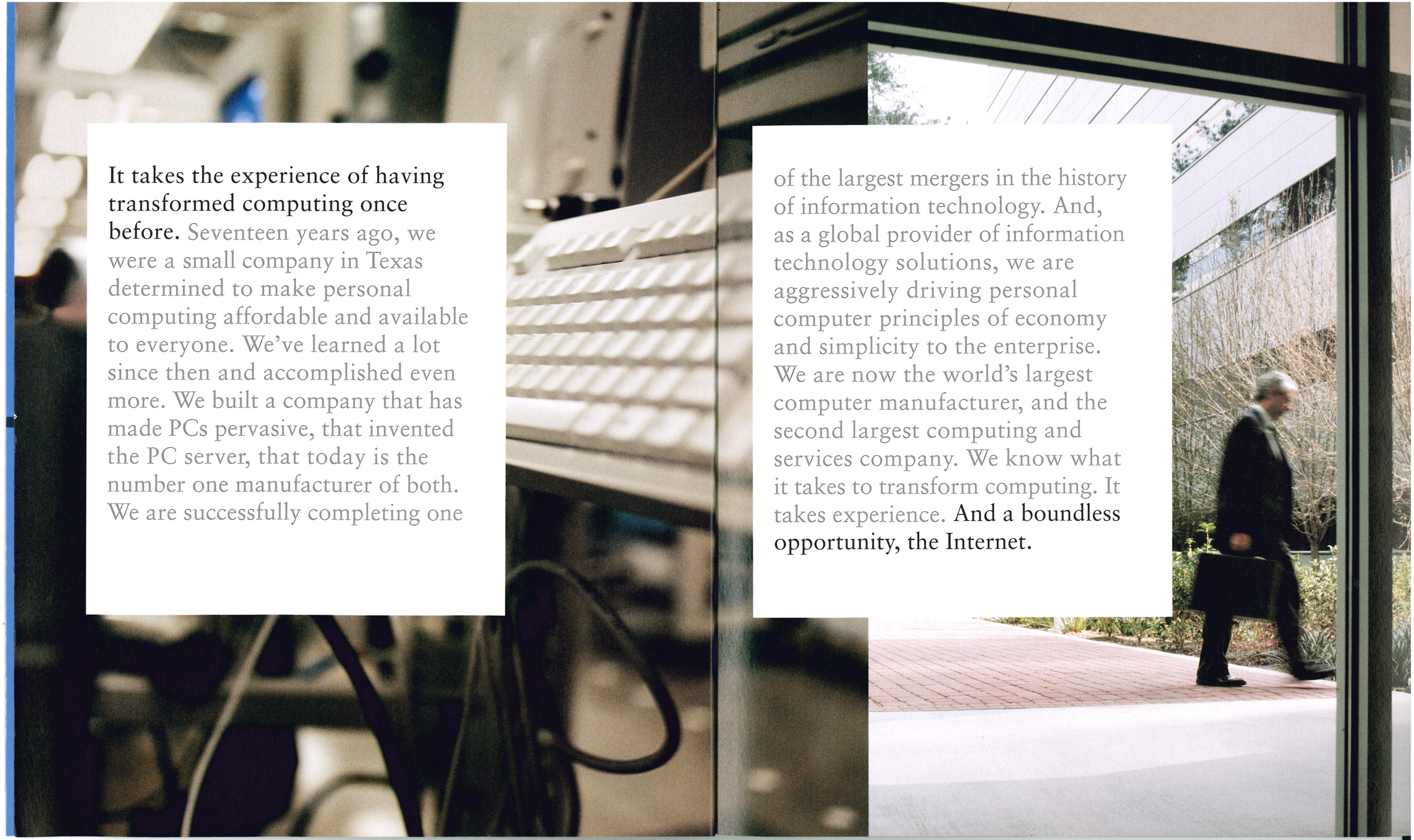
Most people see the future
as an internetworked world.
Computing is transformed.
Society is changed forever.

COMPAQ

We agree.

But what does it take
to get there?



It takes the experience of having transformed computing once before. Seventeen years ago, we were a small company in Texas determined to make personal computing affordable and available to everyone. We've learned a lot since then and accomplished even more. We built a company that has made PCs pervasive, that invented the PC server, that today is the number one manufacturer of both. We are successfully completing one of the largest mergers in the history of information technology. And, as a global provider of information technology solutions, we are aggressively driving personal computer principles of economy and simplicity to the enterprise. We are now the world's largest computer manufacturer, and the second largest computing and services company. We know what it takes to transform computing. It takes experience. And a boundless opportunity, the Internet.

It takes a deep down
devotion to standards.

Standards are
the Internet's DNA.

Only a dozen years ago, every computer company wrote its own rules. And computing was chaos, even for professionals.

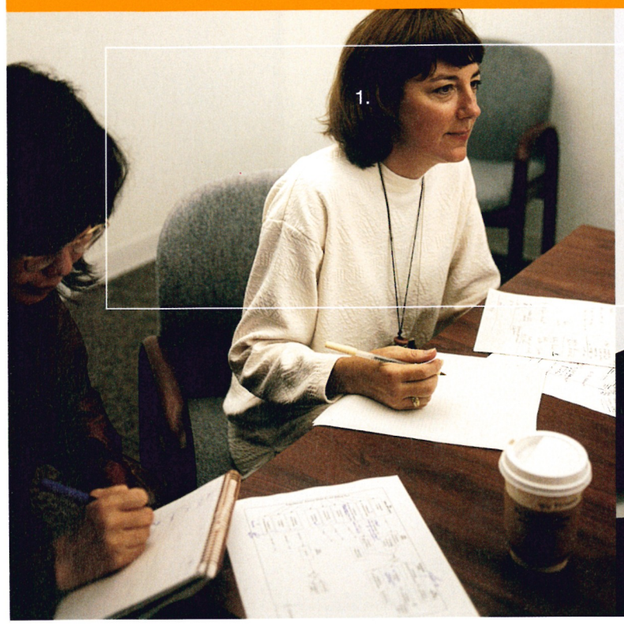
Then Compaq pioneered a new rule—that standards must be shared—and suddenly everything changed.

By establishing, expanding and championing industry standards, Compaq, and our vast array of partners, pushed innovation to new heights and sent costs in the opposite direction.

Standards have made computing easier yet more powerful. And solutions simpler and more accessible, for everyone from grandmas to global enterprises.

Standards have won, and the Internet is their shining star. In a world of countless tongues, "Internet" is spoken everywhere, thanks to universal acceptance of industry standards.

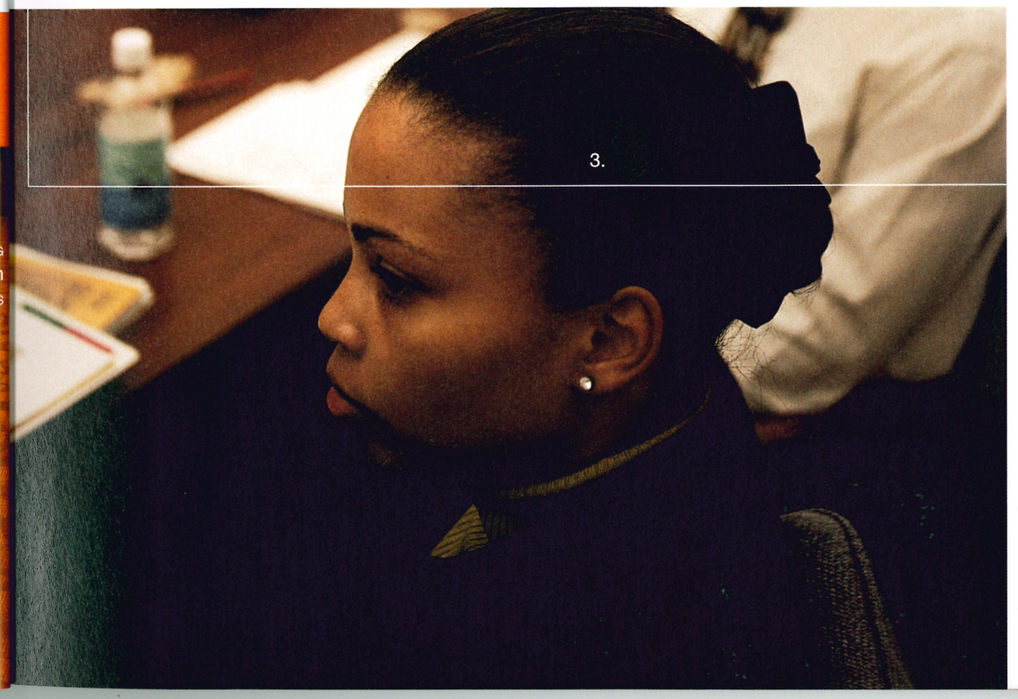
Today, Compaq's lead endures. Behind the scenes, in helping to shape Internet standards. And at the forefront of customers' e-commerce solutions.


1.

4.

2.

1. Janet Daigneault > MANAGER, GLOBAL INTERCOMPANY PROCESSING
2. Tien Le > RESEARCH ANALYST, INVESTOR RELATIONS 3. Cecily Nash > CONSULTANT, GLOBAL FINANCIAL PROCESSES 4. Asif Esbhani > BUSINESS SYSTEMS ANALYST, SAP TEAM


3.

It takes large
enterprise leadership.

The Internet is the
largest enterprise ever.

Big customers are different. For example, a stock exchange. A banking network. An airline reservation system. Because if they stub a toe, thousands limp.

Who keeps them upright? Compaq does. We're the clear leader in fault tolerant, non-stop computing. In fact, nearly 80% of the world's Automated Teller Machine transactions run on Compaq systems.

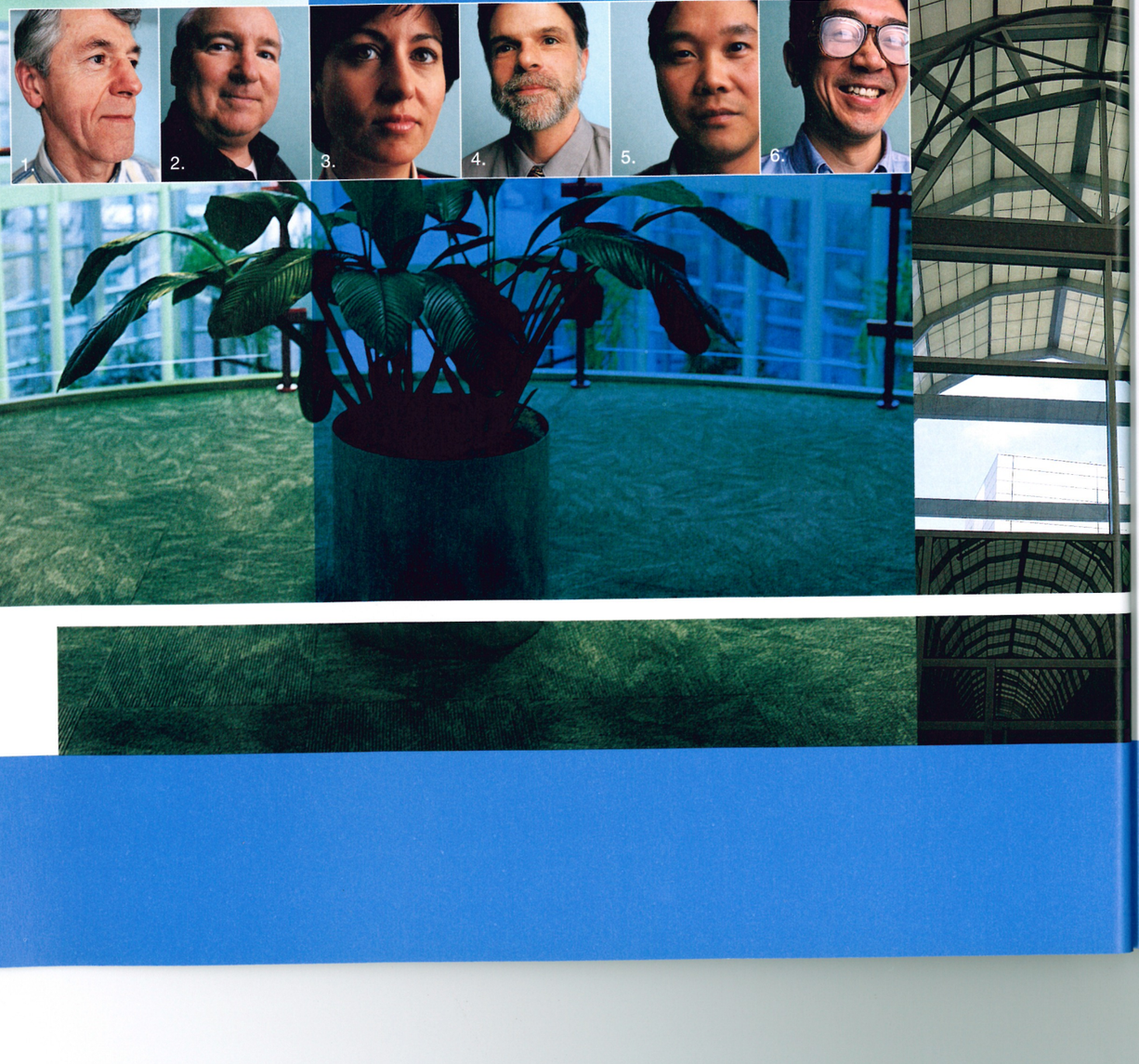
And since we make some of the fastest and most available servers (AltaVista's respond instantly to 90 million hits a day), we also provide the best management tools to run them worldwide.

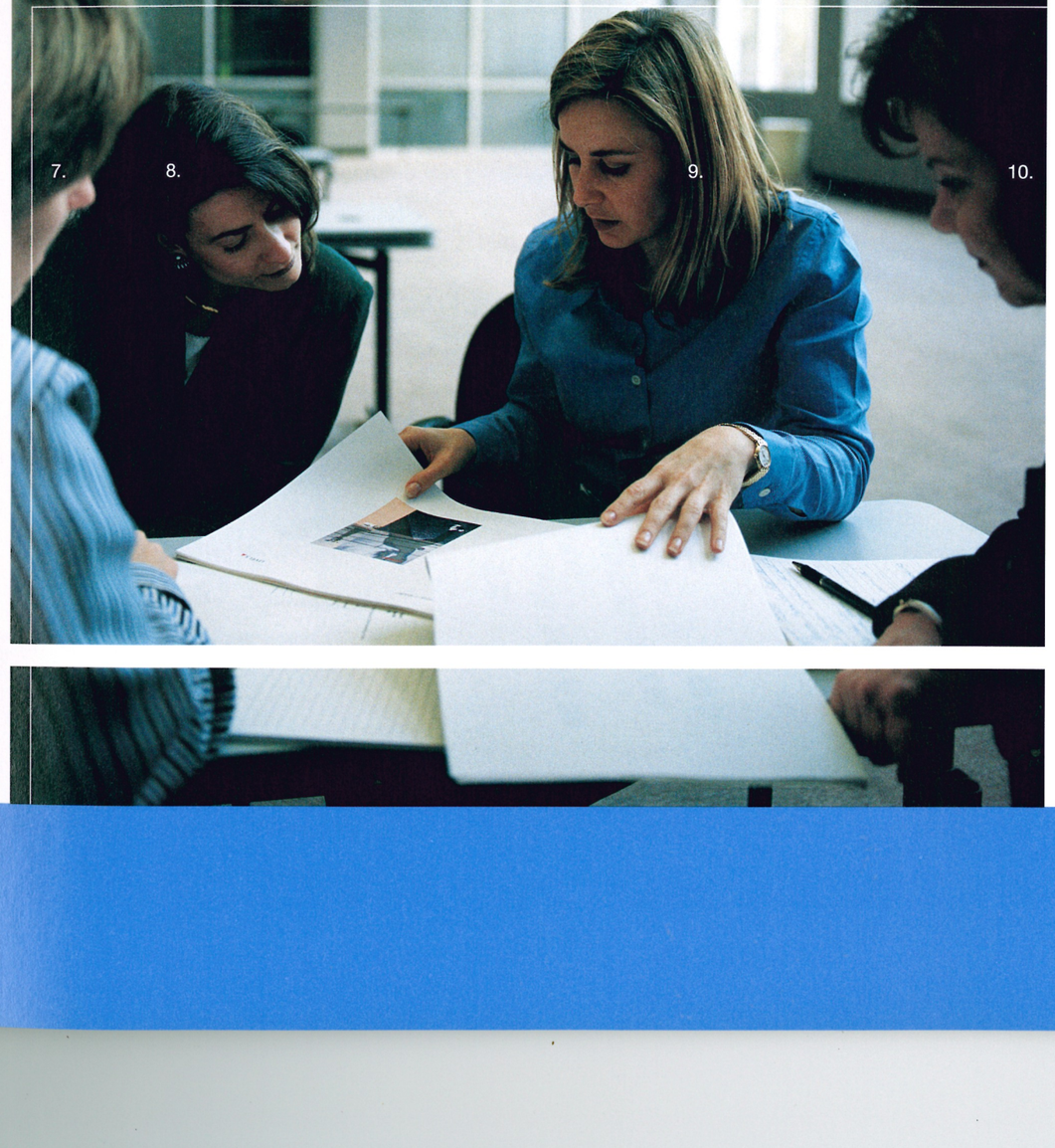
Unfortunately, it's a world that includes hackers. But bad news for them, Compaq has installed more high-security e-commerce firewalls than anyone. Which no hacker has ever broken through.

Of course, there's more to enterprise computing than technology. Big customers need partners who know their business side, too, so Compaq teams are industry specialists.

All of which puts Compaq in good position. Big enterprise know-how meets Internet expertise. It clicks.

1. Ted Staplin > MANAGER, ALPHA SYSTEMS INTEGRATION 2. Robert Collins > PRINCIPAL HARDWARE ENGINEER, CUSTOMSYSTEMS 3. Cynthia Pevehouse > CORPORATE COUNSEL 4. Jack H. Carlton > FINANCIAL CONSULTANT, CUSTOMSYSTEMS 5. Wen Hu > SOFTWARE ENGINEER, ENTERPRISE COMPUTING 6. Hai Huang > SENIOR MEMBER TECHNICAL STAFF, UNIX SOFTWARE 7. Debra LeBlanc > INTERNET COMMUNICATIONS MANAGER, COMPAQ.COM 8. Donna Silber > INTERNET MARKETING & COMMUNICATIONS EDITOR, COMPAQ.COM 9. Amy Berg > INTERNET COMMUNICATIONS MANAGER, COMPAQ.COM 10. Janica McCool > INTERNET COMMUNICATIONS MANAGER, COMPAQ.COM





It takes innovation
that's useful, not just new.

The Internet has no
patience for irrelevance.

When a new idea enters the world, how many other new ideas will it spawn? That's an innovation's acid test—its ability to drive change, to send ripples beyond itself.

Compaq was founded on that kind of idea—that personal computers, like persons, should be mobile—and we've never turned back.

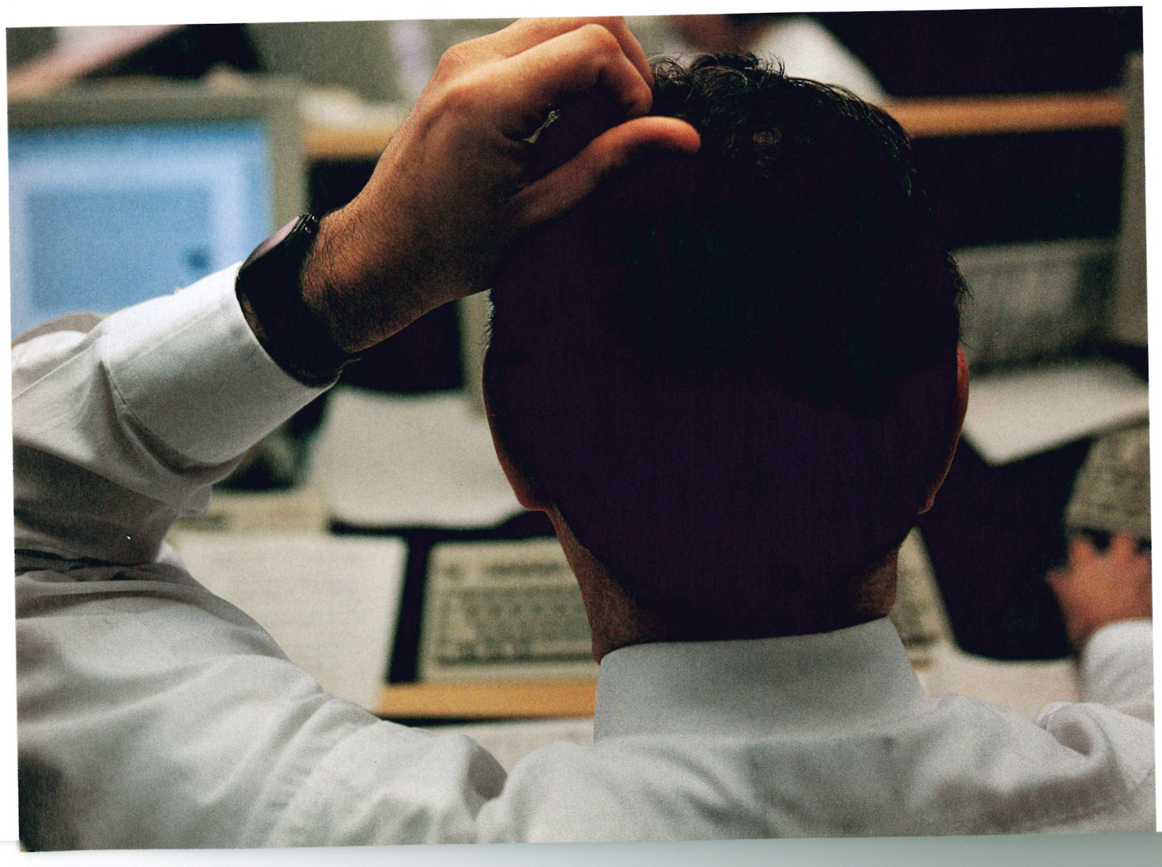
Our acquisitions of Tandem and Digital are perfect examples. Each is famous for innovation that began by spotting a need. And now we have leads in critical markets—communications, finance, aerospace, manufacturing and others—carved by that vision.

And the Internet?

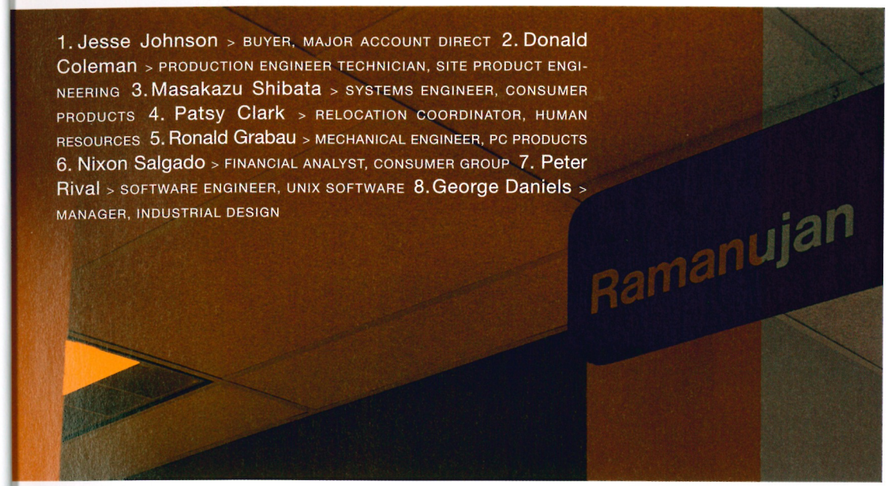
For millions of people every day, it begins with a visit to AltaVista, the Web's most useful, most powerful guide. AltaVista was invented in Compaq research labs, by people who aren't just clever, but who know how other people tick.

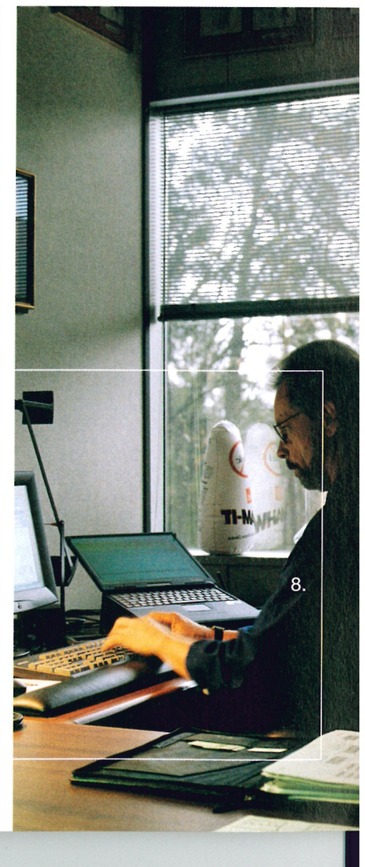
Even the Internet button on our Internet keyboards. It's only a little idea. Until you measure its impact. And that's why the Internet is so great.

It's no place for nonsense. But real innovation? Buckle your seatbelts.



1. Jesse Johnson > BUYER, MAJOR ACCOUNT DIRECT 2. Donald Coleman > PRODUCTION ENGINEER TECHNICIAN, SITE PRODUCT ENGINEERING 3. Masakazu Shibata > SYSTEMS ENGINEER, CONSUMER PRODUCTS 4. Patsy Clark > RELOCATION COORDINATOR, HUMAN RESOURCES 5. Ronald Grabau > MECHANICAL ENGINEER, PC PRODUCTS 6. Nixon Salgado > FINANCIAL ANALYST, CONSUMER GROUP 7. Peter Rival > SOFTWARE ENGINEER, UNIX SOFTWARE 8. George Daniels > MANAGER, INDUSTRIAL DESIGN





It takes the right solutions,
delivered quickly.

Clocks on the
Internet tick faster.

Tradition says computers should bring solutions—new ways to do things better, faster, cheaper.

And now on the Web, more widely.

Except that the Internet isn't traditional. It's a realm where distance shrivels, time evaporates and change accelerates like a bullet.

Not exactly a great place to be late, even a few nano-blinks later than your rivals.

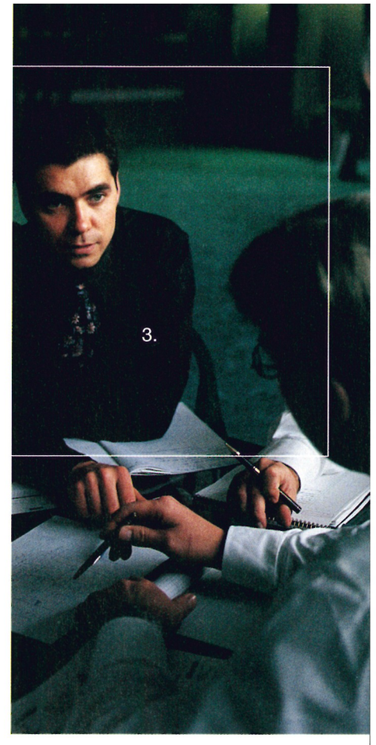
Which means Compaq's mission isn't just to respond, but to anticipate and to lead. Especially as customer lead-times get ever more precious.

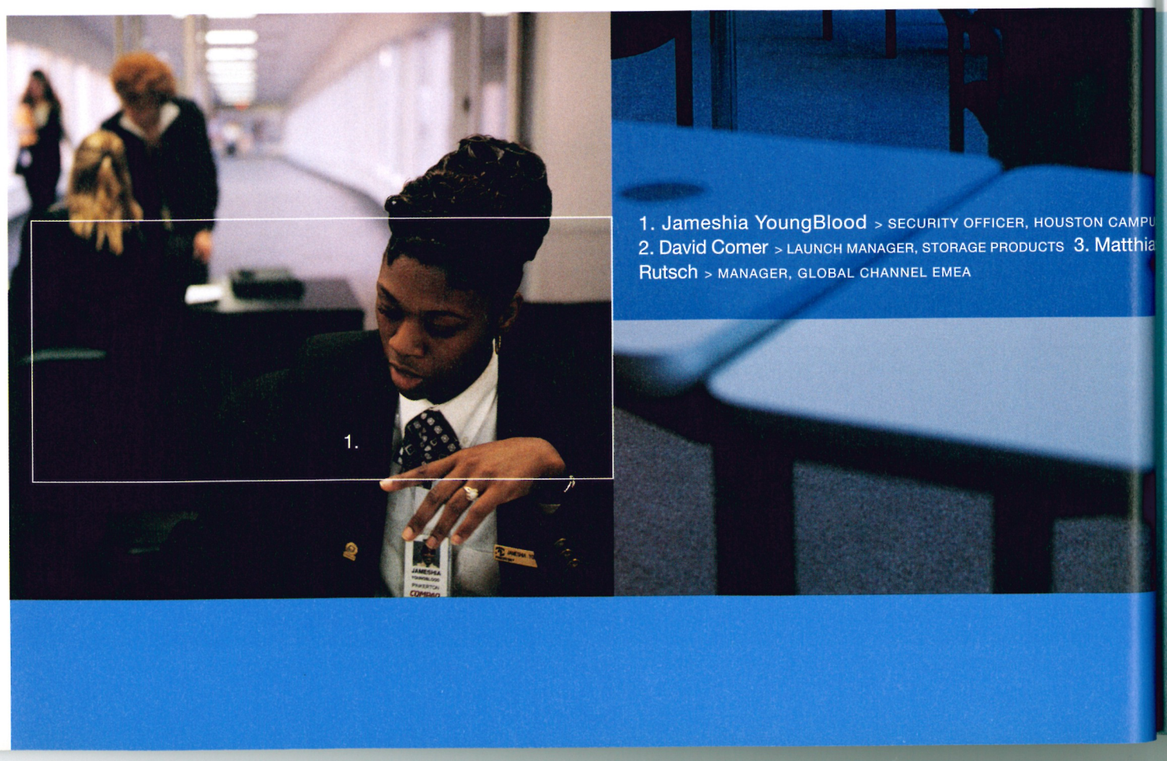
So to us, "timely solution" means more than meeting deadlines. It starts with a visceral connection to customer need, months in advance.

And that's fine with us.

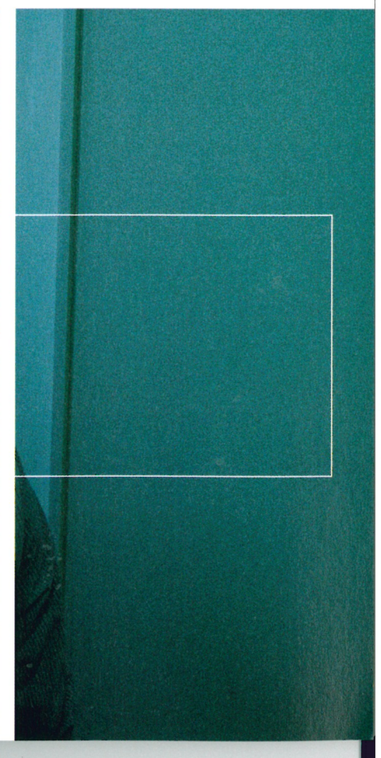
Year after year, we've been an industry leader in time-to-solution, and the Internet only deepens our advantage. It puts us and our customers in the same room all the time, an incubator for excellence.

And no one serves more kinds of customers more ways than Compaq. Thanks to the Internet, millions more new ones will understand why.





1. Jameshia YoungBlood > SECURITY OFFICER, HOUSTON CAMPU
2. David Comer > LAUNCH MANAGER, STORAGE PRODUCTS 3. Matthia
Rutsch > MANAGER, GLOBAL CHANNEL EMEA



It takes the good sense
to be flexible.

On the Internet,
one size fits one.

A computer is a tool for the brain, and no one else's brain is like yours. So the system you choose, and your method of choosing it, should reflect that.

Want to order on-line? Or over the phone? Or in a store? (With a salesperson? Or at a kiosk?) Need the expertise of a reseller? Or a global sales force? Or an on-premise team? Or a systems integrator?

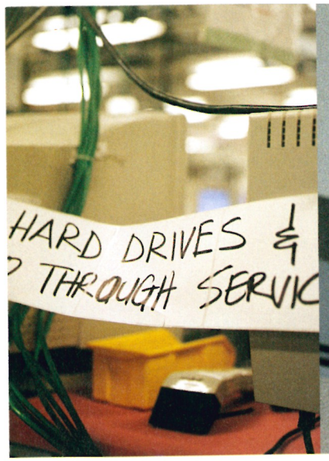
All those options add up to Compaq.

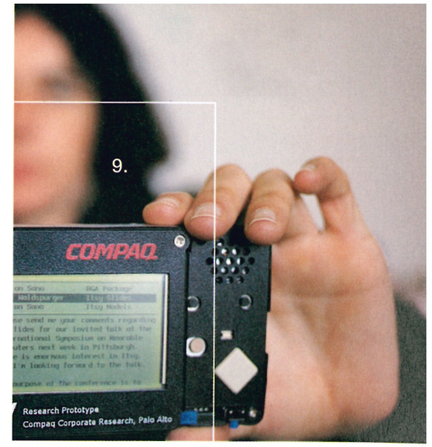
They apply to every product we offer, and let's not get into our product choices. Those combinations are just this side of infinite.

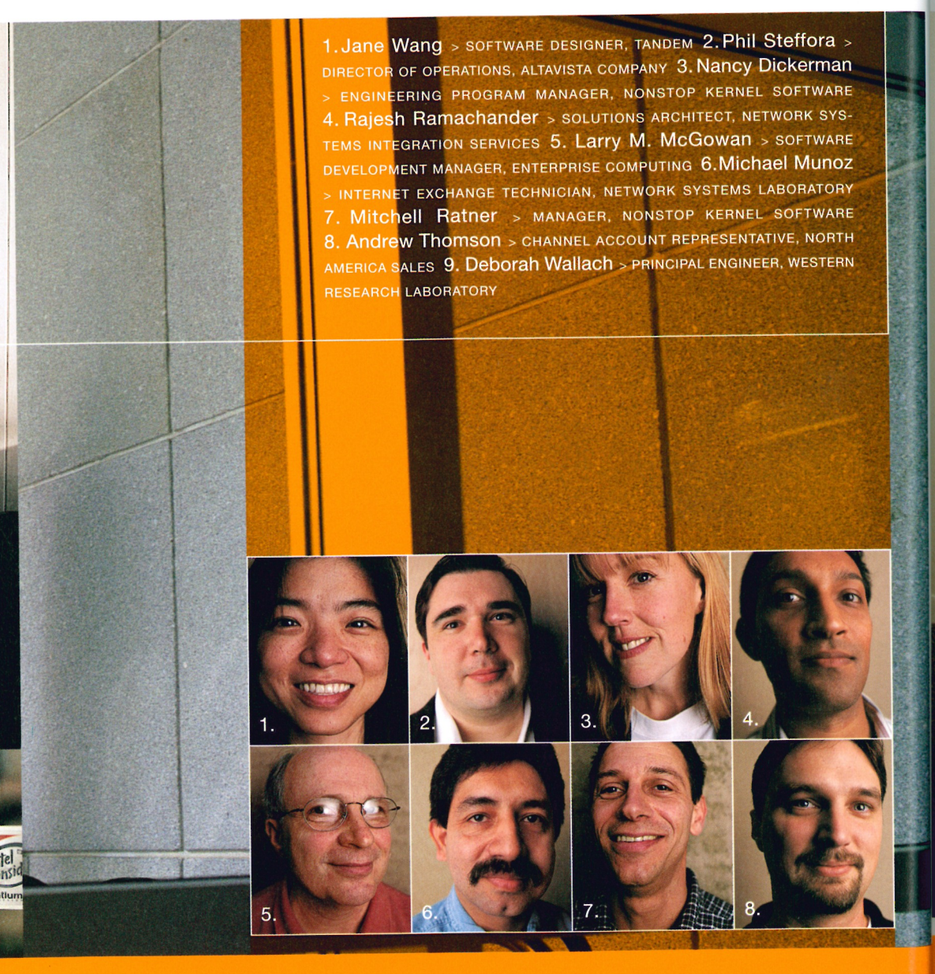
The point is, any way customers want to reach Compaq, Compaq is reaching back. And more responsively than anyone else.

And we keep on responding, with 27,000 service professionals worldwide who don't care whose logo is on your problem. If it needs attention, we provide it.

As for the Web, we were one of the first Fortune 500 companies to sell on it, and we keep inventing. We've just given our e-commerce group a whole new shape. It looks remarkably like you.







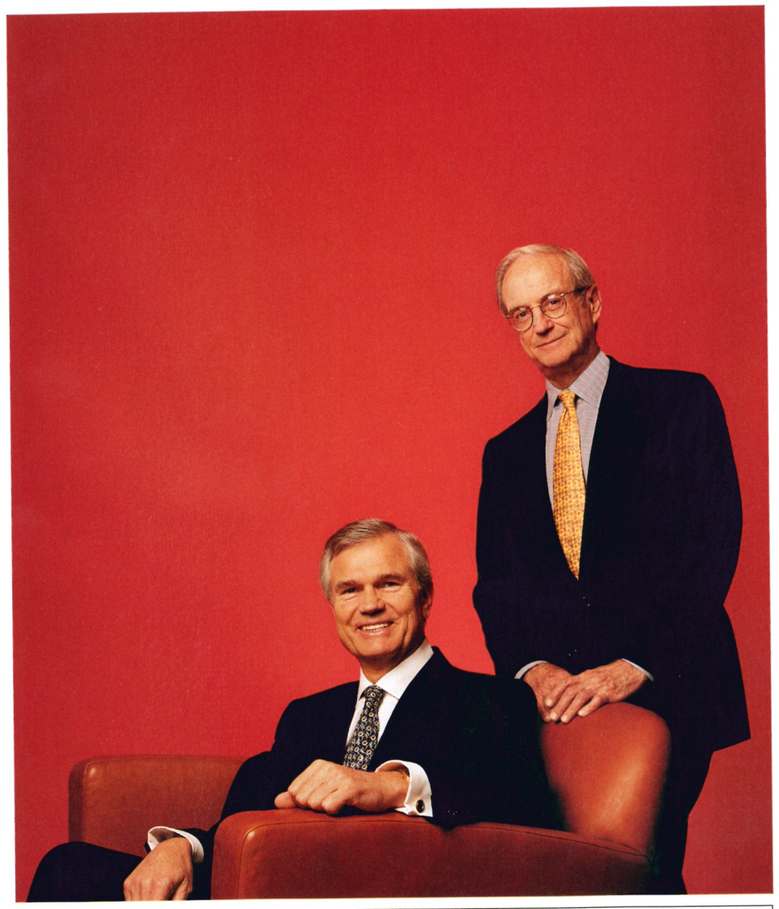
1. Jane Wang > SOFTWARE DESIGNER, TANDEM 2. Phil Steffora > DIRECTOR OF OPERATIONS, ALTAVISTA COMPANY 3. Nancy Dickerman > ENGINEERING PROGRAM MANAGER, NONSTOP KERNEL SOFTWARE 4. Rajesh Ramachander > SOLUTIONS ARCHITECT, NETWORK SYSTEMS INTEGRATION SERVICES 5. Larry M. McGowan > SOFTWARE DEVELOPMENT MANAGER, ENTERPRISE COMPUTING 6. Michael Munoz > INTERNET EXCHANGE TECHNICIAN, NETWORK SYSTEMS LABORATORY 7. Mitchell Ratner > MANAGER, NONSTOP KERNEL SOFTWARE 8. Andrew Thomson > CHANNEL ACCOUNT REPRESENTATIVE, NORTH AMERICA SALES 9. Deborah Wallach > PRINCIPAL ENGINEER, WESTERN RESEARCH LABORATORY

It takes people
who listen.

COMPAQ

Better answers.

www.compaq.com



Eckhard Pfeiffer > PRESIDENT AND CHIEF EXECUTIVE OFFICER
Benjamin M. Rosen > CHAIRMAN OF THE BOARD

Look around the world of information technology today—the world of business—and the evidence is very clear: The Internet is changing everything. How we communicate. How we buy and sell. How we collaborate with customers, partners and suppliers. How and where we compete. How we live and work.

Business cycles that used to be measured in years or months are now measured in days, hours or minutes.

One-size-fits-all is out. One-size-fits-one is in.

On the Web, big is not better. Speed, agility, flexibility and responsiveness are.

The Internet is even reshaping our old notions of time. The Internet economy is a non-stop, 24-hour a day, 7-day-a-week environment.

These are not small changes. They are fundamental changes that are transforming information technology from a back-office function to a strategic asset—one that allows companies to build a competitive advantage.

At Compaq, we envision a world where virtually all information is on line and people can communicate, conduct commerce and securely access the information they need from anywhere at any time.

The way we see it, the market leaders of the future will be those companies that embrace these changes—that transform their enterprise computing strategies by adopting Internet-enabled business models.

This is as true for Compaq as it is for our customers. That's why we have embraced an Internet-enabled business model throughout our company. It is a model that we believe will help establish Compaq as the best computing partner—and the best business partner—in the world. And it is a model that is transforming the way we do business.

ACCELERATING COMPAQ'S TRANSFORMATION. Compaq's transformation from a PC company to a global IT—and Internet—leader accelerated during 1998.

At the heart of this transformation is our effort to build stronger relationships with our customers.

Customers today expect to have a more direct, accountable relationship with their IT partners. They want strategic partners who understand their business—not just their computing needs.

To that end, Compaq enhanced its own capabilities and—through the acquisitions of Tandem and Digital—added significant strengths, including:

> A large, global customer base
> A highly skilled, enterprise-focused sales force
> One of the best services organizations in the industry
> A broad range of IT solutions, and,
> Internet technologies and experience

We completed the largest part of the Digital integration by the end of the year. That helped drive significant momentum in our business. And the deal was accretive—as we predicted when we announced the acquisition—by the fourth quarter of 1998.

CUSTOMER CHOICE. The combination of increased customer expectations and the expansion of our own ability to serve customers is driving a significant change in Compaq's go-to-market model.

During 1998, Compaq introduced and implemented a model based on customer choice. In other words, we do business with our customers the way they choose to do business, whether it is through one of our resellers, a customer account team, or directly via the Web or telephone.

This is superior to the direct-only model because it reflects the way customers actually buy. For example, many customers prefer to purchase PCs and other volume products directly from the manufacturer. For more complex solutions, they often want the expertise and support of a value-added reseller or a systems integrator.

Historically, Compaq has sold its products almost exclusively through resellers and other channel partners. But in 1998—after extensive consultation with our partners to implement our customer choice model—we began to expand our ability to sell direct.

In our consumer business, for example, we now sell over the Web, through customer call centers and through our retail configuration program. We introduced a new family of products for small and medium businesses that are sold directly over the Web and the phone, as well as through our reseller agents. And we began rolling out Web-based "extranets" that enable major customers to configure and order the products they want.

We will expand these capabilities throughout the world in 1999, primarily through our Web site, Compaq.com. We will also work closely with our retailers, resellers and other channel partners, who remain critical to our success.

No matter how customers buy our products, Compaq will take full ownership of the customer relationship. Customer choice is more than a selling model. It is a relationship model focused on accountability and customer satisfaction.

Through our customer relationship management program, we are dramatically increasing our understanding

of what customers need...which businesses they are in...what they buy...what applications they use...and what they do with our products.

With this information, we will be able to create greater value for customers—regardless of how we reach them.

From the Internet to powerful database tools, today's technology allows us to build one-to-one relationships with our customers, complementing the capabilities of our customer account teams. This technology also allows us to tailor our products, services and solutions to individual customer needs.

SUPPLY CHAIN. To meet those needs—and to provide true choice to our customers—we are building a supply chain that enables us to deliver products exactly the way our customers want them, and to do it faster and more efficiently than anyone else in the industry.

In an era of mass customization, supply chain efficiency and responsiveness are more important than ever. During the past few months, Compaq has rolled out configure-to-order capabilities for consumers, small and medium businesses and large companies. We will accelerate these programs throughout 1999.

Our goal is to build a best-in-class supply chain that supports customer choice, including both customers and channel partners. A key element will be the Internet, which will enable us to maintain real-time connections with customers and suppliers.

As a result of these efforts, we expect to achieve an average cycle time—that is, the time between receipt of an order and shipment of the order—of five days or less.

Building a world-class supply chain is also a key element in delivering leadership quality and customer satisfaction.

Compaq has always stood for quality, and we have aggressive quality initiatives focused on the areas that customers tell us are most important to them: predictability, availability, quality and reliability, service and support, and compatibility.

A network of management teams we call Quality Leadership Teams are working throughout the company to drive process improvements in areas critical to our success. I personally lead the Executive QLT consisting of my direct reports. Specially trained employees we call Black Belts work with teams of employees to achieve faster and better change. We compare ourselves to national quality award criteria in rigorous self-assessments to measure our progress.

Our goal is to achieve industry leadership in customer satisfaction. In fact, all of my direct reports are measured in part on their success in improving customer satisfaction and quality. In addition, all employees have incentives tied directly to improvements in customer satisfaction.

INTERNET LEADERSHIP. Compaq's transformation is evident in other ways as well. One of the most important is our corporate strategy, which is focused on a single, overarching objective: Internet leadership.

This is an ambitious goal, but Compaq has a history of setting and achieving ambitious goals. We did it in 1994, when we achieved worldwide PC market leadership. We did it again in 1998, when we became one of the top three computer companies in the world (No. 2 to be precise)—two years ahead of schedule.

From products to services, from solutions to partnerships, Compaq has never been in a stronger position to help our customers prosper in the Internet age. That means all of our customers—from the family that is going online for the first time...to the small business that is opening a storefront on the Web...to the global corporation that is building an Internet-enabled supply chain.

Our market share leadership in PC desktops and servers means that more Web sites are hosted on our systems than those of any other company. Forty-five percent of all Internet deployments are on Compaq systems. And four of the five most-visited Web sites use our computers.

We have significant Internet expertise in our services business. Through Compaq Services, we help companies plan and deploy a wide range of Internet solutions. We also manage the Internet infrastructure for companies like Microsoft.

The Microsoft Network runs on more than 1,000 Compaq ProLiant and AlphaServer systems. We manage and support these systems as well as four international data centers, 2,000 SQL databases and more than three terabytes (one trillion bytes) of information.

Building on the strengths of Tandem and Digital, Compaq is one of the leaders in providing encryption and security solutions that protect the privacy of personal and business data moving across the Web. This is essential for the growth of e-commerce.

We introduced the first Internet PC with a keyboard that provides easy, one-button access to the Internet, e-commerce and e-services. And we offered the first home PC with an ADSL modem that takes advantage of new high-speed Internet connections.

What this all means is that Compaq has the products, services and solutions—and the experience—necessary to support the most demanding Internet applications, from corporate intranets and e-commerce...to Internet-enabled supply chains and customer relationship management.

Compaq is moving into new areas of Internet growth. When we acquired Digital, we also acquired the world's fastest Internet search and navigation guide—AltaVista. Early in 1999, we made it a separate company—The AltaVista Company—with the goal of establishing it as the leading destination site for information and e-commerce on the Internet. We are the first major computer company—and one of the first Fortune 50 companies—to deploy such broad Internet service capabilities.

We see a significant opportunity to increase Compaq's share of the rapidly growing market for Internet content and services. We plan to take the new company public, which will allow us to unlock AltaVista's value for Compaq shareholders.

INVESTING IN PEOPLE. One of the most important investments we make is in Compaq's people. They are the essential ingredient in our success. In fact, it was their persistence through some very challenging days in 1998 that helped us end the year with such strong momentum.

This focus on our human resources is particularly important as we complete the integration of the Compaq and Digital cultures and move forward as one company.

Our employees have been and will continue to be our most important strategic advantage. We believe a diverse, empowered workforce best equips the company to lead our industry and to provide outstanding products and services to a global customer base. As a result, we are committed to attract, develop, reward and retain the best talent in the industry.

We are also committed to the communities in which Compaq does business. We view corporate giving as more than philanthropy or social responsibility. We see it as an investment in the future of both the company and the community. Compaq has developed partnerships with major nonprofit organizations serving children and young adults.

In addition, we consider environmental stewardship an important element of our job. Compaq's ongoing Environmental, Health, Safety & Security programs are recognized as industry leading. In 1998, the U.S. Environmental Protection Agency named Compaq its "Green Lights Corporate Partner of the Year" for our efforts in energy conservation.

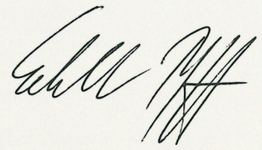
CONCLUSION. As I suggested at the beginning of this letter, Compaq believes that the Internet is the future of computing. And we intend to drive that future, just as we did with the personal computer.

We will work closely with our enterprise customers to make the Internet an easier, more secure and more productive place to do business. Most important, we will help customers build an Internet advantage through industry-standard platforms and applications.

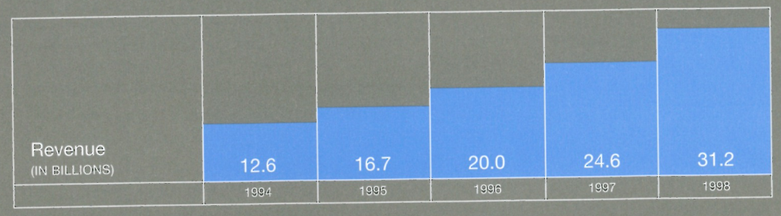
We will make it easier for consumers to journey to the Internet, and to get there more quickly. We will also help provide the kind of content, commerce and community that will make the trip worthwhile.

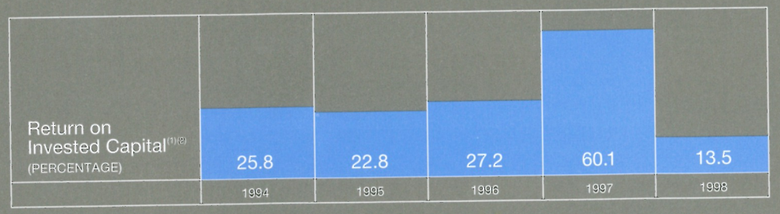
In the process, we will create even greater value for you, our shareholders.

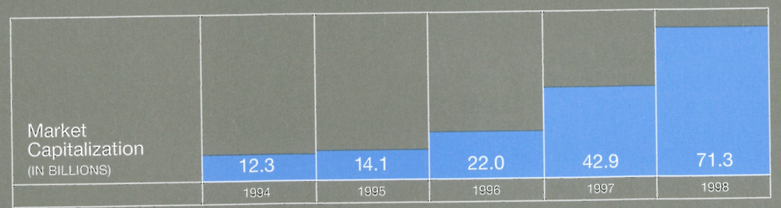
We know that you have a wide choice of investments. We look forward to the opportunity to continue to earn your trust and confidence.



ECKHARD PFEIFFER
President and Chief Executive Officer







(1) Excludes purchased in-process technology, restructuring and asset impairment charges, and merger related costs.
(2) Excludes Compaq Capital Corporation.

Compaq Computer Corporation

A WORLDWIDE INFORMATION TECHNOLOGY COMPANY
FOUNDED 1982 IN HOUSTON, TEXAS

Compaq Computer Corporation, a Fortune Global 100 company, is the second largest computer company in the world and the largest global supplier of computer systems. Compaq develops and markets hardware, software, solutions, and services, including industry-leading enterprise computing solutions, fault-tolerant business-critical solutions, enterprise and network storage solutions, commercial desktop and portable products and consumer PCs. The company is an industry leader in environmentally friendly programs and business practices.

Compaq products are sold and supported in more than 100 countries through a network of authorized Compaq marketing partners.

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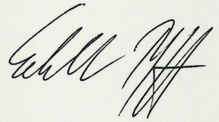
Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with Compaq management. The accompanying financial statements have been prepared in conformity with generally accepted accounting principles, applying certain estimates and judgments as required.

Compaq maintains an effective internal control structure. It consists, in part, of an organization with clearly defined lines of responsibility and delegation of authority, comprehensive systems and control procedures. We believe this structure provides reasonable assurance that transactions are executed in accordance with management authorization and generally accepted accounting principles. An important element of the control environment is an ongoing internal audit program.

To assure the effective administration of internal control, we carefully select and train our employees, develop and disseminate written policies and procedures, provide appropriate communication channels and foster an environment conducive to the effective functioning of controls. We believe that it is essential for Compaq to conduct its business affairs in accordance with the highest ethical standards, as set forth in Compaq's Codes of Conduct. These guidelines, translated into numerous languages, are distributed to employees throughout the world, and reemphasized through internal programs to assure that they are understood and followed.

PricewaterhouseCoopers LLP, independent accountants, is retained to audit Compaq's financial statements. Its accompanying report is based on an audit conducted in accordance with generally accepted auditing standards, including a review of the internal control structure and tests of accounting procedures and records.

The Audit Committee of the Board of Directors is composed solely of outside directors and is responsible for recommending to the Board the independent accounting firm to be retained for the coming year. The Audit Committee meets periodically and privately with the independent accountants, with our internal auditors, as well as with Compaq management, to review accounting, auditing, internal control structure and financial reporting matters.



ECKHARD PFEIFFER
President and
Chief Executive Officer

EARL L. MASON
Senior Vice President and
Chief Financial Officer

YEAR ENDED DECEMBER 31 (IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	1998	1997	1996	1995	1994
Statement of Income					
Revenue:					
Products	$ 27,372	$ 24,122	$ 19,611	$ 16,308	$ 12,274
Services	3,797	462	398	367	331
Total revenue	31,169	24,584	20,009	16,675	12,605
Cost of sales:					
Products	21,383	17,500	14,565	12,026	8,671
Services	2,597	333	290	265	214
Total cost of sales	23,980	17,833	14,855	12,291	8,885
Selling, general and administrative expense	4,978	2,947	2,507	2,186	1,859
Research and development costs	1,353	817	695	552	458
Purchased in-process technology[1]	3,196	208	—	241	—
Restructuring and asset impairment charges[2]	393	—	52	—	—
Merger-related costs[3]	—	44	—	—	—
Other income and expense, net	(69)	(23)	17	79	50
	9,851	3,993	3,271	3,058	2,367
Income (loss) before provision for income taxes	(2,662)	2,758	1,883	1,326	1,353
Provision for income taxes	81	903	565	433	365
Net income (loss)	$ (2,743)	$ 1,855	$ 1,318	$ 893	$ 988
Earnings (loss) per common share:					
Basic	$ (1.71)	$ 1.23	$ 0.90	$ 0.62	$ 0.70
Diluted	$ (1.71)	$ 1.19	$ 0.87	$ 0.60	$ 0.68
Shares used in computing earnings (loss) per common share:					
Basic	1,608	1,505	1,472	1,442	1,405
Diluted	1,608	1,564	1,516	1,492	1,463
Cash dividends per common share	$ 0.065	$ 0.015	$ —	$ —	$ —
Financial Position					
Current assets	$ 15,167	$ 12,017	$ 10,089	$ 7,462	$ 6,037
Total assets	23,051	14,631	12,331	9,637	7,862
Current liabilities	10,733	5,202	4,741	3,580	2,918
Non-current liabilities[4]	967	—	300	300	300
Stockholders' equity	11,351	9,429	7,290	5,757	4,644

(1) Represents non-recurring, non-tax deductible charges associated with purchased in-process technology of $3.2 billion in connection with the Digital acquisition in 1998, and $208 million and $241 million in connection with acquisitions in 1997 and 1995.

(2) Represents a $393 million charge for restructuring and asset impairments in 1998 in connection with the Digital acquisition and the closing of certain Compaq facilities, and a $52 million charge related to restructuring actions taken by Tandem during 1996.

(3) Represents a $44 million non-recurring, non-tax-deductible charge in 1997 related to the Tandem merger.

(4) Includes $422 million of minority interest in 1998 related to Digital preferred stock.

The following discussion should be read in conjunction with the consolidated financial statements.

Results of Operations

The following table presents, as a percentage of revenue, selected consolidated financial data for each of the three years ended December 31.

YEAR ENDED DECEMBER 31	1998	1997	1996
Revenue:			
Products	87.8%	98.1%	98.0%
Services	12.2	1.9	2.0
Total revenue	100.0	100.0	100.0
Cost of sales:			
Products	78.1	72.5	74.3
Services	68.4	72.1	72.9
Total cost of sales	76.9	72.5	74.2
Gross margin:			
Products	21.9	27.5	25.7
Services	31.6	27.9	27.1
Total gross margin	23.1	27.5	25.8
Selling, general and administrative expenses	16.0	12.0	12.5
Research and development costs	4.3	3.3	3.5
Purchased in-process technology (1)	10.2	0.9	—
Restructuring and asset impairment charges (2)	1.3	—	0.3
Merger-related costs (3)	—	0.2	—
Other income and expense, net	(0.2)	(0.1)	0.1
	31.6	16.3	16.4
Income (loss) before provision for income taxes	(8.5)%	11.2%	9.4%

(1) Represents non-recurring, non-tax-deductible charges associated with purchased in-process technology of $3.2 billion in connection with the Digital acquisition in 1998 and $208 million in 1997 in connection with the Microcom acquisition.
(2) Represents a $393 million charge for restructuring and asset impairments in 1998 in connection with the Digital acquisition and the closing of certain Compaq facilities, and a $52 million charge related to restructuring actions taken by Tandem during 1996.
(3) Represents a $44 million non-recurring, non-tax-deductible charge in 1997 related to the Tandem merger.

Overview

Compaq's completion of recent acquisitions has resulted in an expanded and enhanced business model, focused on open industry-standard products, leadership enterprise technology and solutions and a full line of global service offerings. As the second largest computing company in the world and the largest global supplier of computer systems, Compaq delivers customer value through standards-based, partner-leveraged computing that features services, support and market-segment focused solutions, particularly in communications, manufacturing and finance. Compaq is a strategic information technology partner to customers of all sizes, providing product offerings that range from handheld devices to powerful failsafe computers.

The year 1998 was transitional for Compaq. During the first half of the year, the Company accelerated the implementation of the optimized distribution model towards the goal of moving from a build to stock operating model to a build-to-order/configure-to-order model.

During the second half of the year Compaq undertook a major integration effort following the acquisition of Digital in June 1998. These integration efforts included product migration strategies, sales force integration, service organization integration, consolidation of duplicative facilities, employee separations and relocations, and the integration of the internal information systems of the combined companies.

The Company recorded several charges in connection with the Digital acquisition and closing of certain Compaq facilities (see Notes 2 and 3 of the Notes to Consolidated Financial Statements). These charges included approximately $3.2 billion for the write-off of purchased in-process technology and $393 million for restructuring and asset impairment charges related to Compaq employee separations and elimination of certain Compaq facilities.

Revenue

Revenue for 1998 increased approximately $6.6 billion or 26.8% over the prior year as compared with an increase of $4.6 billion or 22.9% during 1997. The increase in 1998 revenue was largely driven by the acquisition of Digital. The increase in 1997 revenue was driven primarily by internal growth.

Products revenue for 1998 increased approximately $3.3 billion or 13.5% over the prior year as compared with an increase of $4.5 billion or 23.0% during 1997. Products revenue in 1998 reflected a growth in worldwide unit sales of 25.1%, compared to 42.9% in 1997. Growth in options revenue was 15.9% in 1998 compared to 43.7% in 1997. The increase in 1998 was primarily the result of the Digital acquisition and strong growth in the consumer business. Offsetting this growth was the expected short-term reduction in revenues relating to the impact of significant pricing and promotional actions taken in conjunction with the Company's transition to the optimized distribution model, the implementation of product migration strategies for Intel-based, Digital-branded personal computers, and the realignment of the sales and marketing organizations of the newly combined companies throughout the world.

Products revenue for North America in 1998 grew $310 million or 2.4% over the prior year as compared with an increase of $2.7 billion or 25.4% during 1997. Products revenue in North America represented 49.0%, 54.3% and 53.3% of total products revenue in 1998, 1997 and 1996, respectively. Products revenue growth in 1998 related to the acquisition of Digital and strong year-over-year growth in the consumer business, partially offset by a decline in commercial products revenue. The decline in commercial products revenue related to the aggressive price reductions and promotional activities implemented primarily in North America in the first half of 1998 due to the transition to the optimized distribution model, lower than expected sales out of the channel, and to respond to competitive pricing conditions. The third and fourth quarter revenues were negatively impacted by the implementation of product migration strategies and the realignment of the sales and marketing organizations as described above. Products revenue growth in 1997 related to strong year-over-year growth in both the commercial and consumer markets, with the most significant commercial product growth relating to enterprise products, most notably servers and workstations.

Products revenue for Europe, Middle East and Africa ("EMEA") in 1998 grew $2.4 billion or 30.2% over the prior year as compared with an increase of $1.4 billion or 21.6% during 1997. Products revenue in EMEA represented 37.0%, 32.3% and 32.6% of total products revenue in 1998, 1997 and 1996, respectively. Products revenue growth in EMEA in 1998 was the result of both the acquisition of Digital and strong year-over-year growth in consumer and commercial products revenue, partially offset by more competitive pricing. Products revenue in 1997 reflected an overall improvement in market share and strong year-over-year revenue growth in each of the product areas, the most significant of which related to enterprise products.

Services revenue for 1998 increased approximately $3.3 billion over the prior year as compared with an increase of $64 million during 1997. Services revenue growth for 1998 was almost entirely due to the acquisition of Digital. With the acquisition of Digital, Compaq now has a world class services organization with market-focused solutions and high availability support, particularly in the communications, manufacturing and finance industries. Services revenue for 1997 and 1996 related primarily to professional services provided by Tandem.

Services revenue for North America in 1998 grew $1.2 billion over the prior year as compared with an increase of $4 million during 1997. Services revenue in North America represented 35.3%, 36.4% and 41.2% of total services revenue in 1998, 1997 and 1996, respectively. Services revenue for EMEA in 1998 grew $1.6 billion over the prior year as compared with an increase of

$43 million during 1997. Services revenue in EMEA represented 47.2%, 32.5%, and 26.9% of total services revenue in 1998, 1997 and 1996, respectively.

Gross Margin

Gross margin as a percentage of revenue was 23.1% in 1998, down from 27.5% in 1997 and 25.8% in 1996. Products gross margin as a percentage of products revenue was 21.9%, 27.5% and 25.7% for 1998, 1997 and 1996, respectively. The decrease in gross margin in 1998 resulted largely from significant pricing and promotional actions taken by Compaq primarily in the North American market during the first and second quarters of 1998 to meet the goals of the Company's optimized distribution model and to respond to competitive pricing conditions. Gross margins improved during the third and fourth quarters, partially offset by the impacts of the implementation of product migration strategies and the realignment of the sales and marketing operations. The increase in gross margins in 1997 primarily resulted from a higher proportion of sales of enterprise products and options, production and logistics cost savings, and overall asset management improvements.

Products gross margin as a percentage of products revenue in North America was 21.5%, 27.4% and 26.6% for 1998, 1997 and 1996, respectively. The decrease in 1998 products gross margin resulted largely from the significant pricing, promotional and other actions taken by Compaq as noted above. Products gross margin as a percentage of products revenue in EMEA was 26.3%, 27.7% and 26.1% for 1998, 1997 and 1996, respectively. The decrease in EMEA 1998 products gross margin was primarily related to the Digital product integration.

Services gross margin as a percentage of services revenue was 31.6%, 27.9% and 27.1% for 1998, 1997 and 1996, respectively. The increase in services gross margin in 1998 is primarily attributable to the acquisition of Digital.

Operating Expenses

Research and development costs increased $536 million or 65.6% in 1998 as compared to 1997, primarily due to the acquisition of Digital. Research and development costs increased $122 million or 17.6% in 1997 as compared to 1996. Compaq is committed to maintaining a significant level of research and development investment in support of its activities as a full-service enterprise computing company, offering leadership technologies and products for the future. In addition, Compaq spent approximately $3.2 billion in 1998 and $208 million in 1997 on purchased in-process technology in connection with the Digital and Microcom acquisitions.

Compaq's selling, general and administrative expense increased $2.0 billion or 68.9% in 1998 as compared to 1997, primarily due to the acquisition of Digital. Compaq's selling, general and administrative expense increased $440 million or 17.6% in 1997 as compared to 1996. As a percentage of revenue, selling, general and administrative expense was 16.0%, 12.0% and 12.5% in 1998, 1997 and 1996, respectively, and in absolute dollars was $5.0 billion, $2.9 billion and $2.5 billion in 1998, 1997 and 1996, respectively. The increase as a percentage of revenue and absolute dollars in 1998 over 1997 is primarily due to the acquisition of Digital and the support of significant new product introductions, expansion into new markets and increases in our investment in services. In the fourth quarter of 1998, operating expenses as a percentage of revenue began to decline due to implementation of the restructuring plans and the realization of synergies for the combined companies. The decrease in selling, general and administrative expense as a percentage of revenue in 1997 reflected efforts to manage operating expense growth relative to revenue and gross margin levels. The increase in the amount of expense resulted from domestic and international selling expense associated with higher unit volumes as well as expense incurred in connection with the introduction of new products, the entry into new markets, the expansion of distribution channels and a greater emphasis on customer service and technical support.

Purchased In-Process Technology

Upon consummation of the Digital acquisition in June 1998, Compaq immediately expensed approximately $3.2 billion representing purchased in-process technology that had not yet reached technological feasibility and had no alternative future use (see Note 2 of Notes to Consolidated Financial Statements). The value was determined by estimating the costs to develop the purchased in-process technology into commercially viable products, estimating the resulting net cash flows from such projects, and discounting the net cash flows back to their present values. The discount rate includes a factor that takes into account the uncertainty surrounding the successful development of the purchased in-process technology.

Management's Discussion and Analysis
COMPAQ COMPUTER CORPORATION

The resulting net cash flows from such projects were based on Compaq management's estimates of revenue, cost of sales, research and development costs, selling, general and administrative costs, and income taxes from such projects. These estimates were based on the following assumptions:

> The estimated revenues projected average compounded annual revenue growth rates of 8% to 39% during 1998-2001, depending on the product areas. For instance, UNIX/OpenVMS compounded annual growth rates were 8% and storage rates were 39%. Estimated total revenue from the purchased in-process product areas were expected to peak in the year 2001 and decline rapidly in 2002-2005 as other new products were expected to enter the market. These projections were based on Compaq management's estimates of market size and growth (supported by independent market data), expected trends in technology (such as new families of products in the external storage product area) and the nature and expected timing of new product introductions by Digital and its competitors. These estimates also included growth estimates related to Compaq utilizing certain Digital technologies in conjunction with Compaq's products, Compaq's marketing and distribution of the resulting products through Compaq's resellers and Compaq's enhancing the market's response to Digital's products by providing incremental financial support and stability.

> The estimated cost of sales as a percentage of revenue was expected to be lower than Digital's on a stand-alone basis (66% in Digital's fiscal 1997), primarily due to Compaq's expected ability to achieve more favorable pricing from key component vendors and production efficiencies due to economies of scale through combined operations. As a result of these savings, the estimated cost of sales as a percentage of revenue was expected to decrease by 1% to 6% from Digital's historical percentage, depending on the product areas.

The combined company was expected to benefit from more favorable pricing from key component vendors and production efficiencies due to economies of scale. As a result of these savings, the estimated cost of sales as a percentage of revenues for the UNIX/OpenVMS and storage markets, the two most significant product areas of purchased in-process technology, were expected to decrease up to 6% from Digital's historical percentages.

> The estimated selling, general and administrative costs were expected to more closely approximate Compaq's cost structure (approximately 12% of revenues in 1997), which was lower than Digital's cost structure (approximately 24% of revenues in Digital's fiscal 1997). Cost savings were expected to result primarily from the changes related to the restructuring actions discussed in Note 3 of Notes to Consolidated Financial Statements, as well as savings resulting from the distribution of Digital's products through Compaq's resellers (i.e., sales of higher volume products with lower direct selling costs) and efficiencies due to economies of scale through combined operations (i.e., consolidated marketing and advertising programs). These cost savings were expected to be realized primarily in 1999 and thereafter. A significant portion of these savings were expected to be achieved through the adoption and execution of restructuring plans during 1998 and 1999.

Discounting the net cash flows back to their present value was based on the weighted average cost of capital (WACC). The WACC calculation produces the average required rate of return of an investment in an operating enterprise, based on various required rates of return from investments in various areas of that enterprise. The WACC assumed for Compaq, as a corporate business enterprise, was 12% to 14%. The discount rate used in discounting the net cash flows from purchased in-process technology ranged from 22% for UNIX/OpenVMS, NT Systems and storage to 40% for advanced development projects. This discount rate was higher than the WACC due to the inherent uncertainties in the estimates described above including the uncertainty surrounding the successful development of the purchased in-process technology, the useful life of such technology, the profitability levels of such technology and the uncertainty of technological advances that were unknown.

If these projects are not successfully developed, the revenue and profitability of the Company may be adversely affected in future periods. Additionally, the value of other intangible assets acquired may become impaired. Compaq began to benefit from the purchased in-process technology in 1998 and is continuously monitoring its development projects. Management believes that the assumptions used in the valuation of purchased in-process technology reasonably estimate the future benefits attributable to the purchased in-process technology. No assurance can be given that actual results will not deviate from those assumptions in future periods.

Similarly, the value assigned to purchased in-process technology for Microcom, Inc., which Compaq acquired in May 1997, was determined by identifying research projects in areas including modems, remote access technologies

and others, for which technological feasibility had not been established; estimating the costs to develop the purchased in-process technology into commercially viable products; estimating the resulting cash flows from such projects, and discounting the net cash flows back to the present value. The discount rate included a factor which took into account the uncertainty surrounding the successful development of the purchased in-process technology.

Restructuring and Asset Impairment Charges

In June 1998, Compaq's management approved restructuring plans, which included initiatives to integrate operations of Compaq and Digital, consolidate duplicative facilities, improve service delivery and reduce overhead. Total restructuring costs of approximately $1.7 billion were recorded in the second quarter related to these initiatives, $1.5 billion of which related to Digital that was recorded as a component of the preliminary purchase price allocation and $286 million of which related to Compaq that was charged to operations.

The restructuring costs recorded in the second quarter of 1998 were comprised of the following:

(IN MILLIONS)	Compaq	Digital	Total
Employee separations	$ 132	$ 999	$ 1,131
Facility closure costs	142	272	414
Relocation	—	99	99
Other exit costs	12	88	100
Total accrued restructuring costs	$ 286	$ 1,458	$ 1,744

At June 30, 1998, the Digital restructuring plans were based on management's best estimate of those costs based on available information. The restructuring costs accrued in June 1998 included estimates of the cost of involuntary employee separation benefits related to approximately 19,700 employees worldwide (approximately 14,700 Digital employees and 5,000 Compaq employees). Employee separation benefits include severance, medical and other benefits. Employee separations affect the majority of business functions, job classes and geographies, with most of the reductions occurring in North America and Europe. The restructuring plans also include costs associated with the closure of 13.2 million square feet of office, distribution and manufacturing space, principally in North America and Europe. Other accrued restructuring costs relate to the relocation of Digital employees, with the majority of this amount attributable to relocations in North America and Europe, and the cost of terminating certain Digital contractual obligations. Compaq expects that most of the restructuring actions will be completed by June 1999.

In the fourth quarter of 1998, Compaq adjusted the Digital restructuring plan which resulted in a reduction of $59 million of accrued Digital restructuring costs. This reduction was recorded as an adjustment to the preliminary purchase price allocation during the quarter ended December 31, 1998. There was no adjustment to the Compaq restructuring plan. The adjustment to the Digital restructuring plan included a $47 million net increase in severance costs. This increase was primarily due to higher than expected costs associated with workforce reductions in Europe, partially offset by higher than expected attrition rates. While the total Digital employee separation target of 14,700 is expected to be achieved, Digital involuntary separations are expected to decrease to approximately 12,400 as a result of the higher than expected rate of attrition. The higher severance costs were more than offset by lower facility closure costs of $55 million, primarily due to lower than expected costs to dispose of facilities. In addition, the estimate of employee relocation costs was reduced by $54 million due to a lower than expected number of employees accepting relocation packages.

The accrued restructuring costs and amounts charged against the accrual as of December 31, 1998, were as follows:

(IN MILLIONS)	Beginning Accrual	Cash Expenditures	Adjustment	Remaining Accrual
Employee separations	$ 1,131	$ (455)	$ 47	$ 723
Facility closure costs	414	(42)	(55)	317
Relocation	99	(2)	(54)	43
Other exit costs	100	(76)	3	27
Total accrued restructuring costs	$ 1,744	$ (575)	$ (59)	$ 1,110

Cash expenditures are not reflective of the actual costs incurred due to the impact of regulatory guidelines in certain countries relating to the timing of payment of severance benefits to affected employees. As of December 31, 1998, employee separations due to restructuring actions totaled 10,542. Total severance costs related to these individuals, including the cash payments of $455 million already made, are approximately $570 million. The total net headcount reduction since the acquisition of Digital including attrition and restructuring, partially offset by selective hiring, was approximately 12,800.

During 1998, Compaq also recorded a $107 million charge related to asset impairments. The asset impairments resulted from the writedown to fair market value, less costs to sell, of assets taken out of service and held for sale or disposal. The majority of this charge related to the impairment of $74 million of intangible assets associated with the acquisition of a company during 1995 that developed, manufactured, and supplied fast ethernet hubs, switches and related products. In May 1998, management decided to close the manufacturing facility and abandoned the technologies acquired through this acquisition and discontinued all related products.

Compaq's selling, general and administrative costs are expected to decrease in the future through the continued implementation of the Company's restructuring plans.

Other Items

In 1998, Compaq's other income was $69 million as compared to other income of $23 million in 1997 and other expense of $17 million in 1996. The increase in 1998 was primarily due to an increase in interest and dividend income related to greater cash and short-term investment balances prior to the Digital acquisition and a reduction in other expenses, partially offset by the minority interest dividend paid to Digital preferred shareholders. The increase in other income in 1997 was primarily driven by an increase in interest and dividend income related to greater average cash and short-term investment balances, partially offset by interest expense.

The translation gains and losses relating to the financial statements of Compaq's international subsidiaries, net of offsetting gains and losses associated with hedging activities relating to the net monetary assets of these subsidiaries, are included in other income and expense and resulted in net losses of $25 million, $27 million and $11 million in 1998, 1997 and 1996, respectively.

Liquidity and Capital Resources

Compaq's cash, cash equivalents and short-term investments decreased to $4.1 billion at December 31, 1998, from $6.8 billion at December 31, 1997. The decrease in cash, cash equivalents and short-term investments in 1998 was primarily due to the cash payment made to acquire Digital of approximately $4.5 billion ($1.4 billion net of cash acquired); the completion of a tender offer for the Digital notes and debentures of $788 million; the repurchase of 11 million shares of common stock for $384 million; cash spent for restructuring activities of $575 million; investments made in 1998 of $574 million, as discussed below; cash dividends paid to Compaq shareholders of $95 million and cash used for the purchase of property, plant and equipment, of $600 million.

Operating activities generated $644 million in cash in 1998, compared to $3.7 billion in 1997 and $3.6 billion in 1996, respectively. The decrease in cash generated by operating activities in 1998 compared to 1997 was significantly affected by the net loss in 1998 (offset by the purchased in-process technology acquired from Digital of approximately $3.2 billion) and an increase in accounts receivable. Accounts receivable increased to $7.0 billion in 1998 from $2.9 billion in 1997, primarily due to the acquisition of Digital. From time to time, Compaq may sell accounts receivable when it is economically

beneficial. Accounts receivable sold at December 31, 1998 were $217 million and $1.1 billion at December 31, 1997. Inventory levels increased to $2.0 billion at December 31, 1998, compared to $1.6 billion at December 31, 1997, due to the acquisition of Digital and increased unit volumes. These increases were partially offset by changes in production planning as a result of Compaq's transition to the optimized distribution model. Inventory turns improved to 13.4 in 1998 versus 12.6 in 1997.

Cash used for investments included a ten percent preferred equity position in a business venture with Time Warner, Advance/Newhouse, MediaOne and Microsoft for approximately $213 million. The venture provides Internet services and intends to accelerate the delivery of broadband services over cable modems to consumers and small businesses under the Road Runner brand. Cash used for investments also included the acquisition of a lease portfolio from G.E. Capital for approximately $361 million.

Compaq plans to use cash to develop the purchased in-process technology related to the Digital acquisition into commercially viable products. This primarily consists of the completion of all planning, designing, prototyping, high-volume manufacturing verification and testing activities that are necessary to establish that a product can be produced to meet its design specifications, including functions, features and technical performance requirements. Bringing the purchased in-process technology to market also includes developing firmware and diagnostic software, device driver development, and testing the technology for compatibility and interoperability with commercially viable products. As of the date of acquisition, the estimated costs to be incurred to develop the purchased in-process technology into commercially viable products totaled approximately $3.1 billion in the aggregate through the year 2005. The remainder to be spent is estimated to be: $510 million in 1999, $660 million in 2000, $630 million in 2001, $520 million in 2002, $400 million in 2003, $210 million in 2004 and $90 million in 2005.

Future uses of cash also include cash expenditures for currently planned restructuring activities which are estimated to be $1.1 billion; capital expenditures for land, buildings and equipment in 1999 which are estimated to be $875 million; and the redemption of the Series A Digital Preferred Stock expected to occur on April 1, 1999 for approximately $400 million plus accrued dividends.

Other future sources and uses of cash include:

> A cash tender offer in January 1999 for all of the outstanding shares of common stock of Shopping.com, an on-line retailer that offers Internet shoppers an array of consumer products. In February the offer was successfully concluded, with 96% of the shares tendered. Compaq is proceeding with the steps necessary to complete the merger, which is anticipated in March. The aggregate purchase price for Shopping.com is anticipated to be approximately $220 million. Completion of the transaction is subject to certain conditions, including clearance under the Hart-Scott-Rodino Antitrust Improvements Act.

> The execution of a definitive merger agreement with Zip2 Corporation, the leading provider of Internet platform solutions for media companies and local e-commerce merchants in February 1999. The aggregate purchase price for Zip2 Corporation is anticipated to be approximately $300 million. Completion of the transaction is subject to customary conditions, including clearance under the Hart-Scott-Rodino Antitrust Improvements Act.

> The formation of the AltaVista Company in January 1999, a wholly owned subsidiary established to become a leading Internet site for search capabilities, localized information, e-commerce and e-services. Compaq will contribute to AltaVista the AltaVista search site and the associated intellectual property, Shopping.com, Zip2 Corporation, and certain additional cash and assets. Compaq anticipates offering a portion of the AltaVista Company to the public in 1999.

Compaq currently expects to fund expenditures for capital requirements as well as liquidity needs from a combination of available cash balances, internally generated funds and financing arrangements. Compaq from time to time may borrow funds for actual or anticipated funding needs. In October 1998, Compaq entered into a one-year $1 billion unsecured revolving credit facility to replace a similar facility that expired in September 1998. Compaq also has a $3 billion syndicated credit facility that expires in September 2002. Both of these facilities were unused at December 31, 1998. Compaq has established a commercial paper program, supported by the syndicated credit facility, which was unused at December 31, 1998. Compaq believes that these sources of credit provide sufficient financial flexibility to meet future funding requirements. Compaq continually evaluates the need to establish other sources of working capital and will pursue those it considers appropriate based upon its needs and market conditions.

Factors That May Affect Future Results

Compaq participates in a highly volatile industry that is characterized by fierce industry-wide competition for market share. Industry participants confront aggressive pricing practices, continually changing customer demand patterns, growing competition from well-capitalized high technology and consumer electronics companies, and rapid technological development carried out in the midst of legal disputes over intellectual property rights and the application of antitrust laws. In accordance with the provisions of the Private Securities Litigation Reform Act of 1995, the cautionary statements set forth below discuss important factors that could cause actual results to differ materially from the projected results contained in the forward-looking statements in this report.

Market Environment. Compaq expects the personal computer market to expand in 1999 in line with third party research organizations' forecasts of unit growth of 15%. The Company expects the enterprise market to expand with the development of Internet and intranet enterprise applications and the corporate MIS migration from legacy systems to client/server systems. This expansion represents an opportunity for Compaq's services business to help enable customers to implement and manage these new environments. With its acquisition of Tandem Computers Incorporated in the third quarter of 1997 and the acquisition of Digital Equipment Corporation in the second quarter of 1998, Compaq confronts a challenge in building the high-end UNIX solutions market while continuing to advance the sphere of NT-based solutions to achieve the lowest cost of ownership and the highest computing value for its customers. Although Compaq has programs, products and services focused on meeting market demand, gaining market share profitably and maintaining gross margins, Compaq's ability to achieve these goals is subject to the risks set forth in this discussion.

Competitive Environment. Competition remains fierce in the information technology industry with a large number of competitors vying for market share. Competition creates an aggressive pricing environment, which continues to put pressure on gross margins. A number of personal computer companies sell directly to end users and, particularly in the U.S., direct sales have increased as a percentage of the total personal computer market. Compaq has established a variety of programs designed to increase its manufacturing, distribution, and business process efficiencies to enable it to compete more effectively in its PC business. Compaq sells directly to end users in its enterprise and service businesses. The success of its programs to increase its business efficiencies depends upon Compaq's ability to continue its successful working relationship with its resellers, to maintain and increase its enterprise and service businesses, to both predict and react quickly to market responses by its competitors, and to continue the implementation of its optimized distribution model, the goal of which is to implement more efficient component supply, manufacturing, and distribution strategies to increase overall efficiencies.

Risks of Newly Acquired Businesses. As a result of the acquisition of Digital, Compaq has, and will continue to, expand its service offerings and enterprise solutions. This expansion includes a number of risks associated with Digital's business. Compaq believes that the Digital acquisition will enhance its operating results, but as with any significant acquisition or merger, it confronts challenges in maintaining key industry alliances and synchronizing product roadmaps and business processes and integrating logistics, marketing, product development, services and manufacturing operations to achieve greater efficiencies. While Compaq has increased its service revenue through this acquisition, there are risks associated with the service business, which include jeopardizing Compaq's long-term relationships with third party resellers while it provides services directly to end-user customers. Compaq has also made certain estimates in connection with the value of purchased in-process technology. If these projects are not successfully developed, its future revenue and profitability may be adversely affected and the value of other intangibles could be reduced. This risk is more fully discussed under "Purchased In-Process Technology." Compaq plans to continue to use strategic acquisitions and mergers to assist in the growth of its business.

Inventory. In the event of a drop in worldwide demand for computer products, lower-than-anticipated demand for one or more of Compaq's products, difficulties in managing product transitions, or component pricing movements, there could be an adverse impact on inventory levels, cash, and related profitability.

Rapid Technology Cycles. Compaq believes the computer industry will continue to drive rapid technology cycles. In planning product transitions, it evaluates the speed at which customers are likely to switch to newer products. The contrast between prices of old and new products, which is related to component costs, is a critical variable in predicting customer decisions to move to the next generation of products. Because of the lead times associated with its volume production, should Compaq be unable to gauge the rate of product transitions accurately, there could be an adverse impact on inventory levels, cash, and profitability. In addition, as a result of the Tandem and Digital acquisitions, Compaq is engaged in direct sales of computer systems with software developed to meet customers' specific needs. The long-term nature of such contracts exposes Compaq to risks associated with changing customer needs and expectations.

Product Transitions. In each product cycle, Compaq confronts the risk of delays in production that could impact sales of newer products while it manages the inventory of older products and facilitates the sale of older inventory held by resellers. To ease product transitions, Compaq carries out pricing actions and marketing programs to increase sales by resellers. It provides currently for estimated product returns and price protection that may occur under reseller programs and under floor planning arrangements with third-party finance companies. Should Compaq be unable to sell the inventory of older products at anticipated prices, should it not anticipate pricing actions that are necessary, or if dealers hold higher than expected amounts of inventory subject to price protection at the time of planned price reductions, there could be a resulting adverse impact on revenues, gross margins, and profitability.

Systems Implementation. Compaq continues to focus on making business and information management processes more efficient in order to increase customer satisfaction, improve productivity and lower costs. In the event of a delay in implementing improvements, there could be an adverse impact on inventory levels, cash and related profitability. In connection with these efforts, Compaq is moving many of its systems from a legacy environment of proprietary systems to client-server architectures as well as integrating systems from newly acquired businesses. Integrating the systems at Digital and Tandem complicates this process. Should the transition to new systems not occur in a smooth and orderly manner, Compaq could experience disruptions in operations, which could have an adverse financial impact.

Technology Standards and Key Licenses. Participants in the computer industry generally rely on the creation and implementation of technology standards to win the broadest market acceptance for their products. Compaq must successfully manage and participate in the development of standards while continuing to differentiate its products and services in a manner valued by customers. While industry participants generally accept, and may encourage, the use of their intellectual property by third parties under license, when intellectual property owned by competitors or suppliers becomes accepted as an industry standard, Compaq must obtain a license, purchase components utilizing such technology from the owners of such technology or their licensees, or otherwise acquire rights to use such technology, which could result in increased costs. Compaq has entered into license agreements with key industry participants. There can be no assurance that it will be able to negotiate terms that give it a competitive market advantage under the license agreements that are necessary to operate its business in the future.

Production Forecasts. In managing production, Compaq must forecast customer demand for its products. Should the Company underestimate the supplies needed to meet demand, it could be unable to meet customer demand. Should it overestimate the supplies needed to meet customer demand, cash and profitability could be adversely affected. Many of the components used in Compaq's products, particularly microprocessors and memory, experience steep price declines over their product lives. If the Company is unable to manage purchases and utilization of such components efficiently to maintain low inventory levels immediately prior to major price declines, it could be unable to take immediate advantage of such declines to lower product costs, which could adversely affect revenues and gross margins. Furthermore, should prices for components increase unexpectedly, Compaq's gross margin could be adversely affected.

Credit Risks. Compaq's primary means of distribution is through third-party resellers. It continually monitors and manages the credit it extends to resellers and attempts to limit credit risks by broadening distribution channels, utilizing certain risk transfer arrangements and obtaining security interests. Compaq's business could be adversely affected in the event that the financial condition of third-party computer resellers erodes. Upon the financial failure of a major reseller, the Company could experience disruptions in distribution as well as a loss associated with the unsecured portion of any outstanding accounts receivable. Geographic expansion, particularly manufacturing operations in developing countries, such as Brazil and China, and the expansion of sales into economically volatile areas such as Asia Pacific, Latin America and other emerging markets, subject Compaq to a number of economic and other risks, such as financial instability among resellers in these regions. Compaq generally has experienced longer accounts receivable cycles in emerging markets, in particular Asia Pacific and Latin America, when compared to U.S. and European markets. In addition, geographic expansion subjects Compaq to political and financial instability of the countries into which Compaq expands, including currency devaluation and interest rate fluctuations. The Company continues to evaluate business operations in these regions and attempts to take measures to limit risks in these areas.

Year 2000 Compliance. The following disclosure is a Year 2000 readiness disclosure statement pursuant to the Year 2000 Readiness and Disclosure Act.

Compaq's Year 2000 program is designed to minimize the possibility of serious Year 2000 interruptions. Possible Year 2000 worst case scenarios include the interruption of significant parts of Compaq's business as a result of critical information systems failure or the failure of suppliers, distributors or customers. Any such interruption may have a material adverse impact on future results. Since their possibility cannot be eliminated, Compaq is incorporating Year 2000 concerns into its contingency plans for dealing with catastrophic events. In addition, Compaq is monitoring the need to develop contingency plans to remediate information systems scheduled to be replaced by systems renewal efforts in case delays in the installation schedule for the new systems make remediation of the older systems necessary.

In 1997, Compaq established a task force to address its personal computer product and customer concerns, and a separate task force to address its internal information systems, including technology infrastructure and embedded technology systems, and the compliance of its suppliers and distributors. In 1998, Compaq integrated the Tandem and Digital task forces with those of its own so that the task force now addresses the product and information systems and supplier and distributor concerns for the entire Company.

With respect to product readiness, the compliance definitions of Compaq, Tandem and Digital remain in effect for most of the respective follow-on products of each company. The readiness status of Compaq, Tandem and Digital products is available on the Compaq Year 2000 Web site at www.compaq.com/year2000. In addition to selling tested products, Compaq also offers a range of Year 2000 readiness services. Because there is no uniform definition of Year 2000 "compliance" and because all customer situations cannot be anticipated, particularly those involving other vendors' products, Compaq may see a change in demand or an increase in warranty and other claims as a result of the Year 2000 transition. Such events, should they occur, could have a material adverse impact on future results.

In 1998, substantially all internal information systems and other infrastructure areas including communication systems, building security systems and embedded technologies in areas such as manufacturing processes were identified, assessed, and categorized for Year 2000 readiness as Priority 1, 2 and 3, with 1 being critical, 2 being intermediate and 3 being non-critical. During the fourth quarter of 1998, the Year 2000 program experienced a significant increase in work resulting from the Digital/Tandem integrations and new business directions. Additional resources have been added and the necessary steps have been taken to maintain the following goals: Priority 1 and Priority 2 items will be Year 2000 compliant by June 30, 1999, and Priority 3 items are to be ready by December 31, 1999 or replaced or left undetermined. As of the end of the fourth quarter of 1998, Compaq completed remediation on approximately 40% of the Priority 1 items, and expects to be approximately 75% complete by the end of March 1999. Specific contingency plans are being made with respect to any Priority 1 listings which cannot be tested or determined to be compliant. Also, key suppliers and distributors have been identified and Compaq is in the process of communicating with them about their Year 2000 readiness plans and progress. In each of these areas, various testing and readiness determination methodologies are being used, based on what is appropriate for each type of system, supplier or distributor.

Coincident with Year 2000 readiness efforts, Compaq is rapidly integrating the Digital operations worldwide. This

includes rationalization of internal systems, facilities and other infrastructure. Compaq is also carrying out major planned enterprise-wide internal system renewal efforts. These planned major enterprise-wide system renewals have been incorporated into the Year 2000 readiness effort. Installations are scheduled through the end of 1999. Based on Compaq's ongoing evaluation of internal information and other systems, the integration of Digital operations, and system renewal roll-out schedules, Compaq does not anticipate significant business interruption. However, should business interruption occur, there could be a material adverse impact on future results. With respect to suppliers and distributors, because Compaq's readiness depends upon their cooperation in identifying, disclosing and remediating problems, failures on the part of suppliers and distributors remain a possibility and could have a material adverse impact on future results.

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 1997 and earlier years and were not broken out from other product engineering costs. No future material product readiness costs are anticipated. The costs of the readiness program for internal information and other systems and suppliers and distributors are a combination of incremental external spending and use of existing internal resources and expertise. Over the life of the internal readiness effort, these costs are estimated to be $130 million, of which approximately 45% has been incurred to date. The costs of implementing enterprise-wide system renewal efforts are not included in this estimate. Milestones and implementation dates and the costs of Compaq's Year 2000 readiness program are subject to change based on new circumstances that may arise or new information becoming available, that may change underlying assumptions or requirements.

EURO CONVERSION. Effective January 1, 1999, 11 of the 15 member countries of the European Union have adopted the euro as their common legal currency. On that date, the participating countries established fixed euro conversion rates between their existing sovereign currencies and the euro. The euro now trades on currency exchanges and is available for non-cash transactions. The participating countries now issue sovereign debt exclusively in euros, and have redenominated outstanding sovereign debt. The authority to direct monetary policy for the participating countries, including money supply and official interest rates for the euro, is now exercised by the new European Central Bank.

In 1997, Compaq established a euro task force to address its PC product and customer concerns, and a separate task force to address Compaq's internal information systems. Compaq hopes to achieve euro product readiness and enable internal information systems to conduct electronic transactions in the euro within the first quarter of 1999. The schedule and details of subsequent phases of internal systems readiness is under review, but will comply with implementation schedules set by the European Commission. We do not believe the costs of the overall effort will have a material adverse impact on future results. However, since all customer situations cannot be anticipated, Compaq may see a change in demand or an increase in warranty and other claims as a result of the euro implementation. Such events, should they occur, could have a material adverse impact on future results. Based on Compaq's ongoing evaluation of internal information systems, integration of Digital operations and system renewal roll-out schedules, Compaq does not anticipate significant business interruption. However, should a significant business interruption occur, there could be a material adverse impact on future results. With respect to compliance by suppliers and distributors, failures remain a possibility and could have a material adverse impact on future results.

Milestones and implementation dates of Compaq's euro readiness program are subject to change based on new circumstances that may arise or new information becoming available, which changes underlying assumptions or requirements.

TAX RATE. Compaq currently has a 15% effective tax rate, before the effect of non-deductible purchased in-process technology and merger-related costs, and expects this rate will increase to 32% in 1999. Compaq benefits from a tax holiday in Singapore that expires in 2001, with a potential extension to August 2004 if certain cumulative investment levels and other conditions are maintained. Compaq's tax rate is heavily dependent upon the proportion of earnings that is derived from its Singaporean manufacturing subsidiary and its ability to reinvest those earnings permanently outside the U.S. If the earnings of this subsidiary as a percentage of Compaq's total earnings were to decline significantly from current levels, or should Compaq's ability to reinvest these earnings be reduced, Compaq's effective tax rate would increase. In addition, should Compaq's intercompany transfer pricing with respect to its Singaporean manufacturing subsidiary require significant adjustment due to audits or regulatory changes, Compaq's overall effective tax rate could increase.

At December 31, 1998 Compaq has recorded a net deferred tax asset of $2.9 billion. Compaq has determined it is more likely than not that this asset will be realized. The future utilization of these deferred tax assets may be restricted from future use by certain limitations imposed by taxing authorities or by a lack of sufficient income generated in the taxing jurisdictions in which the asset arose. If these limitations are significant, or if the circumstances surrounding the expected deductibility of the items change, the ultimate realization of these assets may be adversely impacted and could have an adverse impact on future results.

CURRENCY FLUCTUATIONS. Compaq's risks associated with currency fluctuations are discussed below.

MARKET RISKS. Compaq is exposed to market risks, which include changes in U.S. and international interest rates as well as changes in currency exchange rates as measured against the U.S. dollar and each other. It attempts to reduce these risks by utilizing financial instruments, including derivative transactions, pursuant to Company policies.

Compaq uses market valuations and value-at-risk valuation methods to preliminarily assess market risk of its financial instruments and derivative portfolios. It uses J.P. Morgan's RiskMetrics™ to estimate the value-at-risk of its financial instruments and derivative portfolios based on estimates of volatility and correlation of market factors drawn from J.P. Morgan's RiskMetrics™ data sets for the dates calculated. RiskMetrics™ defines loss as a reduction in the value of a portfolio in the event of adverse market conditions, using a predetermined confidence interval, over a specified period of time. Compaq included all fixed income investments and foreign exchange contracts in the value-at-risk calculation. See Note 1 and Note 13 in the Notes to Consolidated Financial Statements for further information regarding these instruments. The holding period for these instruments varies from two days to nine months. The measured value-at-risk from holding derivative and other financial instruments, using a 95% confidence level and assuming normal market conditions during the periods ended December 31, 1998 and 1997 was immaterial.

The value of the U.S. dollar affects Compaq's financial results. Changes in exchange rates may positively or negatively affect Compaq's revenues (as expressed in U.S. dollars), gross margins, operating expenses, and retained earnings. Compaq engages in hedging programs aimed at limiting in part the impact of currency fluctuations. Using primarily forward exchange contracts, Compaq hedges those assets and liabilities that, when remeasured according to generally accepted accounting principles, impact the income statement. For certain markets, particularly Latin America, Compaq has determined that ongoing hedging of non-U.S. dollar net monetary assets is not cost effective and instead attempts to minimize currency exposure risk through working capital management. There can be no assurance that such an approach will be successful, especially in the event of a significant and sudden decline in the value of local currencies. From time to time, Compaq purchases foreign currency option contracts as well as short-term forward exchange contracts to protect against currency exchange risks associated with the anticipated revenue of Compaq's international marketing subsidiaries, with the exception of Latin America and certain other subsidiaries that reside in countries in which such activity would not be cost effective or local regulations preclude this type of activity. These hedging activities provide only limited protection against currency exchange risks. Factors that could impact the effectiveness of Compaq's hedging programs include accuracy of sales forecasts, volatility of the currency markets, and availability of hedging instruments. All currency contracts that are entered into by Compaq are components of hedging programs and are entered into for the sole purpose of hedging an existing or anticipated currency exposure, not for speculation. Although Compaq maintains these programs to reduce the impact of changes in currency exchange rates, when the U.S. dollar sustains a strengthening position against currencies in which Compaq sells products and services or a weakening exchange rate against currencies in which Compaq incurs costs, Compaq's revenues or costs are adversely affected.

Because of the foregoing factors, as well as other variables affecting Compaq's operating results, past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

Consolidated Balance Sheet

COMPAQ COMPUTER CORPORATION

DECEMBER 31 (IN MILLIONS, EXCEPT PAR VALUE)	1998	1997
Assets		
Current assets:		
Cash and cash equivalents	$ 4,091	$ 6,418
Short-term investments	—	344
Accounts receivable, less allowance of $318 and $243	6,998	2,891
Inventories	2,005	1,570
Deferred income taxes	1,602	595
Other current assets	471	199
Total current assets	15,167	12,017
Property, plant and equipment, less accumulated depreciation	2,902	1,985
Deferred income taxes	1,341	—
Intangible and other assets	3,641	629
	$ 23,051	$ 14,631
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 4,237	$ 2,837
Income taxes payable	282	195
Accrued restructuring costs	1,110	—
Other current liabilities	5,104	2,170
Total current liabilities	10,733	5,202
Postretirement and other postemployment benefits	545	—
Commitments and contingencies (Note 13)		
Minority interest	422	—
Stockholders' equity:		
Preferred stock, $.01 par value (authorized: 10 million shares; issued: none)		
Common stock and capital in excess of $.01 par value (authorized: 3 billion shares; issued and outstanding: 1,698 and 1,687 million shares, respectively, at December 31, 1998; and 1,519 million shares issued and outstanding at December 31, 1997)	7,270	2,096
Retained earnings	4,465	7,333
Treasury stock (at cost)	(384)	—
Total stockholders' equity	11,351	9,429
	$ 23,051	$ 14,631

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

Consolidated Statement of Income

COMPAQ COMPUTER CORPORATION

YEAR ENDED DECEMBER 31 (IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	1998	1997	1996
Revenue:			
Products	$ 27,372	$ 24,122	$ 19,611
Services	3,797	462	398
Total revenue	31,169	24,584	20,009
Cost of sales:			
Products	21,383	17,500	14,565
Services	2,597	333	290
Total cost of sales	23,980	17,833	14,855
Selling, general and administrative expense	4,978	2,947	2,507
Research and development costs	1,353	817	695
Purchased in-process technology	3,196	208	—
Restructuring and asset impairment charges	393	—	52
Merger-related costs	—	44	—
Other income and expense, net	(69)	(23)	17
	9,851	3,993	3,271
Income (loss) before provision for income taxes	(2,662)	2,758	1,883
Provision for income taxes	81	903	565
Net income (loss)	$ (2,743)	$ 1,855	$ 1,318
Earnings (loss) per common share:			
Basic	$ (1.71)	$ 1.23	$ 0.90
Diluted	$ (1.71)	$ 1.19	$ 0.87
Shares used in computing earnings (loss) per common share:			
Basic	1,608	1,505	1,472
Diluted	1,608	1,564	1,516

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

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Cash flows from operating activities:			
Net income (loss)	$ (2,743)	$ 1,855	$ 1,318
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	893	545	483
Provision for bad debts	61	19	160
Purchased in-process technology	3,196	208	—
Deferred income taxes	(130)	202	(405)
Restructuring and asset impairment charges	393	—	52
Changes in operating assets and liabilities, net of effects of purchased businesses:			
Accounts receivable	(1,736)	614	(228)
Inventories	857	(335)	1,014
Other current assets	114	63	34
Accounts payable	589	756	562
Income taxes payable	(265)	(319)	131
Accrued restructuring costs	(575)	—	—
Other current liabilities	(10)	80	445
Net cash provided by operating activities	644	3,688	3,566
Cash flows from investing activities:			
Purchases of property, plant and equipment, net	(600)	(729)	(484)
Purchases of short-term investments	(77)	(2,405)	(1,401)
Proceeds from sale of short-term investments	421	3,134	328
Acquisition of businesses, net of cash acquired	(1,413)	(268)	(22)
Acquisition of lease portfolio	(361)	—	—
Other, net	(437)	(31)	(75)
Net cash used in investing activities	(2,467)	(299)	(1,654)
Cash flows from financing activities:			
Repayment of long-term debt	(788)	(293)	—
Purchase of treasury shares	(384)	—	—
Issuance of common stock pursuant to stock option plans	407	188	131
Tax benefit associated with stock options	234	156	91
Dividends paid	(95)	—	—
Other, net	(18)	(37)	—
Net cash provided by (used in) financing activities	(644)	14	222
Effect of exchange rate changes on cash and cash equivalents	140	7	21
Net (decrease) increase in cash and cash equivalents	(2,327)	3,410	2,155
Cash and cash equivalents at the beginning of the year	6,418	3,008	853
Cash and cash equivalents at the end of the year	$ 4,091	$ 6,418	$ 3,008

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

Consolidated Statement of Cash Flows
COMPAQ COMPUTER CORPORATION

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Supplemental Cash Flow Information			
Interest paid	$ 175	$ 164	$ 106
Income taxes paid	$ 259	$ 804	$ 953
Acquisitions (Note 2)			
Fair value of:			
Assets acquired	$ 16,124	$ 362	
Liabilities assumed	(7,109)	(74)	
Stock issued	(4,284)	—	
Options issued	(249)	(10)	
Cash paid	4,482	278	
Less cash acquired	(3,069)	(10)	
Net cash paid for acquisitions	$ 1,413	$ 268	

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

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Shares of common stock issued:			
Beginning balance	1,519	1,492	1,458
Issuance pursuant to stock option plans	36	30	34
Issuance of stock pursuant to acquisition	141	—	—
Other	2	(3)	—
Ending balance	1,698	1,519	1,492
Common stock par value and capital in excess of par:			
Beginning balance	$ 2,096	$ 1,779	$ 1,543
Issuance pursuant to stock option plans	407	188	131
Issuance of stock pursuant to acquisition	4,284	—	—
Issuance of stock options pursuant to acquisition	249	10	—
Tax benefit associated with stock options	234	156	91
Other	—	(37)	14
Ending balance	7,270	2,096	1,779
Retained earnings:			
Beginning balance	7,333	5,511	4,214
Comprehensive income (loss)			
Net income (loss)	(2,743)	1,855	1,318
Other comprehensive income (loss)	(18)	(22)	(21)
Total comprehensive income (loss)	(2,761)	1,833	1,297
Change in Tandem fiscal period	—	12	—
Cash dividends	(107)	(23)	—
Ending balance	4,465	7,333	5,511
Treasury stock:			
Beginning balance	—	—	—
Repurchase of treasury stock, at cost	(384)	—	—
Ending balance	(384)	—	—
Total stockholders' equity	$ 11,351	$ 9,429	$ 7,290
Accumulated other comprehensive income:			
Beginning balance	$ (18)	$ 4	$ 25
Other comprehensive income (loss)			
Foreign currency translations	20	(22)	(21)
Minimum pension liability adjustment	(38)	—	—
Total other comprehensive income (loss)	(18)	(22)	(21)
Ending balance	$ (36)	$ (18)	$ 4

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

Note 1. Description of Business and Summary of Significant Accounting Policies

DESCRIPTION OF BUSINESS. Founded in 1982, Compaq Computer Corporation ("Compaq" or the "Company") is a global information technology company. Compaq develops and markets hardware, software, solutions and services, including enterprise computing solutions, fault-tolerant business-critical solutions, networking and communication products, commercial desktop and portable products and consumer PCs. Compaq products and services are sold in more than 100 countries through subsidiaries and a network of authorized Compaq marketing partners. Compaq markets its products and services primarily to customers from the business, home, government, and education sectors.

Compaq completed the acquisition of Digital Equipment Corporation ("Digital") in June 1998. This acquisition was accounted for under the purchase method of accounting. Compaq completed the acquisition of Tandem Computers Incorporated ("Tandem") in August 1997. This acquisition was accounted for as a pooling of interests, consequently, the financial information for 1997 and 1996 has been restated to reflect the merger with Tandem.

PRINCIPLES OF CONSOLIDATION. The consolidated financial statements include the accounts of Compaq and its subsidiaries. All significant intercompany transactions and balances have been eliminated.

USE OF ESTIMATES. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS. Cash equivalents include highly liquid temporary cash investments having maturities of three months or less at date of acquisition. Short-term investments include certificate of deposits, commercial paper and other investments having maturities longer than three months at date of acquisition. For reporting purposes, such cash equivalents and short-term investments are stated at cost plus accrued interest which approximates fair value.

INVENTORIES. Inventories are stated at the lower of cost or market, cost being determined on a first-in, first-out basis.

PROPERTY, PLANT AND EQUIPMENT. Property, plant and equipment are stated at cost less accumulated depreciation. Major renewals and improvements are capitalized; minor replacements, maintenance and repairs are charged to current operations. Depreciation is computed by applying the straight-line method over the estimated useful lives of the buildings (10-30 years) and by applying the straight-line or accelerated methods over the estimated useful lives of machinery and equipment (2-10 years). Leasehold improvements are amortized over the shorter of the useful life of the improvement or the life of the related lease.

LONG-LIVED ASSETS. Compaq reviews for the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss would be recognized when estimated future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount.

INTANGIBLE ASSETS. Intangible assets primarily relate to the value of the installed customer base, proven research and development, and trademarks of companies acquired. The cost of the installed customer base, proven research and development and trademarks is amortized on a straight-line basis over the estimated lives of 15 years, 5 years and 5 years, respectively.

REVENUE RECOGNITION. Compaq recognizes products revenue at the time products are shipped to its customers. Provision is made at the time the related revenue is recognized for estimated product returns and price protection which may occur under programs Compaq has with its customers. Compaq provides for the estimated cost of post-sales support and product warranties upon shipment. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. Services revenue is recognized ratably over the contractual period or as the services are performed.

FINANCING TRANSACTIONS. Compaq offers customer financing to assist customers in their acquisition of the

Company's products through its leasing subsidiary, Compaq Capital. At the time a financing transaction is consummated, which qualifies as either a sales-type or direct financing lease, the Company records the total receivable, unearned income and the estimated residual value of the equipment. Unearned income is recognized as finance income using the interest method over the term of the lease. Lease receivables of $271 million, net of unearned income, due within the next twelve months are included in accounts receivable. The non-current portion of $274 million of lease receivables and the residual value, net of unearned income, are included in long-term other assets. Leases not qualifying as either sales-type or direct financing leases are accounted for as operating leases. The underlying equipment is depreciated on a straight-line basis over the initial term of the lease to its estimated residual value. Rental equipment of $166 million, net of accumulated depreciation, is included in property, plant and equipment.

ADVERTISING COSTS. Advertising costs are charged to operations when incurred. The cost of direct-response advertising is not significant. Advertising expenses for 1998, 1997 and 1996 were $336 million, $223 million and $175 million, respectively.

FOREIGN CURRENCY. Compaq's foreign subsidiaries (other than those acquired in the merger with Tandem) have the U.S. dollar designated as their functional currency. Financial statements of these foreign subsidiaries are translated to U.S. dollars for consolidation purposes using current rates of exchange for monetary assets and liabilities and historical rates of exchange for nonmonetary assets and related elements of expense. Revenue and other expense elements are translated at rates that approximate the rates in effect on the transaction dates. Translation gains and losses are included in Compaq's Consolidated Statement of Income. The foreign subsidiaries acquired in the merger with Tandem designated the local currency as their functional currency and related cumulative translation adjustments have not been significant.

INCOME TAXES. The provision for income taxes is computed based on the pretax income (loss) included in the Consolidated Statement of Income. The asset and liability approach is used to recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

EARNINGS PER COMMON SHARE. Basic earnings (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed using the combination of dilutive common share equivalents and the weighted average number of common shares outstanding during the period. Incremental shares of 59 million and 44 million in 1997 and 1996, respectively, were used in the calculation of diluted earnings per common share. Diluted loss per common share for 1998 is based only on the weighted average number of common shares outstanding during the period, as the inclusion of 60 million common share equivalents would have been antidilutive.

Stock options to purchase 13 million, 9 million and 28 million shares of common stock in 1998, 1997 and 1996, respectively, were outstanding but not included in the computation of diluted earnings (loss) per common share because the option exercise price was greater than the average market price of the common shares.

STOCK-BASED COMPENSATION. Compaq measures compensation expense for its stock-based employee compensation plans using the intrinsic value method and has provided in Note 8 the pro forma disclosures of the effect on net income (loss) and earnings (loss) per common share as if the fair value-based method had been applied in measuring compensation expense.

COMPREHENSIVE INCOME. Other comprehensive income refers to revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income but are excluded from net income as these amounts are recorded directly as an adjustment to stockholders' equity. Compaq's other comprehensive income is primarily comprised of foreign currency translation adjustments and adjustments made to recognize additional minimum liabilities associated with the Company's defined benefit pension plans. The tax benefit or expense, as well as any reclassifications related to the components of other comprehensive income were not significant.

SEGMENT DATA. During 1998, Compaq adopted Statement of Financial Accounting Standards No. 131 ("FAS 131"), *Disclosures about Segments of an Enterprise and Related Information*. FAS 131 supersedes FAS 14, *Financial Reporting for Segments of a Business Enterprise*, replacing the "industry segment" approach with the "management" approach. The management approach designates the internal reporting that is used by management for making operating decisions and assessing performance as the source of the Company's reportable segments. FAS 131 also requires disclosures about products and services, geographic areas and major customers. The adoption of FAS 131 did not affect results of operations or the financial position of Compaq but did affect the disclosure of segment information (Note 12).

RECENT PRONOUNCEMENTS. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 ("FAS 133"), *Accounting for Derivative Instruments and Hedging Activities*. FAS 133 is effective for transactions entered into after January 1, 2000. FAS 133 requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and the type of hedge transaction. The ineffective portion of all hedges will be recognized in earnings. Compaq is in the process of determining the impact that the adoption of FAS 133 will have on its results of operations and financial position.

RECLASSIFICATIONS. Certain prior year amounts have been reclassified to conform to the 1998 presentation.

Note 2. Acquisitions

On June 11, 1998, Compaq consummated its acquisition of Digital. Digital was an industry leader in implementing and supporting networked business solutions in multi-vendor environments based on high performance platforms and had an established global service and support team. The aggregate purchase price of $9.1 billion consisted of approximately $4.5 billion in cash, the issuance of approximately 141 million shares of Compaq common stock valued at approximately $4.3 billion and the issuance of approximately 25 million options to purchase Compaq common stock valued at approximately $249 million. The cash component of the purchase price was paid through the use of Compaq's general corporate funds. The results of operations of Digital and the estimated fair value of the assets acquired and liabilities assumed are included in Compaq's financial statements from the date of acquisition.

The purchase price was preliminarily allocated to the assets acquired and liabilities assumed based on Compaq's estimates of fair value at the acquisition date. In the fourth quarter of 1998, Compaq adjusted the fair values of certain assets acquired and liabilities assumed based on the receipt of additional information which was outstanding as of the date of the acquisition. These adjustments did not have a material impact on the initial purchase price allocation. The fair value assigned to intangible assets acquired was based on a valuation prepared by an independent third-party appraisal company of the purchased in-process technology, proven research and development, the installed customer base and trademarks of Digital. The amounts allocated to tangible and intangible assets acquired less liabilities assumed exceeded the purchase price by approximately $4.1 billion. This excess value over the purchase price was allocated to reduce the values assigned to long-term assets and purchased in-process technology in determining their ultimate fair values. As a result of the change in fair values of the long-term assets, the deferred tax liability associated with these assets was also adjusted.

The following table shows the fair value of the long-term assets acquired, the allocation of the excess value over the purchase price and the resulting assigned values for the long-term assets acquired through the acquisition of Digital:

Balance Sheet Category (IN MILLIONS)	Valuation	Excess Value Over Purchase Price	Value Assigned to Net Assets Acquired
Property, plant and equipment	$ 1,470	$ (592)	$ 878
Purchased in-process technology	5,722	(2,526)	3,196
Intangible assets:			
Proven research and development	990	(437)	553
Installed customer base	2,150	(949)	1,201
Trademarks	291	(129)	162
Other assets	953	(262)	691
Deferred tax liability	(1,121)	829	(292)

Approximately $3.2 billion of the purchase price represents purchased in-process technology that had not yet reached technological feasibility and had no alternative future use. Accordingly, this amount was immediately expensed in the Consolidated Statement of Income upon consummation of the acquisition. The value assigned to purchased in-process technology, based on a valuation prepared by an independent third-party appraisal company, was determined by identifying research projects in areas for which technological feasibility had not been established, including UNIX/OpenVMS ($1.6 billion), NT Systems ($800 million), storage ($2.7 billion) and others ($600 million). The value was determined by estimating the costs to develop the purchased in-process technology into commercially viable products, estimating the resulting net cash flows from such projects, and discounting the net cash flows back to their present value. The discount rate included a factor that takes into account the uncertainty surrounding the successful development of the purchased in-process technology. If these projects are not successfully developed, future revenue and profitability of Compaq may be adversely affected. Additionally, the value of other intangible assets acquired may become impaired.

The following table represents unaudited consolidated pro forma information as if Compaq and Digital had been combined as of the beginning of the periods presented. The pro forma data is presented for illustrative purposes only and is not necessarily indicative of the combined results of operations of future periods or the results that actually would have occurred had Compaq and Digital been a combined company during the specified periods. The pro forma combined results include the effects of the purchase price allocation on depreciation of property, plant and equipment and amortization of intangible assets; adjustments to reflect the reversal of interest income resulting from the use of cash related to the acquisition of Digital, and preferred stock dividends paid. The pro forma combined results exclude acquisition-related charges for purchased in-process technology related to Digital.

YEAR ENDED DECEMBER 31 (IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	1998	1997
		Pro forma Unaudited
Revenue:		
Products	$ 29,955	$ 31,350
Services	6,447	6,295
Total revenue	$ 36,402	$ 37,645
Net income	$ 275	$ 1,798
Earnings per common share:		
Basic	$ 0.16	$ 1.09
Diluted	$ 0.16	$ 1.05
Shares used in computing earnings per common share:		
Basic	1,672	1,646
Diluted	1,736	1,706

During 1998, Compaq Capital purchased from G.E. Capital Corporation a lease portfolio for $361 million. The underlying equipment consists primarily of Digital manufactured equipment. Also during 1998, Compaq Capital purchased certain assets and assumed certain liabilities of Dana Commercial Credit Corporation's computer equipment leasing business. The purchase price was $50 million. The assets acquired consist primarily of direct financing leases related to Compaq manufactured equipment.

On August 29, 1997, Compaq merged with Tandem Computers Incorporated ("Tandem") in a stock-for-stock transaction accounted for as a pooling of interests. Tandem provided its customers with reliable, scaleable, fault-tolerant enterprise computer systems and client/server solutions. In connection with the merger, Compaq issued 126 million shares of common stock, based upon an exchange ratio of 1.05 shares of Compaq common stock for each share of Tandem common stock. Merger-related costs of $44 million are comprised primarily of transaction costs for fees of investment bankers, attorneys, accountants and printing, and are reflected in the Consolidated Statement of Income for the year ended December 31, 1997. The financial data included in these financial statements have been restated to reflect the merger with Tandem. There were no material transactions between Compaq and Tandem during the periods prior to the merger. The consolidated financial data for the year ended December 31, 1996 includes the results of Tandem for the year ended September 30, 1996. For 1997, Tandem's fiscal year end was changed from September 30 to December 31. As permitted by Securities and Exchange Commission regulations, Tandem's three-month period ended December 31, 1996 has been omitted from the Consolidated Statement of Income and recorded as an adjustment to retained earnings in 1997. Tandem's revenues, expenses and net income were $436 million, $424 million and $12 million, respectively, for that period. Tandem also generated a $40 million increase in cash and cash equivalents during the quarter ended December 31, 1996.

In May 1997, Compaq completed a tender offer for Microcom, Inc., a manufacturer of remote access technologies and solutions. The aggregate purchase price of $288 million consisted of $278 million in cash and the assumption of certain employee stock options. The transaction was accounted for under the purchase method of accounting. Accordingly, the results of operations of the acquired business and the fair market values of the acquired assets and liabilities were included in Compaq's financial statements from the date of acquisition. The aggregate purchase price has been allocated to the assets and liabilities acquired. The aggregate purchase price included $208 million, representing the value of purchased in-process technology that had not yet reached technological feasibility and had no alternative future use. Accordingly, this amount was expensed in Compaq's Consolidated Statement of Income during 1997.

Note 3. Restructuring and Asset Impairment Charges

In June 1998, Compaq's management approved restructuring plans, which included initiatives to integrate operations of Compaq and Digital, consolidate duplicative facilities, improve service delivery and reduce overhead. Total restructuring costs of approximately $1.7 billion were recorded in the second quarter related to these initiatives, $1.5 billion of which related to Digital that was recorded as a component of the preliminary purchase price allocation and $286 million of which related to Compaq that was charged to operations.

The restructuring costs recorded in the second quarter of 1998 were comprised of the following:

(IN MILLIONS)	Compaq	Digital	Total
Employee separations	$ 132	$ 999	$ 1,131
Facility closure costs	142	272	414
Relocation	—	99	99
Other exit costs	12	88	100
Total accrued restructuring costs	$ 286	$ 1,458	$ 1,744

At June 30, 1998, the Digital restructuring plans were based on management's best estimate of those costs based on available information. The restructuring costs accrued in June 1998 included estimates of the cost of involuntary employee separation benefits related to approximately 19,700 employees worldwide (approximately 14,700 Digital employees and 5,000 Compaq employees). Employee separation benefits include severance, medical and other benefits. Employee separations affect the majority of business functions, job classes and geographies, with most of the reductions occurring in North America and Europe. The restructuring plans also included costs associated with the closure of 13.2 million square feet of office, distribution and manufacturing space, principally in North America and Europe. Other accrued restructuring costs relate to the relocation of Digital employees, with the majority of this amount attributable to relocations in North America and Europe, and the cost of terminating certain Digital contractual obligations. Compaq expects that most of the restructuring actions will be completed by June 1999.

In the fourth quarter of 1998, Compaq adjusted the Digital restructuring plan which resulted in a reduction of $59 million of accrued Digital restructuring costs. This reduction was recorded as an adjustment to the preliminary purchase price allocation during the quarter ended December 31, 1998. There was no adjustment to the Compaq restructuring plan. The adjustment to the Digital restructuring plan includes a $47 million net increase in severance costs. This increase was primarily due to higher than expected costs associated with workforce reductions in Europe, partially offset by higher than expected attrition rates. While the total Digital employee separation target of 14,700 is expected to be achieved, Digital involuntary separations are expected to decrease to approximately 12,400 as a result of the higher than expected rate of attrition. The higher severance costs were

more than offset by lower facility closure costs of $55 million, primarily due to lower than expected costs to dispose of facilities. In addition, the estimate of employee relocation costs was reduced by $54 million due to a lower than expected number of employees accepting relocation packages.

The accrued restructuring costs and amounts charged against the accrual as of December 31, 1998, were as follows:

(IN MILLIONS)	Beginning Accrual	Cash Expenditures	Adjustment	Remaining Accrual
Employee separations	$ 1,131	$ (455)	$ 47	$ 723
Facility closure costs	414	(42)	(55)	317
Relocation	99	(2)	(54)	43
Other exit costs	100	(76)	3	27
Total accrued restructuring costs	$ 1,744	$ (575)	$ (59)	$ 1,110

Cash expenditures are not reflective of the actual costs incurred as of December 31, 1998 due to the impact of regulatory guidelines in certain countries relating to the timing of payment of severance benefits to affected employees. As of December 31, 1998, employee separations due to restructuring actions totaled 10,542. Total severance costs related to these individuals, including the cash payments of $455 million already made, are approximately $570 million. The total net headcount reduction since the acquisition of Digital including attrition and restructuring, partially offset by selective hiring, was approximately 12,800.

During 1998, Compaq also recorded a $107 million charge related to asset impairments. The asset impairments resulted from the writedown to fair market value, less costs to sell, for assets taken out of service and held for sale or disposal. The majority of this charge related to the impairment of $74 million of intangible assets associated with the acquisition of a company during 1995 that developed, manufactured, and supplied fast ethernet hubs, switches and related products. In May 1998, management decided to close the manufacturing facility and abandoned the technologies acquired through this acquisition and discontinued all related products.

Note 4. Balance Sheet Components

Inventories consisted of the following:

DECEMBER 31 (IN MILLIONS)	1998	1997
Raw material	$ 404	$ 439
Work-in progress	403	328
Finished goods	1,198	803
	$ 2,005	$ 1,570

Property, plant and equipment consisted of the following:

DECEMBER 31 (IN MILLIONS)	1998	1997
Land	$ 249	$ 185
Buildings and leasehold improvements	1,653	1,076
Machinery and equipment	2,927	2,392
Construction-in-process and other	394	373
	5,223	4,026
Less accumulated depreciation	2,321	2,041
	$ 2,902	$ 1,985

Depreciation expense totaled $606 million, $447 million and $387 million in 1998, 1997 and 1996, respectively.

Intangibles and other assets consisted of the following:

DECEMBER 31 (IN MILLIONS)	1998	1997
Installed customer base	$ 1,201	$ —
Proven research and development	612	178
Trademarks	164	5
Other assets	2,119	751
	4,096	934
Less accumulated amortization	455	305
	$ 3,641	$ 629

Amortization expense totaled $287 million, $98 million and $96 million in 1998, 1997 and 1996, respectively.

Other current liabilities consisted of the following:

DECEMBER 31 (IN MILLIONS)	1998	1997
Salaries, wages and related items	$ 749	$ 195
Deferred revenue	845	136
Accrued warranty	752	431
Other accrued liabilities	2,758	1,408
	$ 5,104	$ 2,170

Note 5. Credit Agreements and Financing Arrangements

In October 1998, Compaq entered into a one-year $1 billion unsecured revolving credit facility to replace a similar facility that expired in September 1998. In addition, Compaq has a five-year, $3 billion revolving credit facility that expires in September 2002. There were no borrowings under these facilities during 1998 or 1997.

In June 1998, Compaq completed a cash tender offer for Digital debt securities with a fair value of $879 million, including accrued interest. Compaq paid an aggregate of $799 million (including accrued interest) for the notes and debentures tendered. The untendered balance of the notes and debentures is included in other current liabilities.

Note 6. Other Income and Expense

Other income and expense consisted of the following:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Interest and dividend income	$ (287)	$ (266)	$ (126)
Interest (income) expense associated with hedging	9	(4)	(3)
Other interest expense	166	168	106
Currency losses, net	16	31	14
Minority interest dividend	19	—	—
Other, net	8	48	26
	$ (69)	$ (23)	$ 17

Note 7. Provision for Income Taxes

The components of income (loss) before provision for income taxes were as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Domestic	$ (4,782)	$ 1,789	$ 929
Foreign	2,120	969	954
	$ (2,662)	$ 2,758	$ 1,883

The provision for income taxes charged to operations was as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Current tax expense (benefit)			
U.S. federal	$ (92)	$ 430	$ 672
State and local	(9)	30	34
Foreign	312	241	238
Total current	211	701	944
Deferred tax expense (benefit)			
U.S. federal	(429)	194	(332)
State and local	(11)	2	(19)
Foreign	310	6	(28)
Total deferred	(130)	202	(379)
Total provision	$ 81	$ 903	$ 565

The reasons for the differences between income tax expense and amounts calculated using the U.S. statutory rate of 35% were as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Tax expense (benefit) at U.S. statutory rate	$ (932)	$ 965	$ 659
Foreign tax effect, net	(40)	(88)	(105)
Non-deductible purchased in-process technology	1,119	73	—
Release of valuation allowance	(77)	(30)	(7)
Other, net	11	(17)	18
	$ 81	$ 903	$ 565

In connection with the 1998 and 1997 acquisitions, Compaq recorded non-recurring, non-tax-deductible charges for purchased in-process technology of approximately $3.2 billion and $208 million, respectively. In connection with the 1997 Tandem merger, Compaq incurred $44 million of non-recurring, non-tax-deductible merger expenses. The exclusion of these non-taxable charges would result in effective tax rates of 15% and 30% in 1998 and 1997, respectively.

Compaq benefits from a tax holiday in Singapore which expires in 2001, with a potential extension to August 2004 if certain cumulative investment levels and other conditions are maintained. Compaq has determined that the undistributed earnings of its Singaporean manufacturing subsidiary will be reinvested indefinitely. In addition, Compaq has determined that the preacquisition undistributed earnings of the acquired Digital foreign subsidiaries will be reinvested indefinitely. Undistributed post-acquisition earnings of the Digital subsidiaries are not reinvested indefinitely. As a result of these determinations, no incremental tax is reflected for the earnings of Compaq's Singaporean manufacturing subsidiary or for the pre-acquisition earnings of the Digital subsidiaries. These earnings would become subject to incremental foreign withholding, federal and state income tax if they were actually or deemed to be remitted to the U.S. Compaq estimates an additional tax provision of approximately $2.1 billion would be required if the full amount of approximately $6 billion in accumulated earnings were actually or deemed distributed to the U.S.

Compaq recorded a gross deferred tax asset of approximately $2.8 billion upon the acquisition of Digital. This gross deferred tax asset was reduced by a valuation allowance of $562 million, resulting in a net increase in the deferred tax asset of approximately $2.2 billion. The valuation allowance is principally composed of pre-acquisition tax loss carryforwards and credit carryforwards incurred by Digital which management has determined are more likely than not to expire unused. If it is subsequently determined that a portion of the Digital deferred tax asset to which the valuation allowance relates should be recognized, the tax benefit of such recognition will be allocated to noncurrent intangible assets acquired in the acquisition.

During 1998 the Company recorded $65 million of other tax loss and credit carryforwards for which a full valuation allowance was provided due to uncertainty surrounding their realizability.

The valuation allowance was reduced by $77 million to reflect Tandem credit carryforwards which, as a result of the fourth quarter 1998 liquidation of the U.S. Tandem parent company, are now believed more likely than not to be realized. This reduction in the valuation allowance resulted in a tax benefit as a component of the deferred income tax provision.

Deferred tax assets (liabilities) are comprised of the following:

DECEMBER 31 (IN MILLIONS)	1998	1997
Property, plant and equipment	$ 144	$ —
Compensation accruals	227	—
Restructuring accrual	431	—
Post sales support and warranty accruals	255	154
Receivable allowances	349	353
Inventory adjustments	182	99
Capitalized research and development costs	679	95
Loss carryforwards	1,300	50
Credit carryforwards	411	119
Other	441	186
Gross deferred tax assets	4,419	1,056
Difference arising from different tax and financial reporting year ends	—	(254)
Intangible assets	(715)	(64)
Other	(104)	(73)
Gross deferred tax liabilities	(819)	(391)
Deferred tax asset valuation allowance	(684)	(134)
	$ 2,916	$ 531

Tax loss carryforwards will generally expire between 1999 and 2019. Credit carryforwards will generally expire between 1999 and 2013. U.S. tax laws limit the annual utilization of tax loss and credit carryforwards of acquired entities. These limitations should not materially impact the utilization of the tax carryforwards.

Note 8. Stock Option Plans

Compaq maintains various stock option plans for its employees. Options to employees are generally granted at the fair market value of the common stock at the date of grant and generally vest over four to five years. Options granted to employees under the Compaq's stock option plans must be exercised not later than ten years from the date of grant.

In 1998, Compaq adopted the 1998 Stock Option Plan. Pursuant to the terms of this plan, employees and non-employee directors are eligible to receive options to purchase Compaq common stock. Up to 150 million shares may be issued under this plan and will be drawn from either authorized but previously unissued shares or from treasury shares. Options granted under this plan, except those granted in connection with acquisitions (Note 2), are granted at the fair market value of the common stock at the date of grant. The vesting period and option life for grants to employees are at the discretion of the Board of Directors. The terms for initial grants and annual grants to non-employee directors are described below.

Compaq also maintains plans under which it offers stock options to non-employee directors. Pursuant to the terms of the plans under which directors are eligible to receive options, each non-employee director is entitled to receive options to purchase common stock upon initial appointment to the Board (initial grants) and upon subsequent reelection to the Board (annual grants). Initial grants are exercisable during the period beginning one year after initial appointment to the Board and ending ten years after the date of grant. Annual grants vest over two years and are exercisable thereafter until the tenth anniversary of the date of grant. Both initial grants and annual grants have an exercise price equal to the fair market value of Compaq's common stock on the date of grant. Additionally, directors may elect to receive stock options in lieu of all or a portion of the annual retainer to be earned. Such options are granted at 50% of the price of Compaq's common stock at the date of grant and are exercisable during the period beginning one year after the grant date and ending ten years after the grant date. The expense resulting from options granted at 50% of the price of Compaq's common stock at the grant date is charged to operations over the vesting period.

At December 31, 1998, there were 374 million shares of common stock reserved by the Board of Directors for issuance under all of Compaq's stock option plans. For all plans, options of 88 million, 71 million and 73 million shares were exercisable at December 31, 1998, 1997 and 1996 with a weighted average exercise price of $11.76, $6.52 and $5.53, respectively. There were 217 million, 64 million and 101 million shares available for grant under the plans at December 31, 1998, 1997 and 1996, respectively.

The following table summarizes activity under the stock option plans for each of the three years ended December 31, 1998:

	Shares In Millions	Price Per Share	Weighted Average Price Per Share
Options outstanding, December 31, 1995	164		$ 5.94
Options granted	47	$4.71 – $22.39	14.11
Options lapsed or canceled	(15)		8.61
Options exercised	(33)	0.38 – 13.46	3.50
Options outstanding, December 31, 1996	163		8.53
Options granted	46	2.55 – 37.38	27.17
Options lapsed or canceled	(9)		11.57
Options exercised	(29)	0.79 – 25.96	6.26
Options outstanding, December 31, 1997	171		13.63
Options granted in the acquisition of Digital	25	5.94 – 39.23	22.23
Options granted	13	14.44 – 42.00	33.35
Options lapsed or canceled	(16)		21.84
Options exercised	(36)	1.30 – 39.23	11.39
Options outstanding, December 31, 1998	157		16.37

The following table summarizes significant ranges of outstanding and exercisable options at December 31, 1998:

	Options Outstanding			Options Exercisable	
Ranges of Exercise Prices	Shares In Millions	Weighted Average Remaining Life in Years	Weighted Average Exercise Price	Shares In Millions	Weighted Average Exercise Price
under $5.00	31	3.3	$ 3.16	31	$ 3.16
5.01 to 10.00	32	6.2	8.81	21	8.66
10.01 to 15.00	16	6.6	12.26	9	12.26
15.01 to 20.00	26	7.7	16.26	11	16.57
20.01 to 25.00	7	7.5	22.82	7	22.85
25.01 to 30.00	26	8.8	27.97	5	27.98
over $30.00	19	8.5	35.35	4	37.23

The fair value of the stock options granted in the Digital acquisition was included in the purchase price of Digital. Excluding options issued in the Digital acquisition, the weighted average fair value per share of stock based compensation issued during 1998, 1997 and 1996 was $12.95, $9.74 and $6.55, respectively. The fair value for these options was estimated using the Black-Scholes model with the following weighted average assumptions:

YEAR ENDED DECEMBER 31	1998	1997	1996
Expected option life (in years)	5	4	5
Risk-free interest rate	4.6%	6.0%	6.1%
Volatility	33.5%	33.3%	44.0%
Dividend yield	0.2%	0.2%	—

The table that follows summarizes the pro forma effect on net income (loss) if the fair values of stock based compensation had been recognized in the year presented as compensation expense on a straight-line basis over the vesting period of the grant. The following pro forma effect on net income (loss) for the years presented is not representative of the pro forma effect on net income (loss) in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

YEAR ENDED DECEMBER 31 (IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	1998	1997	1996
Income (loss) before provision for income taxes:			
As reported	$ (2,662)	$ 2,758	$ 1,883
Pro forma	(2,832)	2,667	1,835
Net income (loss):			
As reported	(2,743)	1,855	1,318
Pro forma	(2,854)	1,796	1,287
Diluted earnings (loss) per share:			
As reported	(1.71)	1.19	0.87
Pro forma	(1.77)	1.15	0.85

Note 9. Stockholders' Equity

DIVIDENDS. On December 10, 1998, Compaq announced that the Board of Directors approved a cash dividend of $0.02 per share of common stock, or approximately $34 million, to shareholders of record as of December 31, 1998 to be paid in 1999.

TREASURY STOCK. On April 23, 1998, the Board of Directors authorized a systematic common stock repurchase program. Compaq implemented this program in May 1998. Compaq has repurchased approximately 11 million shares through December 31, 1998, for a cost of approximately $384 million under this program. The program was implemented to reduce the dilutive impact of common shares issued under Compaq's equity incentive plans.

Note 10. Pension and Other Benefit Programs

DEFINED BENEFIT PENSION PLANS AND OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS ("OPEB PLANS"). Upon consummation of the Digital acquisition, Compaq assumed certain of Digital's defined benefit pension and OPEB plans. Digital employees who were eligible to participate in the Digital plans at the time of the acquisition continue to be eligible to participate in these plans. Compaq also assumed the OPEB plans that provide medical and dental benefits to Digital's retirees and their eligible dependents in the U.S. and certain other locations.

Benefits under the defined benefit pension plans are generally based on pay and service. In the U.S., the main plan (which covers only certain ex-Digital employees) is a cash balance plan, under which the benefit is usually paid as a lump sum amount.

The Company's OPEB plans are funded as costs are incurred. The majority of these plans are contributory, with contributions in many cases adjusted for general inflation or inflation in costs under the plan.

The Company recorded an additional minimum liability as of December 31, 1998 totaling $55 million ($38 million net of tax) for plans where the accumulated benefit obligation exceeded the fair market value of assets.

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for which the accumulated benefit obligations exceed plan assets approximated $1.1 billion, $994 million and $840 million, respectively. The minimum liability recorded for plans with an overfunded and underfunded status is as follows:

DECEMBER 31, 1998 (IN MILLIONS)	Underfunded Plans	Overfunded Plans	Total
Plan status:			
Accrued pension liability	$ (50)	$ —	$ (50)
Prepaid pension asset	—	16	16
Minimum liability required	(76)	(13)	(89)
Minimum pension liability adjustment reflected in comprehensive income	(26)	(29)	(55)
Tax benefit	8	9	17
Minimum liability reflected in comprehensive income (loss), net of tax	$ (18)	$ (20)	$ (38)

Information regarding Compaq's defined benefit and OPEB plans is as follows:

YEAR ENDED DECEMBER 31, 1998 (IN MILLIONS)	Defined Benefit Pension Plans US	Defined Benefit Pension Plans Foreign	OPEB Plans US	OPEB Plans Foreign
Change in benefit obligation				
Benefit obligation at beginning of year	$ —	$ —	$ —	$ —
Digital acquisition	2,181	1,557	329	15
Service cost	37	35	4	1
Interest cost	87	57	13	—
Plan participants' contributions	—	6	2	—
Actuarial (gain) loss	17	122	(14)	(1)
Benefits paid	(119)	(37)	(14)	—
Currency loss	—	91	—	—
Projected benefit obligation at end of year	2,203	1,831	320	15
Change in plan assets				
Fair value of plan assets at beginning of year	—	—	—	—
Plan assets acquired through acquisition of Digital	2,346	1,833	—	—
Actual return on plan assets	(29)	(99)	—	—
Employer contribution	—	8	12	—
Plan participants' contributions	—	6	2	—
Benefits paid	(119)	(37)	(14)	—
Currency gain	—	102	—	—
Fair value of plan assets at end of year	2,198	1,813	—	—
Funded status	(5)	(18)	(320)	(15)
Unrecognized net actuarial (gain) loss	173	307	(18)	(1)
Prepaid (accrued) benefit cost (measurement date October 31, 1998)	168	289	(338)	(16)
Contributions after measurement date	—	6	3	—
Prepaid (accrued) benefit cost	$ 168	$ 295	$ (335)	$ (16)
Amounts included in the Consolidated Balance Sheet are comprised of:				
Prepaid benefit cost	$ 168	$ 420	$ —	$ —
Accrued benefit liability	—	(180)	(335)	(16)
Accumulated other comprehensive income	—	55	—	—
Net amount recognized	$ 168	$ 295	$ (335)	$ (16)

YEAR ENDED DECEMBER 31, 1998	Defined Benefit Pension Plans US	Defined Benefit Pension Plans Foreign	OPEB Plans US	OPEB Plans Foreign
Weighted-average assumptions as of October 31				
Discount rate	7.00%	5.75%	7.00%	5.25%
Expected return on plan assets	9.00%	7.00%	N/A	N/A
Rate of compensation increase	4.50%	3.25%	N/A	N/A
Health care cost trend rate, current year	N/A	N/A	5.25%	5.5% to 8.5%
Health care cost trend rate, ultimate year	N/A	N/A	4.50%	3.5% to 5.5%
Trend rate decreases to the ultimate rate in the year	N/A	N/A	2001	2001 to 2003
Components of net periodic benefit cost (in millions)				
Service cost	$ 37	$ 35	$ 4	$ 1
Interest cost	87	57	13	—
Expected return on plan assets	(126)	(79)	—	—
Curtailment (gain)	—	(1)	—	—
Net periodic pension cost	$ (2)	$ 12	$ 17	$ 1

Assumed health care cost trend rates could have an effect on the amounts reported for the health care plans. A one-percentage point change in the assumed health care cost trend rates would have the following effects:

(IN MILLIONS)	1% Point Increase	1% Point Decrease
Effect on total service and interest cost components	$ 4	$ (3)
Effect on postretirement benefit obligation	$ 37	$ (32)

DEFINED CONTRIBUTION PLANS. Compaq has defined contribution plans under which Compaq makes matching contributions based on employee contributions. These plans are intended to qualify as deferred compensation plans under Section 401(k) of the Internal Revenue Code of 1986. Contributions are invested at the direction of the employee in one or more funds, including a fund that consists of common stock of Compaq. Amounts charged to expense were $98 million, $48 million and $36 million in 1998, 1997 and 1996, respectively.

INCENTIVE COMPENSATION PLAN. Compaq has an incentive compensation plan for the majority of its employees. Starting in 1998, payments under the plan are based on a uniform percentage of employees' base pay as determined by a matrix using return on invested capital and customer satisfaction results. Prior to 1998, payments were based on 6% of net income from operations, as defined under the previous plan. Payments are made semiannually. Amounts charged to expense were $68 million, $109 million and $76 million in 1998, 1997 and 1996, respectively.

Note 11. Digital Summarized Financial Information (Digital stand-alone)

In 1994, Digital sold to the public 16 million depositary shares under a shelf registration, each representing a one-fourth interest in a share of the Series A Preferred Stock, par value $1.00 per share. Dividends on the Series A Preferred Stock accrue at the annual rate of 8-7/8%, or $36 million per year. The Series A Preferred Stock is not convertible into, or exchangeable for, shares of any other class or classes of Compaq stock. The Series A Preferred Stock is not redeemable prior to April 1, 1999. On or after April 1, 1999, Compaq, at its option, may redeem shares of the Series A Preferred Stock, for cash at the redemption price per share of $100 ($25 per depositary share), plus accrued and unpaid dividends. The redemption is expected to occur on April 1, 1999. Compaq has guaranteed the dividend payments, redemption price and liquidation preference of the Digital Series A Preferred Stock. At December 31, 1998, there were declared and unpaid dividends of $9 million. The minority interest of $422 million on Compaq's Consolidated Balance

Sheet represents the fair value of the Series A Preferred Stock as of the date of the Digital acquisition.

The summarized financial information for Digital and its consolidated subsidiaries on a stand-alone basis is presented below. The financial information for the period subsequent to the acquisition is based on the new basis of accounting reflecting the amounts included in the purchase price allocation resulting from Compaq's acquisition of Digital (see Notes 2 and 3), and is presented in accordance with generally accepted accounting principles. The new basis of accounting adjustments include (i) fair value adjustments to the historical basis of assets and liabilities acquired, (ii) the fair value assigned to intangible assets, including purchased in-process technology and (iii) accrued restructuring charges. Additionally, the Digital stand-alone financial information includes an allocation of certain costs incurred by Compaq including an allocation of $66 million of (i) costs for administrative functions and services performed on behalf of Digital by centralized staff groups within Compaq, and (ii) Compaq's general corporate expenses. The costs of these functions and services have been allocated to Digital using methods that Compaq management believes are reasonable. Such allocations are not necessarily indicative of the costs that would have been incurred if Digital had been a separate entity.

Although Digital financial information is presented on a stand-alone basis, the companies are being managed on a consolidated basis. The stand-alone Digital information does not necessarily reflect the results that Digital would have realized had the acquisition not occurred and is not necessarily indicative of the future results of Digital. Separate financial information and other disclosures concerning Digital are deemed by management to not be meaningful to holders of the Series A Preferred Stock.

(IN MILLIONS)	New Basis	Old Basis
	December 26, 1998	December 27,1997
Current assets	$ 4,781	$ 6,428
Non-current assets	6,704	2,365
Current liabilities	4,432	3,487
Non-current liabilities	545	1,910
Stockholders' equity	6,508	3,396

(IN MILLIONS)	New Basis	Old Basis		
	For the period from June 12, 1998 through December 26, 1998	For the period from December 28, 1997 through June 11, 1998	Year ended December 27, 1997	Year ended December 28, 1996
Revenue:				
Products	$ 2,898	$ 2,650	$ 7,228	$ 7,562
Services	3,294	2,731	5,833	6,046
Total revenue	$ 6,192	$ 5,381	$ 13,061	$ 13,608
Gross margin:				
Products	$ 1,027	$ 779	$ 2,636	$ 2,603
Services	981	834	1,821	1,876
Total gross margin	$ 2,008	$ 1,613	$ 4,457	$ 4,479
Net income (loss)	$ (2,966)[1]	$ (13)	$ 275	$ (378)

(1) Net loss includes $3.2 billion for the write-off of purchased in-process technology resulting from Compaq's acquisition of Digital.

Note 12. Segment Data

Compaq manages its business segments primarily on a geographic basis. The Company's reportable segments are comprised of North America and Europe, Middle East and Africa ("EMEA"). Other operating segments include Japan, Greater China, Asia Pacific and Latin America. Each operating segment provides products and services as further described in Note 1.

The accounting policies of the various segments are the same as those described in the "Summary of Significant Accounting Policies" in Note 1. The Company evaluates the performance of its segments based on segment profit. Segment profit for each segment includes sales and marketing expenses and other overhead charges directly attributable to the segment and excludes certain expenses which are managed outside the reportable segments. Costs excluded from segment profit primarily consist of corporate expenses, including income taxes, as well as other non-recurring charges for purchased in-process technology, restructuring and asset impairment charges and merger-related costs. Corporate expenses are comprised primarily of research and development costs, certain costs related to the Digital integration, corporate marketing costs and other general and administrative expenses which are separately managed. Compaq does not include intercompany transfers between segments for management reporting purposes. Segment assets exclude corporate assets. Corporate assets include cash and cash equivalents, short-term investments, manufacturing facilities and intangible assets. Capital expenditures for long-lived assets are not reported to management by segment and are excluded as presenting such information is not practical.

Summary information by segment is as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
North America:			
Revenue:			
Products	$ 13,411	$ 13,101	$ 10,448
Services	1,341	168	164
Gross margin:			
Products	2,884	3,584	2,783
Services	545	36	45
Segment profit	1,666	2,587	2,015
Interest expense	124	108	65
Depreciation and amortization	100	61	61
Segment assets	3,126	1,924	2,507
EMEA:			
Revenue:			
Products	$ 10,135	$ 7,783	$ 6,398
Services	1,794	150	107
Gross margin:			
Products	2,667	2,157	1,669
Services	530	52	32
Segment profit	1,845	1,484	1,078
Interest expense	5	6	2
Depreciation and amortization	37	24	44
Segment assets	4,028	1,814	1,950
Other segments:			
Revenue:			
Products	$ 3,720	$ 3,238	$ 2,765
Services	768	144	127
Gross margin:			
Products	833	820	587
Services	231	41	31
Segment profit	339	349	137
Interest expense	15	10	8
Depreciation and amortization	33	29	27
Segment assets	3,020	1,217	1,173

A reconciliation of the Company's segment gross margin, segment profit and segment assets to the corresponding consolidated amounts is as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Segment gross margin	$ 7,690	$ 6,690	$ 5,147
Non-segment gross margin	(501)[1]	61	7
Total gross margin	$ 7,189	$ 6,751	$ 5,154
Segment profit	$ 3,850	$ 4,420	$ 3,230
Corporate expenses, net	(2,923)	(1,410)	(1,295)
Purchased in-process technology	(3,196)	(208)	—
Restructuring and asset impairment charges	(393)	—	(52)
Merger-related costs	—	(44)	—
Income (loss) before provision for income taxes	$ (2,662)	$ 2,758	$ 1,883
Segment assets	$ 10,174	$ 4,955	$ 5,630
Corporate assets	12,877	9,676	6,701
Total assets	$ 23,051	$14,631	$12,331

(1) Non-segment gross margin in 1998 primarily related to certain costs incurred by Digital manufacturing operations which were not allocated to the geographic segments for management reporting purposes.

Revenue and long-lived assets related to operations in the United States and other foreign countries are as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Revenue:			
United States	$ 13,981	$ 12,593	$ 10,014
Other foreign countries	17,188	11,991	9,995
Total revenue	$ 31,169	$ 24,584	$ 20,009
Long-lived assets:			
United States	$ 5,490	$ 1,693	$ 1,376
Other foreign countries	1,053	921	866
Total long-lived assets	$ 6,543	$ 2,614	$ 2,242

Additional information regarding revenue by products and services groups is as follows:

YEAR ENDED DECEMBER 31 (IN MILLIONS)	1998	1997	1996
Revenue:			
Enterprise	$ 10,700	$ 8,660	$ 6,228
Commercial PC	11,621	11,558	10,533
Consumer PC	4,945	3,904	2,850
Services	3,903[1]	462	398
Total	$ 31,169	$ 24,584	$ 20,009

(1) 1998 services revenue is presented on a management reporting basis and includes $106 million of products revenue.

Note 13. Commitments, Contingencies, Financial Instruments and Factors that May Affect Future Operations

DERIVATIVE FINANCIAL INSTRUMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS. Compaq primarily utilizes forward contracts and purchased foreign currency options to reduce its exposure to potentially adverse changes in foreign currency exchange rates. Compaq does not hold or issue financial instruments for trading purposes nor does it hold or issue interest rate or leveraged derivative financial instruments.

Compaq's program to reduce currency exposure associated with the net monetary assets of Compaq's international subsidiaries includes agreements to exchange various foreign currencies for U.S. dollars. At December 31, 1998 and 1997, such agreements to sell foreign currencies included forward contracts aggregating $2.7 billion and $1.5 billion, respectively. Generally, gains and losses associated with currency rate changes on these forward contracts are recorded currently to income and are reflected in accounts receivable or other current liabilities in Compaq's balance sheet, while the interest element is recognized over the life of each contract. The amount recorded in the balance sheet approximates the fair value of such contracts at December 31, 1998 and 1997. The maturity dates of the forward contracts which were outstanding at December 31, 1998 ranged from two days to nine months.

From time to time, Compaq hedges a portion of its anticipated but not firmly committed sales of its international marketing subsidiaries using purchased foreign currency options. Realized and unrealized gains and the net premiums on these options are deferred and recognized as a component of revenue in the same period that the related sales occur. Option contracts aggregating $394 million and $311 million were outstanding at December 31, 1998 and 1997, respectively, related to the hedge of such sales for a nine-month period. The unrealized gains deferred on these contracts were not material. In addition, Compaq frequently utilizes forward contracts to protect Compaq from the effects of currency fluctuations on anticipated but not firmly committed sales which are expected to occur within a three-month period. These forward contracts generally do not extend beyond the end of any quarter or year. Any gains or losses and the interest element on these forward contracts are recognized as a component of sales during each quarter.

Compaq may, from time to time, hedge commitments for inventory purchases and capital expenditures and other items constituting firm commitments. Any gain or loss, if realized, or cost related to these contracts are recorded as part of inventory or capital items upon acquisition. At December 31, 1998 and 1997, there were no contracts outstanding to hedge commitments for inventory purchases and capital expenditures.

In the event of a failure to honor one of these forward contracts by one of the banks with which Compaq has contracted, management believes any loss would be limited to the exchange rate differential from the time the contract was made until the time it was compensated. To the extent Compaq has option contracts outstanding, the amount of any loss resulting from a breach of contract would be limited to the amount of premiums paid for the options and the unrealized gain, if any, related to such contracts.

Compaq enters into various other types of financial instruments in the normal course of business. Fair values for certain financial instruments are based on quoted market prices. For other financial instruments, fair values are based on the appropriate pricing models using current market information. The amounts ultimately realized upon settlement of these financial instruments will depend on actual market conditions during the remaining life of the instruments. Fair values of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and other current liabilities reflected in the December 31, 1998 and 1997 consolidated balance sheet approximate carrying value at these dates.

CONCENTRATION OF CREDIT RISK. Compaq's cash, cash equivalents, short-term investments and accounts receivable are subject to potential credit risk. Compaq's cash management and investment policies restrict investments to low risk, highly-liquid securities and Compaq performs periodic evaluations of the relative credit standing of the financial institutions with which it deals.

Compaq distributes products primarily through third-party resellers and as a result, maintains individually significant accounts receivable balances from various major resellers. If the financial condition and operations of these resellers deteriorate, Compaq's operating results could be adversely affected. One customer accounted for 8% of sales for 1998 and 9% of accounts receivable at December 31, 1998. During this period, no other customer of Compaq accounted for 3% or more of sales. In 1998, Compaq's five largest resellers represented approximately 19% of Compaq's 1998 sales. The receivable balances from Compaq's five largest resellers represented approximately 16% of accounts receivable at December 31, 1998. Compaq generally has experienced longer accounts receivable cycles in its emerging markets, in particular Asia Pacific and Latin America, when compared to its U.S. and European markets. In the event that accounts receivable cycles in these developing markets lengthen further or one or more of Compaq's larger resellers in these regions fails, Compaq's operating results could be adversely affected.

CONTINGENCIES. Certain of Compaq's resellers finance a portion of their inventories through third-party finance companies. Under the terms of the financing arrangements, Compaq may be required, in limited circumstances, to repurchase certain products from the finance companies. Additionally, Compaq has on occasion guaranteed a portion of certain resellers' outstanding balances with third-party finance companies and financial institutions. Guarantees under these and other arrangements were not significant at December 31, 1998 or 1997.

Compaq offers lease financing of selected products to its customers. Certain sales-type leases are originated by Compaq and either sold on a nonrecourse basis or used as collateral for borrowings from certain third-party financial institutions. Generally, Compaq receives all proceeds at the inception of the lease. The third-party financial institution assumes the credit risk and the

administrative responsibility for the collection of the lease receivables. In the event of a default by a lessee, the financial institution's only recourse is generally limited to the collaterized computer equipment. Compaq may be required to use its "best efforts" to remarket the computer equipment.

FACTORS THAT MAY AFFECT FUTURE OPERATIONS. Compaq participates in a highly volatile industry that is characterized by fierce industry-wide competition for market share. Industry participants confront aggressive pricing practices, continually changing customer demand patterns, growing competition from well-capitalized high technology and consumer electronics companies, and rapid technological developments carried out in the midst of legal disputes over intellectual property rights. Compaq's operating results could be adversely affected should Compaq be unable to successfully integrate acquired entities, anticipate customer demand accurately, maintain short design cycles while meeting evolving industry performance standards, manage its product transitions, inventory levels and manufacturing processes efficiently, distribute its products quickly in response to customer demand, differentiate its products from those of its competitors or compete successfully in the markets for its new products.

Significant numbers of components are purchased from single sources due to technology, availability, price, quality or other considerations. Key components and processes currently obtained from single sources include certain of Compaq's displays, microprocessors, application specific integrated circuits and other custom chips, and certain processes relating to construction of the plastic housing for Compaq's computers. In addition, new products introduced by Compaq often initially utilize custom components obtained from only one source until Compaq has evaluated whether there is a need for additional suppliers. In the event that a supply of a key single-sourced material process or component were delayed or curtailed, Compaq's ability to ship the related product in desired quantities and in a timely manner could be adversely affected. Compaq attempts to mitigate these risks by working closely with key suppliers on product plans, strategic inventories and coordinated product introductions.

LITIGATION. Compaq is subject to legal proceedings and claims which arise in the ordinary course of business. Management does not believe that the outcome of any of those matters will have a material adverse effect on Compaq's consolidated financial position, operating results or cash flows.

Five class action lawsuits have been consolidated in the United States District Court for the Southern District of Texas, Houston Division. The actions are purported class actions of all persons who purchased Compaq common stock from July 10, 1997 through March 6, 1998, and the named defendants include the Company and certain of its current and former officers and directors. The complaints allege that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by, among other things, withholding information and making misleading statements about channel inventory and factoring of receivables in order to inflate the market price of Compaq's common stock, and further alleges that certain of the individual defendants sold Compaq common stock at these inflated prices. Lead counsel for the plaintiff has been appointed. The plaintiffs seek monetary damages, interest, costs and expenses. Compaq intends to defend the suits vigorously.

Several purported class action lawsuits were filed against Digital during 1994 alleging violations of the Federal Securities laws arising from alleged misrepresentations and omissions in connection with Digital's issuance and sale of Series A 8-7/8% Cumulative Preferred Stock and Digital's financial results for the quarter ended April 2, 1994. During 1995, the lawsuits were consolidated into three cases, which were pending before the United States District Court for the District of Massachusetts. On August 8, 1995, the Massachusetts federal court granted the defendants' motion to dismiss all three cases in their entirety. On May 7, 1996, the United States Court of Appeals for the First Circuit affirmed in part and reversed in part the dismissal of two of the cases, and remanded for further proceedings. The parties are proceeding with discovery.

LEASE COMMITMENTS. Compaq leases certain manufacturing and office facilities and equipment under noncancelable operating leases with terms from one to 30 years. Rent expense for 1998, 1997 and 1996 was $205 million, $135 million and $128 million, respectively.

Compaq's minimum rental commitments under noncancelable operating leases at December 31, 1998 were approximately $249 million in 1999, $177 million in 2000, $123 million in 2001, $100 million in 2002, $67 million in 2003 and $133 million thereafter.

Note 14. Subsequent Events

In February 1999, Compaq announced the execution of a definitive merger agreement with Zip2 Corporation, the leading provider of Internet platform solutions for media companies and local e-commerce merchants. The aggregate purchase price is anticipated to be approximately $300 million. Completion of the transaction is subject to customary conditions, including clearance under the Hart-Scott-Rodino Antitrust Improvements Act.

In January 1999, Compaq announced a cash tender offer for all of the outstanding shares of common stock of Shopping.com, an on-line retailer that offers Internet shoppers an array of consumer products. In February the offer was successfully concluded, with 96% of the shares tendered. Compaq is proceeding with the steps necessary to complete the merger, which is anticipated in March. The aggregate purchase price for Shopping.com is anticipated to be approximately $220 million. Completion of the transaction is subject to certain conditions, including clearance under the Hart-Scott-Rodino Antitrust Improvements Act.

Selected Quarterly Unaudited Financial Data (not covered by report of independent accountants):

The table below sets forth selected unaudited financial information for each quarter of the last two years.

(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	1st quarter	2nd quarter	3rd quarter	4th quarter
1998				
Revenue	$ 5,687	$ 5,832	$ 8,791	$ 10,859
Gross margin	1,023	1,110	2,185	2,871
Net income (loss)(1)	16	(3,632)	115	758
Earnings (loss) per common share(3)				
Basic	$ 0.01	$ (2.33)	$ 0.07	$ 0.45
Diluted	$ 0.01	$ (2.33)	$ 0.07	$ 0.43
1997				
Revenue	$ 5,272	$ 5,515	$ 6,474	$ 7,323
Gross margin	1,417	1,537	1,777	2,020
Net income(2)	414	257	517	667
Earnings per common share(3)				
Basic	$ 0.28	$ 0.17	$ 0.34	$ 0.44
Diluted	$ 0.27	$ 0.17	$ 0.33	$ 0.42

(1) Includes a $3.2 billion non-recurring, non-tax-deductible charge in the second quarter of 1998 and a $38 million non-recurring, non-taxable credit in the fourth quarter of 1998 for purchased in-process technology in connection with the Digital acquisition, and a $393 million charge for restructuring and asset impairments in the second quarter of 1998 in connection with the Digital acquisition and the closing of certain Compaq facilities.

(2) Includes a $208 million non-recurring, non-tax-deductible charge for purchased in-process technology in connection with the Microcom acquisition in the second quarter of 1997, and $44 million of expenses related to the Tandem merger in the third quarter of 1997.

(3) Earnings per common share are computed independently for each of the quarters presented and therefore may not sum to the total for the year.

Disagreements on Accounting and Financial Disclosure

None.

To the Stockholders and Board of Directors of
Compaq Computer Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of stockholders' equity present fairly, in all material respects, the financial position of Compaq Computer Corporation and its subsidiaries at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 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

Houston, Texas
January 26, 1999,
except as to Note 14, which is as of February 16, 1999

The Audit Committee of the Board of Directors is composed of four non-employee directors. The members of the Audit Committee are: Robert Ted Enloe, III, Lawrence T. Babbio, Jr., Thomas J. Perkins and Kenneth Roman. The Committee held eight meetings during fiscal year 1998. The Committee holds regularly scheduled meetings preceding the first meeting of the Board of Directors each quarter.

The responsibilities of the Committee are set forth in its Charter, which is reviewed and amended periodically, as appropriate. The Committee reviews and monitors the Company's financial reporting process on behalf of the Board of Directors. In fulfilling its responsibility, the Committee recommends to the full Board of Directors the selection of the Company's independent accountants. The Audit Committee discusses with the internal auditors and the independent accountants the overall scope and specific plans for their respective audits. The Committee also discusses the Company's consolidated financial statements, the effectiveness and adequacy of the Company's internal controls and pending litigation. The Committee meets regularly with the Company's internal auditors and independent accountants, without management present, to discuss the results of their examinations, their evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting. The meetings also are designed to facilitate any private communication with the Committee desired by the internal auditors or independent accountants.

Audit Committee

Robert Ted Enloe

Robert Ted Enloe, III
Chair

Compaq's common stock is listed on the New York Stock Exchange and trades under the symbol CPQ. As of January 29, 1999, Compaq had approximately 89,000 shareholders of record. The reported high and low closing stock prices, as reported on the NYSE Composite Transaction Tape, were as follows:

	1998		1997	
	High	Low	High	Low
1st Quarter	$ 36.44	$ 23.25	$ 17.35	$ 14.40
2nd Quarter	32.44	24.06	21.63	14.40
3rd Quarter	37.50	27.94	39.13	20.38
4th Quarter	44.31	24.06	38.63	26.66

Dividends and Direct Stock Purchase Plan. Compaq paid its first quarterly dividend of $ 0.015 per share to shareholders of record on December 31, 1997 and increased this dividend to $0.02 per share with the dividend payment to shareholders of record on December 31, 1998. Compaq anticipates that the cash dividend will continue to be paid on a quarterly basis. Compaq has established a direct stock purchase plan through which stockholders may reinvest their dividends and invest additional amounts directly in Compaq common stock. Additional information about the direct stock purchase plan is available at www.compaq.com/corporate/ir/si/irsi.html.

Executive Officers

Eckhard Pfeiffer
President and
Chief Executive Officer

Andreas Barth
Senior Vice President and
General Manager,
Europe, Middle East and Africa

Michael D. Capellas
Senior Vice President,
Information Management and
Chief Information Officer

Hans W. Gutsch
Senior Vice President,
Human Resources,
Organization and Environment

Michael D. Heil
Senior Vice President and
General Manager,
Worldwide Sales and Marketing

Michael J. Larson
Vice President and Group General
Manager, Consumer Products

Earl L. Mason
Senior Vice President and
Chief Financial Officer

Enrico Pesatori
Senior Vice President,
Corporate Marketing

John J. Rando
Senior Vice President and Group
General Manager, Services

John T. Rose
Senior Vice President and
Group General Manager,
Enterprise Computing

Rodney W. Schrock
President and Chief Executive
Officer, AltaVista Company

Thomas C. Siekman
Senior Vice President,
General Counsel and Secretary

Edward M. Straw
Senior Vice President,
Supply Chain Management

William D. Strecker
Senior Vice President, Technology
and Corporate Development

Michael J. Winkler
Senior Vice President and Group
General Manager, PC Products

Directors

Compaq's directors are frequently recognized for outstanding leadership and service. *Director's Alert* named Benjamin Rosen, Chairman of the Board, one of Corporate America's Outstanding Directors in 1998 and *BusinessWeek* magazine named Compaq among the top three in its "Best Boards of Directors" in its last survey.

Benjamin M. Rosen [2,3]
Chairman of the Board,
Compaq Computer Corporation

Eckhard Pfeiffer
President and
Chief Executive Officer,
Compaq Computer Corporation

Lawrence T. Babbio, Jr. [1,2]
President and
Chief Operating Officer,
Bell Atlantic Corporation

Dr. Judith L. Craven [2,3]
Former President of the United Way
of the Texas Gulf Coast

Frank P. Doyle [2,3]
Former Executive Vice President,
General Electric Company

Robert Ted Enloe, III [1,2,3]
Managing Partner, Balquita Partners,
Ltd. Chairman of the
Audit Committee

George H. Heilmeier [2,3]
Chairman Emeritus, Bell
Communications Research, Inc.
(Bellcore)

Peter N. Larson [2,3]
Chairman and Chief Executive,
Brunswick Corporation
Chairman of the Human Resources
Committee

Kenneth L. Lay [2,3]
Chairman of the Board and
Chief Executive Officer, Enron Corp.

Thomas J. Perkins [1,2,3]
General Partner, Kleiner Perkins
Caufield & Byers, L.P.

Kenneth Roman [1,2,3]
Former Chairman and
Chief Executive Officer,
The Ogilvy Group (and
Ogilvy & Mather Worldwide)
Chairman of the Corporate
Governance Committee

Lucille S. Salhany [2,3]
President and Chief Executive
Officer, JH Media Limited

1 Member of Audit Committee
2 Member of Corporate Governance Committee
3 Member of Human Resources Committee

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281-370-0670

Financial Reports

Financial reports, including the Form 10-K, Form 10-Q, and quarterly earnings releases, can be accessed and ordered on our Web site at www.compaq.com.
You may also obtain financial documents by writing:
Compaq Investor Relations, MS110312
P.O. Box 692000
Houston, Texas 77269-2000
or call 800-433-2391.

Earnings Information

Call 281-518-EARN or 281-518-3276 for a recorded message.

Annual Meeting

The Annual Meeting of Shareholders will be held April 22, 1999, at 10:00 a.m. in the Conference Center, Building CCA5, Compaq Computer Corporation, 20555 State Highway 249, Houston, Texas 77070-2698.

Common Stock and Dividends

Compaq stock trades on the New York Stock Exchange under the symbol CPQ. Cash dividends have been paid since 1998. The current rate is $.02 per share per quarter.

Independent Accountants

PricewaterhouseCoopers LLP
Houston, Texas

Compaq Online

For more information about Compaq, including our worldwide operations, products and services, financial performance and computing solutions for customers, visit our Web site at www.compaq.com. Compaq's 1998 Annual Report is also available on the Internet at www.compaq.com/corporate/1998ar.

Transfer Agent and Registrar

For information regarding Compaq's Shareholder Investor Plan that allows participants to purchase stock and reinvest dividends directly, securities transfer, lost certificates, change of address, duplicate mailings or other matters concerning your shareholder account, please contact the transfer agent:
BankBoston, N.A.
c/o EquiServe
P.O. Box 8040
Boston, MA 02266-8040
888-218-4373

If outside the continental U.S. and Canada: 781-575-3170

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COMPAQ-AR-98

2000

power play

COMPAQ COMPUTER CORPORATION 2000 ANNUAL REPORT

Compaq powers 80 of the world's largest Internet Service Provider sites with its *ProLiant*™ and *Alpha*™ servers. | Nearly a third of the world market for Intel-based servers belongs to Compaq *ProLiant* servers – from the largest global corporations to small growing businesses – more than double the nearest competitor. | Compaq customers use more than 4 million Compaq *ProLiant* servers and *TaskSmart*™ Appliance Servers. | We provide fault-tolerant systems for more than 100 stock and commodity exchanges, including 14 of the world's 15 largest exchanges. | Eighty percent of all telecommunications billing and customer care transactions in Europe and Asia depend on us. | Compaq *AlphaServers* and *NonStop Himalaya*™ servers power 95 percent of the world's securities transactions and 80 percent of all ATM transactions. | Compaq is currently building the world's largest and most powerful supercomputer for the U.S. Department of Energy, based on Alpha technology. | We are delivering supercomputers to customers around the world. | Compaq Enterprise Storage ships more Storage Area Networks (SANs) than anyone in the industry and continues to be the leader in capacity shipped with over 60 petabytes in 2000. (A petabyte is equal to one million gigabytes.) | Compaq Global Services has 38,000 service professionals delivering full lifecycle services in 202 countries. | Compaq Global Services has been delivering bet-your-business infrastructures for 20 years to thousands of enterprise companies. | Compaq excels at forging alliances with companies that are leaders in their industries and that complement Compaq's strategy. | Compaq is number one in commercial PC global market share, and the number one company worldwide in home computers. | Compaq is now number one in high-performance technical computing. | Compaq powers 80 of the world's largest Internet Service Provider sites with its *ProLiant* and *Alpha* servers. | Nearly a third of the world market for Intel-based servers belongs to Compaq *ProLiant* servers – from the largest global corporations to small growing businesses – more than double the nearest competitor. | Compaq customers use more than 4 million Compaq *ProLiant* servers and *TaskSmart* Appliance Servers. | We provide fault-tolerant systems for more than 100 stock and commodity exchanges, including 14 of the world's 15 largest exchanges. | Eighty percent of all telecommunications billing and customer care transactions in Europe and Asia depend on us. | Compaq *AlphaServers* and *NonStop Himalaya* servers power 95 percent of the world's securities transactions and 80 percent of all ATM transactions. | Compaq is currently building the world's largest and most powerful supercomputer for the U.S. Department of Energy, based on Alpha technology. | We are delivering supercomputers to customers around the world. | Compaq Enterprise Storage ships more Storage Area Networks (SANs) than anyone in the industry and continues to be the leader in capacity shipped with over 60 petabytes in 2000. (A petabyte is equal to one million gigabytes.) | Compaq Global Services has 38,000

enterprise power

Compaq is a global enterprise player

"Most people know Compaq as the world's largest PC company. And we are. But major businesses around the world also know us as one of the leaders in enterprise computing. Customers depend on Compaq for innovative products, integrated into solutions and delivered globally. They look to us to help them deploy Internet solutions, build wireless networks, securely process billions of dollars in global financial transactions, deliver multimedia content and entertainment and drive new advances in genomics and other life sciences. Our high-performance *NonStop Himalaya* and *Alpha* servers, our enterprise storage solutions and our market-leading industry-standard *ProLiant* servers – together with the 38,000 professionals in Compaq Global Services – have helped make Compaq one of the top competitors at every level of the Information Technology industry. Our global customers include most of the major names in finance, telecommunications, manufacturing, life sciences and e-commerce. With major alliance partners such as Microsoft, Oracle and Intel – and 60,000 other partners – we are delivering the kind of end-to-end solutions that our customers need to compete and win in tough global marketplaces. Compaq is one of the few companies in the world that can put all the pieces together, and make it work anywhere on the globe. To us, it's all about one thing: customer success."

Michael D. Capellas, Chairman and CEO

int™ and *Alpha*™ servers. | Nearly a
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world. | Compaq Enterprise Storage
to be the leader in capacity shipped
Compaq Global Services has 38,000

It's all about customer success That is the very essence of what we're about at Compaq – finding ways for our customers, from individuals to enterprises, to achieve success through our technology and solutions. | We're doing this at a place called the "edge of the network." This is where millions of access devices, from personal computers and handheld devices, to bar code readers and cellular telephones, tap the Internet for information from the vast infrastructure of servers, storage and applications. | Perhaps more than any other Internet-ready company, we're providing the means for customer success in three ways:

Serving up solutions. Ericsson, with 100,000 employees in 140 countries, is a recognized leader in solutions for the new world of mobile communications. Compaq runs their IT service and support.

Creating the infrastructure. British Telecom's BT Ignite Application Services is rolling out data centers across Europe built around Compaq's *ProLiant* servers.

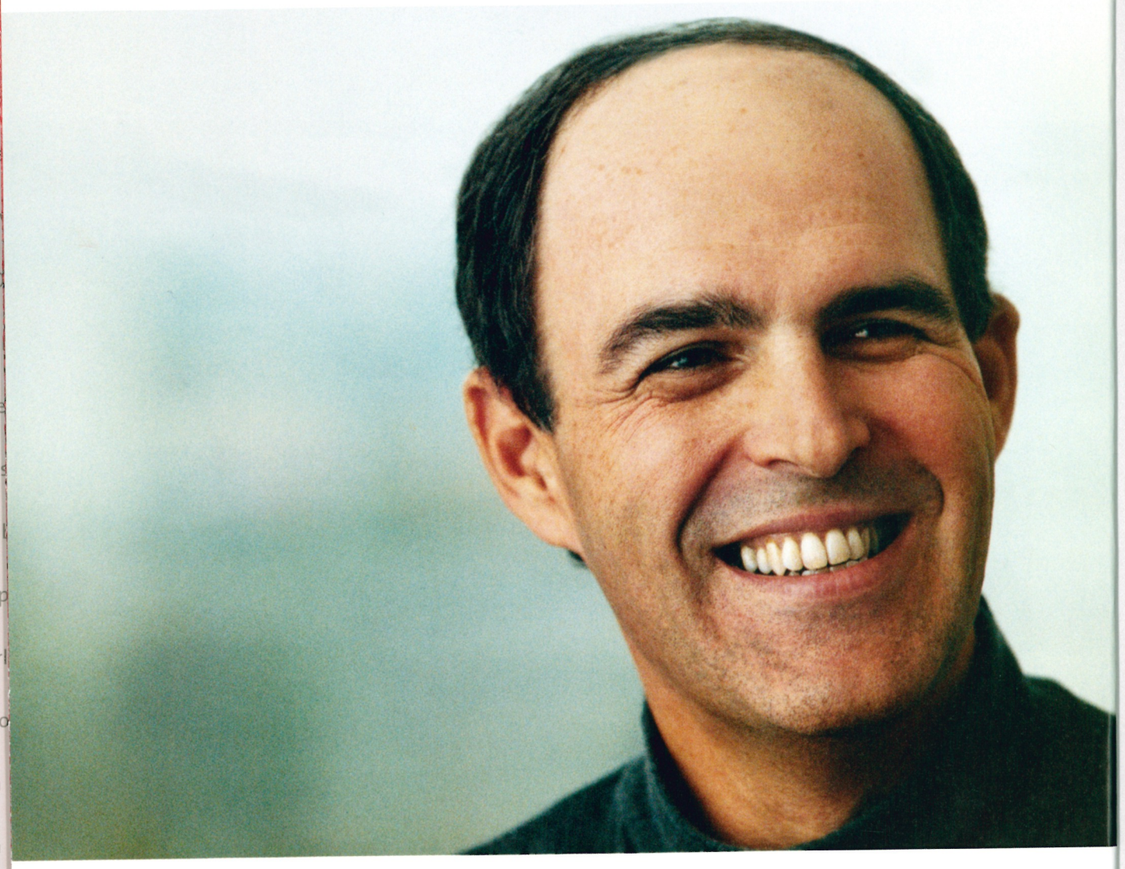
infrastructure First, we're building the business-critical and price-performance servers that make the Internet work – the so-called infrastructure. We are the global leader in storage area networks (SANs) and number two across the industry in enterprise storage solutions. We deliver the most powerful and reliable high-end servers, with our *NonStop Himalaya* and *Alpha* servers – including the world's most powerful supercomputers. With our global services and ability to provide servers and storage systems that easily scale up as needed, we are helping enterprise customers all over the world integrate the Internet for their business and their own customers and suppliers. And, with our *ProLiant* server family, we are the global leader in industry-standard servers.

solutions Second, we're the leading company in providing solutions with our best-in-class alliance partners such as Microsoft, Oracle, Intel and many, many others. Our Zero Latency Enterprise, for example, combines our expertise in high-end servers, enterprise storage and software integration with database and other technology from partners such as Oracle to help larger customers achieve instant access to massive amounts of information in a real-time enterprise. These partnerships not only extend our market reach, they help us get to market faster with technologies and solutions our customers need.

access Third, we are defining the next generation of Internet access with the world's finest personal computers and our innovative *iPAQ*™ family of Internet access devices and appliances, including the Compaq *iPAQ* Pocket PC, the *iPAQ* Desktop PC and the *iPAQ* Home Internet Appliance. We're also integrating wireless and broadband capabilities and new content and services to make Internet access easier, more pervasive and vastly more productive.

Gaining access. Buyproduce.com has gained a major share of the $200 billion produce industry using Compaq access devices, such as the *iPAQ* Pocket PC.

All of these strengths come together for customers such as Buyproduce.com, which is transforming the $200 billion fresh produce industry in the United States from one based on faxes and phone calls to a 24x7 Internet-based commerce; for CLP Power in Hong Kong, which has embraced Internet technology with Compaq storage, systems and services; and for global telecom and datacom giant Ericsson, which is outsourcing their computer support operations to Compaq. | If knowledge is power, then the promise of the Internet is the promise of empowerment. At Compaq, we are transforming our customers' experience by acting as the unifying force across the Internet. It all happens at the edge of the network.



Michael D. Capellas | Chairman and Chief Executive Officer

to our shareholders, customers, partners and employees

For Compaq, 2000 was a year of significant progress – one in which we built a solid foundation for profitable growth. The energy and enthusiasm of our employees were higher than ever. Customer acceptance of our technology and solutions continued to grow. And we accelerated our financial and market momentum.

It all added up to a solid operating performance:[1]

- Revenue was up 10 percent.
- Gross margin was up almost one percentage point.
- Operating expenses were down more than three percentage points.
- Operating profit was up more than threefold.
- Earnings per share more than tripled from 1999.

As we ended the year, the most important driver of our success was our enterprise business – particularly our high-end storage and server businesses. This reflected the increasing number of enterprise customers – from small businesses to the largest global corporations – who are turning to Compaq for the technology and solutions they need to win in the marketplace.

You will see proof points of this success throughout this annual report, but I want to highlight a few of them here:

- Compaq supports 14 of the 15 largest stock exchanges worldwide.
- We are the number one provider of Web servers.
- We shipped more than one million servers in 2000, giving us 27 percent market share worldwide.
- We shipped more storage capacity than the next two companies combined.
- We were ranked number one in the highest measure of system availability.
- And we took over the number one spot in high-performance technical computing.

You will see examples throughout this report of how we are working with telecommunications companies to accelerate the wireless revolution; how we are supporting groundbreaking advances in genomics and other areas of scientific research; and how we are making the Internet a valuable business tool for companies of all sizes.

You will also see examples of how we're breaking new ground in Internet access, from our desktop and notebook PCs to the next generation of Internet devices.

Customers are turning to us because we are differentiating Compaq in three important ways.

Innovative products We have solidified Compaq's reputation as a leader in innovation. And it's the most important kind of innovation: innovation that enables customer success.

Integrated solutions Customers today want to do business with companies that can deliver the products, services and partnerships that make up a solution. And Compaq is one of the few companies that can put it all together on a global scale – building on the strength of Compaq Global Services and our broad global alliances.

Global delivery Our worldwide sales team – including our resellers and other distribution partners – has never been stronger or more focused. Because our products and services are sold in more than 200 countries, we're able to serve the needs of our customers wherever they do business.

As a result, we're expanding our leadership in such key markets as telecommunications, financial services, life sciences, e-government, service providers, and media and entertainment.

Most important of all, we're delivering profitable growth.

Year 2000 – Building the foundation

2000 was a year in which Compaq really began to deliver consistent performance and continuously improved execution. Our business model is working.

Three things in particular stand out about our performance.

First, we increased revenue and gross margin while also reducing operating expenses. As a result, we increased revenue by almost $4 billion over 1999 and grew operating profit[1] by nearly $2 billion. In other words, we were able to drive about half of our revenue growth straight to the bottom line.

One major factor was the turnaround in our commercial PC business. Returning this business to profitability was one of our top priorities in 2000, and we did it ahead of schedule. The result: a $750 million year-over-year improvement in operating profit and a business model focused on leadership in innovation and long-term, profitable growth.

Second, we demonstrated the depth and breadth of our technology and solutions portfolio. Even though the United States PC market weakened in the fourth quarter, we were able to deliver solid year-over-year improvement because of the increasing strength of our high-end server and storage businesses and the solid profitability of our services business. In fact, our enterprise businesses represented more than half of our revenue and nearly 90 percent of business segment operating profit in 2000.

[1] Operating results exclude net investment income (loss), restructuring and related activities and gain on sale of businesses.

And third, we demonstrated the power of our global balance. During the fourth quarter, 58 percent of our revenues came from outside the United States. This strong international presence offset the year-end weakness in the United States. Looking ahead, we see significant opportunities to grow our business around the world.

Overall, I'm pleased with the progress we made in 2000. Compaq has built a balanced, highly competitive business model – a business model that reflects our leadership as a global enterprise company. This gives us a solid foundation for growth. But we have more to do. We want to accelerate growth, continue to increase gross profit margins and make our cost structure and supply chain more efficient. We want to make Compaq Global Services a competitive weapon, building on our strengths in solutions integration and business critical support. We want to take advantage of our significant strengths in high-end systems, software and storage. And we want to accelerate our global expansion while continuing to improve our execution.

If we do these things – and I am confident that we will – we will create greater value for our shareholders as well as for our customers, partners and employees.

Innovation

Of all that we have accomplished, I'm most proud of our record of innovation. When I became CEO, I challenged the Compaq team to cut product development cycles in half and to drive innovation across our products and services. They delivered.

Our new *iPAQ* Pocket PC sets the standard for handheld devices with its innovative design, bright display and flexible expansion packs. We also added other new products to the *iPAQ* family in 2000, including an easy-to-use home Internet appliance, a small personal audio player with the highest quality sound I've ever heard from such a device, a wireless home network gateway and a handheld device that provides always-on, wireless access to corporate e-mail. These products are all part of our effort to define the next generation of Internet access.

On the infrastructure side, we introduced the *AlphaServer* GS series, which represented a breakthrough in system architecture and performance. We added to our family of *TaskSmart* appliance servers to handle specialized tasks rapidly and efficiently. We delivered a thin, two-processor server that can be deployed quickly by service providers and corporate data centers. And we introduced a variety of innovative storage solutions, from storage management software to storage utilities that let customers get the storage they need, when they need it.

We also continued to innovate in Web-based services. Our Services @ Click Speed gives customers and partners instant access to

everything from installation and set up to management and troubleshooting.

This e-services program is just one example of how Compaq is fulfilling our vision of "everything to the Internet." A year ago this vision was a rallying cry. Today it is embedded in our culture.

During 2000, we introduced an e-tracking system that lets customers track their orders on the Web from first entry to delivery. We're also deploying Global Business Exchanges in partnership with Commerce One. In this e-procurement marketplace, customers can buy Compaq products online and add other suppliers to the exchange without having to build customized extranets with each of their vendors.

In addition, we joined with some of our competitors and supply chain partners to establish Converge, an independent, online marketplace for the high-tech industry. Through Converge, members use the Internet to manage their supply chains more efficiently, improve product and service delivery and increase customer satisfaction.

Compaq is now a leader in using the Web to drive more of our business and to enhance our relationships with customers. In fact, in its annual survey, *InformationWeek* magazine ranked Compaq as one of the three most innovative users of information technology.

Pervasive information

Innovation is vital to our success because information technology is being transformed at an ever-increasing pace – and we want to help drive that transformation.

The world we see emerging is a world of pervasive information in which billions of Internet access devices will make growing demands on the Internet infrastructure. Computing, communications and data are converging in a way that allows people to access information and make transactions and decisions in real time.

One of the big drivers will be wireless communications. Market analysts expect the number of wireless Internet access devices to grow to one billion or more in the next three years – and that's probably conservative.

Users will expect more than just weather reports, sports scores and stock market updates. They will demand richer, interactive content, streaming audio and video, peer-to-peer networking and personalized, location-based services.

Most people believe that commerce will drive the growth of the Internet. But I have a contrarian view. I believe that content will lead commerce. That's why you see us building strong alliances with industry-leading content companies such as America Online, the Walt Disney Company, Yahoo! and Microsoft.

Edge of the Web

On the access side, users will be able to choose from a wide variety of devices with different forms and functions, advanced user interfaces – like voice recognition – and embedded services. The lines between business and personal computing will disappear because users will want access to all of their information, wherever they are.

On the infrastructure side, there is a growing need for huge data stores to manage all of the content and transactions in real time. But more and more of the content delivery will move to the edge of the Web.

We define the edge of the Web as the place where access and infrastructure meet. It is not so much a physical space as a virtual space that is closer to the user. This means content and services can be delivered more quickly and reliably and with greater personalization.

We believe that the edge of the Web is where the action is going to be and that Compaq is uniquely positioned to be the leader.

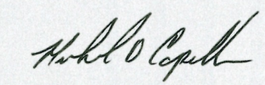
We deliver the access devices – from desktop PCs to our growing *iPAQ* family of Internet devices and appliances. We're the undisputed leader in industry standard servers, which form the foundation of computing at the edge of the Web. We provide the database and transaction engines – as well as the storage systems – that are the backbone of the Internet infrastructure. We have the best-in-class partnerships and global services that help tie it all together. As a result, we deliver the comprehensive solutions our customers need.

Continuous transformation

We live in a world of continuous transformation. Companies must continue to evolve their strategies to adapt to rapidly changing market and new opportunities. It's true for Compaq, and it's true for our customers.

At Compaq, we have a real opportunity to extend our leadership into the new world of pervasive information by defining computing and communications at the edge of the Web while building on our traditional strengths in infrastructure and access.

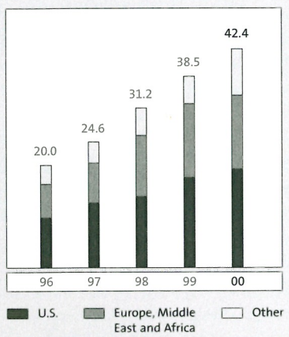
The result will be a company that is increasing value for shareholders, creating new opportunities for employees, expanding business with our partners and delivering on our commitment to customer success.



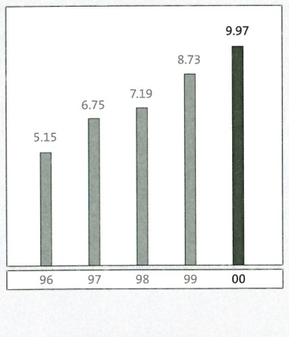
Michael D. Capellas
Chairman and Chief Executive Officer

financial highlights

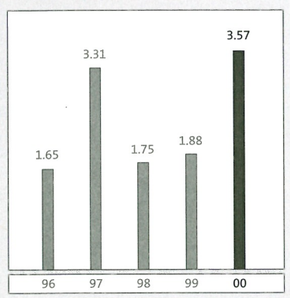
revenue *in billions*



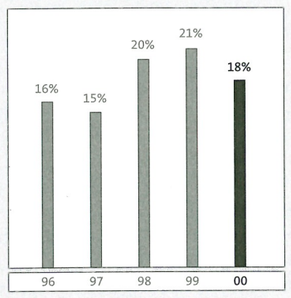
gross margin *in billions*



segment operating income *in billions*



operating expense as a percent of revenue *percentage*



stories from the enterprise

"Compaq has become a leader in powering the enterprise because our customers have chosen us to help them solve the complex problems of doing business on a large scale. Our story is their story."

Michael D. Capellas

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world-leading servers

TAKE CHARGE Compaq's *ProLiant* servers have won nearly a third of the world market for Intel-based servers – more than double the nearest competitor. Our customers have purchased more than 4 million Compaq *ProLiant* servers and *TaskSmart* Appliance Servers – our new range of single-purpose servers, optimized and tuned for one specific application. Our Industry Standard Server Group is also leading the industry with our powerful 8-Way *ProLiant* servers, providing cost-effective power for the enterprise. Nearly two-thirds of all Application Service Providers in North America run on *ProLiant* servers. And Microsoft runs much of its business on *ProLiant* servers. Enterprise power of this magnitude depends on more than just product excellence and innovative technology. Sophisticated and highly sought-after management tools allow customers to get up and running faster, and ensure best performance and increased availability. A complete range of services and software integration support make it all work within the customer's mix of products, along with turnkey solutions that add the depth, richness and power that customers need to propel their own ideas to success.

BRITISH TELECOM AT YOUR SERVICE

BT Ignite, British Telecom's broadband and Internet Protocol (IP) data and solutions business, is the first communications organization to commit to delivering the entire IP value chain, from core networks and Internet connectivity to e-commerce consulting and solutions. BT Ignite offers a unique blend of content hosting, application services, systems integration and outsourcing capabilities. The company is using Compaq *ProLiant* servers in 22 data centers that will be set up to serve customers worldwide. According to David Furniss, Vice President of Products and Marketing, BT Ignite Application Services, "We offer the greatest scale, breadth and reach of applications and services, with B2B solutions that meet the e-business and e-commerce needs of our customers. Working with leading players in the industry, such as Compaq, is a key element in our strategy." BT Ignite has a worldwide network of 90 partners, joint ventures, distributors and wholly owned subsidiaries, and provides services not only to some of the largest companies in the world, including Compaq, but also to Internet start-ups and small and medium size businesses.

VIEWS A DAY. | COMPAQ *ACTIVEANSWERS*,™ ON COMPAQ.COM, IS THE FIRST ONLINE IT SOLUTIONS CENTER WHE

TOMERS CAN EVALUATE, SIZE AND CONFIGURE PRODUCTS ONLINE. | ONLINE SALES HAVE INCREASED MOR

high-performance power

TAKE IT TO THE MAX That continuous and comforting hum you hear at the core of the Internet is the non-stop sound of Compaq's business-critical servers. Compaq powers 80 of the world's largest Internet Service Providers. One hundred million wireless customers connect through our systems, and 80 percent of all telecommunications billing and customer care transactions in Europe and Asia depend on us. Our *NonStop Himalaya* and *Alpha* servers power 95 percent of the world's securities transactions and 80 percent of all ATM transactions. We're breaking new ground with our Zero Latency Enterprise solution, which enables up-to-the-second information and response times at every customer touch point in a large organization. Compaq also delivers the high-performance computing power behind pioneering developments in bioinformatics and supercomputing. What sets us apart? Absolute reliability, maximum power, unlimited scalability and the tools and technology that make it all easy to manage. More than that, we excel at "interoperability." We are one of the few companies in the world that can take all the pieces of a large, complex solution and make them work together.

The Securities Industry Automation Corporation (SIAC) powers the New York Stock Exchange ... and Compaq *NonStop Himalaya* servers help power SIAC.

MARKET READY

Compaq powers more stock and commodity exchanges than any other company, including 14 of the 15 largest stock exchanges in the world. Billions of transactions are processed every day on Compaq *NonStop Himalaya* and on our powerful *Alpha* class servers. The New York Stock Exchange, The Nasdaq Stock Market,® Chicago Mercantile Exchange Inc., the Chicago Board of Trade, major exchanges in Montreal, Toronto, Paris, London, Hong Kong and in Germany, Italy and more than 40 other countries run on Compaq Business Critical Systems. The NonStop infrastructure supplied by these exchanges around the world positions Compaq, its application partners and these major exchanges, to supply next-generation clearing and settlement services to the emerging e-commerce economy.

IN 2000, INCLUDING WEB AND WEB-ENABLED SALES. | COMPAQ IS WORKING CLOSELY WITH COMMERCE [illegible]A, SAP, ORACLE AND OTHERS TO DRIVE COMPAQ'S LEADERSHIP AS AN IT SUPPLIER TO THE MAJOR E-MARKETPLACES.

power in information

TAKE CONTROL Our Enterprise Storage Group delivers Compaq *StorageWorks*™ solutions and *SANworks*™ software for modular, flexible and reliable enterprise solutions. Thought leadership and key partnerships – including storage partner IBM – are helping Compaq drive open industry standards and interoperability to deliver the Open SAN, giving customers the choices and flexibility they need for success. We are also pioneering the concept of the Storage Utility, providing storage capacity on-demand, much the way a public utility supplies electricity to businesses and homes. StorageNetworks, Inc., the world's leading storage service provider and a Compaq strategic partner, is using Compaq storage technology in its Global Data Storage Network to give customers virtually unlimited data storage capacity and capabilities. Our software, our Enterprise Network Storage Architecture, our ability to support multiple systems and our ability to scale up at Internet speed – all make Compaq a market definer in the big business of storage.

TWENTY-FIRST CENTURY POWER

When Hong Kong-based utility company CLP Power needed a twenty-first century e-commerce solution, they chose Compaq and our Global Alliance Partner Microsoft to help their 4,000 employees support nearly two million customers. And to back up their operating data they chose a Compaq *StorageWorks* solution. Why? "Database recovery is a complex task," says CLP Power's management services manager and CIO Richard Brisbane-Cohen,"and simplification, when it is available, is a great opportunity. We chose to deploy Compaq's *StorageWorks* and *SANworks* Data Replication Manager so that our data center management operates in the most cost-effective and efficient way." CLP Power sees Internet-based technologies as a key to the future. That's why they're also using Compaq's 8-Way *ProLiant* servers, disk mirroring and clustering, Microsoft Exchange e-mail and collaboration, a Virtual Private Network that allows them to send secure messages over the Internet, an R/3 enterprise management solution from Global Alliance Partner SAP, and Compaq Professional Services, which helped put it all together.

TAKE IT ON Our 38,000 Services and Support professionals provide the skills and expertise our customers need to re-invent and maintain their businesses in 202 countries. Our consulting services have been building bet-your-business infrastructures for more than 20 years for thousands of enterprises. Today, our Solution Architects are helping to define e-business success – from the vision and architecture design all the way through to the solutions, infrastructure, management and support. As a result, our professional services teams are recognized as among the most skilled in the industry. Similarly, our customer support teams are winning business and praise by helping customers handle the demands of 24x7 e-commerce on a global scale. Our online "Services @ Click Speed" is helping major companies implement end-to-end e-commerce solutions. Also, Compaq partnered with Cable & Wireless to create the world's first global, end-to-end Application Service Provider (ASP), Cable & Wireless a-Services. In addition to being the first worldwide prime integrator for Microsoft Windows 2000 and Microsoft's Global Services Partner of the Year, our Global Services teams and network of 30,000 partners provide continuous availability, security and performance services for any type of hardware, software, operating system and network.

leadership services

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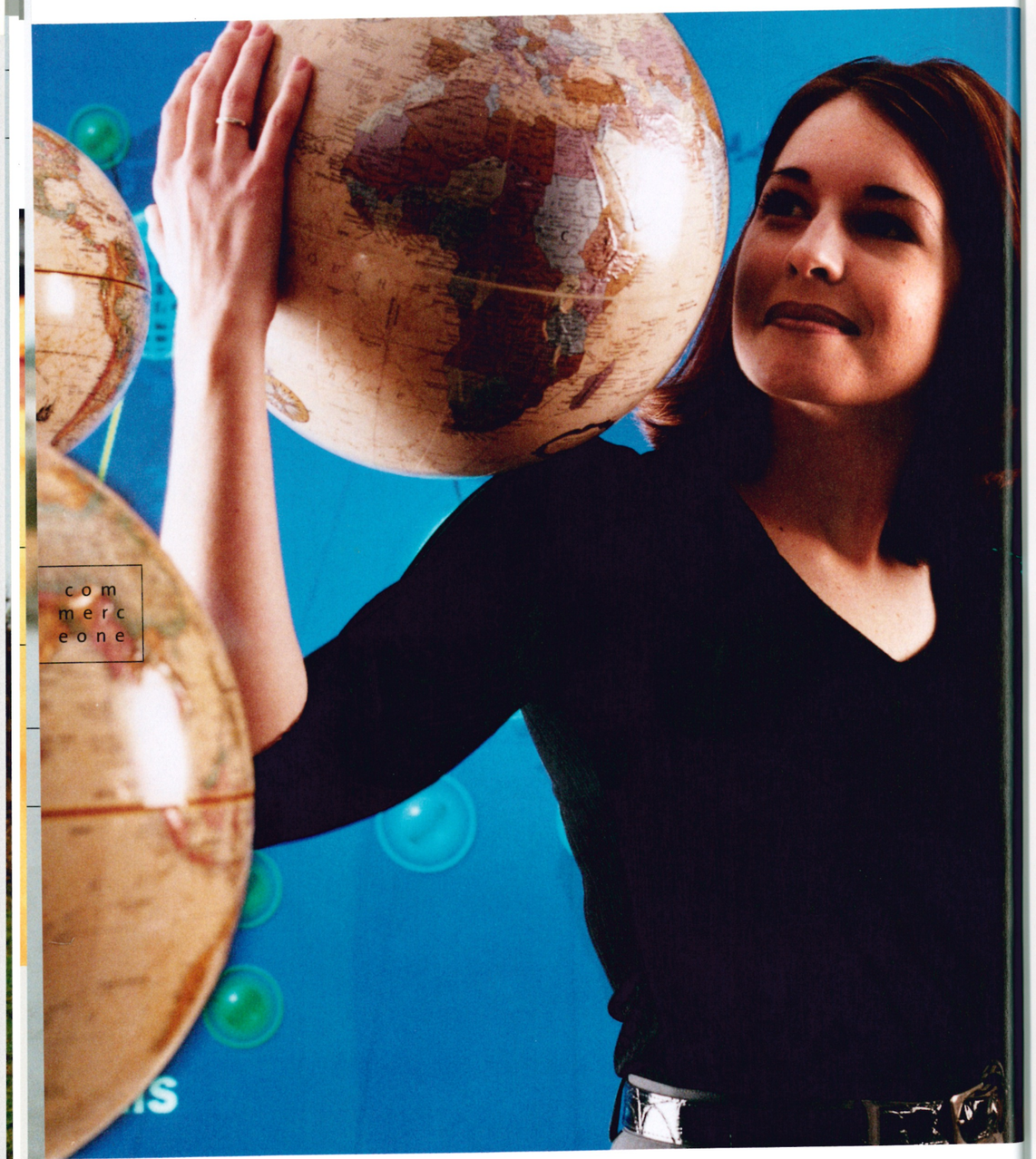
HOLD THE PHONE

ERICSSON With 100,000 employees in 140 countries, Ericsson is a recognized leader in telecom and datacom solutions for the new world of mobile communications. Ericsson has signed a contract to outsource IT Service and Support to Compaq. The agreement covers more than 23,000 end-users in Ericsson companies based in Sweden. "Compaq is an important link in Ericsson's IT standardization agenda," says Håkan Liedman, Ericsson's Chief Information Officer. "Customers demand easy access to Ericsson and to our services. Flexibility in a truly global organization requires standardization of the IT platform."



partner power

TAKE IT FROM THE BEST It has become a cliché to say "No company can do it all." Compaq, however, has been leading the IT industry for years in forging alliances tailored to the needs and interests of customers. When our customers "buy Compaq," they're also benefiting from the capabilities of America Online, Cable & Wireless, Cisco, Commerce One, The Walt Disney Company, Ericsson, Intel, KPMG, Microsoft, Oracle, SAP, Yahoo! and Siebel. These best-in-class Global Alliances help us provide solutions and extend our brand all around the world. They are a primary pillar of our strategy. And we work as hard at developing and refining our long-term relationships with these great companies as we do at developing and delivering our products and services. But there is more to it than that. We also maintain strategic partnerships with thousands of best-of-breed companies, from independent software vendors to middleware and systems integration companies – all focused on providing the exact solutions our customers want.

GLOBAL TRADING

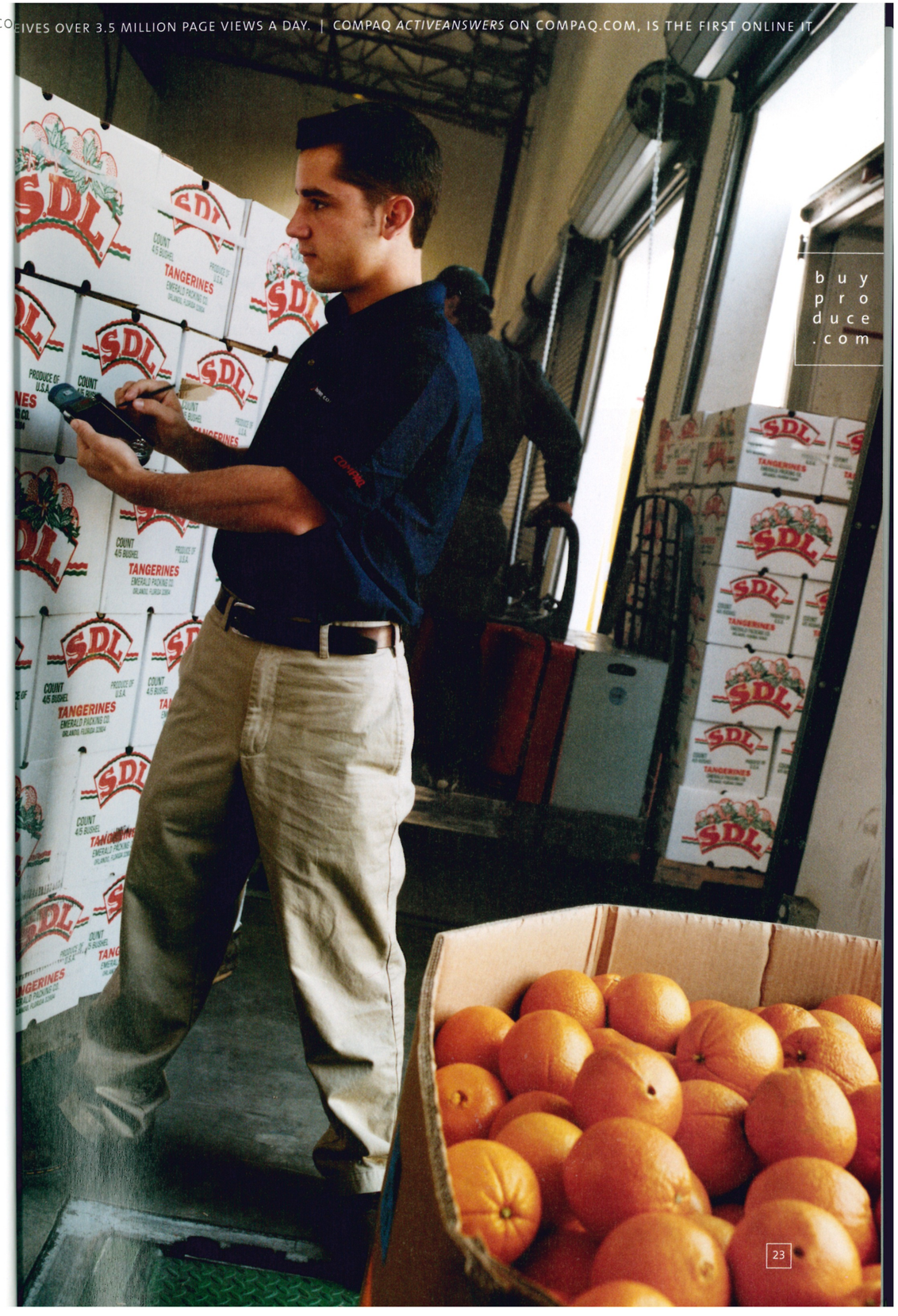
COMMERCE ONE. Commerce One, the e-marketplace company, is the leading force behind the Global Trading Web – an ecosystem of interconnected business communities allowing companies from anywhere in the world to do business with any other company, anytime. Here, buyers and sellers are able to conduct business in everything from car parts to computer chips. Today, Compaq is the preferred platform provider for Commerce One e-marketplaces. More than two-thirds of Commerce One e-marketplaces use Compaq industry-leading *ProLiant* servers. As part of this Global Alliance, Compaq Global Services is a tier one, preferred systems integration partner for Commerce One worldwide. As partners, Compaq and Commerce One work together to simplify access and reduce the overall price of entry into the new economy world of B2B e-commerce solutions – a marketplace that is expected to generate $2.7 trillion by 2004.

access

TAKE THE LEAD If the edge of the network is where infrastructure meets access, then here is where you find the sharpest edge. A leader in commercial PC global market share, our Commercial Personal Computing Group is revolutionizing the way business is conducted. We provide wireless access to corporations and employees, allowing them to send and receive e-mail and to connect to data on the Internet and on their corporate intranets. Our access devices include the award-winning *iPAQ* Pocket PC with its unique expansion pack design, and the *iPAQ* BlackBerry™ Wireless E-mail Solution, an Always On, Always Connected® real-time wireless e-mail device, offered in partnership with RIM.® We also introduced the first *iPAQnet* solutions, which provide wireless computing with nationwide access to intranets and corporate e-mail. In addition, we began shipping the *iPAQ* desktop, a Windows based, legacy-free desktop that originally established Compaq as a market leader in the access device space. In the traditional PC market, our Commercial Personal Computing Group continues to lead the industry in pioneering i-services, PC client manageability and lifecycle solutions for commercial users. The revitalized *Deskpro*™ products represent a major step toward helping customers eliminate the complexity of computing through Intelligent Manageability features and online services. Also, we are the world's top supplier of workstations in the mechanical computer aided design (MCAD), and architecture, engineering and construction (AEC) industries; our *Armada* portables experienced record-breaking shipments in 2000; and we claimed the Best in Show award at Comdex 2000 for the MP2800 – the world's smallest projector.

GROWTH ENTERPRISE

buyproduce Buyproduce.com, the first digital marketplace for produce buyers and sellers, is using Compaq *iPAQ* Pocket PCs and *Aero*™ handheld PCs to help capture more than 15 percent of the $200 billion a year fresh fruit and vegetable business in the United States. The *Aero* and *iPAQ* PCs capture bar codes on truckloads of produce as they arrive at customer docks. Quality problems that used to take 24 hours to resolve with faxes and phone calls now get straightened out in less than two hours. That's just the tip of the iceberg. Buyproduce.com is a Compaq-Microsoft-Oracle end-to-end e-business solution put together by Compaq Global Services. It features clustered Compaq *ProLiant* servers, Microsoft DNA architecture, Windows 2000 and Oracle Financials. The quality of the entire Compaq solution helped Buyproduce.com win key backing in the venture capital markets. Says their CIO, Jim Delurgio, "We expected Compaq to build us an industrial-strength solution. We didn't expect Compaq to become such a critical business partner in our success."



access

s b c

eLifestyle

TAKE IT HOME Today's consumers are moving into a world where the Internet brings digital music, movies and other entertainment and communication anywhere they want to be – inside or outside the home. We call that "eLifestyle" and Compaq recognizes that owning a computer is becoming only a part of making eLifestyle a reality. That's why Compaq's Consumer Group introduced a family of devices this year that enhance the value of a computer and make the Internet accessible from anywhere:

- the *iPAQ* Home Internet Appliance, for specialized one-touch Web and e-mail access. It was named The Best of What's New by *Popular Science* magazine and one of the top 100 products of the year by *Computer Shopper*,
- the much acclaimed *iPAQ* Personal Audio Player, for easy-to-personalize digital music in a case the size of a pager,
- and the *iPAQ* Connection Point, for high-speed Internet access with wireless freedom, flexible home networking, and built-in firewall security.

Compaq's *Presario*™ Internet notebooks and desktops are the number-one selling home computers worldwide because Compaq tailors consumer products to each region of the world – from the language and software on a desktop to the shopping experience inside a store or at one of our Internet sites. Proof of our success in meeting regional tastes is found in the double-digit and, in some countries, triple-digit sales rates in Europe, Japan, Asia Pacific, Latin America and Greater China.

PLUG AND PLAY

When SBC, one of the world's largest telecommunications companies, wanted to promote its new Digital Subscriber Line (DSL) service, they chose Compaq's *Presario* PCs. For the price of a two-year contract for SBC's Basic High-DSL Internet Service – which brings the Internet into homes at speeds roughly 50 times faster than standard modems – consumers in selected promotion areas got a new DSL-equipped *Presario* and access to Prodigy. The "plug and play" promotion allowed customers to set up and tap into the Internet at up to 1.5 megabits per second in about the time it took them to open the box and plug in their *Presario* PCs. It gave users one-button access to entertainment sites on the Web, and provided SBC with the Web-based support they needed to capture customer information. It's a good example of Compaq's ability to deliver multiple Internet-based services and a lifecycle revenue stream built around an Internet-ready PC. Says James Gallemore, SBC Executive Vice President for Strategic Marketing, "Our promotion with Compaq provided a tremendous value that makes high-speed broadband service a viable and affordable option for a diverse consumer base."

TAKE ON THE FUTURE Compaq Corporate Research explores and extends the power of the edge of the Net, developing new technologies for Compaq's business units – including technology that delivers information to the home, the office, data centers and on mobile and wireless devices. For example, to help Compaq customers interact naturally with their hand-held products, Compaq research has developed "Mercury", a multimedia technology employing speech and vision applications to help mobile users communicate. To help people deal with the explosion of online information, Research has developed a way to use text, audio and video content to create a continuously updated repository of billions of documents. Powerful applications then track changes in this information, even as they occur at Internet speed.

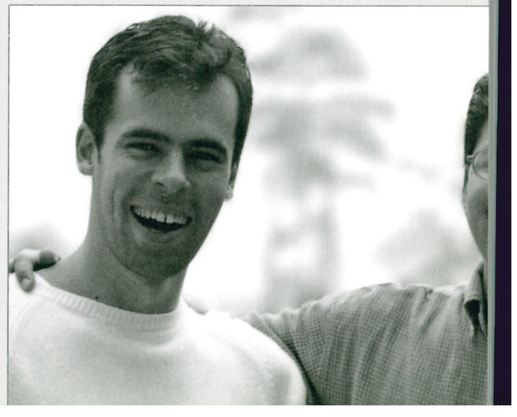
ALPHA RULES

Our *Alpha* systems, in addition to supporting some of the most demanding telecom, financial and manufacturing businesses in the world, are now in demand as research tools all over the world. The world race to map and sequence the human genome is powered by our most powerful *AlphaServer* systems at Celera Genomics, the Sanger Centre, and the Whitehead Institute. We're now working with these organizations and many other researchers to use this information to develop new drugs and therapies that will improve human health. In August, the U.S. Department of Energy signed a major contract with Compaq to build the world's fastest and most powerful supercomputer, capable of performing 30 trillion computations a second. The supercomputer will be used to help eliminate the need for live underground atomic testing. It will initially consist of 375 *AlphaServer* GS320 systems running the Compaq *Tru64* UNIX operating system. The system will include more than 600 terabytes of Compaq *StorageWorks* storage, and receive onsite 24x7 service and support. Compaq also won contracts to provide supercomputers based on *Alpha* technology for the Pittsburgh Supercomputing Center and the French Atomic Energy Commission.

Clockwise, from left: Stephanie Parrish, Program Manager, **U.S.A.**, Jeff Chern, Enterprise Technical Trainer, **Taiwan**, Renel Lai, Technical Support, **Hong Kong**, Petr Kosec, Technical Trainer, **Czech Republic**, Mia Bjorkil, Customer Advocate, **Sweden**, Nelly d' Almeida, Consultants Sales Assistant, **France**, Marcelo Junior Technical Trainer, **Brazil**, Carlos Yakas, Technical Support, **Argentina**

global presence

TAKE IT FROM US While Compaq and its more than 30,000 service partners do business in 202 countries, we manage the challenge of being a large company by directing our energy toward two very important groups: our customers and our people. It's all part of our Balanced Scorecard – the way we measure and hold our managers accountable for business performance, customer satisfaction and employee morale. It means we're working hard for our customers and we're having some fun while we're at it. After just a year, the results are starting to show. Based on 1999 results, we jumped from the 28th to the 20th largest U.S. company in the Fortune 500, and from the 87th to the 70th largest international company in the Global 500. And *InfoWeek Magazine*, which reports on how companies are using Information Technology to run their businesses, ranked us 3rd on their list of Most Innovative IT Users. More important, in another survey, they recognized Compaq as the third ranked company in using IT innovations to support our customers, citing our wide range of online services. Perhaps just as telling, Compaq was ranked the 8th Best Place to Work in the U.S. by BestJobsUSA.com. We like to think it's also a pretty good place to work in the other 201 countries where we do business.



Reading, writing and networking. Compaq is helping to close the digital divide at school by sponsoring techs4schools Online Mentoring Program. It provides online assistance to U.S. schools that do not have a computer specialist on-site.

TAKE CARE At Compaq, we recognize the importance of helping everyone take advantage of the Internet revolution. We believe technology and the Internet, when used effectively, can stimulate learning, enrich lives and provide greater opportunities for the future. So we're doing something about it. In conjunction with TECH CORPS®, the 10,000-volunteer member organization dedicated to helping schools and teachers with education technology, Compaq is sponsoring techs4schools™ Online Mentoring Program. It provides online technical support to schools that cannot be reached by volunteers. Technology experts are connected online with schools to help the resident technology coordinators, teachers and students integrate new technology in the classroom and apply the power and scope of the World Wide Web to education. techs4schools overcomes geographic and demographic barriers to bring the best technical expertise around the country directly to the nation's schools. | And we continue to help out as a corporation and as motivated and caring individuals all around the world. From helping children in Malaysia with personal computers, supporting a diabetes center in Canada, providing technical support and services for Native Americans, fighting AIDS in Africa, supporting efforts to find missing children around the world, to supporting the Boys and Girls Club of Greater Nashua, New Hampshire, with a technology center, Compaq employees continue to help improve the quality of life and the quality of lives everywhere they live and work.

Compaq Computer Corporation
Founded 1982 in Houston, Texas

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Compaq is a leading global provider of enterprise technology and solutions. Compaq designs, develops, manufactures and markets hardware, software, solutions and services, including industry-leading enterprise computing solutions, fault-tolerant business-critical solutions, communication products, and desktop and portable personal computers that are sold in more than 200 countries.

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report of management

Responsibility for the integrity and objectivity of the financial information presented in this Annual Report rests with Compaq management. Compaq management believes that the accompanying consolidated financial statements fairly present Compaq's financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States. In preparing the consolidated financial statements, Compaq management included amounts that are based on estimates and judgments which Compaq management believes are reasonable under the circumstances.

Compaq maintains an effective internal control structure. It consists, in part, of an organization with clearly defined lines of responsibility and delegation of authority, comprehensive systems and control procedures and periodic structured assessments. To assure the effective administration of internal control, Compaq carefully selects and trains its employees, develops and disseminates written policies and procedures, provides appropriate communication channels and fosters an environment conducive to the effective functioning of controls. Compaq management believes this structure provides reasonable assurance that transactions are executed in accordance with management authorization and accounting principles generally accepted in the United States. An important element of the control environment is an ongoing internal audit program.

Compaq management believes that it is essential for Compaq to conduct its business affairs in accordance with the highest ethical standards, as set forth in Compaq's Codes of Conduct. These guidelines, translated into numerous languages, are distributed to employees throughout the world and reemphasized through internal programs to assure that they are understood and followed.

Compaq retains independent auditors to audit Compaq's consolidated financial statements. Their accompanying report is based on an audit conducted in accordance with auditing standards generally accepted in the United States, including a review of the internal control structure and tests of accounting procedures and records.

The Audit Committee of the Board of Directors is composed solely of outside directors and is responsible for recommending to the Board the independent auditing firm to be retained for the coming year. The Audit Committee meets periodically and privately with the independent auditors, with Compaq's internal auditors, as well as with Compaq management, to review accounting, auditing, internal control structure and financial reporting matters.

MICHAEL D. CAPELLAS
Chairman and
Chief Executive Officer

JESSE J. GREENE, JR.
Senior Vice President,
Finance and Administration,
and Chief Financial Officer

five-year financial summary

in millions, except per share amounts	YEAR ENDED DECEMBER 31 2000	1999	1998[1]	1997	1996
STATEMENT OF INCOME					
Revenue:					
Products	$35,667	$31,902	$27,372	$24,122	$19,611
Services	6,716	6,623	3,797	462	398
Total revenue	42,383	38,525	31,169	24,584	20,009
Cost of sales:					
Products	27,624	25,263	21,383	17,500	14,565
Services	4,793	4,535	2,597	333	290
Total cost of sales	32,417	29,798	23,980	17,833	14,855
Selling, general and administrative expense	6,044	6,341	4,978	2,947	2,507
Research and development	1,469	1,660	1,353	817	695
Restructuring and related activities[2]	(86)	868	393	—	52
Purchased in-process technology[3]	—	—	3,196	208	—
Other (income) expense, net[4]	1,664	(1,076)	(69)	21	17
	9,091	7,793	9,851	3,993	3,271
Income (loss) before income taxes	875	934	(2,662)	2,758	1,883
Provision for income taxes	280	365	81	903	565
Income (loss) before cumulative effect of accounting change	595	569	(2,743)	1,855	1,318
Cumulative effect of accounting change, net of tax[5]	(26)	—	—	—	—
Net income (loss)	$ 569	$ 569	$ (2,743)	$ 1,855	$ 1,318
Earnings (loss) per common share:					
Basic:					
Before cumulative effect of accounting change	$ 0.35	$ 0.35	$ (1.71)	$ 1.23	$ 0.90
Cumulative effect of accounting change, net of tax	(0.02)	—	—	—	—
	$ 0.33	$ 0.35	$ (1.71)	$ 1.23	$ 0.90
Diluted:					
Before cumulative effect of accounting change	$ 0.34	$ 0.34	$ (1.71)	$ 1.19	$ 0.87
Cumulative effect of accounting change, net of tax	(0.01)	—	—	—	—
	$ 0.33	$ 0.34	$ (1.71)	$ 1.19	$ 0.87
Shares used in computing earnings (loss) per common share:					
Basic	1,702	1,693	1,608	1,505	1,472
Diluted	1,742	1,735	1,608	1,564	1,516
Cash dividends per common share	$ 0.10	$ 0.085	$ 0.065	$ 0.015	$ —
FINANCIAL POSITION					
Current assets	$15,111	$13,849	$15,167	$12,017	$10,089
Total assets	24,856	27,277	23,051	14,631	12,331
Current liabilities	11,549	11,838	10,733	5,202	4,741
Long-term obligations[6]	575	—	422	—	300
Stockholders' equity	12,080	14,834	11,351	9,429	7,290

[1] 1998 results reflect the acquisition of Digital in June 1998.

[2] Represents an $86 million release of restructuring reserves in 2000; an $868 million charge for restructuring and related charges in 1999; a $393 million charge for restructuring and asset impairments in 1998 in connection with the Digital acquisition and the closing of certain Compaq facilities; and a $52 million charge related to restructuring actions taken by Tandem during 1996.

[3] Represents non-recurring, non-tax-deductible charges associated with purchased in-process technology of $3.2 billion in connection with the Digital acquisition in 1998, and $208 million in connection with acquisitions in 1997.

[4] Includes a $1.8 billion charge for impairment of investments in 2000 and a $1.2 billion gain on the sale of an 81.5 percent interest in AltaVista in 1999.

[5] Effective January 1, 2000, Compaq adopted Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, *as amended.*

[6] Includes $422 million of minority interest acquired in 1998 related to Digital preferred stock which was redeemed in April 1999.

Founded in 1982, Compaq Computer Corporation ("Compaq") is a leading global provider of enterprise technology and solutions. Compaq designs, develops, manufactures and markets hardware, software, solutions and services, including industry-leading enterprise computing solutions, fault-tolerant business-critical solutions, communication products, and desktop and portable personal computers that are sold in more than 200 countries.

The following discussion should be read in conjunction with the consolidated financial statements. Certain statements contained herein may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, as discussed more fully herein.

Results of Operations

Compaq completed the acquisitions of Digital Equipment Corporation ("Digital"), Shopping.Com ("SDC") and Zip2 Corp. ("Zip2") and purchased certain assets and liabilities of InaCom Corp. ("Inacom") in June 1998, February 1999, April 1999 and February 2000, respectively. These transactions were accounted for as purchases. In August 1999, Compaq sold a majority interest in SDC, Zip2 and the AltaVista Company, a business acquired in the Digital acquisition (collectively "AltaVista"), to CMGI, Inc. ("CMGI"). Accordingly, Compaq's consolidated financial statements include the results of operations from the respective dates of acquisition through divestiture or December 31, 2000, as applicable.

During 2000, Compaq realigned the operations of its Enterprise Solutions and Services segment, which resulted in the formation of two reportable segments: Enterprise Computing and Compaq Global Services. These two segments accounted for 50 percent of consolidated revenue and 86 percent of segment operating income in 2000. Compaq's other two reportable segments, Commercial Personal Computing and Consumer, were unaffected by the realignment. Enterprise Computing designs, develops, manufactures and markets advanced computing and telecommunication products, including business-critical servers, industry-standard servers and storage products. Compaq Global Services delivers worldwide infrastructure and solution design implementation, management, and support services through Professional and Customer Services. Commercial Personal Computing delivers standards-based computing emphasizing Internet access through workstations, desktops, portables, monitors, Internet access devices and life-cycle management products. The Consumer segment targets home users with Internet-ready desktops and portables, printers and related products, as well as Internet access and e-services. Financial data for prior periods has been restated to conform to the current presentation.

Summary financial data by business segment follows:

	Year ended December 31		
in millions	2000	1999	1998
Enterprise Computing			
Revenue	$14,316	$12,974	$10,498
Operating income	2,140	1,201	948
Compaq Global Services			
Revenue	6,993	7,162	3,990
Operating income	944	1,148	776
Commercial Personal Computing			
Revenue	13,136	12,185	11,846
Operating income (loss)	289	(448)	(46)
Consumer			
Revenue	7,586	5,994	4,932
Operating income	170	262	183
Other			
Revenue	352	210	(97)
Operating income (loss)	27	(281)	(115)
Consolidated Segment Totals			
Revenue	$42,383	$38,525	$31,169
Operating income	$ 3,570	$ 1,882	$ 1,746

A reconciliation of Compaq's consolidated segment operating income to consolidated income (loss) before income taxes follows:

	Year ended December 31		
in millions	2000	1999	1998
Consolidated segment operating income	$ 3,570	$ 1,882	$ 1,746
Corporate and unallocated shared expenses	(1,117)	(1,156)	(888)
Restructuring and related activities	86	(868)	(393)
Purchased in-process technology	—	—	(3,196)
Other income (expense), net	(1,664)	1,076	69
Income (loss) before income taxes	$ 875	$ 934	$(2,662)

Overview

Compaq reported 2000 consolidated revenue of $42.4 billion, an increase of $3.9 billion, or 10 percent, compared with the prior year. Strong growth in Consumer, Enterprise Computing and Commercial Personal Computing drove higher revenue. Consolidated revenue in 1999 increased $7.4 billion, or 24 percent, compared with 1998 primarily due to higher revenues from Compaq Global Services, Enterprise Computing and Consumer. Revenue in 1998 reflects the acquisition of Digital from June 1998 through the remainder of the year while 1999 and 2000 revenue reflects Digital amounts for the entire year.

Consolidated gross margin of $10.0 billion (23.5 percent of revenue) in 2000 improved 0.9 percentage points compared with the prior year reflecting Compaq's strategy to drive profitable growth. Stronger margins in Commercial Personal Computing and Enterprise Computing led to the overall improvement in gross margin. Consolidated gross margin declined 0.4 percentage points in 1999 compared to 1998, primarily due to lower margins in Commercial Personal Computing.

Consolidated operating expense was $7.5 billion in 2000, a decline of $488 million, or 6.1 percent, compared with 1999. As a percentage of revenue, operating expense declined significantly to 17.7 percent from 20.8 percent in the prior year due to solid execution of spending discipline. Operating expense increased $1.7 billion, or 26 percent, in 1999 compared with 1998 primarily as a result of the Digital acquisition.

The effective tax rate was 32 percent for the year ended December 31, 2000 compared with 39.1 percent for 1999. The higher effective tax rate in 1999 was primarily due to the gain on sale of businesses and restructuring and related charges.

Consolidated net income of $569 million was unchanged from the prior year. Earnings per diluted common share were $0.33 for the year ended December 31, 2000 compared with $0.34 in 1999. Consolidated net income included a $1.1 billion, net of tax, impairment charge for certain equity investments in 2000, while 1999 consolidated net income included a $670 million, net of tax, gain on sale of a business and a $600 million, net of tax, charge for restructuring and related activities. The consolidated net loss of $2.7 billion in 1998 included a one-time charge for purchased in-process technology of $3.2 billion related to the acquisition of Digital.

Effective January 1, 2000, Compaq adopted Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, as amended ("SAB 101"), issued by the Securities and Exchange Commission in December 1999. Compaq's adoption of SAB 101 resulted in a change in the method of accounting for certain product shipments. The cumulative effect of this change was $38 million ($26 million, net of tax). This accounting change did not have a material effect on revenue or quarterly earnings during 2000. Compaq has restated its results for the first three quarters of the year ended December 31, 2000, as reflected in the Selected Quarterly Financial Data on page 66.

Enterprise Computing

Enterprise Computing revenue increased $1.3 billion, or 10 percent, in 2000 compared with the prior year and represented 34 percent of consolidated revenue. In 1999, revenue from this segment increased $2.5 billion, or 24 percent, compared with 1998. Enterprise Computing revenue consisted of the following:

	Year ended December 31		
in millions	2000	1999	1998
Industry Standard Servers [1]	$ 5,847	$ 4,604	$ 4,529
Storage Products	5,240	5,066	3,444
Business Critical Servers [1]	3,226	3,225	2,334
Other	3	79	191
	$14,316	$12,974	$10,498

[1] *Compaq* AlphaServer™ *and* ProLiant™ *systems product revenue does not include attached and enterprise storage, which is captured in Storage Products.*

Industry Standard Servers revenue grew 27 percent during 2000 compared with the prior year. Revenue benefited from higher average unit prices, which were aided by mid-year component shortages and a richer server mix. Demand was strong across all regions as both corporate and Internet service provider customers continued to build out their data centers. Revenue growth was strongest in the Compaq *ProLiant*™ dense rack-optimized server line as an increasing number of customers valued the simplicity and space-saving economies provided by dense servers. Also, higher-end server revenue was strong with solid sales in industry-leading 4-way and 8-way servers. In 1999, Industry Standard Servers revenue benefited from a higher market share in North America compared with 1998.

Storage Products revenue increased 3 percent during the year. Strong growth in enterprise storage, which consisted of external storage, software and high-end tape, was offset by lower attached storage. Enterprise storage growth was driven by solid sales in software and strong acceptance of Compaq's Enterprise Network Storage Architecture solutions. Revenue benefited from an increase in overall storage capacity shipped of 67 percent to 70,000 terabytes during the year, partially offset by aggressive price declines per unit of capacity. Storage Products revenue growth in 1999 resulted primarily from the Digital acquisition.

Business Critical Servers revenue was essentially unchanged in 2000 compared with the prior year due to product transition to the Compaq *Alpha*™ GS Series and related component shortages which have since been resolved. The increase in Business Critical Servers revenue in 1999 was primarily due to the acquisition of Digital.

Enterprise Computing operating income increased $939 million, or 78 percent, in 2000 compared with the prior year due to strong revenue growth and higher gross margins, as well as lower operating expenses. Margins improved due to a mix shift toward the high-end and increased enterprise storage. Strong demand for industry standard servers drove higher average unit prices. Operating expense declined in whole dollars and as a percentage of revenue in the Enterprise Computing segment due to a continued focus on cost control and expense reduction. Operating income improved in 1999 compared with 1998 due to stronger performance in Storage Products, a decline in operating expense as a percentage of revenue and a full year of Digital business.

Compaq Global Services

Compaq Global Services revenue decreased $169 million, or 2 percent, in 2000 compared with the prior year and represented 16 percent of consolidated revenue. Compaq Global Services revenue consisted of the following:

	Year ended December 31		
in millions	2000	1999	1998
Customer Services [2]	$4,336	$4,356	$2,462
Professional Services [2]	2,657	2,806	1,528
	$6,993	$7,162	$3,990

[2] *Compaq Global Services revenue includes revenue from the sale of products made in connection with providing solutions and services to customers.*

Adjusted for the effects of currency, Compaq Global Services revenue increased 3 percent. The decline in Compaq Global Services revenue during the year was primarily a result of lower Professional Services revenue. Adjusted for the effects of currency, Professional Services revenue was essentially unchanged. Compaq has narrowed its focus for Professional Services to target areas of opportunity that are consistent with its Internet-related service strategy and continues to realign its workforce to support growth plans. Customer Services revenue grew 5 percent adjusted for the effects of currency, in line with the market. Such growth was aided by strong attachment of services with product sales and continued penetration of business-critical services. Compaq Global Services revenue increased $3.2 billion, or 79 percent, in 1999 compared with 1998, benefiting from a full year of the Digital business acquired in June 1998. Customer Services benefited from significant growth in Asia-Pacific, Latin America and Greater China, reflecting recovery from Asian and Latin American economic crises. Revenue also improved as a result of growth in software support and business-critical services. Outsourcing business and e-business strengths favorably impacted Professional Services revenue.

Compaq Global Services operating income declined $204 million, or 18 percent, in 2000 compared with the prior year. Given the substantial portion of international business within Compaq Global Services, currency declines significantly impacted operating income during 2000. While profitability in the Customer Services business remains strong, Professional Services operating results were lower primarily due to workforce rebalancing and reskilling. Operating expense increased primarily due to investment in direct sales capability. Operating income was higher in 1999 compared with 1998 primarily due to a full year of Digital business.

Commercial Personal Computing

Commercial Personal Computing revenue increased $951 million, or 8 percent, in 2000 compared with the prior year and represented 31 percent of consolidated revenue. Revenue grew across all regions, benefiting from higher unit sales of portables and Compaq *iPAQ*™ products, offset in part by lower unit sales of desktops. In 1999, Commercial Personal Computing revenue increased $339 million, or 3 percent, compared with 1998. Overall unit sales growth in 1999 was partially offset by declining average unit prices, which were lower due to competitive pricing and a shift in product mix. Demand for portable products shifted from higher-end mobility and power to lower cost during 1999.

Compaq completed the purchase of key assets from Inacom during the first quarter of 2000 and subsequently established Custom Edge Incorporated as a wholly owned subsidiary (also known as Compaq Direct). This purchase adds custom configuration capabilities and direct fulfillment logistics that enable Compaq to better meet customer needs in North America.

Commercial Personal Computing operating income increased $737 million, from a loss of $448 million in 1999 to income of $289 million in 2000. Operating results strengthened dramatically due to continued improvement in the business model, including integration of Compaq Direct's fulfillment capacity, and successful reduction of operating costs. Profitability also benefited from a favorable shift in product mix to higher margin portables and supply chain efficiencies. Operating expense declined due to persistent focus on streamlining processes and increasing efficiencies. Commercial Personal Computing operating loss increased $402 million in 1999 as compared with 1998 due primarily to lower gross margins which resulted from average unit prices falling faster than costs. Costs for processors, memory and hard drives for desktops and portables declined during the year. Gross margin also suffered from aggressive competitive bidding. Operating expenses declined slightly in 1999 as a percentage of revenue due to an increased focus on sales and marketing spending as well as support costs.

Consumer

Consumer revenue increased $1.6 billion, or 27 percent, in 2000 compared with the prior year and accounted for 18 percent of consolidated revenue. Consumer revenue benefited from strong international sales growth, particularly in Asia-Pacific and Latin America. Higher unit sales of desktops and portables also contributed to revenue growth. The Consumer segment continues to hold the number one worldwide consumer PC market share position (according to International Data Corporation). The "beyond the box" business, which includes Internet access, Internet traffic, printers, software, financing and warranty upgrades, increased 86 percent compared with the prior year. Consumer revenue increased $1.1 billion, or 22 percent, in 1999 compared with 1998. Revenue benefited from high unit growth driven by strong consumer demand, partially offset by a decline in average unit prices. Component costs continued to decline, which allowed Compaq to reach lower price points, thus spurring consumer demand. An increase in international sales also drove total revenue higher, particularly in Latin America and Asia-Pacific. Higher revenue from Internet access and traffic benefited the Consumer segment in 1999.

Consumer operating income declined $92 million, or 35 percent, in 2000 compared with the prior year. The decline in operating income was primarily due to a downturn in the U.S. consumer PC market that occurred late in the fourth quarter of 2000. Higher component costs also contributed to lower operating income. Operating expenses were relatively unchanged as a percentage of revenue. Consumer operating income increased $79 million, or 43 percent, in 1999 compared with 1998. The increase in operating income was attributable to higher revenue, which resulted in higher gross margin in absolute dollars, and slightly lower operating expenses as a percentage of revenue.

Corporate and Unallocated Shared Expenses

The results of the business segments exclude separately managed corporate and unallocated shared expenses, which consisted primarily of general and administrative costs as well as other items not controlled by the business segments. Corporate and unallocated shared expenses declined from $1.2 billion in 1999 to $1.1 billion in 2000. Corporate and unallocated shared expenses increased $268 million in 1999 due to higher information management, acquisition integration and other general shared costs.

Restructuring and Related Activities

During 2000, Compaq substantially completed all of the actions contemplated under the 1998 and 1999 restructuring plans. In December 2000, Compaq reversed excess reserves of $86 million for employee separations, facility closure costs and other costs related to the 1999 plan. Accrued costs under both plans at December 31, 2000 included amounts for actions that have already been taken, but for which expenditures have not yet been made.

In September 1999, Compaq's management approved a restructuring plan to realign Compaq's organization, reduce infrastructure and overhead, and eliminate excess and duplicative facilities. Restructuring and related charges of $868 million ($600 million, net of tax) were expensed. These charges were composed of $787 million of accrued restructuring costs, $58 million of related asset impairment charges and a $23 million pension curtailment loss to recognize a change in Compaq's projected pension benefit obligation in connection with employee separations. Costs for employee separations

related to approximately 7,000 employees worldwide affecting the majority of business functions, job classes and regions, predominantly occurring in North America and Europe. Employee separation benefits include severance, medical and other benefits.

In June 1998, Compaq recorded a restructuring charge of approximately $1.7 billion to integrate the operations of Compaq and Digital, consolidate duplicative facilities, improve service delivery and reduce overhead. Approximately $1.5 billion was related to the acquisition of Digital and recorded as a component of purchase accounting and $286 million related to Compaq and was charged to operations. During 1998, Compaq also recorded a $107 million charge related to asset impairments.

An analysis of the accrued costs and amounts charged against the provision follows:

in millions	Beginning Accrual	Expenditures	December 31, 1999	Expenditures and Adjustments	December 31, 2000
1999 Plan					
Employee separations	$ 491	$ (68)	$ 423	$(321)	$102
Facility closure costs	96	—	96	(50)	46
Contract cancellation and other exit costs	200	(167)	33	(28)	5
	$ 787	$ (235)	$ 552	$(399)	$153
1998 Plan					
Employee separations	$1,131	$ (962)	$ 169	$(106)	$ 63
Facility closure costs	414	(184)	230	(124)	106
Relocation	99	(65)	34	(18)	16
Other exit costs	100	(83)	17	(12)	5
	$1,744	$(1,294)	$ 450	$(260)	$190
	$2,531	$(1,529)	$1,002	$(659)	$343

Employee separations related to the 1998 and 1999 restructuring plans were 1,100 and 4,900, respectively, during 2000. Total employee separations related to the 1998 and 1999 restructuring plans were 23,400 as of December 31, 2000.

Other Income and Expense

Other income and expense changed from income of $1.1 billion in 1999 to a $1.7 billion expense in 2000, primarily due to a gain on sale of businesses recorded in 1999 and an investment impairment charge recorded in 2000. In August 1999, Compaq sold an 81.5 percent equity interest in AltaVista for approximately 38 million CMGI common shares, CMGI preferred shares convertible into 3.6 million CMGI common shares and a $220 million three-year note receivable. Total consideration received from CMGI was valued at $1.8 billion. After adjusting for the net assets sold and for the expenses associated with the divestiture, Compaq realized a gain of approximately $1.2 billion ($670 million, net of tax). Compaq recorded a $1.8 billion ($1.1 billion, net of tax) impairment charge during 2000 for certain equity investments, principally Compaq's CMGI investment, that were judged to have experienced an other than temporary decline in value. Excluding the investment impairment charge noted above, net investment income was $188 million ($122 million, net of tax) in 2000 compared with $67 million ($44 million, net of tax) in 1999.

Purchased In-Process Technology

As previously reported, upon consummation of the Digital acquisition in June 1998, Compaq expensed approximately $3.2 billion of purchased in-process technology that had not yet reached technological feasibility and had no alternative future use. The value was determined by estimating the costs to develop the purchased in-process technology into commercially viable products, estimating the resulting net cash flows from such projects and discounting the net cash flows back to their present values. If these projects are not successfully developed, Compaq's revenue and profitability may be adversely affected in future periods. Additionally, the value of other intangible assets acquired may become impaired. Compaq is continually monitoring its development projects and as expected in the normal course of product development, certain projects have experienced delays and other projects are being evaluated due to changes in strategic direction and market conditions.

Liquidity and Capital Resources

Compaq's cash and cash equivalents decreased to $2.6 billion at December 31, 2000, from $2.7 billion at December 31, 1999. The decrease resulted primarily from $1.2 billion used in investing activities, offset in part by $565 million and $298 million provided by operating activities and financing activities, respectively.

Net cash of $565 million provided by operating activities consisted primarily of net income adjusted for non-cash items of $3.1 billion, offset by $3.0 billion used in working capital and other activities. Net cash used in working capital and other activities resulted primarily from an increase in receivables and other assets as well as cash payments for restructuring activities, partially offset by an increase in other current liabilities. Days sales outstanding were 53 days and 52 days for 2000 and 1999, respectively. From time to time, Compaq may sell accounts receivable when it is economically beneficial. Accounts receivable sold were $328 million and $238 million at December 31, 2000 and 1999, respectively. Inventory turns were 14.4 and 14.8 in 2000 and 1999, respectively.

Net cash of $1.2 billion used in investing activities resulted primarily from the following items. Compaq paid cash of $370 million for the acquisition of Inacom. Compaq also used cash of $1.1 billion for capital expenditures, net of disposals. Cash of $364 million was used in other investing activities. These items were partially offset by a $636 million decrease in short-term investments.

Cash provided by financing activities of $298 million consisted primarily of increases in long-term debt and short-term borrowings of $575 million and $258 million, respectively, partially offset by common stock transactions of $365 million and dividends paid to stockholders of $170 million.

Estimated future uses of cash in 2001 include capital expenditures for land, buildings and equipment of approximately $1.0 billion, purchases of equipment to be leased to third parties of approximately $475 million and approximately $630 million for the repurchase of Compaq common shares.

Compaq also plans to use available liquidity to develop the purchased in-process technology related to the Digital acquisition into commercially viable products. At December 31, 2000, the estimated costs to be incurred to develop the purchased in-process technology into commercially viable products totaled approximately $1.4 billion in the aggregate through the year 2004 ($430 million in 2001, $420 million in 2002, $380 million in 2003 and $200 million in 2004).

Compaq currently expects to fund expenditures for capital requirements as well as liquidity needs from a combination of available cash balances, internally generated funds and financing arrangements. Compaq has a $2.2 billion revolving credit facility that expires in September 2001 and a $3.0 billion revolving credit facility that expires in October 2002. The facilities bear interest at LIBOR plus 0.625 percent and LIBOR plus 0.325 percent, respectively. Both of these facilities were unused at December 31, 2000 and 1999. Compaq also operates two short-term commercial paper programs: a $1.5 billion program in the name of Compaq Computer Corporation and a $1.0 billion program in the name of Compaq Financial Services Corporation ("CFS"). Both programs are supported by the $3.0 billion credit facility. Outstanding commercial paper reduces available borrowings under this credit facility. At December 31, 2000, Compaq had $418 million and $218 million in commercial paper outstanding under the Compaq and CFS programs, respectively, with a weighted average interest rate of 7.5 percent. The carrying amounts of the borrowings under the commercial paper programs approximate their fair value. Additionally, Compaq maintains various uncommitted lines of credit, which totaled approximately $275 million at December 31, 2000. There were no outstanding borrowings against these lines at December 31, 2000 and 1999. Compaq believes that these sources of credit provide sufficient financial flexibility to meet future funding requirements. Compaq continually evaluates the need to establish other sources of working capital and will pursue those it considers appropriate based upon its needs and market conditions.

Compaq filed a $2.0 billion shelf registration statement for debt securities with the Securities and Exchange Commission during the second quarter of 2000. In August 2000, Compaq placed under the registration statement $300 million of unsecured 7.65 percent notes that mature on August 1, 2005, and $275 million of unsecured 7.45 percent notes that mature on August 1, 2002 (collectively, the "Notes"), unless previously redeemed. Interest will be paid on the Notes on February 1 and August 1 of each year, beginning on February 1, 2001. The fair value of the Notes approximates carrying value. The financing is for general corporate purposes (including investments in CFS and other subsidiaries), capital expenditures, and repayment of outstanding indebtedness (including commercial paper issued for working capital purposes). Compaq has the capacity to issue an additional $1.4 billion of debt securities under the shelf registration statement.

Factors That May Affect Future Results

Compaq participates in a highly volatile industry that is characterized by intense industry-wide competition. Industry participants confront aggressive pricing practices by competitors, continually changing customer demand patterns and rapid technological developments. The following cautionary statements discuss important factors that could cause actual results to differ materially from the projected results contained in the forward-looking statements in this Annual Report.

Component shortages could curtail production. From time to time, supply for key components in Compaq's products lags behind worldwide demand. In the event that supply of a key material component is delayed or curtailed, Compaq's ability to ship the related product in desired quantities and in a timely manner could be adversely affected. Compaq attempts to mitigate the risks of component shortages by working closely with key suppliers on product plans, coordinated product introductions, purchases on the spot market and selected strategic purchases.

Delays in implementation of changes in delivery models could negatively affect financial results. Compaq sells directly to end users in all market sectors, but the largest proportion of direct sales is in large enterprise accounts. Products in Commercial Personal Computing are sold primarily through third-party resellers while products in Consumer are sold principally through retail outlets. As compared to Compaq, many Compaq competitors sell a higher percentage of their personal computer products directly to end user customers. Direct sales may afford such competitors an advantage that will allow them to price products lower than Compaq's products are priced or to compete on terms of service that Compaq cannot match. Compaq has established a variety of programs designed to achieve similar operational capabilities by simplifying its product-set and pricing model, re-engineering the channel delivery model and more rapidly expanding e-commerce capabilities for large, medium and small businesses.

Competitive environment places pressure on revenue, gross margins and market share. Competition remains intense in the information technology industry with a large number of competitors vying for customers and market share, domestically and internationally. Competition creates an aggressive pricing environment, which continues to put pressure on revenue, gross margins and market share, which is particularly acute during market slowdowns.

Unanticipated delays in product schedules could affect product demand. The process of developing new high-technology products and services is complex and often uncertain. Successful product transitions and deployment of new products requires accurate predictions of the product development schedule as well as volumes, product mix, customer demand and configuration. Compaq may also anticipate demand and perceived market acceptance that differs from the product's realizable customer demand and revenue stream. Further, in the face of intense competition in the industry, any delay in a new product rollout could decrease any advantage Compaq may have to be the first to market. A failure on the part of Compaq to carry out a product rollout in the time frame anticipated and in the quantities appropriately matching current customer demand could directly affect the future demand for the product and the profitability of Compaq's operations.

New form factors introduce uncertainty into the market. The increasing reliance on the Internet is creating new dynamics in the computer industry. As businesses and consumers turn to the Internet, speed and connectivity may become more critical than stand-alone power for client devices. Compaq is introducing a new generation of Internet devices built around simple form factors, customized functions and wireless mobility. Compaq's products will vie for customer acceptance and market share against those of computer companies as well as consumer electronics and telecommunications companies. Hardware products, which are Compaq's traditional area of strength, may become less important than service offerings in attracting and retaining customers. In addition, as new form factors are adopted, sales of traditional personal computers may decline.

Changes in the services business could adversely affect earnings. Compaq's Global Services business has traditionally provided services that included the design and implementation of high-end proprietary systems. If the trend for design and implementation of systems continues to move from proprietary environments to industry standard products, Compaq will need to continue and accelerate retraining its services personnel to compete in the new environment. There can be no assurance that Compaq will be able to successfully continue training, attracting and retaining the necessary personnel to achieve this transition as Compaq adapts its service practices to changing conditions.

Competition for talented employees could hamper business operations. Compaq, like all technology companies, must compete for talented employees in a market where the demand for such individuals exceeds the number of qualified candidates. As a result, Compaq's human resources organization focuses significant efforts on attracting and retaining individuals in key technology positions internationally. These efforts have generated positive results in terms of both reducing attrition rates and filling openings created by prior employee losses. Declining stock market prices, however, make retention more difficult as prior equity grants contain less value and key employees pursue equity opportunities elsewhere. Should Compaq experience a substantial loss of talent or an inability to attract talent for key openings, particularly in critical markets, the resulting talent gaps could impact Compaq's ability to meet its business objectives.

Credit risks could increase if financial condition of resellers or equipment lessees erodes. Much of Compaq's revenue results from selling products through distributors and resellers. Compaq continually monitors and manages the credit it extends to distributors and resellers and attempts to limit credit risks by utilizing risk transfer arrangements and obtaining security interests. The industry's trend from indirect sales models to direct sales models may reduce the market opportunities for the number of distributors or resellers in the market. Compaq's business could be adversely affected in the event that the financial condition of its distributors and resellers erodes. Upon the financial failure of a distributor or reseller, Compaq could experience disruptions in distribution as well as a loss associated with the unsecured portion of any outstanding accounts receivable. Additionally, through its wholly owned subsidiary, CFS, Compaq provides information technology leasing and financing solutions to customers. As a consequence, Compaq is exposed to the risk that lessees will be unable to make required lease payments and to the risk that leased equipment will be worth less upon its return to Compaq than was estimated at lease inception. While Compaq believes that its allowances for credit losses are adequate and that its estimates of the residual value of leased equipment are reasonable, there can be no assurance that such allowances will cover actual losses or that estimated residual values will be realized.

Delays in new systems implementation could hamper operational efficiency. Compaq continues to focus on increasing the effectiveness and efficiency of its business and information management processes to increase customer satisfaction, improve productivity and lower costs. In 2001, Compaq is focusing on improvements required to support more direct sales and changes in manufacturing supply chain operations. Efforts to improve systems infrastructure and increase system security could be hampered by the need to balance increased operational efficiency against budgetary constraints. Delays in implementing further improvements could adversely affect inventory levels, cash and related profitability.

QUARTERLY SALES CYCLE MAKES PLANNING AND OPERATIONAL EFFICIENCIES DIFFICULT. Compaq, like other computer companies, generally sells more products in the third month of each quarter than in the first and second months. This sales pattern places pressure on manufacturing and logistics systems based on internal forecasts and may adversely affect Compaq's ability to predict its financial results accurately. In addition, to rationalize manufacturing utilization, Compaq may build products early in the quarter in anticipation of demand late in the quarter. Developments late in a quarter, such as lower-than-anticipated product demand, a systems failure, or component pricing movements, can adversely impact inventory levels, cash and related profitability in a manner that is disproportionate to the number of days in the quarter affected.

MINORITY INVESTMENTS COULD ADVERSELY AFFECT LIQUIDITY AND EARNINGS. Compaq holds minority interests in companies having operations or technology in areas within Compaq's strategic focus. Some of these investments are in research and development, start-up or development stage companies or companies where operations are not yet sufficient to establish them as going concerns. As a result, Compaq may be called upon under contractual or other terms to provide funding for operations of such companies and may share in the losses of such entities. Certain investments are in publicly traded companies whose share prices are highly volatile. Adverse changes in market conditions or poor operating results of underlying investments could result in Compaq incurring losses or an inability to recover the carrying value of its investments.

DOING BUSINESS IN CERTAIN LOCATIONS CREATES ADDITIONAL RISKS. Manufacturing operations in developing countries, such as Brazil and China, and the expansion of sales into economically volatile areas such as Asia-Pacific, Latin America and other emerging markets, subject Compaq to a number of economic and other risks, such as financial instability among resellers in these regions and the volatility of economic conditions in countries that are dependent on exports from the U.S. and European markets. Compaq generally has experienced longer accounts receivable cycles in emerging markets, in particular Asia-Pacific and Latin America, when compared with U.S. and European markets. Compaq is also subject to any political and financial instability in the countries in which it operates, including inflation, recession, currency devaluation and interest rate fluctuations. Compaq continues to monitor its business operations in these regions and takes various measures to manage risks in these areas.

EXPENSE CONSTRAINTS COULD IMPEDE OPERATIONS. Compaq is focused on bringing its operational expense to appropriate levels for each of its businesses while simultaneously implementing extensive new programs. The significant risks associated with these actions include the failure to expend sufficient revenue generating advertising and marketing funds, unanticipated consequences of reductions in personnel devoted to ongoing programs, and the failure to meet operating expense targets by not matching commitments in new programs to reductions in ongoing programs.

INCOME TAXES. Compaq anticipates an effective tax rate of 30 percent for 2001. Compaq's manufacturing entity in Singapore is subject to a tax holiday that is not expected to extend beyond 2001. Compaq's tax rate has historically been heavily dependent upon the proportion of earnings derived from its Singaporean manufacturing subsidiary and its ability to reinvest those earnings permanently outside the United States. If Compaq's intercompany transfer pricing with respect to its Singaporean manufacturing subsidiary for prior years requires significant adjustment due to audits or regulatory changes, Compaq's overall tax rate could increase.

At December 31, 2000, Compaq had a deferred tax asset of $379 million related to net operating loss carryforwards which, if not utilized, will generally expire between 2001 and 2020 and credit carryforwards of approximately $1.1 billion, which, if not utilized, will generally expire between 2001 and 2014. Compaq had a valuation allowance of $434 million as of December 31, 2000 against the net operating loss and credit carryforwards. Compaq has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. In the event Compaq were to determine that it would not be able to realize all or part of its net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

CURRENCY FLUCTUATIONS. Compaq's risks associated with currency fluctuations are as follows.

MARKET RISKS

Compaq is exposed to market risks, which include changes in U.S. and international interest rates as well as changes in currency exchange rates as measured against the U.S. dollar and each other. Compaq attempts to reduce these risks by utilizing derivatives and other financial instruments.

Compaq uses market valuations and value-at-risk valuation methods to assess the market risk of its financial instruments and derivative portfolios. It uses software by RiskMetrics to estimate the value-at-risk of its financial instruments and derivative portfolios based on estimates of volatility and correlation of market factors drawn from RiskMetrics data sets for the dates calculated. RiskMetrics defines loss as a reduction in the value of a portfolio in the event of adverse market conditions, using a predetermined confidence interval, over a specified period of time. Compaq included all fixed income investments, interest rate swaps, and foreign exchange contracts in the value-at-risk calculation. See Note 1 and Note 13 in the Notes to the Consolidated Financial Statements for further information regarding these instruments. The holding period for these instruments varies from one day to nine months, with the exception of instruments held by CFS which have holding periods up to four years. The measured value-at-risk from holding derivative and other financial instruments, using a 95 percent confidence level and assuming normal market conditions during the years ended December 31, 2000 and 1999, was immaterial.

The value of the U.S. dollar affects Compaq's financial results. Changes in exchange rates may positively or negatively affect Compaq's revenues, gross margins, operating expenses and retained earnings as expressed in U.S. dollars. Compaq engages in hedging programs aimed at limiting in part the impact of currency fluctuations. Compaq primarily uses forward exchange contracts to hedge those assets and liabilities that impact the income statement when remeasured according to accounting principles generally accepted in the United States. For some markets, Compaq has determined that ongoing hedging of non-U.S. dollar net monetary assets is not cost effective and instead attempts to minimize currency exposure risk through working capital management. There can be no assurance that such an approach will be successful, especially if a significant and sudden decline occurs in the value of local currencies. Compaq purchases foreign currency option contracts from time to time as well as short-term forward exchange contracts to protect against currency exchange risks associated with the anticipated revenues of Compaq's international marketing subsidiaries, with the exception of certain subsidiaries that reside in countries in which such activity would not be cost effective or local regulations preclude this type of activity. These hedging activities provide only limited protection against currency exchange risks. Factors that could impact the effectiveness of Compaq's hedging programs include accuracy of sales forecasts, volatility of the currency markets and availability of hedging instruments. All currency contracts that are entered into by Compaq are components of hedging programs and are entered into for the sole purpose of hedging an existing or anticipated currency exposure, not for speculation. Although Compaq maintains these programs to reduce the impact of changes in currency exchange rates, Compaq's revenues or costs are adversely affected when the U.S. dollar sustains a strengthening position against currencies in which Compaq sells products and services or a weakening exchange rate against currencies in which Compaq incurs costs.

Changes in interest rates affect interest income earned on Compaq's cash equivalents and short-term investments, and interest expense on short-term borrowings. Compaq does not enter into derivative transactions related to its cash, cash equivalents or short-term investments. Compaq does periodically enter into interest rate swap transactions for the purpose of hedging existing or anticipated liabilities. All interest rate swaps entered into by Compaq are for the sole purpose of hedging existing or anticipated interest rate sensitive positions, not for speculation.

Compaq is exposed to equity price risks on the marketable portion of investments in publicly traded equity securities. These investments are generally in companies having operations or technology in areas within Compaq's strategic focus. Compaq does not attempt to reduce or eliminate its market exposure on these securities. As of December 31, 2000, the fair value of Compaq's available-for-sale investments was $461 million. A 20 percent adverse change in equity prices would result in an approximate $92 million decrease in the fair value of Compaq's available-for-sale securities as of December 31, 2000.

Because of the foregoing factors (Factors That May Affect Future Results and Market Risks), as well as other variables affecting Compaq's operating results, past financial performance should not be considered a reliable indicator of future performance and investors should not use historical trends to anticipate results or trends in future periods.

consolidated balance sheet

in millions, except par value	December 31 2000	1999
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,569	$ 2,666
Short-term investments	—	636
Trade accounts receivable, net	6,715	5,622
Leases and other accounts receivable	1,677	1,063
Inventories	2,161	2,008
Other assets	1,989	1,854
Total current assets	15,111	13,849
Property, plant and equipment, net	3,431	3,249
Other assets, net	6,314	10,179
Total assets	$24,856	$27,277
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	$ 711	$ 453
Accounts payable	4,233	4,380
Deferred income	1,089	972
Other liabilities	5,516	6,033
Total current liabilities	11,549	11,838
Long-term debt	575	—
Postretirement and other postemployment benefits	652	605
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.01 par value		
Shares authorized: 10 million shares; shares issued: none	—	—
Common stock and capital in excess of $.01 par value		
Shares authorized: 3 billion		
Shares issued: 2000 – 1,742 million; 1999 – 1,715 million	8,039	7,627
Retained earnings	5,347	4,948
Accumulated other comprehensive income	27	2,919
Treasury stock (shares: 2000 – 53 million; 1999 – 21 million)	(1,333)	(660)
Total stockholders' equity	12,080	14,834
Total liabilities and stockholders' equity	$24,856	$27,277

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

consolidated statement of income

in millions, except per share amounts	Year ended December 31 2000	1999	1998
Revenue:			
Products	$35,667	$31,902	$27,372
Services	6,716	6,623	3,797
Total revenue	42,383	38,525	31,169
Cost of sales:			
Products	27,624	25,263	21,383
Services	4,793	4,535	2,597
Total cost of sales	32,417	29,798	23,980
Selling, general and administrative expense	6,044	6,341	4,978
Research and development	1,469	1,660	1,353
Restructuring and related activities	(86)	868	393
Purchased in-process technology	—	—	3,196
Other (income) expense, net	1,664	(1,076)	(69)
	9,091	7,793	9,851
Income (loss) before income taxes	875	934	(2,662)
Provision for income taxes	280	365	81
Income (loss) before cumulative effect of accounting change	595	569	(2,743)
Cumulative effect of accounting change, net of tax	(26)	—	—
Net income (loss)	$ 569	$ 569	$ (2,743)
Earnings (loss) per common share:			
Basic:			
Before cumulative effect of accounting change	$ 0.35	$ 0.35	$ (1.71)
Cumulative effect of accounting change, net of tax	(0.02)	—	—
	$ 0.33	$ 0.35	$ (1.71)
Diluted:			
Before cumulative effect of accounting change	$ 0.34	$ 0.34	$ (1.71)
Cumulative effect of accounting change, net of tax	(0.01)	—	—
	$ 0.33	$ 0.34	$ (1.71)
Shares used in computing earnings (loss) per common share:			
Basic	1,702	1,693	1,608
Diluted	1,742	1,735	1,608

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

consolidated statement of cash flows

in millions	Year ended December 31 2000	1999	1998
Cash flows from operating activities:			
Net income (loss)	$ 569	$ 569	$ (2,743)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	1,407	1,402	893
Investment impairment	1,756	—	—
Gain on sale of businesses	—	(1,182)	—
Restructuring and related activities	(86)	868	393
Purchased in-process technology	—	—	3,196
Deferred income taxes and other	(26)	21	(53)
Changes in assets and liabilities, net of effects of acquired and divested businesses:			
Receivables	(1,920)	185	(1,736)
Inventories	(72)	(97)	857
Accounts payable	(228)	135	589
Other assets and liabilities	(835)	(598)	(518)
Net cash provided by operating activities	565	1,303	878
Cash flows from investing activities:			
Capital expenditures, net	(1,133)	(1,185)	(600)
(Increase) decrease in short-term investments	636	(636)	344
Acquisition of businesses, net of cash acquired	(370)	(517)	(1,413)
Other investing activities, net	(364)	(131)	(798)
Net cash used in investing activities	(1,231)	(2,469)	(2,467)
Cash flows from financing activities:			
Increase in short-term borrowings	258	453	—
Issuance (repayment) of long-term debt	575	—	(788)
Common stock transactions, net	(365)	(93)	23
Dividends to stockholders	(170)	(136)	(95)
Payments to retire Digital preferred stock	—	(400)	—
Other financing activities	—	—	(18)
Net cash provided by (used in) financing activities	298	(176)	(878)
Effect of exchange rate changes on cash and cash equivalents	271	(83)	140
Net decrease in cash and cash equivalents	(97)	(1,425)	(2,327)
Cash and cash equivalents at the beginning of the year	2,666	4,091	6,418
Cash and cash equivalents at the end of the year	$ 2,569	$ 2,666	$ 4,091

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

consolidated statement of cash flows – *supplemental cash flow information*

in millions	Year ended December 31 2000	1999	1998
Interest paid	$ 288	$ 152	$ 175
Income taxes paid	$ 488	$ 415	$ 259
ACQUISITION OF BUSINESSES			
Fair value of:			
Assets acquired	$ 499	$ 811	$16,124
Liabilities assumed	(129)	(201)	(7,109)
Stock issued	—	—	(4,284)
Options issued	—	(60)	(249)
Cash paid	370	550	4,482
Less: Cash acquired	—	(33)	(3,069)
Net cash paid for acquisitions	$ 370	$ 517	$ 1,413
SALE OF BUSINESSES			
Fair value of:			
Equity proceeds	$ —	$ 1,597	$ —
Note receivable	—	204	—
Cash received	—	70	—
	—	1,871	—
Less: Basis in net assets sold	—	(689)	—
Gain on sale of businesses	$ —	$ 1,182	$ —

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

consolidated statement of stockholders' equity

in millions	Common Stock: Number of Shares	Common Stock: Par Value and Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Beginning balance, December 31, 1997	1,519	$2,096	$ 7,351	$ (18)	$ —	$ 9,429
Comprehensive income:						
Net loss			(2,743)			(2,743)
Foreign currency translation adjustment				20		20
Minimum pension liability adjustment				(38)		(38)
Total comprehensive loss						(2,761)
Issuance pursuant to stock option plans	36	407				407
Issuance pursuant to acquisitions	141	4,533				4,533
Stock option tax benefits and other	2	234				234
Cash dividends			(107)			(107)
Repurchase treasury stock, at cost					(384)	(384)
Ending balance, December 31, 1998	1,698	$7,270	$ 4,501	$ (36)	$ (384)	$11,351
Comprehensive income:						
Net income			569			569
Changes in unrealized gains and losses on investments, net of reclassifications				2,978		2,978
Foreign currency translation adjustment				(26)		(26)
Minimum pension liability adjustment				3		3
Total comprehensive income						3,524
Issuance pursuant to stock option plans	17	183				183
Issuance pursuant to acquisitions		32				32
Stock option tax benefits		142				142
Gain on redemption of Digital preferred stock			22			22
Cash dividends			(144)			(144)
Repurchase of treasury stock, at cost					(276)	(276)
Ending balance, December 31, 1999	1,715	$7,627	$ 4,948	$ 2,919	$ (660)	$14,834
Comprehensive income:						
Net income			569			569
Changes in unrealized gains and losses on investments, net of reclassifications				(2,904)		(2,904)
Foreign currency translation adjustment				(12)		(12)
Minimum pension liability adjustment				24		24
Total comprehensive loss						(2,323)
Issuance pursuant to stock plans	27	308				308
Stock option tax benefits		104				104
Cash dividends			(170)			(170)
Repurchase of treasury stock, at cost					(673)	(673)
Ending balance, December 31, 2000	1,742	$8,039	$ 5,347	$ 27	$(1,333)	$12,080

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

notes to consolidated financial statements

NOTE 1 DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Founded in 1982, Compaq Computer Corporation ("Compaq") is a leading global provider of enterprise technology and solutions. Compaq designs, develops, manufactures and markets hardware, software, solutions and services, including industry-leading enterprise computing solutions, fault-tolerant business-critical solutions, communication products, and desktop and portable personal computers that are sold in more than 200 countries.

Compaq completed the acquisition of Digital Equipment Corporation ("Digital"), Shopping.Com ("SDC") and Zip2 Corp. ("Zip2") and purchased certain assets and liabilities of InaCom Corp. ("Inacom") in June 1998, February 1999, April 1999 and February 2000, respectively. These acquisitions were accounted for as purchases. In August 1999, Compaq sold a majority interest in SDC, Zip2 and the AltaVista Company, a business acquired in the Digital acquisition (collectively "AltaVista"), to CMGI, Inc. ("CMGI"). Accordingly, Compaq's consolidated financial statements include the results of operations from the respective dates of acquisition through divestiture or December 31, 2000, as applicable.

Principles of Consolidation

The consolidated financial statements include the accounts of Compaq and its controlled subsidiaries. All significant intercompany transactions and balances have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Cash Equivalents and Short-Term Investments

Cash equivalents include highly liquid, temporary cash investments having original maturity dates of three months or less. Short-term investments include certificates of deposit, commercial paper and other investments not qualifying as cash equivalents. For reporting purposes, such cash equivalents and short-term investments are stated at cost plus accrued interest which approximates fair value.

Inventories

Inventories are stated at the lower of cost or market, cost being determined on a first-in, first-out basis.

Long-Lived Assets

Property, plant and equipment are stated at cost less accumulated depreciation. Major renewals and improvements are capitalized; minor replacements, maintenance and repairs are charged to current operations. Depreciation is computed by applying the straight-line method over the estimated useful lives of the buildings (ten to thirty years) and by applying the straight-line or accelerated methods over the estimated useful lives of machinery and equipment (two to ten years). Leasehold improvements are amortized over the shorter of the useful life of the improvement or the life of the related lease. Compaq performs reviews for the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Long-Term Investments

Compaq holds minority equity investments in companies having operations or technology in areas within Compaq's strategic focus. Certain of the investments carry restrictions on immediate disposition. Investments in public companies with restrictions of less than one year are classified as available-for-sale and are adjusted to their fair market value with unrealized gains and losses recorded as a component of accumulated other comprehensive income. Upon disposition of these investments, the specific identification method is used to determine the cost basis in computing realized gains or losses. Declines in value that are judged to be other than temporary are reported in other income and expense.

Intangible Assets

Intangible assets primarily relate to the value of the installed customer base, proven research and development, and trademarks of companies acquired, as well as capitalized software and goodwill. The cost of the installed customer base, proven research and development, trademarks, capitalized software and goodwill is amortized on a straight-line basis over the estimated lives of fifteen years, five years, five years, up to three years and up to ten years, respectively. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Revenue recognition

Compaq recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. Generally, these criteria are met at the time product is shipped. Provision is made at the time the related revenue is recognized for estimated product returns, price protection and other offerings which may occur under programs Compaq has with its customers. Compaq provides for the estimated cost of product warranties upon shipment. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. Revenue from fixed price, long-term contracts is generally recognized over the contract term using the percentage of completion method, based on the achievement of external milestones. Losses on fixed price contracts are recognized during the period in which the loss first becomes apparent. Revenue in excess of billings on service contracts is recorded as unbilled receivables and is included in trade accounts receivable. Billings in excess of revenue recognized on service contracts are recorded as deferred income until revenue recognition criteria are met. Revenue earned from services is recognized ratably over the contractual period or as the services are performed. Shipping and handling costs are included in cost of goods sold.

Financing transactions

Compaq offers customer financing to assist customers in their acquisition of Compaq's products through its leasing subsidiary, Compaq Financial Services Corporation ("CFS"). At the time a financing transaction is consummated, which qualifies as either a sales-type or direct financing lease, Compaq records the total lease receivable net of unearned income and the estimated residual value of the equipment. The non-current portion of lease receivables and the residual value, net of unearned income, are included in long-term other assets. Unearned income is recognized as finance income using the interest method over the term of the lease. Leases not qualifying as either sales-type or direct financing leases are accounted for as operating leases. The underlying equipment is depreciated on a straight-line basis over the initial term of the operating lease to its estimated residual value.

Advertising costs

Advertising costs are charged to operations when incurred. Advertising expenses for 2000, 1999 and 1998 were $370 million, $385 million and $336 million, respectively.

Foreign currency

Compaq's foreign subsidiaries predominately have the U.S. dollar designated as their functional currency. Financial statements of these foreign subsidiaries are remeasured to U.S. dollars for consolidation purposes using current rates of exchange for monetary assets and liabilities and historical rates of exchange for nonmonetary assets and related elements of expense. Revenue and other expense elements are remeasured at rates that approximate the rates in effect on the transaction dates. Remeasurement gains and losses are included in other income and expense. Certain foreign subsidiaries designate the local currency as their functional currency and related cumulative translation adjustments are included as a component of accumulated other comprehensive income.

Income taxes

Compaq accounts for income taxes under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. The asset and liability approach is used to recognize deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. Compaq records a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized.

Earnings per common share

Basic earnings (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed using the combination of dilutive common share equivalents and the weighted average number of common shares outstanding during the period. Incremental shares of 40 million and 42 million in 2000 and 1999, respectively, were used in the calculation of diluted earnings per common share. Diluted loss per common share for 1998 is based only on the weighted average number of common shares outstanding during the period, as the inclusion of 60 million common share equivalents would have been antidilutive. Stock options to purchase 107 million, 66 million and 13 million shares of common stock in 2000, 1999 and 1998, respectively, were outstanding but not included in the computation of diluted earnings (loss) per common share because the option exercise price was greater than the average market price of the common shares. For the year ended December 31, 1999, net income used in the calculation of earnings per common share was adjusted to include a $22 million gain on redemption of Digital preferred stock.

Stock-based compensation

Compaq measures compensation expense for its stock-based employee compensation plans using the intrinsic value method, and has provided in Note 8 the pro forma disclosure of the effect on net income (loss) and earnings (loss) per common share as if the fair value based method had been applied in measuring compensation expense.

Comprehensive income (loss)

Other comprehensive income (loss) refers to revenues, expenses, gains and losses that under accounting principles generally accepted in the United States are included in comprehensive income (loss) but are excluded from net income (loss) as these amounts are recorded directly as an adjustment to stockholders' equity, net of tax. Compaq's other comprehensive income (loss) is composed of unrealized gains and losses on available-for-sale securities, foreign currency translation adjustments and adjustments made to recognize additional minimum liabilities associated with Compaq's defined benefit pension plans. Amounts relating to realized investment gains and losses and investment impairment charges are reclassified from other comprehensive income as they are included in net income.

Segment data

Compaq reports segment data based on the management approach which designates the internal reporting that is used by management for making operating decisions and assessing performance as the source of Compaq's reportable operating segments. Compaq also discloses information about products and services, geographical areas and major customers.

Recent pronouncements

Effective January 1, 2001, Compaq adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended ("FAS 133"). This statement establishes a new model for accounting for derivatives and hedging activities. Under FAS 133, all derivatives must be recognized as assets and liabilities and measured at fair value. The impact of the adoption will be based on factors such as specific derivative and hedging activities, market conditions and contractual arrangements at the date of adoption. The effect of the adoption will not have a significant impact on Compaq's financial position or results of operations in 2001.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 2 ACCOUNTING CHANGE

Effective January 1, 2000, Compaq adopted Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, as amended ("SAB 101"), issued by the Securities and Exchange Commission in December 1999. Compaq's adoption of SAB 101 resulted in a change in method of accounting for certain revenue product shipments. The cumulative effect of this accounting change was $38 million ($26 million, net of tax). The accounting change did not have a material effect on revenue or quarterly earnings during 2000. Compaq has restated its results for the first three quarters of the year ended December 31, 2000, as reflected in the Selected Quarterly Financial Data on page 66. Pro forma results for prior years are not disclosed due to immateriality.

NOTE 3 ACQUISITIONS AND DIVESTITURES

In February 2000, Compaq acquired certain configuration and distribution assets of Inacom, a provider of information technology services and products, for approximately $370 million in cash and the assumption of certain related liabilities. This acquisition was accounted for as a purchase. The estimated purchase price was allocated to the assets acquired and liabilities assumed, including goodwill of $230 million which is being amortized on a straight-line basis over a period of ten years. Pro forma statements of operations reflecting this acquisition are not shown as such disclosure is not material.

In August 1999, Compaq sold an 81.5 percent equity interest in AltaVista for approximately 38 million CMGI common shares, CMGI preferred shares convertible into 3.6 million CMGI common shares and a $220 million three-year note receivable. In October 1999, CMGI converted the CMGI preferred shares held by Compaq into 3.6 million CMGI common shares. The CMGI common shares acquired by Compaq in this transaction carry certain restrictions whereby Compaq may not sell more than 50 percent (20.8 million) of such shares prior to August 2001. Total consideration received from CMGI was valued at $1.8 billion. After adjusting for the net assets sold and for the expenses associated with the divestiture, Compaq realized a gain of approximately $1.2 billion ($670 million, net of tax). Compaq accounts for its minority investments in CMGI and AltaVista under the cost method. All CMGI share information reflects CMGI's two-for-one stock split, effective January 2000.

In April 1999, Compaq acquired Zip2 for an aggregate purchase price of $341 million consisting of $307 million in cash, the issuance of employee stock options to purchase AltaVista stock with a fair value of $28 million and other acquisition costs. In February 1999, Compaq acquired SDC for an aggregate purchase price of $257 million consisting of $219 million in cash, the issuance of employee stock options to purchase Compaq stock with a fair value of $32 million and other acquisition costs. These transactions were accounted for as purchases.

In June 1998, Compaq consummated its acquisition of Digital for an aggregate purchase price of $9.1 billion. The purchase price consisted of approximately $4.5 billion in cash, the issuance of approximately 141 million shares of Compaq common stock valued at approximately $4.3 billion and the issuance of approximately 25 million options to purchase Compaq common stock valued at approximately $249 million. This acquisition was accounted for as a purchase. The unaudited consolidated pro forma information for 1998 as if Compaq and Digital had been combined as of the beginning of 1998 included revenue and net income of $36.4 billion and $275 million, respectively, and basic and diluted earnings per common share of $0.16 each.

NOTE 4 CERTAIN BALANCE SHEET COMPONENTS

Compaq's trade accounts receivable are reported net of allowance for doubtful accounts of $211 million and $222 million at December 31, 2000 and 1999, respectively. Other current assets include deferred tax assets of $1.7 billion and $1.5 billion at December 31, 2000 and 1999, respectively. The net investment in lease receivables consisted of the following:

	December 31	
in millions	2000	1999
Minimum lease payment receivable	$1,868	$1,160
Unguaranteed residual values	122	59
Initial direct costs	21	12
Allowance	(27)	(12)
Unearned income	(217)	(118)
	$1,767	$1,101

Contractual maturities of Compaq's lease receivables at December 31, 2000 were $866 million in 2001, $601 million in 2002, $328 million in 2003, $66 million in 2004 and $7 million in 2005. Compaq also leases its products to customers under operating leases. Minimum future rentals under operating leases at December 31, 2000 were $426 million in 2001, $244 million in 2002 and $48 million in 2003.

Inventories consisted of the following:

	December 31	
in millions	2000	1999
Raw material	$ 540	$ 448
Work-in-progress	298	394
Finished goods	1,323	1,166
	$2,161	$2,008

Property, plant and equipment consisted of the following:

	December 31	
in millions	2000	1999
Land	$ 342	$ 342
Buildings and leasehold improvements	1,493	1,572
Machinery and equipment	3,786	3,095
Equipment leased to third parties	1,166	741
Construction-in-process	261	301
	7,048	6,051
Less: Accumulated depreciation	(3,617)	(2,802)
	$ 3,431	$ 3,249

Depreciation expense totaled $1.1 billion, $839 million and $606 million in 2000, 1999 and 1998, respectively. Accumulated depreciation related to equipment leased to third parties was $422 million and $224 million at December 31, 2000 and 1999, respectively.

Other non-current assets consisted of the following:

	December 31	
in millions	2000	1999
Investments	$ 864	$ 6,617
Intangible assets	2,637	2,351
Deferred income taxes	1,604	342
Other assets	2,032	1,442
	7,137	10,752
Less: Accumulated amortization	(823)	(573)
	$6,314	$10,179

Amortization expense related to intangible assets totaled $313 million, $563 million and $287 million in 2000, 1999 and 1998, respectively. The cost basis and fair value of Compaq's available-for-sale securities at December 31, 2000 was $350 million and $461 million, respectively. Gross unrealized gains and gross unrealized losses related to these investments at December 31, 2000 were $132 million ($86 million, net of tax) and $21 million ($14 million, net of tax), respectively. At December 31, 1999, the cost basis and fair value of available-for-sale securities was $857 million and $5.4 billion, respectively, and the cumulative unrealized gain was $4.6 billion ($3.0 billion, net of tax). Compaq made cash purchases of investments of approximately $480 million and $89 million during 2000 and 1999, respectively.

Other current liabilities consisted of the following:

	December 31	
in millions	2000	1999
Salaries, wages and related items	$ 922	$ 644
Accrued restructuring costs	343	1,002
Income taxes payable	769	992
Accrued warranties	938	937
Other accrued liabilities	2,544	2,458
	$5,516	$6,033

NOTE 5 BORROWINGS

Compaq has a $2.2 billion revolving credit facility that expires in September 2001 and a $3.0 billion revolving credit facility that expires in October 2002. The facilities bear interest at LIBOR plus 0.625 percent and LIBOR plus 0.325 percent, respectively. Fees associated with these facilities are immaterial. Both of these facilities were unused at December 31, 2000 and 1999. Compaq also operates two short-term commercial paper programs: a $1.5 billion program in the name of Compaq Computer Corporation and a $1.0 billion program in the name of CFS. Both programs are supported by the $3.0 billion credit facility. Outstanding commercial paper reduces available borrowings under this credit facility. At December 31, 2000, Compaq had $418 million and $218 million in commercial paper outstanding under the Compaq and CFS programs, respectively, with a weighted average interest rate of 7.5 percent. The carrying amounts of the borrowings under the commercial paper program approximate their fair value. Additionally, Compaq maintains various uncommitted lines of credit, which totaled approximately $275 million at December 31, 2000. There were no outstanding borrowings against these lines at December 31, 2000 and 1999.

Compaq filed a $2.0 billion shelf registration statement for debt securities with the Securities and Exchange Commission during the second quarter of 2000. In August 2000, Compaq placed under the registration statement $300 million of unsecured 7.65 percent notes that mature on August 1, 2005, and $275 million of unsecured 7.45 percent notes that mature on August 1, 2002 (collectively, the "Notes"), unless previously redeemed. Interest will be paid on the Notes on February 1 and August 1 of each year, beginning on February 1, 2001. The fair value of the Notes approximates carrying value. The financing is for general corporate purposes (including investments in CFS and other subsidiaries), capital expenditures and repayment of outstanding indebtedness (including commercial paper issued for working capital purposes). Compaq has the capacity to issue an additional $1.4 billion of debt securities under the shelf registration statement.

NOTE 6 OTHER INCOME AND EXPENSE

Other (income) expense consisted of the following:

	Year ended December 31		
in millions	2000	1999	1998
Investment (income) loss, net	$1,568	$ (67)	$ (9)
Gain on sale of businesses	—	(1,182)	—
Interest and dividend income	(276)	(196)	(287)
Interest expense	273	211	166
Currency losses, net	75	136	16
Other, net	24	22	45
	$1,664	$(1,076)	$ (69)

Net investment loss in 2000 included a $1.8 billion ($1.1 billion, net of tax) impairment charge for certain equity investments judged to have experienced an other than temporary decline in value, a $252 million ($164 million,

net of tax) realized gain on the sale of available-for-sale securities and a $77 million loss from investments accounted for under the equity method. Net investment income in 1999 included a $126 million ($82 million, net of tax) realized gain on the sale of available-for-sale securities and a $52 million loss from investments accounted for under the equity method. Proceeds associated with the sale of available-for-sale securities were $264 million and $149 million in 2000 and 1999, respectively.

NOTE 7 PROVISION FOR INCOME TAXES

The components of income (loss) before provision for income taxes were as follows:

	Year ended December 31		
in millions	2000	1999	1998
Domestic	$200	$ 94	$(4,782)
Foreign	675	840	2,120
Income (loss) before income taxes	$875	$934	$(2,662)

The provisions for income taxes charged to operations were as follows:

	Year ended December 31		
in millions	2000	1999	1998
Current tax expense (benefit)			
U.S. Federal	$ (91)	$ 1	$ (92)
State and local	5	11	(9)
Foreign	353	460	312
Total current	267	472	211
Deferred tax expense (benefit)			
U.S. Federal	(91)	47	(429)
State and local	(2)	43	(11)
Foreign	106	(197)	310
Total deferred	13	(107)	(130)
Total provision	$280	$ 365	$ 81

The reasons for the differences between income tax expense and amounts calculated using the U.S. statutory rate of 35 percent were as follows:

	Year ended December 31		
in millions	2000	1999	1998
Tax expense (benefit) at U.S. statutory rate	$306	$327	$ (932)
Foreign tax effect, net	—	(31)	(40)
Non-deductible purchased in-process technology	—	—	1,119
Release of valuation allowance	—	—	(77)
Disposition of businesses	—	77	—
Recovery of operating subsidiary stock basis	(61)	—	—
Other, net	35	(8)	11
Total provision	$280	$365	$ 81

Compaq's 2000 effective tax rate was primarily affected by the recovery of tax basis in the stock of Microcom, Inc., a former operating subsidiary which was acquired in 1997. In addition, Compaq decreased the level of activity of its Singaporean manufacturing subsidiary which, when considered with other foreign effects, reduced the beneficial foreign tax effect as had occurred in previous years.

The Singapore tax holiday for manufacturing operations will continue through August 2001 and could be extended through August 2004 if cumulative investment levels and other conditions are maintained. Compaq ceased utilization of a portion of its Singaporean manufacturing subsidiary's production capacity during 2000. Consequently, the profitability of this facility has decreased significantly resulting in a corresponding decrease in the impact of the tax holiday on Compaq's effective tax rate during 2000.

Compaq's 1999 effective tax rate was primarily affected by benefits from its Singaporean manufacturing subsidiary's tax holiday and by incremental taxes resulting from the disposition of AltaVista. In connection with the 1998 acquisition of Digital, Compaq recorded non-recurring, non-tax-deductible charges for purchased in-process technology of approximately $3.2 billion.

Compaq has determined that the undistributed earnings of certain foreign subsidiaries will be permanently reinvested. As a result of these determinations, no incremental tax is reflected for the earnings of Compaq's Singaporean manufacturing subsidiary or for the earnings of certain other foreign subsidiaries. These earnings would become subject to incremental foreign withholding, Federal and state income tax if they were actually or deemed to be remitted to the U.S. Compaq estimates an additional tax provision of approximately $2.1 billion would be required if the full amount of approximately $6.2 billion in accumulated earnings were actually or deemed distributed to the U.S.

Compaq recorded a gross deferred tax asset of approximately $2.8 billion in conjunction with the acquisition of Digital in 1998. This gross deferred tax asset was reduced by a valuation allowance of $562 million, resulting in a net increase in the deferred tax asset of approximately $2.2 billion in 1998. The valuation allowance consisted principally of pre-acquisition tax loss carryforwards and credit carryforwards incurred by Digital which management has determined are more likely than not to expire unused. The valuation allowance was reduced by $95 million during 2000 and $152 million during 1999 as a result of tax loss and credit carryforward expirations.

During 1998, Compaq recorded $65 million of other tax loss and credit carryforwards for which a full valuation allowance was provided due to uncertainty surrounding their realizability. In addition, the valuation allowance was reduced by $77 million to reflect Tandem Computers Incorporated ("Tandem") credit carryforwards which, as a result of the liquidation of the U.S. Tandem parent company at the close of 1998, are now believed more likely than not to be realized. This reduction in the valuation allowance resulted in a tax benefit in the 1998 deferred income tax provision.

Deferred tax assets (liabilities) were as follows:

	December 31	
in millions	2000	1999
Loss carryforwards	$ 379	$ 1,230
Credit carryforwards	1,109	960
Accrued liabilities	748	655
Tax versus financial reporting year-end	446	—
Capitalized research and development costs	349	449
Receivable allowances and related reserves	278	380
Inventory adjustments	347	341
Other	514	273
Gross deferred tax assets	4,170	4,288
Equity investments	(46)	(1,604)
Intangible assets	(333)	(382)
Other	(87)	(27)
Gross deferred tax liabilities	(466)	(2,013)
Deferred tax asset valuation allowance	(434)	(529)
Total deferred tax asset	$3,270	$ 1,746

Tax loss carryforwards will generally expire between 2001 and 2020. Credit carryforwards will generally expire between 2001 and 2014. U.S. tax laws limit the annual utilization of tax loss and credit carryforwards of acquired entities. These limitations should not materially impact the utilization of the tax carryforwards.

NOTE 8 EMPLOYEE STOCK PLANS

Compaq maintains various stock plans for its employees. Options to employees are generally granted at the fair market value of the common stock at the date of grant and generally vest over two to five years. Options granted to employees under Compaq's stock option plans must be exercised no later than ten years from the date of grant. The vesting period and option life for grants to employees are at the discretion of the Board of Directors (the "Board").

Compaq also maintains plans under which it offers stock options to non-employee directors. Pursuant to the terms of the plans under which directors are eligible to receive options, each non-employee director is entitled to receive options to purchase common stock upon initial appointment to the Board (initial grants) and upon subsequent reelection to the Board (annual grants). Initial grants are exercisable during the period beginning one year after initial appointment to the Board and ending ten years after the date of grant. Annual grants vest over two years and are exercisable thereafter until the tenth anniversary of the date of grant. Both initial grants and annual grants have an exercise price equal to the fair market value of Compaq's common stock on the date of grant. Additionally, directors may elect to receive stock options in lieu of all or a portion of the annual retainer to be earned. Such options are granted at 50 percent of the price of Compaq's common stock at the date of grant and are exercisable during the period beginning one year after the grant date and ending ten years after the grant date. The expense resulting from options granted at 50 percent of the price of Compaq's common stock at the grant date is charged to operations over the vesting period.

Compaq had approximately 2 million shares of restricted stock outstanding at December 31, 2000. Compaq records unearned compensation equal to the market value of the restricted shares on the date of grant and charges the unearned compensation to expense over the vesting period.

At December 31, 2000, there were 336 million shares of common stock reserved for issuance under all of Compaq's stock option plans. For all plans, options of 107 million, 101 million and 88 million shares were exercisable at December 31, 2000, 1999 and 1998 with a weighted average exercise price of $20.16, $16.13 and $11.76, respectively. There were 31 million, 123 million and 217 million shares available for grant under the plans at December 31, 2000, 1999 and 1998, respectively.

The following table summarizes stock option activity for each of the three years ended December 31:

	Shares In Millions	Price Per Share	Weighted Average Price Per Share
Options outstanding, December 31, 1997	171		$13.63
Options granted in the acquisition of Digital	25	$ 5.94–$39.23	22.23
Options granted	13	$14.44–$42.00	33.35
Options lapsed or canceled	(16)		21.84
Options exercised	(36)	$ 1.30–$39.23	11.39
Options outstanding, December 31, 1998	157		16.37
Options granted	118	$ 3.36–$47.63	31.42
Options lapsed or canceled	(24)		28.18
Options exercised	(17)	$ 1.30–$39.23	9.66
Options outstanding, December 31, 1999	234		23.37
Options granted	119	$15.04–$34.08	22.74
Options lapsed or canceled	(30)		29.99
Options exercised	(23)	$ 1.58–$31.25	10.40
Options outstanding, December 31, 2000	300		$23.45

The following table summarizes significant ranges of outstanding and exercisable options at December 31, 2000:

	Options Outstanding			Options Exercisable	
Ranges of Exercise Prices	Shares In Millions	Weighted Average Remaining Life In Years	Weighted Average Exercise Price	Shares In Millions	Weighted Average Exercise Price
under $ 5.00	15	1.8	$ 3.20	15	$ 3.20
5.01 to 10.00	20	3.7	8.82	20	8.82
10.01 to 15.00	8	4.3	12.40	8	12.36
15.01 to 20.00	77	9.0	17.67	13	16.22
20.01 to 25.00	20	7.5	23.25	10	23.27
25.01 to 30.00	122	8.7	26.54	22	26.61
over $30.00	38	7.1	43.34	19	42.34
	300	7.7	$23.45	107	$20.16

In April 1999, Compaq's stockholders approved the Compaq Computer Corporation Employee Stock Purchase Plan (the "ESPP") which became effective in April 2000. Most employees are eligible to participate. Employees who choose to participate are granted an option to purchase common stock at 85 percent of market value on the first or last day of the six month purchase period, whichever is lower. The ESPP authorizes the issuance, and the purchase by employees, of up to 25 million shares of common stock through payroll deductions. No employee is allowed to buy more than $25,000 of common stock in any year, based on the market value of the common stock at the beginning of the purchase period. During 2000, employees purchased approximately 2 million shares for approximately $61 million under the ESPP. At December 31, 2000, there were approximately 23 million shares available for future purchases under the ESPP.

The weighted average fair value per share of options granted during 2000, 1999 and 1998 was $11.80, $13.22 and $12.95, respectively. The weighted average fair value per share of options granted under the ESPP during 2000 was $8.62. The fair value for these options was estimated using the Black-Scholes model with the following weighted average assumptions:

	Stock Options			ESPP
	Year ended December 31			
	2000	1999	1998	2000
Expected option life (in years)	6	5	5	0.5
Risk-free interest rate	5.0%	5.5%	4.6%	6.3%
Volatility	49.7%	39.8%	33.5%	55.9%
Dividend yield	0.4%	0.3%	0.2%	0.4%

The table that follows summarizes the pro forma effect on net income (loss) in the year presented if the fair values of stock-based compensation had been recognized as compensation expense on a straight-line basis over the vesting period of the grant. The following pro forma effect on net income (loss) for the years presented is not representative of the pro forma effect on net income (loss) in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

	Year ended December 31		
in millions, except per share amounts	2000	1999	1998
Income (loss) before income taxes:			
As reported	$ 875	$ 934	$(2,662)
Pro forma	293	623	(2,832)
Net income (loss):			
As reported	569	569	(2,743)
Pro forma	191	367	(2,854)
Diluted earnings (loss) per share:			
As reported	0.33	0.34	(1.71)
Pro forma	0.11	0.23	(1.77)

NOTE 9 STOCKHOLDERS' EQUITY

On December 29, 2000, the Board approved a cash dividend of $0.025 per share of common stock, or approximately $43 million, to stockholders of record as of December 31, 2000 to be paid in 2001. Total dividends declared in 2000, 1999 and 1998 were $170 million ($0.10 per share), $144 million ($0.085 per share) and $107 million ($0.065 per share), respectively.

During 1998, a systematic common stock repurchase program was authorized by the Board and implemented by Compaq. Compaq repurchased approximately 10 million shares during 2000, for a cost of approximately $303 million under this program. The program was implemented to reduce the dilutive impact of common shares issued under Compaq's equity incentive plans. On December 1, 2000, the Board authorized a new program for the repurchase of up to $1 billion of Compaq common shares. The systematic repurchase program initiated in 1998 has been suspended while this new program is in effect. During 2000, total shares repurchased to date under the new plan were 22 million, for a cost of approximately $370 million. Compaq accounts for treasury stock using the cost method.

In April 1999, Compaq redeemed the four million outstanding shares of the Digital Series A 8 7/8 percent Cumulative Preferred Stock, par value $1.00 per share. The redemption price was $400 million, plus accrued and unpaid dividends of $9 million. Compaq realized a gain of $22 million on the redemption that was recorded directly to retained earnings.

NOTE 10 PENSION AND OTHER BENEFIT PROGRAMS

Compaq sponsors a number of defined benefit and other postretirement employee benefit plans ("OPEB Plans") that were acquired in the Digital acquisition. Benefits under the defined benefit pension plans are generally based on pay and service. In the U.S., the defined benefit plan is a cash balance plan, under which the benefit is usually paid as a lump sum.

Compaq recorded an additional minimum liability as of December 31, 2000 and 1999 totaling $33 million and $78 million, respectively, for plans where the accumulated benefit obligation exceeded the fair market value of assets.

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for which the accumulated benefit obligations exceed plan assets approximated $401 million, $324 million and $154 million, respectively, for the year ended December 31, 2000, and $353 million, $332 million and $161 million for the year ended December 31, 1999. The measurement dates of the plans were October 31, 2000 and 1999.

Information regarding Compaq's defined benefit and OPEB Plans was as follows:

	Year ended December 31, 2000			Year ended December 31, 1999		
	Defined Benefit Pension Plans		OPEB Plans	Defined Benefit Pension Plans		OPEB Plans
in millions, except assumptions	U.S.	Foreign	(1)	U.S.	Foreign	(1)
Change in benefit obligation						
Benefit obligation at beginning of year	$2,085	$1,728	$ 344	$2,203	$1,831	$ 335
Service cost	40	66	6	41	65	10
Interest cost	147	94	25	140	96	24
Actuarial (gain) loss	(127)	144	(11)	(99)	(37)	5
Curtailment (gain) loss	—	(7)	—	13	(55)	(7)
Benefits paid	(204)	(70)	(30)	(213)	(120)	(27)
Currency loss	—	(172)	(1)	—	(101)	(1)
Other	—	(16)	5	—	49	5
Projected benefit obligation at end of year	1,941	1,767	338	2,085	1,728	344
Change in plan assets						
Fair value of plan assets at beginning of year	2,371	1,827	—	2,198	1,813	—
Actual return on plan assets	174	233	—	381	209	—
Benefits paid	(204)	(70)	(30)	(213)	(120)	(26)
Currency loss	—	(161)	—	—	(114)	—
Other	3	5	30	5	39	26
Fair value of plan assets at end of year	2,344	1,834	—	2,371	1,827	—
Funded status	403	67	(338)	286	99	(344)
Unrecognized net actuarial (gain) loss	(179)	82	(22)	(94)	124	(11)
Unrecognized prior service cost	—	50	3	—	45	4
Prepaid (accrued) benefit cost	224	199	(357)	192	268	(351)
Contributions after measurement date	—	8	—	—	5	—
Prepaid (accrued) benefit cost	$ 224	$ 207	$(357)	$ 192	$ 273	$(351)
Amounts included in the Consolidated Balance Sheet are composed of:						
Prepaid benefit cost	$ 230	$ 344	$ —	$ 199	$ 377	$ —
Accrued benefit liability	(6)	(170)	(357)	(8)	(182)	(351)
Other assets	—	22	—	—	44	—
Accumulated other comprehensive income	—	11	—	1	34	—
Net amount recognized	$ 224	$ 207	$(357)	$ 192	$ 273	$(351)
Weighted average assumptions as of October 31						
Discount rate	8.00%	5.75%	8.00%	7.50%	5.75%	7.50%
Expected return on plan assets	9.00%	7.35%	N/A	9.00%	7.50%	N/A
Rate of compensation increase	4.50%	3.60%	N/A	4.50%	3.30%	N/A
Healthcare cost trend rate, current year	N/A	N/A	5.50%	N/A	N/A	5.50%
Healthcare cost trend rate, ultimate year	N/A	N/A	5.00%	N/A	N/A	5.00%
Trend rate decreases to the ultimate rate in the year	N/A	N/A	2001	N/A	N/A	2001
Components of net periodic benefit cost						
Service cost	$ 40	$ 66	$ 6	$ 41	$ 65	$ 10
Interest cost	147	94	25	140	96	24
Expected return on plan assets	(199)	(125)	—	(191)	(138)	—
Settlement/curtailment gain	(17)	(3)	—	(9)	(4)	(7)
Other	—	9	1	—	3	(1)
Net periodic pension cost	$ (29)	$ 41	$ 32	$ (19)	$ 22	$ 26

(1) The OPEB Plans are consolidated to include both U.S. and foreign results. Foreign results are immaterial for separate disclosure.

Assumed healthcare cost trend rates could have an effect on the amounts reported for the healthcare plans. A one-percentage point increase in rates would result in an increase of $3 million in the total service and interest costs components and a $34 million increase in the postretirement benefit obligation. Conversely, a one-percentage point decrease in rates would result in a decrease of $3 million in total service and interest costs and a $29 million decrease in the postretirement benefit obligation.

Compaq has defined contribution plans under which Compaq makes matching contributions based on employee contributions. These plans are intended to qualify as deferred compensation plans under Section 401(k) of the Internal Revenue Code of 1986. Contributions are invested at the direction of the employee in one or more funds, including a fund that consists of common stock of Compaq. Amounts charged to expense were $138 million, $121 million and $98 million in 2000, 1999 and 1998, respectively.

Compaq has an incentive compensation plan for the majority of its employees. Payments under the plan are based on a uniform percentage of employees' base pay as determined by a matrix using financial performance as defined by the plan and customer satisfaction results. Payments are made semiannually. Amounts charged to expense were $106 million, $26 million and $68 million in 2000, 1999 and 1998, respectively.

NOTE 11 RESTRUCTURING AND RELATED ACTIVITIES

During 2000, Compaq substantially completed all of the actions contemplated under the 1998 and 1999 restructuring plans. In December 2000, Compaq reversed excess reserves of $86 million for employee separations, facility closure costs and other costs related to the 1999 plan. Accrued costs under both plans at December 31, 2000 include amounts for actions that have already been taken, but for which expenditures have not yet been made.

In September 1999, Compaq's management approved a restructuring plan to realign Compaq's organization, reduce infrastructure and overhead, and eliminate excess and duplicative facilities. Restructuring and related charges of $868 million ($600 million, net of tax) were expensed. These charges were composed of $787 million of accrued restructuring costs, $58 million of related asset impairment charges and a $23 million pension curtailment loss to recognize a change in Compaq's projected pension benefit obligation in connection with employee separations. Costs for employee separations related to approximately 7,000 employees worldwide affecting the majority of business functions, job classes and regions, predominantly occurring in North America and Europe. Employee separation benefits include severance, medical and other benefits.

In June 1998, Compaq recorded a restructuring charge of approximately $1.7 billion to integrate the operations of Compaq and Digital, consolidate duplicative facilities, improve service delivery and reduce overhead. Approximately $1.5 billion was related to the acquisition of Digital and recorded as a component of purchase accounting and $286 million related to Compaq and was charged to operations. During 1998, Compaq also recorded a $107 million charge related to asset impairments.

An analysis of accrued costs and amounts charged against the provision follows:

in millions	Beginning Accrual	Expenditures	December 31, 1999	Expenditures and Adjustments	December 31, 2000
1999 Plan					
Employee separations	$ 491	$ (68)	$ 423	$(321)	$102
Facility closure costs	96	—	96	(50)	46
Contract cancellation and other exit costs	200	(167)	33	(28)	5
	$ 787	$ (235)	$ 552	$(399)	$153
1998 Plan					
Employee separations	$1,131	$ (962)	$ 169	$(106)	$ 63
Facility closure costs	414	(184)	230	(124)	106
Relocation	99	(65)	34	(18)	16
Other exit costs	100	(83)	17	(12)	5
	$1,744	$(1,294)	$ 450	$(260)	$190
	$2,531	$(1,529)	$1,002	$(659)	$343

Employee separations related to the 1998 and 1999 restructuring plans were 1,100 and 4,900, respectively, during 2000. Total employee separations related to the 1998 and 1999 restructuring plans were 23,400 as of December 31, 2000.

NOTE 12 SEGMENT DATA

During 2000, Compaq realigned the operations of its Enterprise Solutions and Services segment, which resulted in the formation of two reportable segments: Enterprise Computing and Compaq Global Services. Compaq's other two reportable segments, Commercial Personal Computing and Consumer, were unaffected by the realignment. Enterprise Computing designs, develops, manufactures and markets advanced computing and telecommunication products, including business-critical servers, industry-standard servers and storage products. Compaq Global Services delivers worldwide infrastructure and solution design implementation, management, and support services through Professional and Customer Services. Commercial Personal Computing delivers standards-based computing emphasizing Internet access through workstations, desktops, portables, monitors, Internet access devices and life-cycle management products. The Consumer segment targets home users with Internet-ready desktops and portables, printers and related products, as well as Internet access and e-services. Business activities that do not qualify for separate segment reporting are aggregated in Other. Financial data for prior periods has been restated to conform to the current presentation.

The accounting policies of the segments are the same as those used in the preparation of Compaq's consolidated financial statements. Compaq evaluates the performance of its operating segments based on segment operating income, which includes sales and marketing expenses, research and development costs and other overhead charges directly attributable to the operating segment. Certain expenses which are managed outside of the operating segments are excluded. These consist primarily of corporate and unallocated shared expenses, other income and expense items, and other non-recurring charges such as purchased in-process technology and restructuring and related activities. Corporate and unallocated shared expenses consist primarily of indirect information management expenses, certain costs related to business integration and other general and administrative expenses that are separately managed. Gains and losses associated with sale of businesses and investments are excluded from segment operating income. Compaq does not include inter-segment transfers for management reporting purposes. Asset information by operating segment is not reported since Compaq does not identify assets by segment.

Summary financial data by operating segment was as follows:

	Year ended December 31		
in millions	2000	1999	1998
Enterprise Computing			
Revenue	$14,316	$12,974	$10,498
Operating income	2,140	1,201	948
Compaq Global Services			
Revenue	6,993	7,162	3,990
Operating income	944	1,148	776
Commercial Personal Computing			
Revenue	13,136	12,185	11,846
Operating income (loss)	289	(448)	(46)
Consumer			
Revenue	7,586	5,994	4,932
Operating income	170	262	183
Other			
Revenue	352	210	(97)
Operating income (loss)	27	(281)	(115)
Consolidated segment totals			
Revenue	$42,383	$38,525	$31,169
Operating income	$ 3,570	$ 1,882	$ 1,746

A reconciliation of Compaq's consolidated segment operating income to consolidated income (loss) before income taxes follows:

	Year ended December 31		
in millions	2000	1999	1998
Consolidated segment operating income	$ 3,570	$ 1,882	$ 1,746
Corporate and unallocated shared expenses	(1,117)	(1,156)	(888)
Restructuring and related activities	86	(868)	(393)
Purchased in-process technology	—	—	(3,196)
Other income (expense), net	(1,664)	1,076	69
Income (loss) before income taxes	$ 875	$ 934	$(2,662)

Geographic revenue and long-lived assets related to operations as of and for the years ended December 31 were as follows:

in millions	2000	1999	1998
Revenue:			
United States	$18,966	$17,351	$13,981
Europe, Middle East and Africa	14,178	14,420	11,929
Other	9,239	6,754	5,259
	$42,383	$38,525	$31,169
Long-lived assets:			
United States	$ 2,229	$ 2,332	$ 2,166
Other	1,202	917	736
	$ 3,431	$ 3,249	$ 2,902

NOTE 13 COMMITMENTS, CONTINGENCIES, FINANCIAL INSTRUMENTS AND FACTORS THAT MAY AFFECT FUTURE OPERATIONS

Derivative financial instruments and fair value of financial instruments

Compaq primarily utilizes forward contracts and purchased foreign currency options to reduce its exposure to potentially adverse changes in foreign currency exchange rates and simple interest rate swaps to reduce exposure to interest rate volatility. Compaq does not hold or issue financial instruments for trading purposes nor does it hold or issue leveraged derivative financial instruments.

Compaq's program to reduce currency exposure associated with the net monetary assets of Compaq's international subsidiaries includes agreements to exchange various foreign currencies for U.S. dollars. At December 31, 2000 and 1999, such forward contracts to sell foreign currencies, net of forward contracts to purchase foreign currencies aggregated $4.2 billion and $2.6 billion, respectively. Generally, gains and losses associated with currency rate changes on these forward contracts are recorded currently to income and are reflected in accounts receivable or other current liabilities in Compaq's consolidated balance sheet, while the interest element is recognized over the life of each contract. The amount recorded in the consolidated balance sheet approximates the fair value of such contracts at December 31, 2000 and 1999. The maturity dates of the forward contracts which were outstanding at December 31, 2000 ranged from three days to nine months, except for CFS which had forward contracts with maturity dates up to three years.

Compaq frequently utilizes forward contracts to protect Compaq from the effects of currency fluctuations on anticipated but not firmly committed sales which are expected to occur within a three-month period. These forward contracts generally do not extend beyond the end of any quarter or year. Any gains or losses and the interest element on these forward contracts are recognized as a component of sales during each quarter. In prior years, Compaq hedged a portion of its anticipated but not firmly committed sales of its international marketing subsidiaries using purchased foreign currency options. Realized and unrealized gains and the net premiums on these options are deferred and recognized as a component of revenue in the same period that the related sales occur. Option contracts aggregating $660 million were outstanding at December 31, 1999, related to hedges of sales for the first half of the year. The unrealized gains deferred on these contracts were not material.

Compaq does periodically enter into interest rate swap transactions for the purpose of hedging interest rate exposure on existing or anticipated liabilities. All interest rate swaps entered into by Compaq are for the sole purpose of hedging existing or anticipated interest rate sensitive positions, and not for speculation. At December 31, 1999, Compaq had entered into interest rate swaps with a notional value of $250 million with maturity dates of up to nine months. Amounts to be paid or received under interest rate swap agreements are accrued as interest rates change and are recognized over the life of the swap transactions as an adjustment to interest expense.

In the event of a failure to honor one of these forward or swap contracts by one of the banks with which Compaq has contracted, management believes any loss, which could be material, would be limited to the exchange rate differential from the time the contract was made until the time it was compensated. In the case of a default by a counterparty to an interest rate swap transaction, management believes any loss would be limited to the interest rate differential between market rates and the rates contractually set in the swap contract. To the extent Compaq has option contracts outstanding, the amount of any loss resulting from a breach of contract would be limited to the amount of premiums paid for the options and the unrealized gain, if any, related to such contracts.

Compaq enters into various other types of financial instruments in the normal course of business. Fair values for certain financial instruments are based on quoted market prices. For other financial instruments, fair values are based on the appropriate pricing models using current market information. The amounts ultimately realized upon settlement of these financial instruments will depend on actual market conditions during the remaining life of the instruments. Carrying values of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and other current liabilities reflected in the December 31, 2000 and 1999 consolidated balance sheet approximate fair value at these dates.

Concentration of credit risk

Compaq's cash, cash equivalents, short-term investments and accounts receivable are subject to potential credit risk. Compaq's cash management and investment policies restrict investments to low risk, highly liquid securities and Compaq performs ongoing evaluations of the relative credit standing of the financial institutions with which it deals.

Compaq distributes products primarily through third-party resellers and as a result, maintains individually significant accounts receivable balances from various major resellers. If the financial condition and operations of these resellers deteriorate, Compaq's operating results could be adversely affected. One such reseller, Ingram Micro, Inc., accounted for approximately 14 percent of consolidated revenue in 2000 and 11 percent of accounts receivable as of December 31, 2000, predominately in the Commercial Personal Computing segment. In 1999, Ingram Micro accounted for approximately 11 percent of consolidated revenue and 8 percent of accounts receivable at December 31, 1999. During these periods, no other customer of Compaq accounted for 10 percent or more of consolidated revenue. In 2000, Compaq's two largest resellers represented approximately 21 percent of consolidated revenue and 15 percent of accounts receivable at December 31, 2000. In 1999, Compaq's four largest resellers represented approximately 22 percent of consolidated revenue and 12 percent of accounts receivable at December 31, 1999. Compaq generally has experienced longer accounts receivable cycles in its emerging markets, in particular Asia-Pacific and Latin America, when compared to its U.S. and European markets. In the event that accounts receivable cycles in these developing markets lengthen further or one or more of Compaq's larger resellers in these regions fails, Compaq's operating results could be adversely affected.

Contingencies

Certain of Compaq's resellers finance a portion of their inventories through third-party finance companies. Under the terms of the financing arrangements, Compaq may be required, in limited circumstances, to repurchase certain products from the finance companies. Additionally, Compaq has on occasion guaranteed a portion of certain resellers' outstanding balances with third-party finance companies and financial institutions. Guarantees under these and other arrangements were not significant at December 31, 2000 or 1999.

In January 2001, Compaq exercised an option to sell an investment in a limited liability corporation accounted for under the equity method. Once the sale of the investment closes and proceeds are received, Compaq expects to record a gain.

Factors that may affect future operations

Compaq participates in a highly volatile industry that is characterized by intense industry-wide competition for market share. Industry participants confront aggressive pricing practices, continually changing customer demand patterns and rapid technological developments. Compaq's operating results could be adversely affected should Compaq be unable to successfully anticipate customer demand accurately, manage its product transitions, inventory levels and manufacturing processes efficiently, distribute its products quickly in response to customer demand, differentiate its products from those of its competitors or compete successfully in the markets for its new products.

Significant numbers of components are purchased from single sources due to technology, availability, price, quality or other considerations. Key components and processes currently obtained from single sources include certain of Compaq's displays, microprocessors, application specific integrated circuits and other custom chips, and certain processes relating to construction of the plastic housing for Compaq's computers. In addition, new products introduced by Compaq often initially utilize custom components obtained from only one source until Compaq has evaluated whether there is a need for additional suppliers. In the event that a supply of a key single-sourced material process or component were delayed or curtailed, Compaq's ability to ship the related product in desired quantities and in a timely manner could be adversely affected. Compaq attempts to mitigate these risks by working closely with key suppliers on product plans, strategic inventories and coordinated product introductions.

Litigation

Compaq is subject to legal proceedings and claims that arise in the ordinary course of business. Compaq does not believe that the outcome of any of those matters will have a material adverse effect on Compaq's consolidated financial position, operating results or cash flows.

Compaq and certain of its current and former officers and directors are named in two consolidated class action lawsuits pending in the United States District Court for the Southern District of Texas, Houston Division. One lawsuit was filed in 1998 and the other in 1999. The 1998 litigation consolidates five class action lawsuits, brought by persons who purchased Compaq common stock from July 10, 1997 through March 6, 1998. It asserts claims under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and Section 20(a) of the Exchange Act. Allegations in the 1998 lawsuit include the claim that the defendants withheld information and made misleading statements about channel inventory and factoring of receivables in order to inflate the market price of Compaq's common stock and further alleges that certain of the individual defendants sold Compaq common stock at the inflated prices. The 1999 litigation also consolidates a number of class action lawsuits. The litigation is brought on behalf of purchasers of Compaq common stock between January 27, 1999 and April 9, 1999. It asserts claims for alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder; Section 20(a) of the Exchange Act; and Sections 11 and 15 of the Securities Act. Allegations in the 1999 litigation include the claim that certain defendants and Compaq issued a series of materially false and misleading statements concerning Compaq's prospects in 1999 in order to inflate the market price of Compaq's common stock and further alleges that certain of the individual defendants sold Compaq common stock at the inflated prices. Lead counsels for the plaintiffs have been appointed in both the 1998 and 1999 litigation. The plaintiffs seek monetary damages, interest, costs and expenses in both the 1998 and 1999 litigation. In the 1998 litigation,

the court entered an order granting class certification on July 18, 2000. Compaq has appealed class certification and is awaiting a decision. Discovery has been stayed by order of the appellate court pending their decision on the class certification appeal. On December 12, 2000, the judge in the 1999 litigation dismissed the consolidated amended complaint after finding that it failed to comply with pleading requirements under the law. The plaintiffs filed a second amended complaint on January 31, 2001, which Compaq will move to dismiss. Compaq is vigorously defending both lawsuits.

Several purported class action lawsuits were filed against Digital during 1994 alleging violations of the Federal Securities laws arising from alleged misrepresentations and omissions in connection with Digital's issuance and sale of Series A 8 7/8 percent Cumulative Preferred Stock and Digital's financial results for the quarter ended April 2, 1994. During 1995, the lawsuits were consolidated into three cases, which were pending before the United States District Court for the District of Massachusetts. On August 8, 1995, the Massachusetts federal court granted the defendants' motion to dismiss all three cases in their entirety. On May 7, 1996, the United States Court of Appeals for the First Circuit affirmed in part and reversed in part the dismissal of two of the cases, and remanded for further proceedings. The parties are proceeding with discovery.

Compaq is vigorously defending consumer class action lawsuits alleging various defects in computers sold by Compaq. These lawsuits are pending in Texas, North Carolina, Illinois, California, Colorado and Washington. A class has been certified in the North Carolina case. All of these cases are in the discovery stage. Three of these class actions (Thurmond v. Compaq, LaPray v. Compaq, and Sprung v. Compaq) are part of a series of similar lawsuits filed against other major computer manufacturers, involving claims that the computer industry sold computers with allegedly defective floppy disk controllers. Thurmond is pending in federal district court in Beaumont, Texas; LaPray in Texas state court in Beaumont; Sprung in Colorado federal district court. No class has been certified in any of these cases although a hearing on class certification has been scheduled in the Thurmond case for March 19, 2001. Compaq is also providing information to the federal government and state attorneys general in California and Illinois in response to inquiries regarding floppy disk controllers in computers sold to government entities.

Non-current other assets as of December 31, 2000 included approximately $97 million ($22 million, net of reserve) owed to Compaq in connection with the sale of products. Compaq believes such amounts were misdirected by its customers to Inacom, which was acting as an agent for Compaq in connection with such sales. Compaq believes that such funds were improperly applied to reduce Inacom's indebtedness to its lenders. Inacom filed for bankruptcy on June 16, 2000 in the District of Delaware Bankruptcy Court. Compaq is seeking to realize the full value of these receivables in an adversary proceeding filed October 20, 2000 against Inacom, Deutsche Bank, A.G. and other Inacom lenders. In the same proceeding, Inacom has sued Compaq for approximately $41 million that Compaq is holding as a setoff against the $97 million. Compaq has recorded a reserve of $75 million related to this asset.

Lease commitments

Compaq leases certain manufacturing and office facilities and equipment under noncancelable operating leases with terms from one to thirty years. Rent expense for 2000, 1999 and 1998 was $347 million, $283 million and $205 million, respectively.

Compaq's minimum rental commitments under noncancelable operating leases at December 31, 2000 were approximately $235 million in 2001, $184 million in 2002, $136 million in 2003, $98 million in 2004, $69 million in 2005 and $376 million thereafter.

THE BOARD OF DIRECTORS AND STOCKHOLDERS
OF COMPAQ COMPUTER CORPORATION

We have audited the accompanying consolidated balance sheet of Compaq Computer Corporation as of December 31, 2000, and the related consolidated statement of income, stockholders' equity, and cash flows for the year ended December 31, 2000. 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 audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Compaq Computer Corporation at December 31, 2000, and the consolidated results of its operations and its cash flows for the year ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2000, the Company changed its method of accounting for certain product shipments.

Ernst & Young LLP

Houston, Texas
January 23, 2001

TO THE STOCKHOLDERS AND BOARD OF DIRECTORS
OF COMPAQ COMPUTER CORPORATION

In our opinion, the consolidated balance sheet as of December 31, 1999 and the related consolidated statements of income, of cash flows and of stockholders' equity for each of the two years in the period ended December 31, 1999 present fairly, in all material respects, the financial position, results of operations and cash flows of Compaq Computer Corporation and its subsidiaries at December 31, 1999 and for each of the two years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States of America. 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 auditing standards generally accepted in the United States of America, 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 our opinion. We have not audited the consolidated financial statements of Compaq Computer Corporation for any period subsequent to December 31, 1999.

PricewaterhouseCoopers LLP

Houston, Texas
January 25, 2000

selected quarterly financial data (unaudited)

The table below sets forth selected unaudited financial data for each quarter of the last two years.

in millions, except per share amounts	1st Quarter[1]	2nd Quarter[1]	3rd Quarter[1]	4th Quarter
2000				
Revenue	$9,505	$10,135	$11,217	$11,526
Gross margin	2,184	2,388	2,683	2,711
Income (loss) before cumulative effect of accounting change[2]	322	388	557	(672)
Basic earnings (loss) per common share[3]	$ 0.19	$ 0.23	$ 0.32	$ (0.39)
Diluted earnings (loss) per common share[3]	$ 0.19	$ 0.22	$ 0.31	$ (0.39)
Net income (loss)	296	388	557	(672)
Basic earnings (loss) per common share[3]	$ 0.17	$ 0.23	$ 0.32	$ (0.39)
Diluted earnings (loss) per common share[3]	$ 0.17	$ 0.22	$ 0.31	$ (0.39)
1999				
Revenue	$9,419	$ 9,420	$ 9,208	$10,478
Gross margin	2,327	1,936	2,136	2,328
Net income (loss)[4]	281	(184)	140	332
Earnings (loss) per common share[3]				
Basic	$ 0.17	$ (0.10)	$ 0.08	$ 0.20
Diluted	$ 0.16	$ (0.10)	$ 0.08	$ 0.19

[1] *Effective January 1, 2000, Compaq adopted Staff Accounting Bulletin No. 101,* Revenue Recognition in Financial Statements, *as amended. Compaq has restated its results for the first three quarters of the year ended December 31, 2000.*

[2] *Includes a $1.7 billion charge for impairment of investments in the fourth quarter of 2000.*

[3] *Earnings (loss) per common share are computed independently for each of the quarters presented and therefore may not sum to the total for the year.*

[4] *Includes a $1.2 billion gain on the sale of a business and an $868 million charge for restructuring and related charges to realign Compaq's organization, reduce infrastructure and overhead, and eliminate excess and duplicative facilities occurring in the third quarter of 1999.*

other items

Market for common stock

Compaq's common stock is listed on the New York Stock Exchange and trades under the symbol CPQ. As of January 31, 2001, Compaq had approximately 91,000 stockholders of record. The reported high and low closing stock prices, as reported on the NYSE Composite Transaction Tape, were as follows:

	2000		1999	
	High	Low	High	Low
1st Quarter	$33.00	$24.69	$49.25	$30.13
2nd Quarter	30.25	24.50	31.56	21.19
3rd Quarter	34.63	25.00	28.00	22.25
4th Quarter	31.42	14.70	28.75	18.69

Dividends, dividend reinvestment and direct stock purchase plan

Compaq paid quarterly dividends of $0.025 per share during 2000 and in the fourth quarter 1999 and $0.02 per share for the first three quarters of 1999. Compaq anticipates that the cash dividend will continue to be paid on a quarterly basis. Compaq has established a dividend reinvestment plan through which stockholders may reinvest their dividends in Compaq common stock. Compaq also has a direct stock purchase plan through which Compaq stock may be purchased directly from the company. Information about both plans is available at www.compaq.com/corporate/ir/si/irsi.html.

Recent issuances of unregistered securities

None.

Changes in and disagreements with accountants on accounting and financial disclosures

None.

executive officers

Michael D. Capellas
Chairman and
Chief Executive Officer

Peter Blackmore
Executive Vice President,
Worldwide Sales and Services

Michael J. Winkler
Executive Vice President,
Global Business Units

Howard D. Elias
Senior Vice President
and General Manager,
Business Critical Server Group

Douglas B. Fox
Senior Vice President,
Marketing and Strategy

Jesse J. Greene, Jr.
Senior Vice President,
Finance and Administration
and Chief Financial Officer

Yvonne R. Jackson
Senior Vice President,
Human Resources,
Organization and Environment

Michael J. Larson
Senior Vice President
and General Manager,
Consumer Group

Mary T. McDowell
Senior Vice President
and General Manager,
Industry Standard Server Group

Robert V. Napier
Senior Vice President,
Global Business Solutions
and Chief Information Officer

Shane V. Robison
Senior Vice President,
Technology and
Chief Technology Officer

Thomas C. Siekman
Senior Vice President
and General Counsel

directors

Michael D. Capellas
Chairman and
Chief Executive Officer

Lawrence T. Babbio, Jr.[2,3]
Vice Chairman and President,
Verizon Communications, Inc.
Chairman of the Human Resources
Committee

Judith L. Craven[3]
Former President of the United Way
of the Texas Gulf Coast

Robert Ted Enloe, III[1,2]
Managing General Partner,
Balquita Partners, Ltd.
Chairman of the Audit Committee

George H. Heilmeier[1]
Chairman Emeritus,
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Peter N. Larson[3]
Former Chairman and Chief Executive,
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Kenneth L. Lay[2]
Chairman,
ENRON Corp.

Sanford M. Litvack
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Walt Disney Company

Thomas J. Perkins[1]
General Partner,
Kleiner Perkins Caufield and Byers

Kenneth Roman[1]
Former Chairman and
Chief Executive Officer,
The Ogilvy Group

Lucille S. Salhany[2]
Co-President and Chief Executive Officer,
Life FX Networks, Inc.
Chairman of the Corporate Governance
Committee

[1] Member of Audit Committee
[2] Member of Corporate Governance Committee
[3] Member of Human Resources Committee

glossary of terms

8-Way *ProLiant* servers: Compaq's industry-standard server employing the power of eight processors.

***Aero* handheld PC:** Compaq's super-lightweight handheld PC.

***AlphaServer* systems:** Compaq's powerful RISC-based servers, used for such high-performance work as finance and telecommunications.

Application Service Provider: Company that delivers software programs via a network to other companies or end-users.

B2B: Business to business.

Compaq *Tru64* UNIX operating system: Compaq's 64-bit operating system for UNIX processors. UNIX is a flexible operating system for high-performance systems.

Deskpro: Compaq's industry-leading commercial PC line.

Digital Subscriber Line: High-speed Internet access line, generally 30 to 50 times faster than telephone modem lines.

e-marketplace: An Internet-based system for buying, selling and trading.

ENSA: Compaq's Enterprise Network Storage Architecture.

Independent Software Vendor: Company that develops specialized application software.

Internet Service Provider: Company that provides access to the Internet for companies and individual users.

***iPAQ* BlackBerry Wireless E-mail Solution:** Compaq's always-on wireless e-mail products. *iPAQ* is Compaq's sub-brand for innovative Internet products.

***iPAQ* Connection Point:** Compaq's high-speed wireless Internet access product for the home.

***iPAQ* Desktop PC:** Compaq's powerful, yet easy-to-use and maintain, computer for Internet-based computing.

***iPAQ* Home Internet Appliance:** Compaq's easy-to-use Internet access computer for the home.

***iPAQ* Personal Audio Player:** Compaq's lightweight personal digital device for playing music downloaded from the Internet.

***iPAQ* Pocket PC:** A full-function handheld PC with expansion cards for multiple uses.

i-services: Any of the several Internet-based services Compaq offers with its consumer and commercial products.

Middleware: Software programs that integrate disparate computer systems and applications. Standards-based interfaces are examples of middleware.

***NonStop Himalaya* systems:** Compaq's powerful, high-end systems for maximum reliability and power. Many of the world's stock exchanges rely on *NonStop Himalaya* systems.

Open SAN: The Open SAN enables multiple vendors systems to be supported on the same Storage Area Network; this includes storage systems, servers, applications, tape libraries and operating systems.

OpenVMS: An operating system developed by Digital Equipment Corporation – now used on 450,000 computer systems worldwide, including Compaq's *AlphaServer* systems.

Petabyte: Approximately one thousand terabytes. (1,024 terabytes). A terabyte is 1,024 gigabytes.

Point of Presence: Access point to a network, such as the Internet.

***Presario* PCs and Notebooks:** Compaq's line of desktop computers and notebooks for home users.

***ProLiant* servers:** Compaq's world leading industry-standard servers.

***SANworks*:** Compaq's enterprise storage management software solutions.

***SANworks* Data Replication Manager:** *SANworks* DRM is data replication storage software for disaster tolerance, disaster recovery and data movement.

Solution Architect: Compaq Service Professional who helps customers design and implement networked solutions.

***StorageWorks* solutions:** Compaq's industry leading, heterogeneous enterprise storage products known for their modularity and scalability.

Systems Integrator: A company, typically a Compaq business partner, that combines engineering and software skills with products from several sources to develop a customer solution.

***TaskSmart* Appliance Servers:** Compaq's new single-purpose servers, tuned and optimized for one specific task, that offer performance out of the box and are easy to deploy and manage.

Terabyte: Approximately one thousand gigabytes, or one million megabytes of data.

Zero Latency Enterprise: A revolutionary Compaq-developed framework that marries high-powered systems with applications and databases to provide up-to-the second information on a huge scale for the retail, telecommunications, finance and other industries.

stockholder information

Compaq Computer Corporation

20555 State Highway 249
Houston, Texas 77070-2698
281-370-0670

Web address

Compaq can be found on the Internet at www.compaq.com.

Financial reports

Financial reports, including Form 10-K, Form 10-Q and Annual Reports, can be accessed and ordered online at www.compaq.com/corporate/ir/fd/irfd.html.

You may also obtain financial documents by writing:
Compaq Investor Relations, MS110312
P.O. Box 692000
Houston, Texas 77269-2000
or call 800-433-2391.

Earnings information

Press releases can be accessed online at www.compaq.com/newsroom/. For a recorded message of current earnings, call 281-518-EARN or 281-518-3276.

Products, support and solutions

For information on Compaq products or to purchase Compaq products online, please visit our Web site at www.compaq.com/showroom/ or call us at 800 AT COMPAQ.

For information on Compaq support services, please visit our Web site at www.compaq.com/support/ or call our technical support services group at 800 OK COMPAQ.

To build your e-business and sell online, visit our All-in-One eBusiness Web site at www.compaq.com/smb/onlineservices/ebusiness.html.

For e-commerce, security and intranet portal solutions, visit our Web site at www.compaq.com/services/internet/.

For other solutions, including enterprise and industry solutions, visit our Web site at www.compaq.com/solutions/.

Annual meeting

The Annual Meeting of stockholders will be held April 26, 2001, at 10:00 a.m. in the J.W. Marriott located at 5150 Westheimer, Houston, Texas 77056.

Common stock and dividends

CPQ LISTED **NYSE** Compaq stock trades on the New York Stock Exchange under the symbol CPQ. Cash dividends have been paid since 1998. The current rate is $0.025 per share per quarter.

Transfer agent

You may contact our Transfer Agent to assist you with matters of purchasing stock through Compaq's Shareholder Investor Plan, reinvestment of your dividends, transfer of ownership, reporting lost certificates, change of address, register to receive your Compaq Annual Report and proxy mailing notice through the Internet, duplicate mailings or other matters concerning your stockholder account:
Fleet National Bank
c/o EquiServe
P.O. Box 43014
Providence, RI 02940-3014
888-218-4373

Interactive voice response system (24 hours a day; representatives available from 9 a.m. to 5 p.m. Eastern time, Monday through Friday)

If outside the continental United States and Canada:
781-575-3170

TDD for the deaf, hard of hearing or speech impaired:
800-952-9245

Transfer agent Web address: www.equiserve.com

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This Annual Report Was Printed on Recycled Paper. Design: Critt Graham + Associates. Atlanta/New York/Boston
Photography: George Lange Photography. Printing: QuebecorWorld Acme.

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COMPAQ 1487-0301A-WWEN