harris Bank, HP's transfer agent. Please contact Harris Bank at the address and phone numbers listed under Transfer Agent and Registrar for information on this program.

Corporate Information

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Europe, Africa, Middle East
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CH-1217 Meyrin 2
Geneva, Switzerland
Telephone: (41/22) 780-8111

Asia Pacific
17-21/F Shell Tower
Times Square, 1 Matheson Street
Causeway Bay, Hong Kong
Telephone: (852) 2 599-7777

A directory of sales and support locations can be obtained from the Corporate Communications department at HP's headquarters in Palo Alto. Please call 800-825-5497 to request this information.

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