MEMOREX

1971 Annual Report

Memorex Corporation
1971 Annual Report

Contents

Cover: Pictured are sections of the control panel of the MRX/Systems now being introduced to the marketplace. These innovative, general-purpose computer systems offer the user significant price/performance benefits over competitive systems.

Management

Officers:

Laurence L. Spitters, *President*

D. James Guzy, *Executive Vice President*

Vice Presidents:

Richard D. Boucher X
John R. Eastling
David H. Elliott
Robert Jaunich II
Richard M. Kirk X
Lawrence R. Knowles X
John J. Kramer
Harold J. Krauter INT
E. Douglas Larson
~~William S. McCalmont~~ X
Hiroshi Nagakura
John A. Perri
Edward J. Phillippe
Hillard P. Tavrow
Laurence M. Wilson

Carl A. Anderson, *Secretary*

Gordon O. Sheppard, *Treasurer*

Principal Subsidiaries

MRX Sales and Service Corporation

J. Garrett Fitzgibbons, *President*

William F. Emmons, Jr., *Vice President*

John P. Kelly, *Vice President*

MRX Engineering and Development Corporation

Alan F. Shugart, *President*

N. David Wheeler, *Vice President*

Midwest Systems Corporation

Donald H. Malcolm, *President*

Board of Directors:

Laurence L. Spitters, *Chairman of the Board*

Alger Chaney, *Chairman of the Board, Medford Corporation*

Prentis C. Hale, *Chairman of the Board, Broadway-Hale Stores, Inc.*

T. Robert Sandberg, *Vice President (Retired), Cutter Laboratories, Inc.*

Benno C. Schmidt, *Managing Partner, J. H. Whitney & Co.*

Fred M. van Eck, *Partner, J. H. Whitney & Co.*

Dr. Theodore Vermeulen, *Professor of Chemical Engineering, University of California*

Dr. Alejandro Zaffaroni, *President, ALZA Corporation*

Memorex Corporation

Financial Highlights
for the years ended December 31, 1971 and 1970

(All information shown is for Memorex Corporation and Majority-Owned Subsidiaries and ILC Peripherals Leasing Corporation as combined)

	1971	1970
Net sales and revenues (excluding $73,054,000 in 1971 and $42,345,000 in 1970 billed to ILC)	$ 110,201,000	$ 78,997,000
Net income (loss)	(13,390,000)	3,183,000
Earnings (loss) per common share	(3.43)	.83
Depreciation and amortization charged to income	26,984,000	9,391,000
Additions to property, plant and equipment	20,885,000	37,201,000
Increase in equipment for lease to others	72,460,000	37,901,000
Research and development expenditures:		
Charged to income during the year (including amortization)	5,096,000	4,824,000
Capitalized as cost of equipment for lease to others (including amortization)	9,814,000	3,177,000
Sub-total: expenses and capitalized costs relating to products marketed	14,910,000	8,001,000
Capitalized as deferred research and development costs	11,840,000	8,141,000
Less: amortization of deferred research and development costs	(6,341,000)	(1,577,000)
Total research and development expenditures	20,409,000	14,565,000
Working capital	35,123,000	38,561,000
Total assets	318,129,000	225,807,000
Capitalization:		
Unsubordinated debt—		
ILC Perpiherals Leasing Corporation	89,718,000	31,628,000
Memorex Corporation and Majority-Owned Subsidiaries	65,146,000	26,913,000
Subordinated debentures (convertible), due 1990	75,000,000	75,000,000
Shareholders' equity	25,956,000	39,117,000
Number of employees at year's end	5,729	6,101

To Shareholders:

As I wrote in the February 25th Letter to Shareholders, 1971 was a disappointing year from the standpoint of our financial results.

Combined Memorex-ILC revenues in 1971 increased 40% to $110,201,000. These revenues, however, were less than planned. Combined Memorex-ILC net loss for the year, after tax credits, was $13,390,000, or a loss per share of $3.43. In 1970, the combined net profit was $3,183,000, or $0.83 per share. The combined net loss in 1971 includes non-recurring charges, after tax credits, in a net amount of $2,566,000, or $0.66 per share. The elimination of profit of ILC, representing the 80% interest of ILC's other shareholders, was $730,000, or $0.19 per share, compared with $159,000, or $0.04 per share in 1970.

Overall levels of costs and expenses were maintained at or below planned levels during 1971, but revenues fell far short of plan. This revenue shortfall occurred both in rental income from equipment-for-lease and in sales of computer tape and broadcast video tape. Rental income suffered more from rental rate reductions, compelled by IBM's price competition for peripheral equipment, than from less-than-planned physical volume. The computer tape business experienced price degradation, and broadcast video tape sales suffered from our failure to achieve satisfactory production until late in the year. These difficulties were the major operating factors which, together with the effect of operating lease accounting (further discussed at page 10), contributed to the year's net loss.

Continued progress was made in 1971 in the building of the equipment-for-lease business, increasing combined rental revenues to $46 million from $9 million in 1970. In terms of revenues, investment, and employment, our equipment manufacturing and leasing operations are now predominant in Memorex's business. The measurement of the Company's progress in building its leasing business is discussed at page 10.

Our task for 1972 is to insure the implementation of our current operating plan whose primary objective is to restore our profitability. Our plan encompasses five major undertakings which include realistic performance targets — they are the product of a much better understanding of the dynamics of our business than we possessed last year.

First, we have undertaken to be conservative in our forecast of the volume of business and revenues which we expect to achieve in 1972. Accordingly, we have scaled current levels of operating expenses and employment to this conservative forecast.

Second, diversification of our equipment business, which we have pursued since 1969 in new product development programs, will culminate with initial shipments in the fourth quarter of 1972 of the recently announced Memorex Computer Systems/40 and 50. (Because entry into the systems business is a major event in corporate development and topical at the date of this annual report, the subject is discussed in detail at page 5).

The market opportunity for Memorex's Systems/40 and 50 computers, in conjunction with our terminals and communication controller units, is uniquely attractive. Each of these products will aid the computer user to obtain timely and low cost access to central data files from remote locations, which is among the most pressing requirements in data processing. Such on-line data processing networks are generally projected to increase to one-half of all computer systems installed by the mid-1970's. Memorex's 1970-1971 investment in building our customer base — currently over 2,500 installations of more than 1,500 customers use Memorex computer equipment — and in establishing our reputation for reliable products and customer service, will facilitate our marketing of new system products. We are confident that many of our customers will implement on-line data processing networks by connecting Memorex's Systems products and terminals to their IBM System/360 and System/370 computers.

Third, during 1972 we shall effect the transition in manufacturing to our next generation 3670 disc storage system and the computer systems. This transition will mean a gradual decline in manufacturing volume of the existing generation 3660 disc storage system, and, during the second half of the year, the startup and rapid expansion of manufacturing activity for the 3670 and the Systems products.

Fourth, we shall continue to expand our equipment-for-lease base with limited external capital in comparison to the amounts of capital we required in prior years. The growth of our lease base is increasingly self-financed, because the internal cash flow from combined rental revenues is now substantial; in 1972, we anticipate that about one-half of this continuing investment will be provided by internal cash flow. The balance of external capital is now provided for, in part, under existing ILC loan agreements; additional external capital for second-half 1972 needs is expected to be provided by a financing program which is presently in its planning stage.

Fifth, media marketing will be directed to those segments of the computer tape,

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Note: ILC Peripherals Leasing Corporation's financial statements are combined with those of Memorex because of the inter-relationship between the operations of Memorex and ILC and the financial commitments and contingencies that exist between the companies, as disclosed in notes to Memorex Corporation's financial statements.

Laurence L. Spitters, chairman and president, and (left) D. James Guzy, executive vice president.

video tape, and business products markets which are obtainable by Memorex at profitable prices. We shall also continue to emphasize the growth of our consumer audio tape business and capitalize on market success achieved to date.

Nationwide marketing of Memorex's new cassette audio tapes was established in 1971, although the product's heavy start-up spending added to the Company's loss for the year. Effective promotion through television and magazine advertisements produced excellent consumer response, and aggressive selling established extensive distribution. Sales were increased in each quarter of the year, and the Memorex cassette achieved consumer acceptance as a high-quality and premium-priced product in this fast growing market of high fidelity enthusiasts. We expect this consumer product to account for the majority of projected growth of our media sales business during the next few years.

During 1971, we restructured the organization of our Company as our predominant business shifted from sales of media products to leasing of computer equipment, and as a scaling back of some operations was necessitated by the shortfall from planned revenues. By combining most of the media business's product development, manufacturing, and marketing operations with those of our equipment business, we achieved sizeable reductions in employment in media operations and administration. These difficult actions are now behind us, and we now have a much reduced level of operating expenses from the level experienced throughout most of 1971. Assuming achievement of the projected increases in revenues in 1972, we anticipate the return to profitable operations.

Our adjustments to IBM's price competition in the disc file storage business were made during 1971 by lowering Memorex's rental rates and by cutting back on manufacturing and administrative budgets. Our 3660 disc file equipment has continued to be a sound investment with good profit potential despite the lowered monthly rentals. During 1971 our placements of disc file equipment were twice those of the next leading independent supplier and achieved for Memorex an approximate 10% share of market. This record says that we have designed superior products in our development groups, that our manufacturing personnel have performed superbly in building these products, and that our marketing organization has earned its reputation for excellence in the selling and field support of our products.

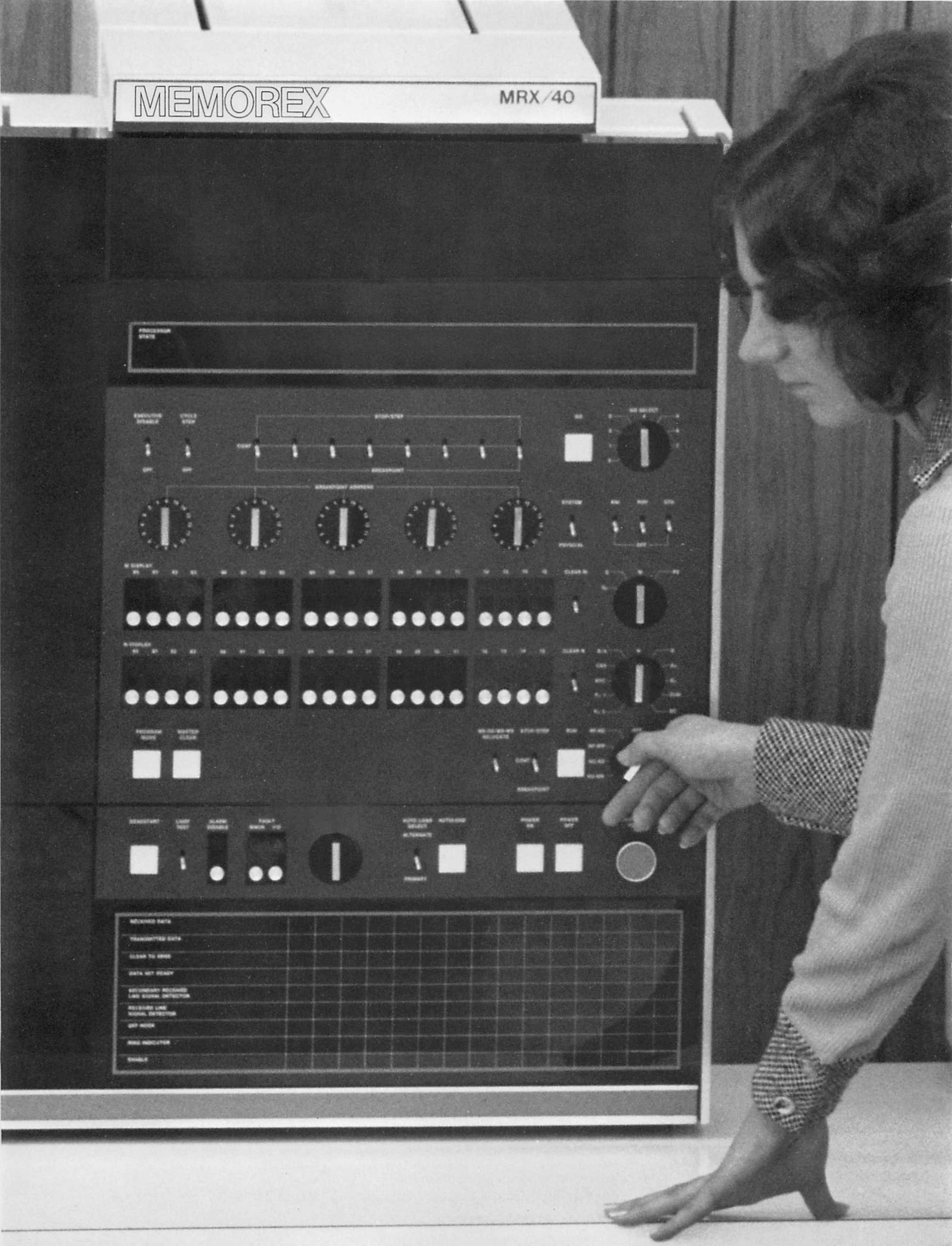
In summary, the year 1971 was disappointing because of its financial results, but its important accomplishments included the building of our computer equipment leasing business, the diversification of our product lines and strengthening of Memorex's competitive position, and the improvement of operating efficiency which provides the basis for profitable operations in 1972. The hard work of Memorex employees responsible for these accomplishments merits the congratulations of our shareholders.

Sincerely,

Laurence L. Spitters

Laurence L. Spitters
President

March 24, 1972


MEMOREX
MRX/40

Corporate Development: Entry into the Systems Business

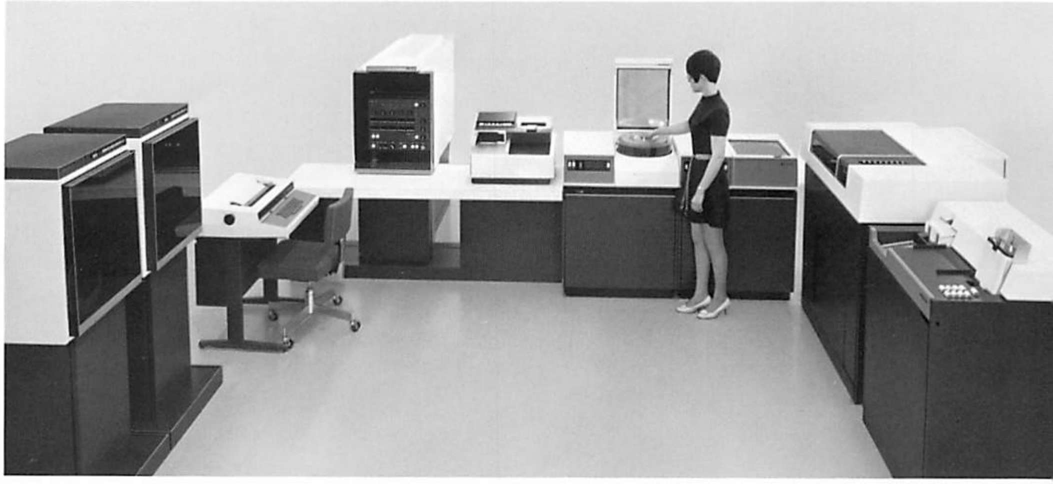
Utilizing a full line of peripheral equipment, Memorex's computer systems function as remote data communication processors or as stand-alone processors. These systems will measurably extend the useful life of the Company's disc drives.

Corporate Strategy

In March, 1972, Memorex publicly announced its entry into the computer systems business. The announcement set forth performance specifications, prices and availability of our initial products, the Memorex Systems/40 and 50, which were well publicized with very favorable reception by our customers and prospects. Firm orders and letters of intent have been received from customers for initial deliveries, which will begin in the fourth quarter of 1972.

The entry into the computer systems business marks the third phase of Memorex's strategy for its now predominant computer equipment business. The first phase began in 1967 with announcement of plug-compatible disc storage drives which were manufactured for other computer makers and independent re-marketing agents who marketed our equipment to their end-user customers. This phase successfully achieved two objectives: demonstration of Memorex's ability to develop high quality disc storage devices and to manufacture the equipment at low cost, and generation of sales volume to provide cash with which to finance growth of our equipment business.

The second phase began in 1970, with introduction of plug-compatible peripheral devices, which were marketed on a rental basis directly to end-users. These plug-compatible products were aimed at the most rapidly growing sectors of electronic data processing: on-line, direct access data storage, remote communications with central computers, and high speed printing output by terminals from computers. Key to the second phase was the establishment of a field sales and service organization, comprised largely of professional personnel experienced in computer systems marketing. This organization is now operating in approximately 95 domestic and international field locations.



Representing the Company's first entrance into the mainframe computer system marketplace, MRX/Systems are structured to take advantage of the Company's already established customer base, existing manufacturing facilities, an experienced sales force and the Memorex reputation for quality products and superior service.

The entry into the business of plug-compatible equipment-for-lease has also been characterized by the very substantial capital investment in the equipment lease base, an asset which is now the fundamental determinant of combined operating income. This business has progressed to the successful achievement of its two principal objectives. First, we have built a sizeable lease base whose cash flow increasingly supports its own continuing growth and a base of customers whose requirements provide a basis for directing new product developments. At year-end 1971, Memorex-ILC had installed equipment in some 2,500 locations, representing in excess of 1,500 customers. Second, Memorex's sales and service organization has demonstrated its capability to sell, install and maintain a broad range of computer equipment, thereby achieving the credibility in the marketplace which is an essential prerequisite for a successful systems supplier.

The first and second phases of Memorex's strategy have been enabling, but of themselves do not constitute a sufficient basis for building a long-term computer equipment business. The opportunity for manufacturing equipment for remarketing by others has been transient and is attractive only from time to time when other computer makers' requirements for system components exceed their development and manufacturing capabilities. The plug-compatible business remains attractive but is characterized by intensive competition and dependence upon initiatives of systems manufacturers which limit opportunity for product differentiation.

Thus, it is Memorex's strategy to exploit its successes in these two previous phases by proceeding to the ensuing corporate development objective: entry into the computer systems business. This third phase, unlike the plug-compatible business, should allow Memorex to seize product and market initiatives. Also, systems products will underpin Memorex's investment in peripheral equipments which will also be used with the systems hardware. Auspicious resources — a customer base, international and national sales and service organization, computer equipment development capability, and manufacturing experience — are now being leveraged in this entry into the computer systems marketplace.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Market Opportunity

The marketplace targets of the Memorex Systems/40 and 50 are the users of small commercial computer systems. Our system products offer prospective customers Memorex peripheral equipment with improved functional capability and performance capability, high performance processors, and functionally advanced software which is optimized for the commercial data processing environment, at prices much lower than comparable competitive products.

The essence of our systems design is to provide in small systems the function and performance heretofore only available in medium and large scale computer systems. The technical character and configuration of Memorex Systems/40 and 50 are based on a comprehensive analysis of projected market potential and future customer requirements, and anticipate the expected product announcements and strategy of the industry's dominant manufacturer.

The computer systems market is segmented, on the basis of users' budgets for data processing, into large, medium and small users. All users, however, employ small-scale computer systems. Small users are characterized by use of small computers whose rentals range from $3,000 to $12,000 per month, the category of systems which include the Memorex/40 and 50. Medium users typically utilize one medium size computer ($10,000 to $30,000 per month) and one or more small additional computers. Large users employ large computers ($30,000 and more per month), as well as multiple medium and small computers. The large user's data processing installation has, at minimum, three computer systems installed: one large and two small. Thus, small commercial computer systems of the genre of Memorex Systems/40 and 50 are utilized not only by small users but also by medium users, and to a much greater extent by large users. This market profile is important because more than 50% of the Memorex-ILC installed equipment base is with large users; the balance of the base is equally distributed among medium and small users.

This 670 Disc Drive is part of the 3670 Disc Storage System scheduled for shipment in the second half of 1972. It represents the next generation of Memorex's development in this product area. Plug-compatible with the IBM 3330 for attachment to System/370, the 3670 sets new industry standards for speed, reliability and price/performance.

The demand for small commercial computer systems is generally projected to grow faster than the computer market as a whole because of two factors. First, many small businesses, educational institutions, and other prospective customers who are not now computer users will become users in the 1970's. Second, large users will increasingly utilize small computers to distribute and summarize information at local sites via communications networks, in much the same way that they have distributed management talent to achieve improved control over decentralized organizations.

The growth of demand for small commercial computer systems will also be compounded because of application trends among large users. That is, large users are increasingly employing small computers to perform data processing work other than accounting which enables them to gain improved control of their business and to improve customer service. These application trends are dependent on two system characteristics: rapid access to on-line data files, and improved access via communications equipment to these files from physically remote sites. Airline passenger reservation systems, on-line patient monitoring, parts inventory management, and utility facilities management are representative of these non-accounting applications. They are economical because of the availability of large size, low cost disc storage files, an area of computer technology in which Memorex has concentrated, and the emergence of more complex communications networks, an area in which we believe that Memorex Systems/40 and 50 will be preeminent.

Small commercial computer configurations are often deliberately constrained by manufacturers in terms of file and memory capacity and communications facilities to compel the small users to "upgrade" periodically to higher capacity, higher rental equipment. The Systems/40 and 50, by comparison, will provide the small user with substantially larger file capacity and easy-to-use communications which will enable him to emulate his larger competitors in their data processing applications and thereby compete more effectively. By providing these facilities, which otherwise are available to the small user only by upgrading to medium and large computers, Memorex intends to penetrate the small user sector of the computer marketplace, as well as the sector of large users which are predominant among our existing customers.

The price advantages of Systems/40 and 50 derive from, among other factors, the advances in semiconductor technology which have only recently been available to computer system designers. The benefit to users is a significant reduction in costs of central processor logic and memory, i.e., Memorex is able to offer more function at lower price. These advances in component technology have also enabled Memorex to make a substantial advance in processor architecture which removes limitations upon peripheral equipment performance experienced by today's small computer system users. This improved input/output performance combined with the lower cost, higher capacity disc storage equipment of Systems/40 and 50 give our products a substantial price edge over existing competitive systems. Finally, the limitations of

Achievement of consistent quality in volume production of communication terminals results from Memorex's extensive experience in manufacturing computer-related products.

In the first full year, Memorex's audio products were successfully established through extensive advertising and marketing efforts as quality leaders in the rapidly growing blank recording tape markets.

common carrier data communications facilities place importance on reliability characteristics and error recovery capabilities of communications-oriented data processing networks. Systems/40 and 50 have emphasized these capabilities, because our large customer prospects especially require more intelligent remote computers in their networks to achieve satisfactory economics in their overall data communications and processing investment, and to minimize the impact of communications line failures.

Competitive Factors

Management's judgment regarding expected competitive reaction has been an important factor in determining our strategy for entry into the computer systems business.

Established competitors in the business of leasing computer equipment are ordinarily reluctant to improve the price/performance of their systems products lines because the result is always a depreciation of their existing investments in systems on lease. The dominant supplier in the computer market has introduced systems with improved price/performance as it has determined new product introductions would enhance its lease base and add to its revenues, but only infrequently has it done so to respond to the inroads of competitors. Hence, when a new entrant to the computer systems business has no investment in systems on lease, his opportunity is to improve upon competitive price/performance standards and thereby to achieve an initial market penetration.

Until his share of market becomes significant, the expected competitive response of IBM and other suppliers with investments in lease bases is a more aggressive marketing of their systems to protect their customer relationships, in lieu of rental price reductions. We believe these factors characterize the expected competitive reactions to the Memorex Systems/40 and 50.

The opportunity for marketing Memorex Systems/40 and 50 is enhanced by Memorex's comprehensive aids to conversion, which will enable prospective customers to adapt their application programs to Memorex systems at greatly reduced costs vis-a-vis the costs imposed by the dominant systems supplier. This results because users of IBM's small computers, Model 20, System/3 and 1130, face significant conversion costs in upgrading those computers to the non-compatible product line of System/360's and 370's. These considerations of non-compatibility and high conversion costs are also encountered in upgrading in the product lines of many other major computer system suppliers. Memorex Systems/40 and 50, on the other hand, provide a compatible growth vehicle which spans a wide price/performance range of customer demands for small computer systems.

Memorex is not attempting to penetrate other than the market for small computers for commercial data processing. Medium and large scale systems do not permit the same leveraging of Memorex's technical and marketing resources. The typical user, particularly if he is a large user, is also extremely reluctant to consider changing his existing system supplier, which would necessitate his abandoning the programming investment he will otherwise continue to employ while upgrading to higher capacity systems. Memorex's competitive thrust is not to displace these medium and large scale systems, but to market the Memorex Systems/40 and 50 for use in conjunction with, for example, the System/360 and System/370 computers, and to offer to these users the performance advantages heretofore available only at higher price on larger computers.

Risks and Rewards

Memorex's entry into the systems business represents an evolutionary step whose risks are warranted by its potential profit and strengthening of our business. Because of our sizeable customer base, proven technology in disc storage and communications equipment, manufac-

The final stages of Memorex's new Santa Clara facilities were completed during 1971. Development, manufacturing and administrative functions involving approximately 2,000 employees are located on the 54-acre site.

The solvent recovery plant at our Santa Clara tape plant symbolizes Memorex's commitment to the protection of the environment. Built in 1971 at a cost of $1 million, the plant recovers gaseous effluent resulting from the manufacture of magnetic tape.

turing experience, and international sales and service capabilities, this step does not involve more than incremental investment and incremental operating expense budgets. It does involve the normal risks of new product introductions which relate to the extent of customer acceptance and the costs of unpredicted delays in product development activities.

Memorex has minimized the risk of limited customer acceptance by undertaking a limited manufacturing build-up. Investment in new manufacturing facilities and equipment for systems production has been relatively minor. Working capital for inventory, the principal capital requirement, will be related to the near-term orders received backlog. The systems program will be executed with no major increases in the current levels for product development, marketing, or administration.

Memorex's sales and service organization has marketed plug-compatible equipment with demonstrated competence and its adaptation to systems marketing is underway. Nearly all of the field marketing management and many of the field sales representatives are experienced systems sales personnel. In-depth system engineering and special market support teams have been established in each sales district to assist the field force. The build-up of systems engineering, because it is primarily a resource utilized in installation of the systems, is programmed to increase with the shipment rate. The risk of product development delays is concentrated in two areas: the central processor and software products. Both development programs are well advanced and on schedule.

The first processor prototype was operational in the second quarter of 1971. Since then, seven additional processors have been built and have been utilized to assist in programming development activities. If hardware were sufficient to compete, Memorex could have announced its systems in mid-1971. Software program products, which necessarily lag hardware development, have been under development since late 1969 pursuant to a detailed checkpoint procedure. A number of the program products are now operational and are undergoing comprehensive product test. Their functional characteristics have been tailored to specific customer application environments, not only to improve the systems' performance, but also to reduce the schedule risks which are incident to development of general purpose software products.

We anticipate that rewards to be realized from a successful execution of the Memorex systems program will be substantial. Upon acceptance by customers of Memorex's systems and programming products, Memorex will secure stronger customer ties and will obtain the initiative for the future direction of its new product development. A successful systems program will also provide a new secondary market for plug-compatible products, and its increase in the density of Memorex equipment at field locations will result in better field service efficiencies and reduced service costs. Finally, a successful systems entry will provide Memorex with a growth vehicle for building a base of satisfied systems customers—a growth vehicle which, if developed as successfully as Memorex's plug-compatible business, will make Memorex a leading systems supplier.

Measurement of the Equipment-for-Lease Business

Our most important business, the manufacture of equipment-for-lease and operation of our lease base, is accounted for by the "operating lease method" of accounting in the Memorex-ILC combined financial statements. This accounting method reflects in current revenues the rentals earned in the period covered by the financial statements. These revenues are only a portion of the total rental revenues expected to be derived from successive leases of the equipment manufactured in the period. Costs of general and administrative activities and interest expenses, which are related to manufacturing operations, are fully charged against current revenues. Hence, losses may be expected to result when substantial start-up costs are incurred and leasing revenues are modest.

The Memorex-ILC combined financial statements, therefore, do not currently show the potential economic result of manufacturing equipment-for-lease. Over a longer period of years, the result of rentals from successive leases and properly matched costs and expenses will accurately reflect the profitability of our leasing business. This long-term economic result can be anticipated in part by analysis of current fundamentals.

For management's use in the measurement of the potential economic result of our equipment-for-lease business, we have developed six key indices. These indices, which are discussed below, will also be useful in the critical analysis of our business by shareholders. They involve data and operating detail which are not typically published in unaudited quarterly reports, but which we shall provide in our quarterly reports during 1972.

Lease Base as a Source of Revenue.
Growth of Memorex's leasing business is evidenced by the increasing volume of rental revenues. During 1971, rental revenues more than doubled from the first to the fourth quarter. For the full year, rental revenues amounted to $46 million, up from $9 million in 1970.

The predominance of our leasing business at year-end 1971 is indicated by December's rental revenues which, when annualized, exceeded $66 million. This year-end rate of rental revenues amounted to one-half of the year-end rate of total sales and revenues. Apart from IBM and Xerox, no major computer equipment manufacturer derives relatively as much revenue from its lease base, and few exceed 25%.

Greater stability and predictability of rental revenues, relative to the projected revenues of a sales business, are the important advantages of Memorex's lease base as a source of revenue. Its stability of revenues is important to sustain our operating level when, in 1972, Memorex will effect a transition from production of 3660 disc storage products to start-up production of the next generation 3670 disc storage products and the new Memorex computer systems.

Because of the greater predictability of rental revenues, the expected cash flow from our leasing business is also more predictable than cash flow from projected sales operations. Thus, the size of our lease base as a source of revenue and cash flow is of vital importance. It provides the ability to satisfactorily maintain and service a level of indebtedness which might be considered excessive for a company whose cash flow was solely dependent upon sales business. Finally, the cash flow from the lease base is an essential source of capital for the building of the lease base, as discussed below.

Cash Flow From Operations
Cash flow (here defined as net income plus non-cash charges against revenues) is determined to a large extent by the leasing business of Memorex-ILC. In turn, cash flow is a principal determinant of our ability to build the lease base by providing an internal source of funds for investment in equipment-for-lease. Application of increasing amounts of cash flow to such investment occurs as the lease base grows, and Memorex's objective over the five-year period 1970-74 is to build a largely self-financing lease base, i.e., a lease base whose annual cash flow approximates its annual investment requirements while producing a steady annual growth of rental revenues.

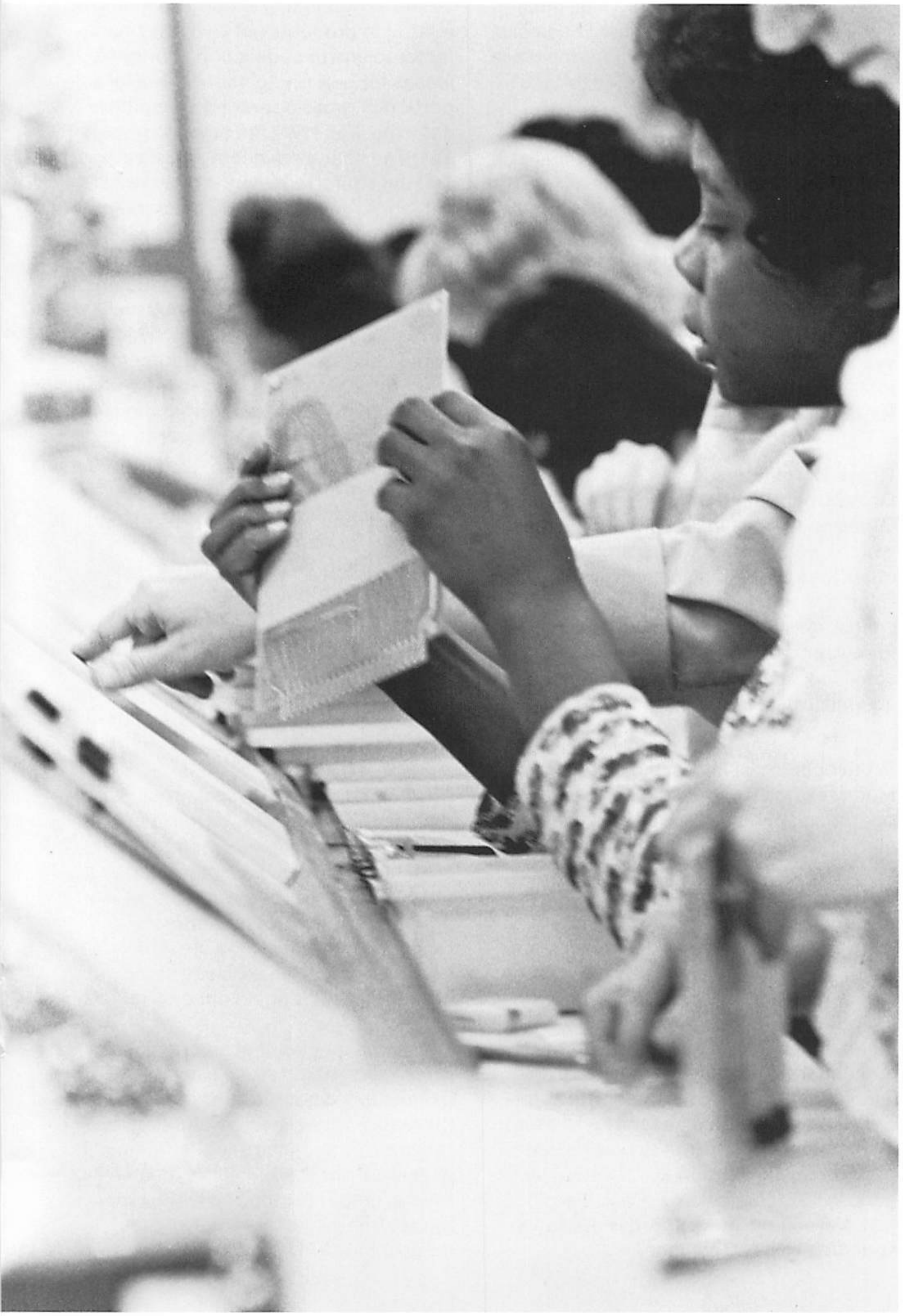
During 1970 and 1971, Memorex invested in new product developments, manufacturing facilities, equipment-for-lease, working capital, and lease acquisition costs. Expenditures for all of these purposes, which are the bases for our leasing business, required Memorex-ILC to obtain from external capital sources approximately one dollar for each dollar of expenditure.

During 1972, the Company's internally generated cash flow is expected to increase materially, based upon expected improvement in profitability and an increase in the non-cash charges to income. As a result, we project that Memorex-ILC will require from external capital sources only about fifty cents for each dollar of 1972's investment in new equipment-for-lease.

Gross Investments in Equipment-for-Lease
In the building of a leasing business, the desired mode of operations is to achieve the essential scale of product development, manufacturing, and marketing operations which are economic and, once achieved, to operate facilities and maintain these activities at such scale. The result is operating stability, particularly as pertains to manufacturing, and an orderly operating environment in which the costs of equipment-for-lease can be minimized. This operating stability also permits the cumulative growth of rental revenues to catch up, thereby steadily reducing the cash drain from operations.

During 1971, gross additions of equip-

Many of the components and subassemblies used in Memorex products are manufactured at Company plants. These printed circuit boards are being assembled in Santa Clara.



ment-for-lease remained at a relatively stable annual rate totaling $70,067,000. Rental revenues rose during the year from $6,747,000 in the first quarter, which amounted to 37% of the first quarter's gross additions of $18,152,000, to $15,620,000 in the fourth quarter, equal to 75% of gross additions of $20,861,000.

During product transitions, such as that which Memorex will accomplish in initiating 1972 production of the 3670 disc file and the Memorex computer systems, there may be temporary reductions in the rate of additions to equipment-for-lease. The effect of reductions is to tend temporarily to improve Memorex's self-financing ability. However, for the full year 1972, Memorex plans an investment in additions to equipment-for-lease which will closely approximate that of 1971.

Turnover Ratio: Relationship of Annual Rentals to Net Investment

A manufacturing business whose equipment-for-lease base is well established and experiencing satisfactory growth, and whose investment is economic, should report annual rental revenues in excess of one-half of its net investment in computer equipment-for-lease and related intangibles. The resulting turnover ratio will generally permit the equipment manufacturer to profitably recover his investment through a conservatively forecasted average product rental life.

Memorex's turnover ratio improved from 0.38-to-1 in the first quarter of 1971 to 0.50-to-1 in the fourth quarter; further improvement is anticipated during 1972. It is our belief that this critical ratio, in which all investment in leasing is compared to rental revenues, is the best assurance of the soundness of that investment, and that the year-end 1971 ratio convincingly demonstrates the soundness of Memorex's investments in equipment-for-lease and related intangibles.

Major programs for the development and introduction of new products to manufacturing may, when costs are not yet reduced by production volume and experience, temporarily result in higher levels of investment relative to added rentals, and thereby temporarily lower the turnover ratio. However, Memorex's experience to date and its continuing improvement of marketing effectiveness and competitive position support our expectation for a consistent long-term achievement of the 0.50-to-1 ratio objective. To the extent that lease revenues continue after the expiration of the products' depreciable lives, the turnover ratio should improve over the currently very acceptable 0.50-to-1.

Intangible Assets as Related to Equipment-for-Lease

The value of intangible assets resulting from deferred accounting for spending related to equipment-for-lease must be substantiated by analyzing the likely recovery of these investments. Programs economically conducted and responsive to customers' demands should, when such spending is deferred, give rise to revenues which should enable Memorex to recover its total investment comprised of both tangible and intangible assets. Soundness and recoverability can be measured best, in our judgment, by the inclusion of our intangible assets with our equipment-for-lease in evaluating the current 0.50-to-1 turnover ratio of this total investment (see above). The prudence of creating intangible assets should also be considered in the context of Memorex's total assets. At the beginning of 1971, our intangible assets relating to our equipment business were $20 million (non-equipment business intangibles amounted to $7 million), compared to equipment-for-lease of $41 million, and to other assets of $165 million (which include the plant and working capital invested in leasing operations, as well as the investment in our sales business). At the end of 1971, such intangibles had grown to $36 million compared to equipment-for-lease of $96 million, and other assets of $186 million. Thus, intangibles relating to our equipment business decreased relative to equipment-for-lease, and at year-end 1971 amounted to 11% of total assets.

The disposition of management should be to limit the amount of intangible assets by rapid commercialization of new products and by increasing rental revenues relative to current operating spending, as discussed above. Memorex expects to report continuing progress during 1972 in improving the turnover ratio, and by year-end to decrease the amount of the intangible assets relative to equipment-for-lease and to total assets.

Gross Margin Versus Gross Operating Spending

Gross margin is the amount of revenues which remains after subtracting the costs, other than operating spending, which are related to the revenues. Gross operating spending is the sum of amounts expended for current product development activities, marketing, and general and administrative functions.

In the building of its leasing business, Memorex has since 1970 engaged in gross operating spending in excess of gross margin. Gross margin has been determined by rental revenues, which necessarily lag our spending for new product development and marketing the equipment-for-lease, and by sales revenues, which in 1971 were adversely affected by a poor media business. Gross operating spending has been geared to product development, sales and service activities, and general and administrative activities, which are at levels consistent with Memorex's manufacturing capacity and which management believes is appropriate to product diversification and revenue targets. In 1971, Memorex's gross margin was $35 million, and our gross operating spending was $52 million.

To the extent that operating spending is related to products not yet being manufactured and to acquisition of original leases for new equipment-for-lease, a portion of gross operating spending is deferred. For 1971, the amount of such deferred spending, net of amortization of amounts deferred in prior years, was $14 million. At year-end 1971, the aggregate of such unrecovered deferred spending approximated $36 million, which comprised our equipment-related "intangible assets." It is our judgment that there was no feasible alternative by which Memorex could have implemented its corporate strategy of building a lease base without incurring gross operating spending in excess of gross margin. The creation of these "intangible assets" by deferring a major portion of such spending is a concomitant of our strategy. The critical question for analysis relates to the recoverability of yet-unrecovered spending as well as other investment in the lease base, irrespective of whether the expenditures were for tangible or intangible assets of the leasing business. Its answer is suggested by the turnover ratio discussed in the prior paragraphs.

The immediate goal of Memorex management is to restrain any increase in gross operating spending (currently at a reduced level from that prevailing throughout most of 1971) while gross margin increases, primarily because of higher rental revenues. We expect the cross-over point, when gross margin exceeds gross operating spending, to occur in mid-1972.

It is also expected that amortization of prior years' deferrals will, in late 1972, exceed any amounts deferred and, thereafter, no further net additions will be made to our balance sheet's "intangible assets." Prior thereto, it is expected that the net amounts deferred will be approximately one-half of the total amount deferred in 1971.

Memorex Corporation

Five Year Summary of Financial Highlights
for the years ended December 31
(Dollar amounts in thousands, except per common share amounts)

	1971 (1)	1970 (1)	1969 (2)	1968 (2)	1967 (2)
Net sales and revenues (excluding $73,054 in 1971 and $42,345 in 1970 billed to ILC)	$ 110,201	$ 78,997	$ 74,067	$ 52,961	$ 33,957
Net income (loss)	(13,390)	3,183	6,902	4,939	3,576
Earnings (loss) per common share (3)	(3.43)	.83	1.85	1.34	1.06
Depreciation and amortization charged to income	26,984	9,391	5,860	3,476	1,687
Additions to property, plant and equipment	20,885	37,201	11,901	8,363	6,484
Increase in equipment for lease to others	72,460	37,901	7,441	4,236	282
Research and development expenditures:					
Charged to income during the year (including amortization)	5,096	4,824	5,141	3,458	2,361
Capitalized as cost of equipment for lease to others (including amortization)	9,814	3,177	403	360	16
Sub-total: expenses and capitalized costs relating to products marketed	14,910	8,001	5,544	3,818	2,377
Capitalized as deferred research and development costs	11,840	8,141	3,683	1,487	758
Less: amortization of deferred research and development costs	(6,341)	(1,577)	(387)	(134)	—
Total research and development expenditures	20,409	14,565	8,840	5,171	3,135
Working capital	35,123	38,561	16,127	7,538	7,232
Total assets	318,129	225,807	88,197	52,988	30,981
Capitalization:					
Unsubordinated debt—					
ILC Peripherals Leasing Corporation	89,718	31,628			
Memorex Corporation and Majority-Owned Subsidiaries	65,146	26,913	22,419	4,289	6,816
Subordinated debentures (convertible), due 1990	75,000	75,000	—	—	—
Shareholders' equity	25,956	39,117	35,074	27,295	15,486
Average number of common shares outstanding (3)	3,900,899	3,829,879	3,733,547	3,680,919	3,120,120
Number of employees at year's end	5,729	6,101	3,409	1,916	1,304

(1) All information shown for 1971 and 1970 is for Memorex Corporation and Majority-Owned Subsidiaries and ILC Peripherals Leasing Corporation as Combined. Because of the transition of Memorex's business from one primarily engaged in the manufacture and sale of magnetic media products in 1969 to large-scale manufacturing and leasing of data processing equipment to computer users in 1970, prior years' data are not comparable.

(2) 1969, 1968, and 1967 adjusted to reflect consolidation of Memorex Leasing Corporation.

(3) Retroactively adjusted for 3-for-1 split-up, conversion of debentures, and acquisition of minority shares as poolings of interests.

Memorex Corporation

Consolidated and Combined Statements of Income (Loss) for the years ended December 31, 1971 and 1970
(Dollars in thousands, except per common share amounts)

	1971		
	Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
Net Sales and Revenues:			
Net sales (excluding $73,054 in 1971 and $42,345 in 1970 billed by Memorex to ILC) (Note 2)	$ 63,760	$ 794	$ 64,554
Rental and service revenues	24,174	24,427	45,647
Realized income on transactions with ILC (including $183 for 1971 and $40 for 1970 representing 20% equity in ILC earnings) (Note 2)	19,072		—
	107,006	25,221	110,201
Operating Costs and Expenses (excluding $51,370 in 1971 and $32,311 in 1970 applicable to amounts billed to ILC) (Notes 2 & 6):			
Cost of sales and revenues	64,836	16,899	74,919
Research and development expenses	5,096	—	5,096
Costs applicable to realized income on transactions with ILC	14,796		—
Selling, general and administrative expenses	38,170	1,030	38,067
	122,898	17,929	118,082
Operating Income (Loss)	(15,892)	7,292	(7,881)
Interest expense	9,967	6,352	16,271
Income (Loss) Before Taxes and ILC Extraordinary Item	(25,859)	940	(24,152)
Provision (credit) for income taxes (Note 9):			
Taxes payable (refundable) for the period—net	(3,964)	—	(3,964)
Deferred taxes	(8,505)	521	(7,528)
	(12,469)	521	(11,492)
Income (Loss) Before ILC Extraordinary Item	(13,390)	419	(12,660)
ILC extraordinary item—credits issued by Memorex to ILC in 1971 net of applicable income taxes (deferred) of $456 (Note 2)		494	—
Income (loss) before elimination of other shareholders' equity in ILC earnings	(13,390)	913	(12,660)
Less other shareholders' equity in ILC earnings (80%)			730
Net Income (Loss)	$ (13,390)	$ 913	$ (13,390)
Earnings (Loss) Per Common Share (Note 12)			$ (3.43)

The accompanying notes are an integral part of these statements.

Memorex Corporation
Notes to Consolidated and Combined Financial Statements

1. Basis of Consolidated and Combined Financial Statements

The Memorex Corporation and Majority-Owned Subsidiaries consolidated financial statements include the accounts of Memorex Corporation and all majority-owned subsidiaries after elimination of intercompany accounts and transactions. All such subsidiaries were wholly-owned as of December 31, 1971, except for three subsidiaries in which the Company owned an interest of 80% or more. The minority stockholders' equity is not material and is included in accounts payable and accrued liabilities.

In consolidation, foreign currencies are translated at the prevailing rates of exchange, using historical rates for non-monetary balance sheet accounts. Net gains and

1970		
Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
$ 69,873	$ —	$ 69,873
7,847	1,449	9,124
1,539		—
79,259	1,449	78,997
46,487	870	46,844
4,824	—	4,824
1,158		—
15,118	143	15,260
67,587	1,013	66,928
11,672	436	12,069
5,234	30	5,264
6,438	406	6,805
(1,308)	—	(1,308)
4,563	208	4,771
3,255	208	3,463
3,183	198	3,342
	—	—
3,183	198	3,342
		159
$ 3,183	$ 198	$ 3,183
		$ .83

losses from revaluation of foreign currencies during 1971 and 1970 were not material.

The accompanying combined financial statements represent a combination of the accounts of ILC Peripherals Leasing Corporation (ILC), a leasing company incorporated on June 29, 1970, with consolidated financial statements of Memorex Corporation and its majority-owned subsidiaries, after elimination of intercorporate accounts in accordance with usual principles of consolidation. The significant elimination and combination entries for the combining of ILC include the following:

(1) Deferred profits on shipments billed to ILC by Memorex and equipment purchased by ILC are eliminated; Memorex's costs are capitalized as computer peripheral equipment and deferred lease acquisition and marketing costs.

(2) Depreciation based on ILC's cost is eliminated and replaced by depreciation based on Memorex's capitalized costs.

(3) The realized portion of deferred profits on billings to ILC is eliminated.

(4) Other shareholders' equity (80%) in ILC earnings is eliminated.

The financial statements of ILC are not consolidated with those of Memorex because ILC is a separate legal entity with a Board of Directors and equity voting interests not controlled by Memorex (see Note 2). Combined financial statements are presented, however, to disclose the interrelationship between the operations of Memorex and ILC and the financial commitments and contingencies that exist between the companies.

2. ILC Peripherals Leasing Corporation (ILC)
A financing program completed for ILC by a number of banks, institutional investors and Memorex Corporation provides for program funds which total $141,793,000.

Under these financial arrangements, Memorex Corporation holds a 10% voting interest in ILC for which Memorex paid $10 million and which comprises all of the Class B common stock of ILC. Institutional investors hold a 90% voting interest (Classes A and C common stock) for which they paid $4,058,000 in conjunction with loan commitments to ILC which they and several commercial banks have made which aggregate $111,235,000. Classes A and C common stock of ILC have a preference to Class B common stock only with respect to certain rights in liquidation. The Company has granted ILC a security interest in its Class B shares. The Class A common stock investors hold the right to select three-fifths of the authorized members of the ILC Board of Directors; the bank lenders have the right to select one-fifth of the number of Directors and certain other voting rights; and Memorex holds the right to select the remaining one-fifth of the number of Directors. Fundamental changes in the ILC corporate structure require a majority vote of each class of ILC common stock, giving effect to the bank lenders' right to vote with the Class A shareholders.

Memorex also holds an option, exercisable for 90 days beginning January 1, 1974, to acquire all or none of the Class A and C shares. The exercise price will be determined as follows: (a) in the event the market price of Memorex shares at the time of exercise is less than $135 per share, the exercise price will be $12,174,000 cash and warrants for 90,178 shares at a warrant exercise price of $135 per share expiring December 31, 1977; or (b) in the event the market price of Memorex shares at the time of exercise is more than $135 per share, the maximum exercise price will be $12,174,000 cash. However, prior to consummation of the purchase under Memorex's option,

Memorex Corporation

Consolidated and Combined Statements of Changes in Financial Position for the years ended December 31, 1971 and 1970
(Dollars in thousands)

	1971		
	Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
Working Capital Was Obtained From:			
Net income (loss)	$(13,390)	$ 913	$ (13,390)
Add expenses (credits) not requiring outlay of working capital—			
Depreciation and amortization charged to income	18,583	12,979	26,984
Increase (decrease) in deferred income taxes	(5,855)	977	(4,879)
Deferred items applicable to billings to ILC—net	20,559		—
Total Working Capital Obtained from Operations and Deferred Items	19,897	14,869	8,715
Proceeds from issuance of long-term debt	46,145	73,040	116,235
Proceeds from issuance of common stock	229	422	229
Depreciation and amortization capitalized	6,217	—	6,924
Increase in other shareholders' equity in ILC			1,152
Decrease in cash of ILC deposited as required by long-term loan agreement		750	750
Total Working Capital Obtained	72,488	89,081	134,005
Working Capital Was Used For:			
Additions to property, plant and equipment	20,881	4	20,885
Increase in equipment for lease to others	33,912	72,373	72,460
Deferred lease acquisition and marketing costs	3,522	—	12,916
Deferred research and development costs	10,474	—	10,474
Investment in ILC	202		—
Costs incident to long-term debt financing	—	108	108
Increase in other assets	407	262	688
Increase in cash of ILC deposited as required by long-term loan agreement		—	—
Reduction of long-term debt	7,912	12,000	19,912
Purchase of ILC subordinated notes	2,950		—
Total Working Capital Used	80,260	84,747	137,443
Increase (Decrease) in Working Capital	$ (7,772)	$ 4,334	$ (3,438)
Represented by:			
Cash	$ 1,789	$ 1,342	$ 3,131
Accounts receivable	184	2,768	2,905
Memorex—ILC intercorporate accounts	(647)	647	—
Inventories	(781)	—	(781)
Claims for refund of income taxes	3,421	—	3,421
Prepayments	715	58	773
Current portion of long-term debt	(9,510)	—	(9,510)
Notes payable, primarily to banks	(3,779)	—	(3,779)
Accounts payable and accrued liabilities	329	(419)	(30)
Federal, state and foreign income taxes	507	(62)	432
	$ (7,772)	$ 4,334	$ (3,438)

The accompanying notes are an integral part of these statements.

1970		
Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
$ 3,183	$ 198	$ 3,183
8,965	705	9,391
2,223	209	2,432
13,634		—
28,005	1,112	15,006
97,574	31,628	129,202
863	13,636	863
2,093	—	2,137
		3,794
	—	—
128,535	46,376	151,002
37,201	—	37,201
18,672	42,345	37,901
1,394	—	10,648
8,141	—	8,141
10,096		—
1,065	580	1,644
499	63	612
	14,340	14,340
18,080	—	18,080
—		—
95,148	57,328	128,567
$ 33,387	$(10,952)	$ 22,435
$ 1,657	$ 273	$ 1,930
1,258	762	2,020
11,417	(11,417)	—
31,695	—	31,695
2,152	—	2,152
794	63	857
(528)	—	(528)
(4,242)	—	(4,242)
(13,048)	(620)	(13,681)
2,232	(13)	2,232
$ 33,387	$(10,952)	$ 22,435

Notes (Continued)

Class A and C shareholders have the right to exchange their shares for 90,178 Memorex shares in lieu of cash.

ILC's Class A and C shareholders have been granted the right to exchange all of their ILC shares, during the period beginning January 1, 1973, and ending December 31, 1977, for an aggregate of 90,178 shares of Memorex common stock.

Memorex and ILC have executed a Master Sales and Maintenance Agreement which calls for ILC to purchase a total of approximately $197 million of disc drives, disc drive controllers, computer-output-microfilm printers and communication terminal equipment during the period ending December 31, 1972. Since inception to December 31, 1971, Memorex has shipped equipment to ILC in the total amount of approximately $115 million. ILC is the lessor of the equipment under leases, a majority of which are for one or two year periods with renewal options. Memorex's contract with ILC provides, among other things, that Memorex will (1) provide maintenance service for ILC's equipment on lease, for which Memorex receives a portion of the maintenance revenue, and (2) re-lease ILC owned equipment on a best efforts basis.

In 1970 (ILC's initial year of operations), the estimated useful life of ILC's equipment was four years, without residual value. As of January 1, 1971, ILC changed the above estimate, as to certain equipment, to recognize a residual value of 20% of original cost, without a change in the estimated useful life of the equipment. As a result of this change, ILC's 1971 depreciation charge for equipment acquired in 1970 and 1971 was reduced by $600,000 and $1,975,000 respectively. ILC's income before extraordinary credit and net income were increased by $1,895,000 and $1,439,000 respectively. Had the new estimate of residual value been applied from inception of ILC's operations in 1970, its income before taxes and net income in 1970 would have been increased by approximately $74,000 and $37,000 respectively. See Note 5 for effect on combined basis.

ILC's equipment "off-rent" (equipment previously on lease and not yet re-leased) at ILC's cost, was $8,146,000 (7.1%) at December 31, 1971, and $10,912,000 (8.8%) at February 29, 1972.

The Company defers all revenue and related costs and expenses applicable to its billings to ILC. The revenues and costs and expenses so deferred are subsequently reflected in the Company's statement of income ratably over the ensuing 48 months.

Under terms of the contracts with ILC, Memorex purchased ILC's subordinated notes of $2.0 million in October, 1971, and has agreed to purchase $14.5 million of additional subordinated notes in July, 1972.

In addition, upon the occurrence of certain events, Memorex may be required to purchase additional subordinated notes from ILC should (1) the aggregate leased equipment value (remaining depreciable life in months times monthly equipment rental rates) of Memorex equipment owned by ILC fall below 130% of ILC's

Memorex Corporation

Consolidated and Combined Statements of Financial Position
December 31, 1971 and 1970 (Page 1 of 2)
(Dollars in thousands)

	1971		
Working Capital and Non-Current Assets	Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
Current Assets:			
Cash, including Memorex short-term investments of $541 in 1970	$ 7,034	$ 1,615	$ 8,649
Accounts receivable—			
Memorex accounts, including $10,770 and $11,417 currently due from ILC in 1971 and 1970, (less allowance of $1,151 and $719 for doubtful accounts in 1971 and 1970)	32,135		21,318
ILC accounts (less allowance of $242 and $66 for doubtful accounts in 1971 and 1970)		3,530	3,530
Inventories, at the lower of cost (first-in, first-out) or market (Note 3)	46,964	—	46,964
Claims for refund of income taxes	5,573	—	5,573
Prepayments	3,461	121	3,582
Total Current Assets	95,167	5,266	89,616
Current Liabilities:			
Current portion of long-term debt	10,038	—	10,038
Notes payable, primarily to banks	18,296	—	18,296
Accounts payable and accrued liabilities	24,589	1,039	25,581
Accounts payable to Memorex		10,770	—
Federal, state and foreign income taxes	503	75	578
Total Current Liabilities	53,426	11,884	54,493
Working Capital	41,741	(6,618)	35,123
Property, Plant and Equipment, at cost (Note 4)	93,292	4	93,296
Less accumulated depreciation	(17,625)	—	(17,625)
	75,667	4	75,671
Equipment for Lease to Others (Note 5):			
Disc pack equipment, less amortization and depreciation	16,584	—	16,584
Computer peripheral equipment, at cost—			
Memorex Corporation and Majority-Owned Subsidiaries	31,821		31,821
ILC Peripherals Leasing Corporation		114,686	57,896
Less accumulated depreciation on computer peripheral equipment—			
Memorex Corporation and Majority-Owned Subsidiaries	(3,011)		(3,011)
ILC Peripherals Leasing Corporation		(13,504)	(6,881)
	45,394	101,182	96,409
Deferred Lease Acquisition and Marketing Costs, including sales and service organization start-up expenses (Note 5)	4,124	—	20,099
Deferred Research and Development Costs (Note 6)	17,648	—	17,648
Other Assets:			
Cash of ILC deposited as required by long-term loan agreement		13,590	13,590
Investment in ILC capital stock, at cost plus equity in undistributed earnings (Note 2)	10,298		—
Other assets and deferred charges	7,107	864	5,096
	17,405	14,454	18,686
Total Working Capital and Non-Current Assets	$ 201,979	$ 109,022	$ 263,636

The accompanying notes are an integral part of these statements.

1970		
Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
$ 5,245	$ 273	$ 5,518
32,598		21,181
	762	762
47,745	—	47,745
2,152	—	2,152
2,746	63	2,809
90,486	1,098	80,167
528	—	528
14,517	—	14,517
24,918	620	25,551
	11,417	—
1,010	13	1,010
40,973	12,050	41,606
49,513	(10,952)	38,561
74,335	—	74,335
(11,903)	—	(11,903)
62,432	—	62,432
17,683	—	17,683
4,330		4,330
	42,345	19,230
(216)		(216)
	(698)	(317)
21,797	41,647	40,710
1,374	—	10,476
12,149	—	12,149
	14,340	14,340
10,096		—
4,842	635	5,533
14,938	14,975	19,873
$ 162,203	$ 45,670	$ 184,201

outstanding liabilities (reduced by cash balances and certain accounts payable to Memorex) to finance equipment purchased from Memorex, (2) the ratio of ILC's senior liabilities to tangible net worth be greater than 6.25 to 1 through June 30, 1972, 4.0 to 1 through September 29, 1972, 3.75 to 1 through December 30, 1972, and 3.65 to 1 thereafter, or (3) ILC's tangible net worth including subordinated notes, if any, be less than $16,058,000 through June 30, 1972, $30,558,000 through September 29, 1972, $33,036,000 through December 30, 1972, and $33,599,000 thereafter. As of December 31, 1971, the aggregate leased equipment value amounted to 138.6% of ILC's liabilities (reduced by cash of $15,205,000 and accounts payable to Memorex of $9,753,000), the ratio of senior liabilities to tangible net worth was 5.0 to 1, and ILC's tangible net worth amounted to $17,517,000. During 1971, Memorex purchased an aggregate of $950,000 of subordinated notes from ILC in order for ILC to meet the tangible net worth test.

During 1971 Memorex also issued credits of $950,000 to ILC as a reduction of maintenance charges to ILC from Memorex. These credits have been accounted for as an extraordinary item by ILC and have the effect of increasing ILC's net income by $494,000. These credits were issued primarily to offset the effect upon ILC's income of interest expense which was higher in relation to ILC's rental revenue than was originally projected.

To qualify as a vendor for ILC, Memorex has agreed to maintain during the term of the Master Sales and Maintenance Agreement its current assets to current liabilities at a ratio of at least 2 to 1 and a ratio of its consolidated senior liabilities to tangible net worth of not more than 1.25 to 1. As of December 31, 1971, these ratios were 1.78 to 1 and 1.18 to 1, respectively. The requirement to maintain a 2 to 1 ratio of current assets to current liabilities has been waived by ILC through June 30, 1972, by reducing the requirement to a 1.5 to 1 ratio.

Promissory notes from ILC held by institutional investors are for 5 year terms at an interest rate of 12%. Term loans to ILC from bank lenders are repayable in 10 equal quarterly installments beginning the first quarter of 1973 and are at interest rates which vary with the prime bank lending rate but in no event less than 9½ %.

3. Inventories

Inventories used in determining cost of sales were priced at the lower of cost (first-in, first-out) or market, and were as follows:

	December 31 1971	December 31 1970
	(Dollars in Thousands)	
Raw materials	$ 13,702	$ 13,185
Work in process	16,470	17,842
Finished goods	16,792	16,718
	$ 46,964	$ 47,745

Included in December 31, 1971, inventories are $27,463,000 of domestic inventories related to the manufacture of computer peripheral equipment of which a significant portion will be shipped to ILC in 1972. The comparable amount of inventories at December 31, 1970, was $28,861,000.

Consolidated and Combined Statements of Financial Position
December 31, 1971 and 1970 (Page 2 of 2)
(Dollars in thousands)

	1971		
Long-Term Liabilities and Shareholders' Equity	Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
Long-Term Debt (Unsubordinated):			
Memorex Corporation and Majority-Owned Subsidiaries (Note 7)	$ 65,146		$ 65,146
ILC Peripherals Leasing Corporation (Note 2)—			
Under loan agreement with banks dated December 29, 1970		$ 57,254	57,254
Under loan agreement with institutional investors		32,464	32,464
Subordinated notes due Memorex Corporation		2,950	—
		92,668	89,718
Subordinated Debentures:			
Memorex Corporation—5¼%, convertible, due 1990 (Note 7)	75,000		75,000
Commitments and Contingent Liabilities of Memorex:			
Agreements with ILC and its lenders and investors require the Company to make an additional investment of $14.5 million in 1972 and contain other commitments and contingent liabilities. Under certain future circumstances the Company could become co-obligor of ILC's indebtedness (Note 2)			
Other commitments and contingent liabilities (Note 8)			
Deferred Items Applicable to Billings to ILC (Note 2):			
Deferred profits on billings to ILC (before income taxes)	27,283		—
Allowance for re-leasing and maintenance costs	6,909		—
	34,192		—
Deferred Income Taxes (Note 9)	1,685	1,185	2,870
Other Shareholders' Equity in ILC			4,946
Shareholders' Equity (Notes 7, 10 & 11):			
Preferred stock	—	—	—
Common stock	3,922	5	3,922
Paid-in surplus	12,042	14,053	12,042
Retained earnings	9,992	1,111	9,992
Total Shareholders' Equity	25,956	15,169	25,956
Total Long-Term Liabilities and Shareholders' Equity	$ 201,979	$ 109,022	$ 263,636

The accompanying notes are an integral part of these statements.

1970		
Memorex Corporation & Majority Owned Subsidiaries	ILC Peripherals Leasing Corporation	Combined
$ 26,913		$ 26,913
	$ 18,700	18,700
	12,928	12,928
	—	—
	31,628	31,628
75,000		75,000
9,693		—
3,940		—
13,633		—
7,540	208	7,749
		3,794
—	—	—
3,870	4	3,870
11,865	13,632	11,865
23,382	198	23,382
39,117	13,834	39,117
$ 162,203	$ 45,670	$ 184,201

4. Property, Plant and Equipment

Property, plant and equipment consist of the following:

	December 31	
	1971	1970
	(Dollars in Thousands)	
Land	$ 7,413	$ 6,222
Buildings and improvements	35,438	22,852
Equipment, furniture and fixtures	44,150	28,228
Construction in progress	6,295	17,033
	93,296	74,335
Less accumulated depreciation	(17,625)	(11,903)
	$ 75,671	$ 62,432

Depreciation, for financial reporting purposes, is computed using the straight-line method based on the following estimated useful lives:

Buildings and improvements	15-33 years
Equipment, furniture and fixtures	3-10 years

5. Accounting for Equipment for Lease to Others

Computer Peripheral Equipment:

During 1970, Memorex began leasing certain computer peripheral equipment in the U. S. (equipment not shipped to and leased by ILC) through its wholly-owned subsidiary Memorex Leasing Corporation. Foreign leasing of computer peripheral equipment, which commenced in 1969, continued through the Company's foreign subsidiaries. Computer equipment leased by Memorex Corporation and Majority-Owned Subsidiaries is accounted for on the operating method with lease revenue recorded as earned. Computer peripheral equipment leased is capitalized at cost including installation expenses; such costs are amortized on a straight-line basis over the estimated useful life of the equipment, which varies between 4 and 5 years. Initial lease acquisition costs are deferred and amortized on a straight-line basis over 4 years. Subsequent costs of re-leasing and reinstallation are expensed as incurred.

In the accompanying combined financial statements, accounting for computer peripheral equipment for lease to customers is on the operating method as stated above. The ILC purchase price of equipment has been restated to Memorex's cost of the equipment, and the related initial lease acquisition and marketing costs (including sales and service organization start-up expenses) have been deferred. Equipment costs are being depreciated on a straight-line basis over the estimated useful life of the equipment, which varies between 4 and 5 years. Deferred lease acquisition and marketing costs are being amortized on a straight-line basis over 4 years.

As of January 1, 1971, ILC and Memorex established an estimated residual value of 20% of original cost for certain equipment. The resulting decrease in the provision for depreciation for Memorex Corporation and Majority-Owned Subsidiaries in 1971 was not material. As a result of the combining eliminations, including the elimination of the other shareholders' equity in ILC earnings (80%), the establishment of a 20% residual value by ILC (see Note 2) did not have a material effect on the combined net loss.

Disc Pack Equipment:

The Company leases disc pack equipment to customers for periods of up to five years. A portion of the rentals

Consolidated and Combined Statements of Shareholders' Equity for the two years ended December 31, 1971
(Dollars in thousands)

Memorex Corporation & Majority-Owned Subsidiaries*	Total Shareholders' Equity	Common Stock	Paid-in Surplus	Retained Earnings
Balance December 31, 1969	$ 35,074	$ 3,721	$ 11,154	$ 20,199
Net income for the year	3,183	—	—	3,183
Sale of common stock to employees under stock option plan	685	21	664	—
Acquisition of minority interests in subsidiary companies	175	114	61	—
Shares issued to former shareholders of subsidiary company under performance agreement	—	14	(14)	—
Balance December 31, 1970*	39,117	3,870	11,865	23,382
Net income (loss) for the year	(13,390)	—	—	(13,390)
Sale of common stock to employees under stock option plan	224	19	205	—
Conversion of convertible subordinated promissory notes issued by subsidiary company in 1971	5	5	—	—
Shares issued to former shareholders of subsidiary company under performance agreement	—	28	(28)	—
Balance December 31, 1971*	$ 25,956	$ 3,922	$ 12,042	$ 9,992

*The Statement of Shareholders' Equity on a combined basis with ILC is the same as shown above.

ILC Peripherals Leasing Corporation	Total Shareholders' Equity	Common Stock	Paid-in Surplus	Retained Earnings
Balance December 31, 1969	$ —	$ —	$ —	$ —
Net income for the year	198	—	—	198
Sale of common stock	13,636	4	13,632	—
Balance December 31, 1970	13,834	4	13,632	198
Net income for the year	913	—	—	913
Sale of common stock	422	1	421	—
Balance December 31, 1971	$ 15,169	$ 5	$ 14,053	$ 1,111

The accompanying notes are an integral part of these statements.

Notes (Continued)

may be applied by customers to purchase of the equipment under a purchase option. Prior to 1971, the company accounted for disc pack equipment by amortizing its investment in the equipment to estimated values. Estimated values for this purpose were less than the customers' net option prices and resulted in recovery of the entire investment in the disc pack equipment over less than four years or upon exercise of the purchase option.

Disc pack equipment initially leased during 1971 is accounted for on the operating method with lease revenues recorded as earned. The investment in disc pack equipment leased prior to 1971 is being amortized, effective January 1, 1971, over the remaining life of the equipment and related lease revenues are being recorded as earned. The use of the operating method during 1971, as compared to the method previously used, does not have a material effect on the financial statements.

6. Deferred Research and Development Costs
Research and development costs related to major new product developments are deferred. When commercial production commences, costs are no longer deferred and amortization begins.

It is management's intention to amortize these costs over a period which does not exceed the expected life of the products. The Company presently amortizes such costs based upon expected product shipments over approximately three years from the time when commercial production begins. As of December 31, 1971, the Company had deferred costs remaining on a total of thirteen major new product developments, certain of which are in the development stage; the remainder have achieved production status and the related deferred costs are in process of amortization. Should it be determined in any period that any deferred costs cannot be recovered from future revenues, they will be written off against operations for that period. Costs amortized for 1971 include $2,370,000 of such write-offs.

Changes in deferred research and development costs on a combined basis were:

	1971	1970
	(Dollars in Thousands)	
Balance, beginning of year	$ 12,149	$ 5,585
Costs deferred	11,840	8,141
Costs amortized—		
Charged to income	(2,804)	(397)
Capitalized to equipment for lease	(3,537)	(1,180)
Balance, end of year	$ 17,648	$ 12,149

7. Long-Term Debt of Memorex Corporation

Long-term debt of Memorex Corporation and Majority-Owned Subsidiaries consisted of the following:

	December 31	
	1971	1970
	(Dollars in Thousands)	
Term loans	$ 61,916	$ 24,593
Other notes and contracts	3,182	2,280
5¼% convertible subordinated debentures due April 1, 1990	75,000	75,000
Convertible subordinated promissory notes issued by subsidiaries—		
5% due January 15, 1974	30	30
5¼% due December 31, 1976	18	10
	$140,146	$101,913

Term loans at December 31, 1971, which are net of current portion, are with domestic and European banks with interest rates ranging from 6% to 9⅜%. The bank loan agreement, as amended in March, 1972, requires among other things that (1) the combined working capital must be at least $26 million through May 31, 1972, $15 million at June 30, 1972, increasing ratably to $60 million after December 31, 1973, (2) the ratio of combined unsubordinated debt to tangible net worth plus subordinated debt must not exceed 3.3 to 1 through March 31, 1972, increasing periodically to 4.0 to 1 at December 31, 1972, and thereafter, (3) the ratio of combined current assets to combined current liabilities must be at least 1.4 to 1 through June 30, 1972, and 1.5 to 1 thereafter, and (4) the combined tangible net worth plus subordinated debt must be at least $65.1 million through March 31, 1972, $63.5 million through June 30, 1972, $60.8 million through December 30, 1972, and $62.5 million thereafter. Under the loan agreement, the Company may not pay cash dividends. Upon request of the bank, the Company must grant to the bank security interests in such assets of the Company as may be designated by the bank.

Other notes and contracts, which are net of current portion, are primarily for the purchase of real property with interest rates ranging from 5.5% to 10%, with a portion thereof secured by deeds of trust.

Interest on the 5¼% convertible subordinated debentures is payable April 1 and October 1. The debentures are convertible into common stock, unless previously redeemed, at a conversion price of $142.50 per share, subject to adjustment under certain conditions. The Company has reserved 526,315 shares of common stock for issuance upon conversion. The debentures are redeemable at the Company's option at prices set forth in the Indenture. The Company will pay into a sinking fund, beginning in 1980, an amount sufficient to redeem $6,000,000 of debenture principal annually on April 1 from 1980 through 1989. The debentures are subordinated to all senior indebtedness as defined in the Indenture.

Convertible subordinated promissory notes issued by subsidiaries in the amount of $48,000 at December 31, 1971, are convertible, upon the occurrence of certain events, into 48,000 shares of the Company's common stock.

Annual maturities of long-term debt over the next five years are: $10,038,000 in 1972, $26,282,000 in 1973, $23,697,000 in 1974, $14,139,000 in 1975, and $122,000 in 1976.

8. Other Commitments and Contingent Liabilities

Memorex Corporation and Majority-Owned Subsidiaries lease certain buildings, including district sales offices, under long-term lease contracts which expire at various dates through 1991. Aggregate rentals remaining under these contracts were approximately $8,500,000 as of December 31, 1971, of which approximately $1,700,000 was due within one year.

On June 24, 1971, the Securities and Exchange Commission filed a complaint against the Company and certain of its officers alleging that the Company violated certain sections of the Securities Exchange Act and rules thereunder by making false and misleading statements in interim financial statements, press releases, reports to shareholders and a Form 9-K filing with the Commission in 1970, and by making false and misleading statements in connection with revision of previous earnings reports. The suit was settled without trial or admission of any liability with the filing of a consent decree on July 21, 1971. The consent decrees make clear the consent "does not constitute an admission by or presumption against the [defendants] of any wrongdoing, misconduct or liability. . ."

Since the consent decree, a number of private class actions and two derivative actions have been filed against the Company, certain officers, directors, and non-Memorex defendants, based substantially on the allegations of the Commission's complaint. All allege violations of the federal securities laws or common law fraud. The defendants are alleged to have violated the federal securities laws by employing accounting methods to reflect Memorex's transactions with ILC during part of 1970, which methods are alleged to have materially overstated Memorex's sales and income for the second and third quarters of 1970, as reflected in the interim reports issued by Memorex for those two periods. In addition, the defendants are alleged to have issued public statements and press releases which were, in the same respect, assertedly false and misleading. None of the various complaints names a precise amount of compensatory damages sought, with the exception of one class action which seeks slightly over $209,000 as compensatory damages. One complaint seeks recision of purchases of the Company's securities in the alternative to compensatory damages, and another seeks punitive damages of $1,500,000. Certain of the complaints also seek punitive damages against Memorex in unstated amounts. In the opinion of counsel, the Company has meritorious defenses to all of these currently pending actions.

9. Income Taxes

The Company's Federal income tax returns through 1967 have been examined by the Internal Revenue Service without material adjustments to net income.

Deferred income taxes were provided in prior years to recognize timing differences in reporting certain income and expenses in the tax returns from those recorded in the books. For Memorex Corporation and Majority-Owned Subsidiaries, income taxes in the amount of $1,685,000 remain deferred at December 31, 1971, to reflect timing differences resulting principally from depreciation computed on the accelerated method for tax purposes and the straight-line method for book purposes, research and development costs expensed for tax purposes and deferred for book purposes, and the difference between the tax and book basis of costs applicable to disc pack equipment for lease. Deferred Income Taxes (including those of ILC) on the combined basis of $2,870,000 reflect the same timing differences as above. Such amounts have been previously charged to income and recorded as deferred income taxes in the consolidated and combined financial statements.

Prepaid taxes, and current and deferred tax classifications for 1970 have been restated to be consistent with present tax and book reporting.

10. Preferred and Common Stock

Authorized and outstanding shares of $100 par value preferred stock and $1 par value common stock of Memorex Corporation were as follows:

	December 31	
	1971	1970
Authorized preferred stock	1,000,000	1,000,000
Outstanding preferred stock	—	—
Authorized common stock	10,000,000	10,000,000
Outstanding common stock (excluding 10,000 shares held in treasury)	3,912,155	3,860,370

The Company has entered into agreements with key employees of several of its subsidiaries which call for the potential issuance of up to 305,000 shares of Memorex common stock upon the occurrence of certain events.

The Company has reserved 100,000 shares of common stock for shareholders of Class A and Class C stock of ILC Peripherals Leasing Corporation under agreements which call for the potential issuance of up to 90,178 shares of Memorex common stock upon the occurrence of certain events (see Note 2).

11. Stock Options (Memorex Corporation)

Changes during 1971 in the status of options granted under the Stock Option Plan were:

Year Granted	Option Price		Shares Under Option—Changes During Year: Jan. 1, 1971	Granted	Exercised	Terminated	Dec. 31, 1971
1966	$16.33 to	$17.17	4,175		4,175	—	—
1967	34.79 to	63.92	65,657		2,837	18,738	44,082
1968	65.81 to	66.63	2,750		—	—	2,750
	1.00		1,539		550	—	989
1969	71.25 to	163.50	94,783		—	31,670	63,113
	1.00 to	1.50	34,580		9,953	750	23,877
1970	45.44 to	116.25	41,450		—	10,250	31,200
	1.00 to	1.50	5,150		1,113	—	4,037
1971	20.00 to	35.38	—	122,312	—	3,625	118,687
	1.00		—	2,100	—	—	2,100
			250,084	124,412	18,628	65,033	290,835

Stock options outstanding at option prices of $1.00 and $1.50 were assumed by the Company in 1970 and 1971 upon acquisition of the minority interests of three of its subsidiaries. Terms for exercise of the assumed options are the same as under the Company plan. Options were granted under a Qualified Stock Option Plan adopted in 1965. Under this plan, options may be issued to key employees to purchase common stock at 100% of market value of the shares at the dates the options are granted. The plan provides that options may be exercised at one-fourth the total shares each year on a cumulative basis, beginning one year after date of grant, with options to expire five years after date of grant. Of the 290,835 shares under option as of December 31, 1971, wrap-around options for 139,645 shares have been granted at a price of $35.38 per share. The wrap-around options do not increase the number of options outstanding, and can be exercised only to the extent the earlier options have expired and have not been exercised. As of December 31, 1971 the Company has reserved 543,427 shares of its common stock for issuance under this plan.

12. Earnings (Loss) Per Common Share

Earnings (loss) per common share have been computed on the basis of the weighted average number of common shares outstanding during the year (3,900,899 in 1971 and 3,829,879 in 1970), excluding 10,000 shares held in treasury. Shares potentially issuable in exchange for the 5¼% Convertible Subordinated Debentures and the ILC Class A and Class C stock (both common stock equivalents) do not result in dilution of earnings per common share. Other common stock equivalents (stock options) do not result in a material dilution of earnings per common share.

Memorex has entered into agreements to exchange shares of the Company's common stock for minority interests in subsidiaries upon occurrence of specific profit performance of the subsidiaries. The Company does not expect that issuance of shares under these agreements would result in material dilution of earnings per common share.

Auditors' Report

Memorex Corporation
San Tomas at Central Expressway
Santa Clara, California 95052

Offices in principal cities throughout the world

**To the Shareholders and
Board of Directors of
Memorex Corporation**

We have examined the consolidated statements of financial position of Memorex Corporation (a California corporation) and Majority-Owned Subsidiaries as of December 31, 1971, and 1970, the combined statements of financial position as of December 31, 1971 and 1970, and the related consolidated and combined statements of income (loss), shareholders' equity and changes in financial position for the two years ended December 31, 1971 and 1970. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of ILC Peripherals Leasing Corporation, included in the combined statements referred to above, were not examined by us but were examined by other auditors whose report thereon has been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for ILC Peripherals Leasing Corporation, is based solely upon the report of the other auditors.

In our opinion, the consolidated financial statements referred to above present fairly the consolidated financial position of Memorex Corporation and Majority-Owned Subsidiaries as of December 31, 1971 and 1970, and the results of their operations and changes in financial position for the two years then ended, and, based upon our examination and the report of other auditors, the combined financial statements referred to above present fairly the combined financial position of Memorex Corporation and Majority-Owned Subsidiaries and ILC Peripherals Leasing Corporation as of December 31, 1971 and 1970, and the results of their combined operations and changes in financial position for the two years then ended, all in conformity with generally accepted accounting principles consistently applied during the periods.

San Jose, California
March 24, 1972 **Arthur Andersen & Co.**

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1971 Annual Report