MEMOREX

1977 Financial Report

Report of Independent Certified Public Accountants

To the Shareholders and Board of Directors of Memorex Corporation:

We have examined the consolidated balance sheets of Memorex Corporation and subsidiaries as of December 31, 1977 and 1976 and the related consolidated statements of income, shareholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to in the preceding paragraph present fairly the financial position of Memorex Corporation and subsidiaries at December 31, 1977 and 1976 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied.

Haskins + Sells

San Francisco, California
January 13, 1978

MEMOREX CORPORATION

Consolidated Statements of Income

For the Years Ended December 31, 1977 and 1976

	1977	1976
	Thousands	
Revenues		
Sales	$330,019	$237,811
Rental and Service	120,093	106,822
Total Revenues	450,112	344,633
Costs and Expenses		
Cost of Sales	196,796	142,454
Cost of Rental and Service	62,293	55,647
Selling, General and Administrative	95,525	69,913
Research and Development	19,216	13,943
Interest	10,787	11,827
Total Costs and Expenses	384,617	293,784
Income Before Income Taxes and Extraordinary Credit	65,495	50,849
Provision for Income Taxes	31,438	25,973
Income Before Extraordinary Credit	34,057	24,876
Extraordinary Credit—		
Income Tax Benefit from Utilizing Loss Carryforwards	22,268	15,254
Net Income	$ 56,325	$ 40,130

	Primary	Fully Diluted	Primary	Fully Diluted
Income Per Common Share				
Before Extraordinary Credit	$5.28	$5.25	$4.35	$4.29
Net Income	$8.87	$8.83	$7.10	$7.01
Proforma Income Per Common Share—Assuming preferred dividends had been payable at the maximum rate scheduled to be paid after 1980:				
Before Extraordinary Credit	$4.78	$4.76	$3.78	$3.73
Net Income	$8.37	$8.34	$6.53	$6.45
Common Shares and Equivalents (Thousands)	6,613	6,642	5,674	5,747

See accompanying notes to consolidated financial statements.

MEMOREX CORPORATION

Consolidated Balance Sheets

December 31, 1977 and 1976

	1977	1976
	Thousands	
Assets		
Current Assets:		
Cash and Temporary Investments, at cost of $5,699 and $36,263 which approximates market	$ 12,021	$ 43,803
Accounts Receivable, less allowance for doubtful accounts of $2,605 and $1,937	76,089	56,118
Inventories, at lower of standard cost (which approximates first-in, first-out cost) or market	85,315	55,603
Prepaid Income Taxes and Other	5,722	1,867
Total Current Assets	179,147	157,391
Rental Equipment and Spare Parts, at cost less accumulated depreciation	64,444	58,039
Property, Plant and Equipment, at cost less accumulated depreciation	60,541	43,637
Intangibles Arising from Business Acquisition	4,119	—
Prepaid Income Taxes and Other	9,503	3,529
Total Assets	$317,754	$262,596
Liabilities and Shareholders' Equity		
Current Liabilities:		
Notes Payable, due within one year	$ 6,591	$ 19,609
Accounts Payable	30,095	18,849
Accrued Income Taxes	29,159	15,930
Accrued Liabilities	31,062	25,0[illegible]
Total Current Liabilities	96,907	79,449
Long-Term Debt:		
Notes Payable	41,143	68,393
Convertible Subordinated Debentures, 5¼% due 1990	65,687	67,218
Total Long-Term Debt	106,830	135,611
Shareholders' Equity:		
Preferred Stock	65,912	62,815
Common Shareholders' Equity—		
Common Stock	5,513	4,875
Additional Capital	44,831	39,205
Retained Earnings (Deficit)	(2,239)	(59,359)
Total Common Shareholders' Equity (Deficiency)	48,105	(15,279)
Total Shareholders' Equity	114,017	47,536
Total Liabilities and Shareholders' Equity	$317,754	$262,596

See accompanying notes to consolidated financial statements.

MEMOREX CORPORATION

Consolidated Statements of Changes in Financial Position

For the Years Ended December 31, 1977 and 1976

	1977	1976
	Thousands	
Funds were provided by:		
Operations—		
Income before extraordinary credit	$ 34,057	$ 24,876
Items included in determining income but not requiring (providing) funds—		
Depreciation and amortization—		
Rental equipment and spare parts	19,340	28,021
Property, plant and equipment	7,541	5,057
Intangibles	241	125
Interest paid with preferred stock	3,097	3,758
Prepaid income taxes	(7,700)	—
Gain on purchase of convertible subordinated debentures	(576)	(399)
Funds provided by operations before extraordinary credit	56,000	61,438
Extraordinary credit—Income tax benefit from utilizing loss carryforwards	22,268	15,254
Funds provided by operations	78,268	76,692
Common stock issued in acquisitions	7,462	—
Borrowings	—	3,860
Stock issued under employee benefit plans	524	1,385
Dispositions of property, plant and equipment	862	234
Other	2,025	2,211
Total funds provided	89,141	84,382
Funds were used for:		
Reduction of long-term notes payable	27,250	25,882
Additions to rental equipment and spare parts, net	25,745	15,795
Additions to property, plant and equipment	25,307	13,239
Intangibles arising from business acquisition	4,212	—
Purchase of convertible subordinated debentures	1,531	827
Dividends on preferred stock	798	634
Total funds used	84,843	56,377
Increase in working capital	$ 4,298	$ 28,005
Increase (decrease) in working capital by component:		
Cash and temporary investments	$ (31,782)	$ 3,621
Accounts receivable	19,971	15,705
Inventories	29,712	18,508
Prepaid income taxes and other	3,855	78
Notes payable, due within one year	13,018	3,831
Accounts payable	(11,246)	(2,379)
Accrued income taxes	(13,229)	(6,537)
Accrued liabilities	(6,001)	(4,822)
Increase in working capital	$ 4,298	$ 28,005

See accompanying notes to consolidated financial statements.

MEMOREX CORPORATION

Consolidated Statements of Shareholders' Equity

For the Years Ended December 31, 1977 and 1976

		Common Shareholders' Equity				
	Preferred Stock	Common Stock	Additional Capital	Retained Earnings (Deficit)	Total	Total Shareholders' Equity
			Thousands			
Balance, January 1, 1976	$ 59,057	$ 4,484	$ 38,405	$(98,855)	$(55,966)	$ 3,091
Net Income for 1976	—	—	—	40,130	40,130	40,130
Issuance of stock:						
In payment of interest accrued through December 31, 1976; issued in 1977	3,758	—	—	—	—	3,758
For employee benefit plans	—	391	994	—	1,385	1,385
Imputed discount adjustments	—	—	(194)	—	(194)	(194)
Dividends on preferred stock	—	—	—	(634)	(634)	(634)
Balance, December 31, 1976	62,815	4,875	39,205	(59,359)	(15,279)	47,536
Net Income for 1977	—	—	—	56,325	56,325	56,325
Issuance of Stock:						
Acquisitions	—	540	5,329	1,593	7,462	7,462
In payment of interest accrued through December 31, 1977; to be issued in 1978	3,097	—	—	—	—	3,097
For employee benefit plans	—	98	426	—	524	524
Imputed discount adjustments	—	—	(129)	—	(129)	(129)
Dividends on preferred stock	—	—	—	(798)	(798)	(7[illegible]
Balance, December 31, 1977	$ 65,912	$ 5,513	$ 44,831	$ (2,239)	$ 48,105	$114,017

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Summary of Significant Accounting Policies

Basis of Presentation

Leasing activities and the related financing are not as significant to the Company's financial position as in prior years. Accordingly, the Company now distinguishes between current and non-current assets and liabilities. The 1977 financial statements reflect this format and the 1976 financial statements have been reclassified to conform.

Consolidation

The consolidated financial statements include Memorex Corporation and all of its subsidiaries.

Depreciation and Amortization

Depreciation of property, plant and equipment and amortization of intangibles are computed using the straight-line method. Rental equipment and spare parts are depreciated using accelerated methods. Estimated economic lives and amortization periods are as follows: buildings and improvements—15 to 33 years; manufacturing equipment, furniture and fixtures—3 to 10 years; rental equipment and spare parts—4 to 7 years; and intangibles arising from business acquisition—30 years.

Income Taxes

U.S. income taxes are not provided on the earnings of foreign subsidiaries or on the undistributed earnings of the Company's DISC subsidiaries since it is the Company's intention to indefinitely reinvest these earnings in foreign operations or qualified export assets. Undistributed earnings of these subsidiaries for which no U.S. income taxes have been provided approximate $10,000,000 as of December 31, 1977. Investment tax credits are accounted for as reductions of the provision for income taxes on the "flow-through" method.

Pension Costs

Pension costs charged against operations include normal costs and amortization of prior service costs over thirty years. Pension costs are funded as accrued.

Acquisitions

Year ended December 31, 1977

During 1977, the Company acquired Business Systems Technology, Inc. (BST), a manufacturer of computer peripheral equipment for small business computers, and Lencor International (CFI), a computer media manufacturer. The BST acquisition was consummated in July 1977, involved the issuance of approximately 340,000 shares of common stock, and was accounted for as a pooling of interests. BST's results of operations for the year ended December 31, 1977 have been consolidated; however, financial statements for 1976 have not been restated to reflect this pooling because its effect on the consolidated financial statements was not material. The CFI acquisition was consummated in April 1977 and was accounted for as a purchase. CFI shareholders received approximately 200,000 shares of common stock with a market value of approximately $5,200,000 plus $2,440,000 in cash. The excess of purchase price over net assets acquired is reported as Intangibles Arising from Business Acquisition. CFI's results of operations since acquisition have been consolidated. The effect of the acquisition on the consolidated financial statements was not material. Combined unaudited revenues of BST and CFI for the year ended December 31, 1976 were approximately $26,000,000.

Subsequent to December 31, 1977

In January 1978, the Company agreed to acquire the European marketing subsidiaries of Telex Corporation. These companies, which had combined unaudited revenues of approximately $39,000,000 during the year ended December 31, 1977, market computer peripheral equipment, principally magnetic tape systems, disc drives and terminal products, for Telex Corporation and other original equipment manufacturers. The acquisitions are subject to approval by various foreign government agencies, will be accounted for as purchases and involve the payment to Telex Corporation of approximately $14,000,000. Payment will be made with a combination of cash and notes payable.

Inventories

Inventories, net of allowances for obsolescence and excess stock of approximately $5,700,000 and $5,200,000, as of December 31, 1977 and 1976, respectively, are as follows:

	1977	1976
	Thousands	
Raw materials	$ 23,920	$ 16,144
Work in progress	26,159	13,455
Finished goods	35,236	26,004
Total	$ 85,315	$ 55,603

Spare parts which were previously reported as a component of inventories have been classified with rental equipment as a non-current asset. Inventories include amounts which may ultimately be capitalized as rental equipment and spare parts.

Rental Equipment and Spare Parts

Rental equipment and spare parts as of December 31, 1977 and 1976 are as follows:

	1977	1976
	Thousands	
Computer peripheral equipment	$131,062	$145,226
Disc packs	15,809	15,062
Spare parts	16,356	11,895
Total	163,227	172,183
Less accumulated depreciation	98,783	114,144
Net	$ 64,444	$ 58,039

Certain classes of products are fully depreciated but generally continue to produce rental revenues. The original cost of these classes of products included above was approximately $33,100,000 and $49,700,000 as of December 31, 1977 and 1976, respectively. During 1977, $8,200,000 of fully depreciated products which no longer have economic value were removed from the accounts.

Property, Plant and Equipment

	1977	1976
	Thousands	
Land	$ 6,721	$ 5,849
Buildings and improvements	22,305	20,211
Equipment, furniture and fixtures	66,678	52,696
Construction in progress	11,765	7,171
Total	107,469	85,927
Less accumulated depreciation	46,928	42,290
Net	$60,541	$43,637

In addition to owned property, the Company leases certain of its administrative, manufacturing and marketing facilities under non-capitalized lease agreements. One of these non-capitalized lease agreements will be capitalized during 1978 under provisions of Financial Accounting Standard No. 13. The capital amount of this lease is approximately $15,200,000. Had the lease been capitalized at inception, accumulated depreciation as of December 31, 1977 and 1976 would have approximated $2,700,000 and $2,200,000, respectively. The present value, discounted at 9.3%, of the related lease obligation at December 31, 1977 and 1976 was approximately $14,450,000 and $14,600,000, respectively. Capitalization will not have a material effect on net income or shareholders' equity.

Most leases contain renewal options and management expects that in the normal course of business the leases will either be renewed or replaced by other leases. Rental expense was approximately $9,000,000 in 1977 and $7,000,000 in 1976.

Minimum rental commitments under non-cancellable leases as of December 31, 1977 are as follows:

	Capital Lease	Total
	Thousands	
Year Ending December 31:		
1978	$ 1,500	$ 5,422
1979	1,500	4,848
1980	1,500	3,938
1981	1,500	3,113
1982	1,500	2,552
Thereafter	29,400	34,871
Total	$36,900	$54,744

Estimated Replacement Cost Information
(Unaudited)

In 1976, the Securities and Exchange Commission (SEC) adopted a requirement that certain companies disclose the impact which current estimated replacement costs would have on their operations, and on the economic investment which would be required for inventories, rental equipment, and productive capacity if such assets were valued on a replacement cost basis.

The replacement of the Company's inventories and rental equipment would generally entail lower estimated replacement costs primarily due to improved technology in semiconductor components and increased capacity utilization. The replacement of the Company's plant and equipment would generally entail higher estimated replacement costs which reflect the cumulative impact of inflation on the long-lived nature of these assets. The net impact of the estimated replacement costs would be to decrease the Company's operating costs.

The Company's annual report to the SEC on Form 10-K includes specific information relating to the estimated replacement costs of inventories, rental equipment and productive capacity (plant and equipment and leased facilities) as of December 31, 1977 and 1976 and the related cost of sales and depreciation expense for the years then ended based on estimated replacement costs.

Notes Payable

The Company's agreement with its senior lender, Bank of America (the Bank), provides for interest payments at the prime rate for domestic loans and 1% over the Bank's cost of funds for overseas loans. During 1977 and 1976 interest on these loans was at a reduced rate, 4% per annum, and was or will be paid in preferred stock. The reduced interest rate and the right to pay interest with preferred stock terminated December 31, 1977. During 1977 and 1976 interest expense was charged against operations at the rate of 7¾% which was comprised of 4% actual interest plus 3¾% imputed discount which was recorded during 1974 at the time the interest reduction was granted and amortized over the reduced interest period which ended December 31, 1977. Imputed discount amortization was $2,827,000 for 1977 and $3,513,000 for 1976.

Significant terms of the loan agreement are as follows:

(1) Monthly principal payments of $2,250,000 are required until outstanding loans are repaid. Voluntary prepayments of principal, which aggregated $26,000,000 at December 31, 1977, apply against scheduled payments as they become due. Such prepayments may be reborrowed during the prepayment period. A commitment fee of ½ of 1% per annum is required for funds available under the reborrowing provision.

(2) The Bank has security interest in all assets.

(3) An additional line of credit is available through 1981. Funds available under this additional line approximate $30,000,000 through 1979 and decline thereafter. No funds have been borrowed under this line.

(4) The Company is precluded from paying dividends on common stock without prior approval from the Bank.

Approximately $4,700,000 of temporary investments at December 31, 1977 were used as collateral on certain foreign borrowings. Approximately $29,000,000 of the December 31, 1977 outstanding indebtedness is payable in currencies other than the U.S. dollar.

Notes payable transactions for the two years ended December 31, 1977 are as follows:

	Bank Loans	Other	Total
		Thousands	
Balance at January 1, 1976	$ 98,848	$ 18,714	$117,562
Additions	3,860	1,008	4,868
Repayments	(11,782)	(17,632)	(29,414)
Foreign exchange adjustments	(2,010)	(48)	(2,058)
Balance at December 31, 1976	88,916	2,042	90,958
Additions	—	3,323	3,323
Repayments	(47,405)	(129)	(47,534)
Foreign exchange adjustments	987	—	987
Balance at December 31, 1977	$ 42,498	$ 5,236	$ 47,734

Annual maturities of notes payable as of December 31, 1977 are: $6,591,000—1978, $27,079,000—1979, and $14,064,000—1980.

Convertible Subordinated Debentures, 5¼% Due 1990

Interest is payable semiannually. Outstanding debentures are convertible into shares of common stock at $142.50 per share.

For ten years, beginning in 1980, annual sinking fund payments of $6,000,000 are required. Debenture purchases can be used to satisfy sinking fund requirements and aggregated $9,313,000 through December 31, 1977.

Shareholders' Equity

Preferred Stock

As of December 31, 1977 and 1976, 1,000,000 shares of Series A and B $100 par value ($100 liquidation and redemption value) and 1,500,000 shares of no par preferred stock were authorized. The Board of Directors is authorized to determine rights, preferences and terms of the no par preferred stock. As of December 31, 1977, no shares of the no par preferred stock were issued or outstanding.

Shares of Series A and B preferred stock were issued to senior lenders, principally Bank of America, under terms of loan agreements. Shares included in the balance sheet are summarized as follows:

	Series A	Series B
December 31, 1976:		
Outstanding	158,381	432,189
Issued in 1977 for payment of 1976 interest	1,258	36,317
Total	159,639	468,506
December 31, 1977:		
Outstanding	159,639	468,506
To be issued in 1978 for payment of 1977 interest	—	30,984
Total	159,639	499,490

The Series A has terms which provide for:

(1) Cumulative annual dividends at $4 per share, increasing to $5 per share in 1977 and 1978, $6 per share in 1979 and 1980 and $8 per share thereafter.
(2) Sinking fund payments during 1983-1987 in equal annual amounts.
(3) Liquidation preference over any other issue of stock.

The Series B has terms which provide for:

(1) Cumulative annual dividends at $4 per share beginning in 1978 and increasing to $6 per share in 1981.
(2) Sinking fund payments during 1983-1992 in equal annual amounts.
(3) Liquidation preference over any other issue of stock except Series A preferred stock.

Early redemption of a portion of the preferred stock may be required if Memorex receives net proceeds in excess of $1,000,000 from the litigation against IBM.

Common Stock

Ten million shares of $1 par value common stock were authorized as of December 31, 1977 and 1976. Shares outstanding, net of treasury shares, were 5,513,230 and 4,875,027 as of December 31, 1977 and 1976, respectively. Treasury shares were 78,804 and 48,804 as of December 31, 1977 and 1976, respectively.

Shares reserved for possible future issuance as of December 31, 1977 were as follows:

	Number of Shares
Warrants issued at $10 per share to senior lenders, expiring in 1989	867,460
Conversion of subordinated debentures	477,508
To employees under:	
Stock option plans	630,091
Common stock bonus plan	150,000
Total shares reserved	2,125,059

Leasing Activities

The Company earns a significant portion of its revenues through leasing activities. As a lessor, the Company markets its products under variable term lease agreements which usually provide the customer with the opportunity to apply a portion of previously paid rentals toward the purchase of the equipment. Most of these leases are cancellable and are for periods of three years or less. Substantially all of the lease agreements between the Company and its customers are operating leases and accordingly, rental revenues are recorded as earned.

The Company also sells a significant portion of its rental equipment and assigns related lease agreements to unrelated third-party financing institutions. The arrangements between the Company and these third-party financial institutions vary; however, the Company usually administers and is reimbursed for the rental billing and collection process. Most of the agreements provide the Company with residual rights in the sold equipment after the institutions have achieved measured returns on their investments. Certain of these agreements provide the Company with the option to reacquire the equipment at nominal cost; other agreements provide for sharing, on a percentage basis, in any future rental revenues. Residual benefits will begin to accrue in 1978 and will be reflected in income as realized.

Employee Benefit Plans

Stock Option Plans

The Company has three stock option plans: the 1973 Stock Option Plan, for "non-qualified" options; the 1974 Stock Option Plan, for "qualified" options; and the 1976 Stock Option Plan, for either "qualified" or "non-qualified" options. Under these plans, options may be granted to key employees to purchase up to 1,335,000 shares of common stock at 100% of market value on the date options are granted. The term of each option granted is determined by the Board of Directors and all options granted through December 31, 1977 expire either five or ten years from date of grant.

Stock option transactions under these plans and options assumed in an acquisition are summarized as follows:

	1977		1976	
	Price per Share	Number of Shares	Price per Share	Number of Shares
Outstanding, beginning of year	$1.75-31.06	339,668	$1.00- 9.06	696,744
Exercised	1.45-27.31	(95,241)	1.00- 9.06	(390,814)
Terminated	2.06-27.31	(26,172)	1.00- 9.06	(26,762)
Qualified options Granted	24.75	40,000	27.31-31.06	5,500
Assumed	1.45- 8.69	25,990		
Non-qualified options Granted	24.75-27.81	140,750	15.06-31.06	55,000
Outstanding, end of year	$1.45-31.06	424,995	$1.75-31.06	339,668
Exercisable		180,263		202,757
Available for grant		205,096		359,674

Incentive Compensation Plans

The Company has an employment agreement with its President and Chief Executive Officer and incentive compensation and bonus plans for certain other employees. Incentive awards, which depend on earnings and are charged to operations in the year earned, were approximately $2,100,000 in 1977 and $2,000,000 in 1976.

Pension Plan

The Company has a pension plan for the benefit of all eligible U.S. employees. Effective January 1, 1978, the plan was changed from a contributory to a non-contributory plan. Participation in the non-contributory plan is automatic. Pension costs charged to 1977 and 1976 operations were approximately $1,500,000 and $1,200,000, respectively.

Common Stock Bonus Plan

Effective January 1, 1978, the Company adopted a common stock bonus plan for the benefit of all qualified U.S. employees. If established financial goals are met in 1978, the Company will distribute previously unissued common stock or its cash equivalent in value. The amount of distribution will be based upon a percentage of the participating employees' earnings.

Income Taxes

The provisions for income taxes are as follows:

	Federal	Foreign	State	Total
		Thousands		
1976				
Charge in lieu	$14,031	$ 1,223	$ —	$15,254
Currently payable	—	5,597	4,889	10,486
Deferred	—	233	—	233
Provision for income taxes	14,031	7,053	4,889	25,973
Loss carryforward benefits	(14,031)	(1,223)	—	(15,254)
Net provision for income taxes	$ —	$ 5,830	$ 4,889	$10,719
1977				
Charge in lieu	$21,400	$ 868	$ —	$22,268
Currently payable	10,000	3,000	5,800	18,800
Deferred (prepaid)	(10,000)	370	—	(9,630)
Provision for income taxes	21,400	4,238	5,800	31,438
Loss carryforward benefits	(21,400)	(868)	—	(22,268)
Net provision for income taxes	$ —	$ 3,370	$ 5,800	$ 9,170

For purposes of filing U.S. Federal income tax returns, the Company has fully utilized its net operating loss and investment tax credit carryforwards as of December 31, 1977. For purposes of filing foreign income tax returns, certain subsidiaries of the Company have net operating loss carryforwards aggregating approximately $7,000,000 as of December 31, 1977. A portion of these foreign tax loss carryforwards expire at various dates through 1982.

For financial reporting purposes, the Company provides deferred (prepaid) income taxes for timing differences between financial accounting and income tax accounting. Principal timing differences at December 31, 1977 relate to U.S. income tax accounting and are comprised of 1) intercompany profits which are taxed but have been eliminated in the consolidated income statement and 2) inventory valuation allowances which are not yet deductible in tax returns. As of December 31, 1977, the Company has approximately $11,000,000 of U.S. financial accounting loss carryforwards in addition to the $7,000,000 of foreign tax loss carryforwards, referred to in the preceding paragraph, both of which may be used to reduce income taxes provided on financial accounting income.

The effective tax rates for 1976 and 1977 were 51% and 48% respectively. Investment tax credits used in computing these effective rates were approximately $3,800,000 in 1976 and $3,300,000 in 1977. The 1976 effective tax rate was in excess of the Federal statutory rate principally because of the effect of certain foreign losses for which tax benefits were not then available.

Income Per Common Share

Income per share amounts are computed by dividing adjusted income by the weighted average number of common shares outstanding plus common stock equivalents resulting from stock options, warrants and convertible subordinated debentures. Income is adjusted for dividends on preferred stock and interest on convertible subordinated debentures.

Litigation

In December 1973, Memorex and certain of its subsidiaries (the Company) filed complaints against International Business Machines Corporation (IBM) alleging that IBM is using and has used its monopoly power to control prices and eliminate competition. The Company further alleges that in violation of the Federal antitrust laws and to the direct detriment of the Company, IBM has monopolized and attempted to monopolize the development, production, distribution, sale, leasing and servicing of certain markets for computers and computer equipment, including, but not limited to, computer peripheral products for use with IBM central processing units. The Company estimates that its actual damages as a result of IBM's actions approximate $600 million, and seeks to recover treble damages. The Company also seeks such injunctive relief, including divestiture, as is reasonably necessary to restore effective competition in the electronic data processing industry. IBM has denied liability, raised affirmative defenses and asserted that it is entitled to an offset for unjust enrichment. IBM's assertion that it is entitled to an offset for unjust enrichment has been stricken by the court. Trial of this case commenced in January 1978 and is expected to continue through a major portion of the year.

In July 1977, the United States District Court for the Northern District of California entered an order approving a Consent Decree settling individual and class action suits against the Company by two female former employees who had alleged employment discrimination. The settlement will not have a material impact on operations or on the financial position of the Company.

Although there are other actions pending to which the Company is a party, management is of the opinion that such actions will not have a material adverse impact on operations or on the financial position of the Company.

Business Segments

The Company manufactures and markets computer peripheral equipment and products utilizing magnetic coating technology for information storage. The principal markets for its products include users of data processing installations, manufacturers of data processing systems, broadcasters and educational users of video tape, home audio equipment users, and users of electronic word processing equipment. The Company's products are principally distributed by its own sales force and, to a lesser extent, through independent distributors. Operations are conducted in three distinct geographic areas: United States; Europe, Middle East and Africa; and Americas and Asia.

Operations can be grouped into two product lines: Equipment Products and Media Products. The Equipment Products line consists of computer peripheral equipment based on electromechanical and electronic technology, such as disc storage systems, semiconductor memory units, communications controllers and terminals, tape storage systems, printers and computer output microfilm products. The Media Products line consists of products such as computer tape, disc packs, audio tape and video tape, based on magnetic coating technology which are used in computer information storage systems, recording equipment and word processing equipment.

The following tables summarize the operations of the Company on a geographic and on a product line basis as of December 31, 1977 and for the year then ended.

Geographic Basis *(Thousands)*	**REVENUES**			**OPERATING INCOME****			**Identifiable Assets**
	External	**Internal***	**Total**	**External**	**Internal***	**Total**	
1977							
United States	$281,922	$ 88,288	$370,210	$ 83,539	$ 31,688	$115,227	$178,242
Europe, Middle East & Africa	126,102	—	126,102	4,000	—	4,000	102,197
Americas & Asia	42,088	—	42,088	4,700	—	4,700	37,386
General Corporate	—	—	—	(15,957)	—	(15,957)	29,003
	450,112	88,288	538,400	76,282	31,688	107,970	346,828
Elimination	—	(88,288)	(88,288)	—	(31,688)	(31,688)	(29,074)
	$450,112	$ —	$450,112	$ 76,282	$ —	$ 76,282	$317,754

Product Line Basis *(Thousands)*				**Depreciation**		**Capital Expenditures**	
	Revenue	**Operating Income**	**Identifiable Assets**	**Prop. Plant & Equip.**	**Rental Equip. & Spare Parts**	**Prop. Plant & Equip.**	**Rental Equip. & Spare Parts**
1977							
Equipment Products	$273,351	$ 65,251	$174,444	$ 2,252	$ 16,002	$ 7,431	$ 22,316
Media Products	176,761	26,988	114,307	4,416	3,338	12,902	3,429
General Corporate	—	(15,957)	29,003	873	—	4,974	—
	$450,112	$ 76,282	$317,754	$ 7,541	$ 19,340	$ 25,307	$ 25,745

*Internal revenues accrue to United States operations from product sales to foreign subsidiaries which are principally sales and service operations. Internal selling prices are designed to allocate manufacturing profits to manufacturing entities and sales and service profits to those entities.

**Operating income is derived by adding interest expense to income before income taxes and extraordinary credit.

Revenues, operating income and identifiable assets of foreign subsidiaries as of December 31, 1976 and for the year then ended were $136 million, $12 million and $121 million, respectively.

Quarterly Summary (Unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	1977	1976	1977	1976	1977	1976	1977	1976
			(Thousands except per share amounts)					
Revenues:								
Sales	$74,466	$53,785	$78,641	$54,661	$84,432	$57,181	$92,480	$72,184
Rental and Service	29,290	25,634	29,541	26,178	29,699	27,139	31,563	27,871
Total Revenues	103,756	79,419	108,182	80,839	114,131	84,320	124,043	100,055
Costs and Expenses:								
Cost of Sales, Rental and Service	59,068	47,156	63,762	46,253	65,217	46,989	71,042	57,703
Other Costs and Expenses	25,678	17,605	26,580	20,006	30,320	21,379	32,163	24,866
Interest	2,794	3,160	2,730	2,991	2,673	2,923	2,590	2,753
Total Costs and Expenses	87,540	67,921	93,072	69,250	98,210	71,291	105,795	85,322
Income before Income Taxes and Extraordinary Credit	16,216	11,498	15,110	11,589	15,921	13,029	18,248	14,733
Provision for Income Taxes	7,935	6,209	7,201	5,565	7,543	6,645	8,759	7,554
Income before Extraordinary Credit	8,281	5,289	7,909	6,024	8,378	6,384	9,489	7,179
Extraordinary Credit	5,470	3,794	5,150	3,132	5,722	3,909	5,926	4,419
Net Income	$13,751	$ 9,083	$13,059	$ 9,156	$14,100	$10,293	$15,415	$11,598
Primary Income per Common Share:								
Before Extraordinary Credit	$1.32	$ .95	$1.23	$1.04	$1.28	$1.11	$1.44	$1.23
Net Income	$2.23	$1.66	$2.07	$1.59	$2.19	$1.80	$2.37	$2.03
Fully Diluted Income per Common Share:								
Before Extraordinary Credit	$1.32	$ .91	$1.23	$1.03	$1.27	$1.11	$1.43	$1.22
Net Income	$2.23	$1.59	$2.07	$1.58	$2.17	$1.80	$2.36	$2.01
Proforma Income per Common Share— Assuming preferred dividends had been payable at the maximum rate scheduled to be paid after 1980:								
Primary:								
Before Extraordinary Credit	$1.19	$ .80	$1.11	$ .90	$1.16	$ .96	$1.32	$1.10
Net Income	$2.10	$1.51	$1.95	$1.45	$2.07	$1.66	$2.25	$1.90
Fully Diluted:								
Before Extraordinary Credit	$1.19	$ .77	$1.11	$ .89	$1.15	$ .96	$1.31	$1.09
Net Income	$2.10	$1.45	$1.95	$1.44	$2.05	$1.66	$2.24	$1.88

MEMOREX CORPORATION

Five-Year Summary

Years Ended December 31

	1977	1976	1975	1974	1973
	(Thousands except per share amounts)				
Summary of Operations					
Revenues:					
Sales	$330,019	$237,811	$162,139	$118,297	$ 83,991
Rental and Service	120,093	106,822	101,855	99,330	92,932
Total Revenues	450,112	344,633	263,994	217,627	176,923
Costs and Expenses:					
Cost of Sales, Rental and Service	259,089	198,101	163,651	147,743	138,392
Other Costs and Expenses	114,741	83,856	67,245	60,181	103,427
Interest	10,787	11,827	15,268	18,675	20,487
Total Costs and Expenses	384,617	293,784	246,164	226,599	262,306
Income (Loss) before Taxes and Extraordinary Credits	65,495	50,849	17,830	(8,972)	(85,383)
Provision for Income Taxes	31,438	25,973	9,585	—	4,925
Income (Loss) before Extraordinary Credits	34,057	24,876	8,245	(8,972)	(90,308)
Extraordinary Credits	22,268	15,254	9,777	—	—
Net Income (Loss)	$ 56,325	$ 40,130	$ 18,022	$ (8,972)	$(90,308)

	Primary	Fully Diluted	Primary	Fully Diluted		Primary	
Per Share Data							
Income (Loss) per Common Share:							
Before Extraordinary Credits	$5.28	$5.25	$4.35	$4.29	$ 1.74	$ (2.08)	$ (20.96)
Net Income (Loss)	8.87	8.83	7.10	7.01	3.80	(2.08)	(20.96)
Proforma Income (Loss) per Common Share:							
Before Extraordinary Credits	$4.78	$4.76	$3.78	$3.73	$ 1.03	$ (2.60)	—
Net Income (Loss)	8.37	8.34	6.53	6.45	3.09	(2.60)	—
Common Shares and Equivalents	6,613	6,642	5,674	5,747	4,740	4,314	4,309

Operating Data	1977	1976	1975	1974	1973
Total Revenues:					
Equipment	$273,351	$210,370	$156,307	$116,043	$ 92,678
Media	176,761	134,263	107,687	101,584	84,245
Operating Income (Loss):					
Equipment	65,251	54,248	27,942	(1,267)	(71,380)
Media	26,988	20,508	5,156	10,970	6,484
General Corporate	(15,957)	(12,080)	*	*	*
International Revenue	168,190	136,000	112,000	87,000	75,000
Research and Development Expenses	19,216	13,943	9,282	7,462	3,658
Depreciation and Amortization	27,122	33,203	40,532	46,323	59,162
Financial Position at Year End					
Cash and Temporary Investments	$ 12,021	$ 43,803	$ 40,182	$ 11,783	$ 4,099
Inventories	85,315	55,603	37,095	43,394	52,260
Rental Equipment and Spare Parts:					
At Cost	163,227	172,183	182,211	204,749	181,52[illegible]
Net of Accumulated Depreciation	64,444	58,039	68,769	92,231	99,17[illegible]
Notes Payable	47,734	90,958	117,562	163,117	226,022
Convertible Subordinated Debentures	65,687	67,218	68,045	75,000	75,000
Total Shareholders' Equity (Deficiency)	114,017	47,536	3,091	(23,677)	(86,857)

*General Corporate expenses were allocated to product lines in these years.

Management's Discussion and Analysis of the Summary of Operations

The following discussion contains general comments on the results of Memorex's operations during 1977 and 1976 as compared to the previous years (1976 and 1975).

Revenues

Total revenues increased 31 percent in both 1977 and 1976. These increases were primarily due to increased volumes of product shipments as unit price changes were not significant. Acquisitions in 1977 accounted for 7 percent of the 1977 increase. Sales revenue increased 39 percent in 1977 and 47 percent in 1976 while rental and service revenues increased 12 percent and 5 percent in 1977 and 1976, respectively. Equipment products revenue increased 30 percent in 1977 and 35 percent in 1976 and media products revenue increased 32 percent in 1977 and 25 percent in 1976.

Cost of Sales, Rental and Service

Cost of sales increased 38 percent in 1977 and 42 percent in 1976. These increases were principally due to increased sales volumes. Cost of sales as a percentage of sales decreased from 1975 to 1976 principally because of increased 1976 capacity utilization and productivity improvements. Cost of rental and service increased 12 percent in 1977 and decreased 12 percent in 1976. The 1977 cost increase parallels the increase in rental and service revenues and is due to an increased volume of business and increased costs of service associated with the expanding base of equipment in customer hands. These 1977 increases were offset in part by a reduction in rental equipment depreciation costs from the 1976 level. The 1976 decrease in cost of rental and service was primarily due to a comparative reduction in rental equipment depreciation resulting from certain classes of rental equipment becoming fully depreciated during 1976.

Other Costs and Expenses

Other costs and expenses increased 37 percent in 1977 and 25 percent in 1976. These increases were due to continued expansion in the volume of the Company's business and are comprised of increased selling, general and administrative expenses of 37 percent in 1977 and 22 percent in 1976 and increased research and development expenditures of 38 percent and 50 percent in 1977 and 1976, respectively. The annual increases in selling, general and administrative expenses are primarily due to increased levels of employment which are necessary to support expanding sales and marketing activities and increased costs incurred in preparation for the IBM litigation. Also included in the 1977 increase is the comparative effect of foreign exchange adjustments which resulted in a 1977 loss of $300,000 and a 1976 gain of $200,000. The increases in research and development expenditures are primarily due to the Company's expanded development efforts, principally associated with equipment products.

Interest

Interest expense decreased 9 percent in 1977 and 23 percent in 1976. These decreases are due to reductions in average outstanding borrowings. Interest rates relating to borrowings under the Company's principal loan agreement and on its convertible subordinated debentures have remained constant during 1977 and 1976.

Provision for Income Taxes

The effective tax rates of 48 percent in 1977 and 51 percent in 1976 represent taxes on Federal, state and foreign income. The effective rates are governed by the origin of the various components of consolidated financial income and the tax rates which are applicable to those components. Factors which tend to raise the effective rate above the Federal statutory rate include losses of foreign subsidiaries for which tax benefits are not currently available, state income taxes and foreign income taxes which are in excess of the Federal rate. Factors which tend to lower the effective rate are investment tax credits, Domestic International Sales Corporation income not taxable and foreign taxes which are lower than the Federal rate. The 1976 effective tax rate was higher than the 1977 rate and was in excess of the Federal rate principally because of the effect of certain foreign losses. The 1976 rate was lower than the 1975 rate principally because of investment tax credits.

Extraordinary Credit

The extraordinary credit in 1977 and 1976 consisted of the estimated tax benefits from utilizing net operating loss carryforwards.

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