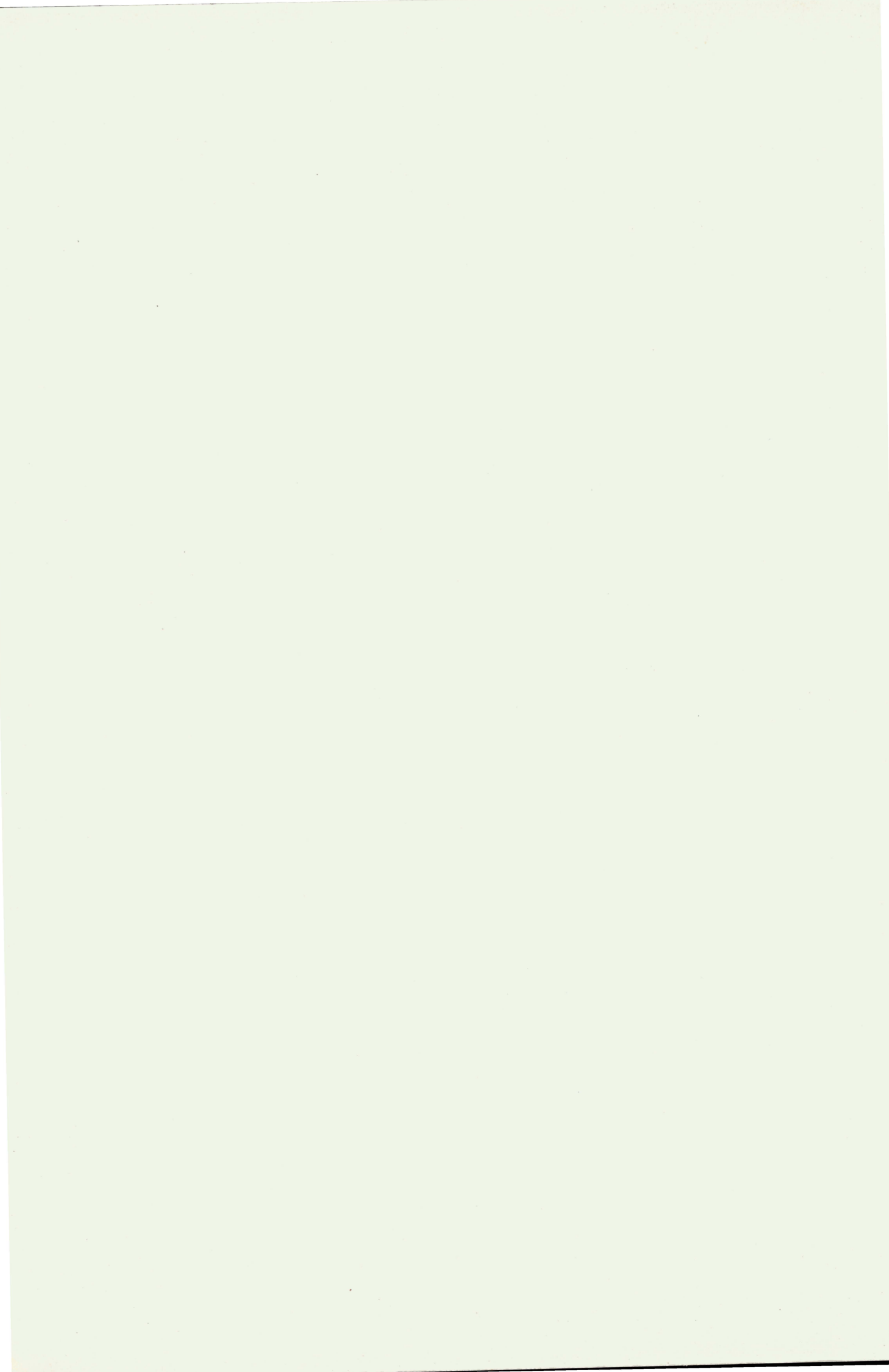




DIGITAL EQUIPMENT CORPORATION
ANNUAL REPORT 1986



CORPORATE PROFILE

Digital Equipment Corporation is one of the world's largest manufacturers of networked computer systems and associated peripheral equipment and the leader in systems integration with its networks, communications and software products. The Company's products are used worldwide in a variety of applications and programs, including scientific research, computation, communications, education, data analysis, industrial control, timesharing, commercial data processing, graphic arts, word processing, personal computing, health care, instrumentation, engineering and simulation.

FINANCIAL HIGHLIGHTS

Fiscal Year	1986	1985	% Change
Total operating revenues . . .	\$7,590,357,000	\$6,686,316,000	+ 14
Net income	\$ 617,420,000	\$ 446,682,000	+ 38
Net income per share	\$4.81	\$3.71	+ 30
Total stockholders' equity . .	\$5,727,827,000	\$4,554,599,000	+ 26
Stockholders' equity per share	\$ 44.54	\$ 38.43	+ 16

ANNUAL MEETING OF STOCKHOLDERS

The Annual Meeting of Stockholders will be held at 11:00 A.M., Thursday, November 6, 1986, at the New England Life Hall, 225 Clarendon Street, Boston, Massachusetts. Stockholders of record on September 8, 1986 will be entitled to vote at this meeting.

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On the Cover ■ Under the banner, "Digital Has It Now!," DECworld '86 attracted more than 20,000 customers to Boston in February for the industry's largest-ever single-company trade show. By any measure the most successful marketing event in the company's history, DECworld's 400 exhibits showcased Digital's broad range of fully integrated network solutions.

To our Shareholders, Customers, Employees and Friends:

Fiscal 1986 was a good year for Digital. During a time when the computer industry was slow, we grew in revenues and profits, with a significant improvement in our use of assets.

We solidified our position as the leader in high-speed computer networks. We introduced more important new products than in any comparable period in the company's history. And, to get us even closer to our customers, we realigned our marketing organization to give it an industry-specific focus with solutions that directly address customer needs.

Digital's Board of Directors was expanded during the year with the addition of Robert R. Everett, recently retired president of The MITRE Corporation and a renowned computer pioneer who helped lead development of the Whirlwind computer at MIT in the 1950s. We are privileged to have Mr. Everett's distinguished technical credentials and management skills at our disposal.

Digital has undertaken a difficult mission. Our goal is to connect all parts of an organization – the office, the factory floor, the laboratory, the engineering department – from the desktop to the data center. We can connect everything within a building; we can connect a group of buildings on the same site or at remote sites; we can connect an entire organization around the world. We propose to connect a company from top to bottom with a single network that includes the shipping clerk, the secretary, the manager, the vice president, even the president.

The difficulty of our mission goes beyond the technical challenges involved. Change also becomes an important factor. Progressive companies analyze their organizations, understand their goals and then completely change the way they run their business in order to make them more competitive and more effective in pursuing their goals. They recognize the benefits of tying their entire company together with a single computer network that is as accessible and easy to use as a telephone system.

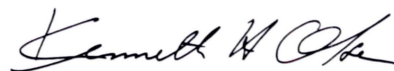
But for many other companies the change to open, company-wide computer networks is happening more slowly because of traditional centralized computing approaches. Without meaning to, those in charge of such companies stifle the involvement and creativity of many of their people by restricting the availability and flow of information throughout the organization.

In the organization of the future that we propose, the free flow of information creates excitement and motivation and enthusiasm, and helps unify the company. The information becomes a strong internal catalyst and a powerful competitive tool.

Today's Digital is very much this kind of organization. We have become a truly unified company with one clear strategy and one strong message, and everyone in the company is working toward a common goal. And yet, we have been able to retain a strong entrepreneurial spirit. We have achieved this by creating the kind of organization we are proposing for the future, one which is tied together by an accessible, easy to use computer network.

Included later in this report are comments from some of our customers for whom Digital's ability to interconnect their organizations – and in some instances to link them to others – has created a significant competitive advantage.

All of us at Digital are far more excited about our products and the future than at any time in the past. We have more ideas than we've ever had on how to improve current products and develop new ones – so many, in fact, that we need to use great discipline to limit our development activities to only those products which will contribute directly to our mission.



Kenneth H. Olsen, President
September 8, 1986



The information that an organization possesses is being recognized as a corporate asset every bit as valuable as its buildings, inventory, people and technology. It needs to be managed efficiently and effectively to maximize its value and create a competitive advantage for its owner.

The problem no longer is just collecting, processing and storing data. Today's organizations are challenged to convert the data into useful information and to communicate in a timely fashion to those parts of the organization where it is needed. They also recognize that there are

significant advantages in being able to share workloads among the various levels of the organization. And they must be able to do this easily and cost-effectively.

Digital has spent most of the last 20 years strategically developing computer networks to meet these needs, using just one computer architecture, one software system and one simple interconnect technology. The result is a wide range of fully compatible products and services that simplify the planning, building, modification, expansion, merging, maintenance and management of local and global networks to meet the information management needs of organizations of any size.



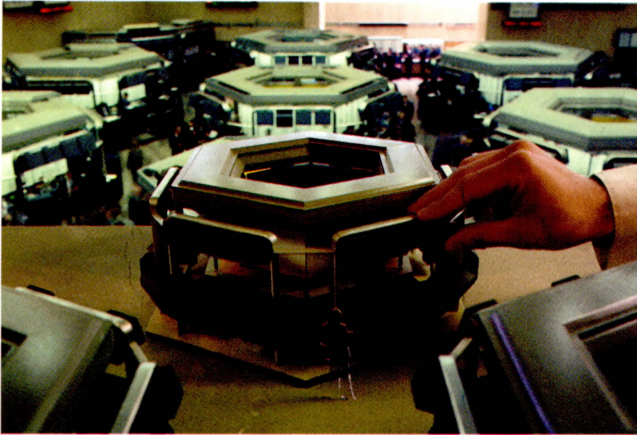
“As the third-largest stock exchange in the world, we planned for growth when we rebuilt our trading floor, anticipating a doubling of trading volume over the next several years. The VAXclusters and Ethernet local area networks are flexible enough to support this increased activity. We merely add systems, where needed, without disrupting trading. They also enable us to share data directly with information distributors, such as Reuters, around the world.”

*Kevin M. Kane, Vice-President,
Corporate Marketing; Midwest Stock Exchange, Inc., Chicago*

To fulfill our vision of how computers should serve their users, Digital has been doggedly pursuing a very explicit strategy for developing all the components and skills needed to build fully integrated, easy-to-use high-speed computer networks. It has taken much discipline, much hard work and an enormous investment to produce a set of products, all of them available today, which make it possible for users to build computer networks of almost any size and scope, from a few desktop systems linked by a single wire within the same room to ones involving hundreds of large, powerful computers spread throughout a vast global organization.

DNA ▪ Development of the Digital Network Architecture (DNA) began in the early 1970s with DECnet, a very advanced protocol for integrating similar or different computers in a network. We believe that DECnet is the most widely used networking protocol in the world.

VAX ▪ Next, in the mid-1970s, came the architecture for VAX, which we designed to be as effective as a desk top machine as it was a large data center system. We designed it to last for many, many years but, most importantly, we designed it to work effectively in networks.



“We compete in a global marketplace, where our success depends on how open and efficient a market we are. To that end, the Exchange underwent the Big Bang of deregulation in October. In little more than 24 months, we had to create a new market reporting system that was fast, reliable, based on proven technology, and expandable to meet future needs. We installed VAXclusters and an Ethernet/DECnet network as the heart of that new system.”

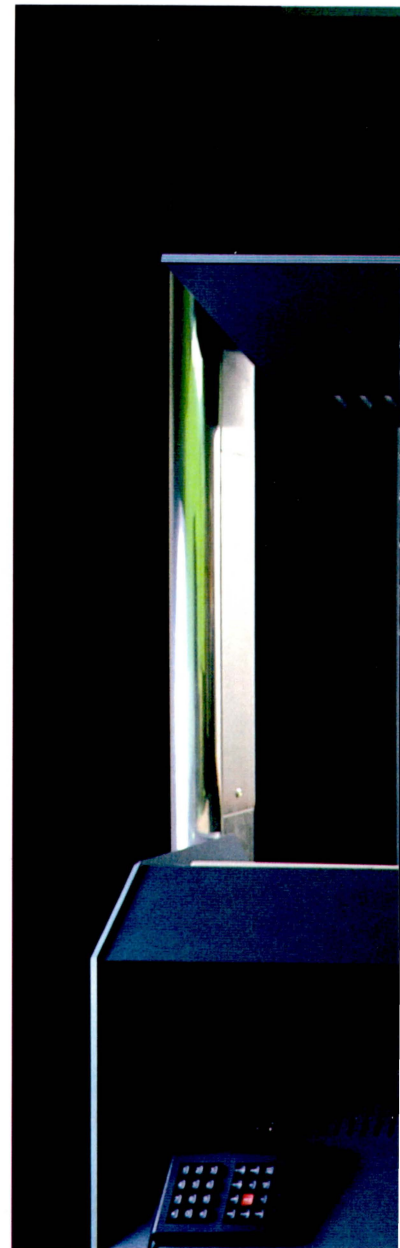
*George Hayter, Divisional Director, Information Services;
The Stock Exchange, London*

The idea of concentrating on a single architecture was very different from the standard industry practice of developing different architectures and software systems for different sizes and classes of computers. Instead, with VAX, Digital provides a stable, predictable environment that encompasses a range of systems from very small to very large.

With the introduction of the first VAX system in 1977, Digital introduced a computing architecture that could be—and would be—implemented on very large systems and on a single microprocessor chip. The idea was to

make it possible for a user to move applications from one system to another; to be able to run an application developed on one VAX system on any other VAX system, thereby eliminating the cost and inconvenience of software conversion.

VMS ■ To maximize the effectiveness of our networks, and to fully exploit the functionality and versatility of a single VAX hardware architecture, we concurrently developed a single software system—VMS—that would have one powerful version of each programming language and that could work as effortlessly in networks as in single systems.





It is VMS that ties together all of our computers, clusters and networks. VMS provides a consistent user and programmer environment that significantly reduces staffing, training and program maintenance costs. The value of this environment was quickly recognized by software developers and third parties selling applications solutions. They have developed a wealth of software to complement and supplement the applications developed by Digital. Literally thousands of applications are available on VMS.

There are also security features built into VMS which provide significant protection to systems and stored data. For all these reasons, we believe that VMS is the best software system in the world.

ULTRIX • Digital also provides one of the world's best UNIX-based systems, called ULTRIX, for those customers who already have UNIX applications or do not need the array of features or the networking capabilities of VMS. Digital is the first major vendor to deliver a UNIX operating system that provides a native 4.2 BSD (Berkeley Software Division) environment with System V compatibility.

“For more than 20 years we have used Digital’s computers to help create the largest worldwide distribution network for news and financial information. Our subscribers operate in a competitive, global market. They require fast and reliable information gathering and distribution services. Digital’s VAX computers and network architecture allow us to create the network we need to meet those demands; it grows as we do, without disrupting service.”

*Martin Davids, European Technical Development Manager;
Reuters Ltd., London*



VAXclusters ▪ Also key to Digital’s networking strategy are VAXclusters, a unique technology developed in response to the rapid growth and constant change that characterize business today. As growth and change accelerate, users must buy larger systems and rewrite their applications as they move them from one system to the next.

VAXclusters eliminate this problem by linking high-speed computers sharing a common database to deliver more power and performance than the largest mainframes. Up to 16 VAX computers and needed storage disks can be added at any time without disrupting ongoing opera-

tions. The entire VAXcluster is managed as a single system. Because VAXclusters permit a “building block” approach to using computers of various sizes in combination with storage devices, users can achieve optimum resource utilization and maximum return on investment.

Ethernet ▪ In the late 1970s, Digital committed to Ethernet as a key element in its networking strategy, and we have directed a large portion of our development investment into the systems components required to make the implementation of Ethernet networks practical. Ethernet makes it easy to build computer networks of any size that can be changed or expanded just as easily,



as user needs require. The ease and flexibility afford maximum efficiency in the use of expensive computer resources.

Digital's approach to building networks with Ethernet is quite simple. Just as telephone lines, low-speed data lines and, where needed, video cable are wired throughout a building, so is Ethernet. Using Digital's wiring scheme, called DECconnect, all four of these communications technologies can be accessed easily through a single wallplate. Wallplates can be installed anywhere in a building, making the assembly of a high-speed computer network as easy as plugging in an appliance.

Because of the inherent simplicity of this approach, networks can be built easily in any environment – office, factory, laboratory, engineering department, computer room. And they can be built at any level of an organization. To illustrate, we use a simple model to define the various levels which make up a typical organization:

Not surprisingly, the first level is the *individual*. A number of individuals – they can also be devices such as robots or laboratory equipment – all performing a similar task or using the same database, constitute a *workgroup*. In turn, one or more workgroups make up a *department*, and the sum of these entities is the *organization*.



Within this organization, Ethernet can be used to build networks of any size, from the simplest local hookups to the largest, most global networks. And all of these local networks can be fully integrated into a single, seamless network. For example, a simple office network could consist of a small number of linked personal computers. Or it could be a small VAX system supporting a number of individuals using word processors. On the factory floor, a VAX system could support a network of robots or machine tools; the laboratory network could support terminals used in experiments, and the engineering network could support workstations.

In the foregoing examples, the same simple method is used to build each network: the devices being supported are connected directly to Ethernet which, in turn, is connected to a VAX system.

This approach allows the creation of a single network consisting of as few or as many computer systems as the current local workload requires. The user can connect a few personal computers or workstations into a simple local network; smaller systems can be connected to larger ones, or large systems to each other. The options are virtually unlimited.



Digital's computers, used throughout the Lockheed Corporation, are helping ensure smooth material flow to keep production of the largest aircraft in the West on schedule. At peak production, one C-5B will roll out of Lockheed-Georgia's Marietta plant every ten days. VAXclusters and PDP-11s control the precise cutting and machining of thousands of separate parts making up the airframe and skin.

With Ethernet all the functions within an organization can easily be merged into a single, seamless network. With Ethernet, you can literally plug anything in anywhere and it is immediately on the network. And because Ethernet is a "throughway," rather than a chain or a ring, devices can be added or removed without interrupting traffic on the network.

Second Generation of VAX ■ The company introduced seven new second-generation VAX systems in a period of eight months, thereby completing the replacement of the original industry-standard 700-series VAX systems that debuted in 1977. Following is the current line-up of 8000-

series VAX processors. Included are two midrange systems that were announced as this report was being prepared. Introduction dates and power comparisons with the de facto standard created by the original VAX-11/780 are shown in parentheses.

- VAX 8800: the highest-performance computer system ever produced by the company, delivering up to 12 times the power of the original VAX-11/780. It is designed for use in such compute-intensive areas as seismic analysis, image processing, artificial intelligence, circuit design, simulation and high-energy physics. (January 1986, -12X)

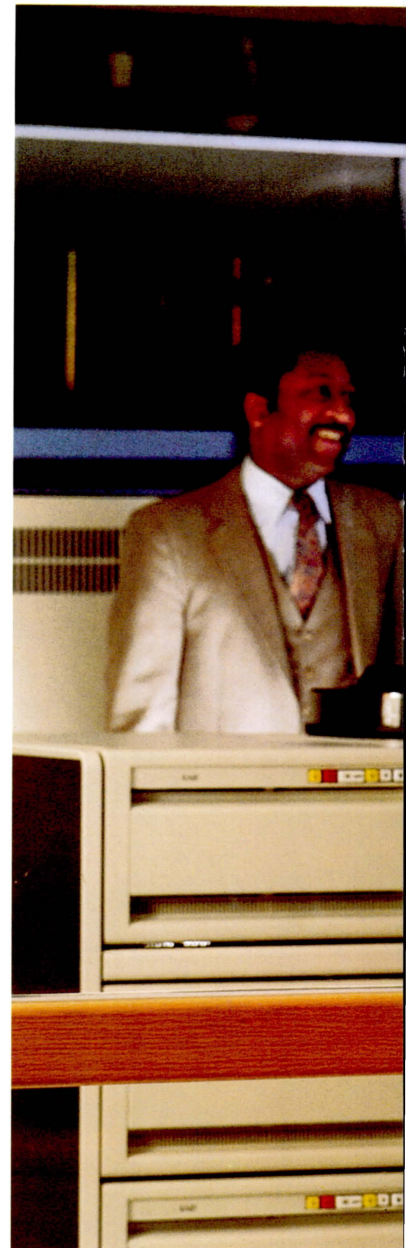


“Our hospital clients operate in an increasingly competitive market with both regulatory agencies and insurance companies pressuring them to control costs. Integrating such diverse information as patient care data and financial, staffing, and market data rapidly and efficiently allows a hospital to maintain quality care and remain competitive. We and our customers rely on VAX computers to provide fast and reliable information systems, and a responsive service organization, in an environment where peoples’ lives are at stake.”

*Stephen Macaleer, Vice-President;
Shared Medical Systems Corporation, Malvern, Pennsylvania*

- VAX 8700: a high-performance system suitable for industrial and scientific applications requiring very large memory and data transfer rates. It is particularly suited to management information systems, scientific or financial modeling and data acquisition. (August 1986–6X)
- VAX 8650: a large and powerful system that combines fast throughput, high system availability and operating economy, making it popular in office automation, computer-integrated manufacturing and management information systems. (December 1985–6X)

- VAX 8600: the first member of the second generation, it brought VAX power and functionality for the first time to the largest compute-intensive applications. It is popular in commercial data processing, administrative and information management systems and transactional processing, as well as in the scientific, research and engineering communities. (October 1984–4X)
- VAX 8550: provides high-performance computing in a very compact package. It is an excellent system for large departments that want to support general purpose office information systems, simulation or computer-aided design. (August 1986–6X)





- VAX 8500: a compact system designed for multiuser customers in all technical and commercial markets. It is particularly suited to users who need midrange power but who are faced with space and facility constraints. (April 1986–3X)

- VAX 8300: a low-cost, midrange system that brings VAX power and versatility to compute-intensive applications such as simulation, image processing and computer-aided design and where cost and compactness are important criteria. (January 1986–1.9X)

- VAX 8200: as powerful as the original VAX-11/780, but at half the price. It is an ideal departmental system in office, manufacturing, commercial and scientific applications.

Each member of this new second generation of systems is designed within the same proven VAX architecture and each employs the same VMS software system. Thus, a program written on one VAX system can run on any other VAX system, including MicroVAX, without modification, giving any VAX user access to the industry's most comprehensive offering of networking products and to the more than 3,000 applications that have been written on VMS.



“Operating in one of the fastest-growing regions of the country, we require a flexible data network that can provide key corporate information to the people who need it instantly at their fingertips. Our decision support system, based on ALL-IN-1 Office and Information Systems software running on VAX and MicroVAX II computers, provides such information as the status of the telecommunications network, traffic load through our long distance switching centers, and quality control indexes for service and repair orders—maintaining accountability and customer service.”

*David J. Baker, Manager, Office Automation Systems;
United Telephone Company of Florida, Altamonte Springs,
Florida*

In addition to the seven new second-generation VAX systems, Digital introduced scores of other new products during the year, each an implementation of the integrated network strategy on which the company has been building for many years. Each is designed to work within the Digital networking environment and each addresses a specific information management need. Here are a few of the highlights of the most prolific new product year in our history:

LAN Bridge 100 ■ This important connectivity product dramatically extends the ability to build and connect Ethernet local area networks (LANs). Previously, local



networks were usually limited to the confines of a single room or a small building. This bridge makes it possible to interconnect several local networks into a single, virtually seamless network capable of supporting thousands of computers, workstations, printers and other devices.

The bridge also directs message traffic dynamically within a local network or between networks to ensure optimum utilization. Intradepartmental messages are kept within the local segment, and those messages intended for other departments are passed along to other segments.



MicroVAX Enhancements ▪ During the year, two of Digital's most important integrated software systems, ALL-IN-1 and A-to-Z, were made available for the MicroVAX II system:

The ALL-IN-1 Office and Information System is a comprehensive set of integrated office software for work-groups and departments in large organizations. It offers word processing, electronic mail, desk management, time management and other office functions through one menu on a single terminal or an industry-standard personal computer. It can also be customized to include departmental data and information processing applications.

The A-to-Z Integrated Software System was developed to allow Original Equipment Manufacturers (OEMs), software developers and resellers to pursue significant new opportunities to reach new classes of potential customers among small businesses by being able to offer more than 1600 higher quality business software packages available on Digital's computers.

AI VAXstation ▪ Digital's AI VAXstation is the industry's first fully integrated artificial intelligence (AI) workstation. Based on the MicroVAX II, this system provides a practical and inexpensive development tool in the fast-



growing “knowledge engineering” field. It offers such features as multitasking, multiwindowing and high-resolution graphics on a large, easy-to-read screen. This new system is popular in a wide variety of commercial, technical and industrial markets, including aerospace, petrochemicals, government, finance and education. And because it is a VAX, applications developed on the AI VAXstation can run on any other computer in the VAX family.

This workstation is evidence of Digital’s commitment to maintain its leadership in the artificial intelligence market. The company offers a wide range of AI software

tools, including VAX LISP, Digital’s version of the emerging standard AI language; ADA an AI language widely used in government projects and VAX OPS5, a language used by customers with expertise in knowledge engineering. The company also introduced three additional high-performance VAXstation systems, each of which combines high-resolution color graphics with full VAX power and functionality for applications in the electronics, laboratory, petroleum and government markets.

VMS/SNA • VMS/SNA is a low-cost software product that links Digital’s MicroVAX-based systems directly to computing environments using the IBM Systems Network



Architecture (SNA). Intended for traditional MIS and data processing centers, this product allows users to take advantage of VAX power and versatility while still being able to access large IBM databases. For example, local workgroups can use MicroVAX or VAXstation as their primary computer and still gain direct access to an SNA environment.

DECconnect ■ DECconnect, Digital's strategy for wiring a building, provides a simple means of integrating all the communications options needed in a user environment today and in the future, and makes them easily accessible through a single wallplate. DECconnect, then,



"We depend on talented people using the best technologies available to keep us competitive. Our VAXcluster in New York receives foreign exchange currency rates directly from Reuters VAX system in Europe. This VAX-to-VAX system link gives our FOREX traders a ten-second edge in identifying profit positions in Eurocurrency arbitrage. In a market as volatile as currency trading, that competitive edge can make all the difference."

Jay Pomrenze (left), Senior Vice-President, Foreign Exchange and Kevin McGilloway, Senior Vice-President, Technology; Bankers Trust Company, New York, New York

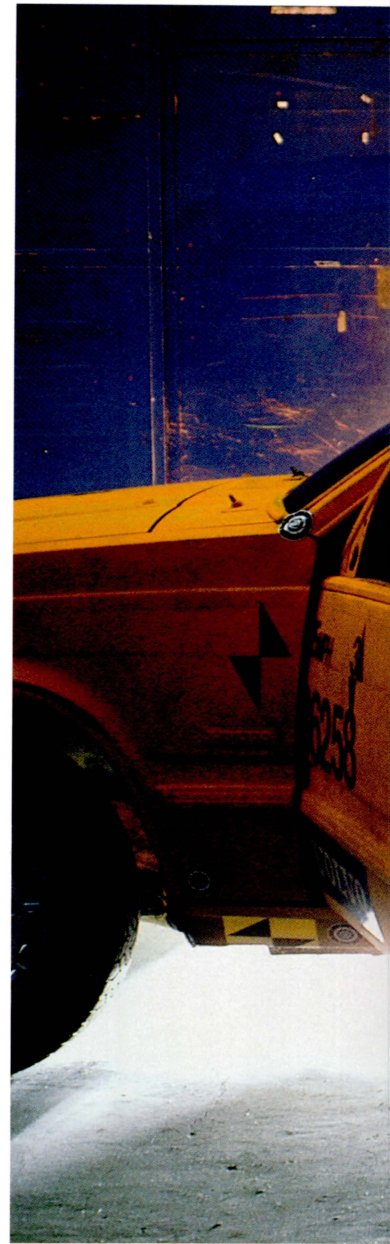
makes the building of Ethernet networks as easy as plugging in an appliance.

Enhanced DECnet-DOS ■ Enhanced DECnet DOS Software allows an IBM PC, PC/AT and IBM PC/XT to participate via DECnet as full members of a Digital network with all the benefits of remote file transfer and network management usually associated with Digital networks.

VAXstation II/GPX ■ This powerful system is Digital's first technical workstation for the UNIX marketplace. It provides high-performance color capabilities, sophisti-



At Volvo Car Corporation, networks and VAX computers are used in virtually every step of production, from design and testing to manufacture. The company's new Uddevalla, Sweden, manufacturing plant is being designed to function competitively well into the 21st century with the most advanced CIM (Computer Integrated Manufacturing) technologies available, run entirely on VAXclusters.



cated windowing, multiple graphics interfaces and a choice of networking options – all essential features in the computer-aided design, manufacturing and engineering markets to which it is targeted. It supports ULTRIX, Digital's implementation of standard UNIX, as well as Digital's VMS operating system.

VAXstation II/RC ■ This entry-level member of the VAXstation family is designed for primary applications in such areas as electronics, mechanical design, and software development, where users require high performance and extensive networking capabilities at modest system cost.

Standard Network Packages ■ As the result of extensive involvement with our customers in helping them plan, build and maintain the networks they need for effective information management throughout their organizations, we have assembled seven standard network packages which are designed to solve a majority of the connectivity problems most commonly encountered in creating computer networks at any level of an organization. Each package facilitates the building of high-speed data networks to link an assortment of personal computers and workstations to departmental or corporate computers.



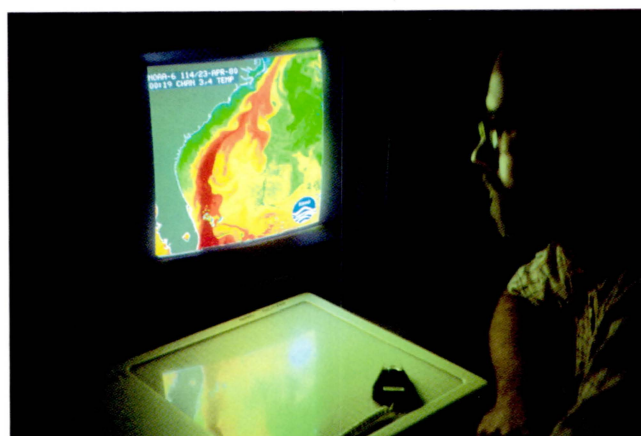
- Package One is for low-speed communications. It connects terminals or personal computers into a local area network within a workgroup. It can link 16 offices, and can eventually expand to serve a maximum of 64 offices.
- Package Two is for high-speed communications. It is also for use at the workgroup level. It uses ThinWire Ethernet cable to link workstations and personal computers, including IBM products, in 16 offices. It, too, can be expanded to serve a maximum of 64 offices.
- Package Three permits the linking of up to 64 offices on the same floor. It requires that the components of Packages One and Two be located in the same equipment room on the same floor.
- Package Four is designed to link different floors within a building or different buildings within a site, using either coaxial cable or fiber-optic connection. One variation of this package connects buildings up to 10 miles apart.



- Package Five connects up to eight computers within a computer room. It uses Digital Ethernet communications controllers, permitting any central processor or standard system to be incorporated into this package.
- Package Six lets a Digital computer network communicate with an IBM SNA network. For example, it allows users of IBM 3270 terminals within the SNA environment to access the VAX system. A total of nine access routines are available, including Gateway Management, Remote Job Entry, Terminal or Printer Emulation and IBM's DISOSS Document Exchange.
- Package Seven provides interconnection among multiple buildings. It permits users within a Digital network environment to access remote network users over an X.25 public data network or a DECnet private network.

Each of these new packages can be used alone or in combination with other packages. Each package consists of the appropriate hardware, software, installation, services and a one-year warranty.

As this report was being prepared, Digital announced three important new products that warrant mention here:



“Our image processing system, which has become the de facto standard for oceanographic satellite remote sensing research, creates color photographs portraying surface temperature, current, winds, and chlorophyll content from more than two billion bytes of information fed daily to our network of VAX and MicroVAX II computers. These exceedingly complex images are compiled from millions of observations and cover thousands of squares miles of geography. The images are then shared, through a DECnet network, with 16 major ocean research institutions around the world.”

Drs. Otis B. Brown (opposite) and Robert H. Evans (above), Rosenstiel School of Marine and Atmospheric Science; University of Miami, Florida

PC ALL-IN-1 ▪ This easy-to-use MicroVAX-based system allows up to 30 previously isolated personal computers to be linked into an office workgroup network. These PCs can run thousands of industry-standard applications, enjoy the use of shared resources and have access to the other systems throughout the network. Multiple workgroup networks can be linked into a single departmental network to provide the benefits of ALL-IN-1 to thousands of users.

VAX/VMS Services for MS-DOS ▪ This new software product is specifically designed for users of the popular Microsoft MS-DOS applications packages. It combines

the resources of Digital's VAX/VMS and MS-DOS into a network environment that integrates personal and organizational computing.

VAXmate ▪ Digital's newest personal computer is the first in the industry to be designed from the ground up for networking and information sharing. It is IBM PC/AT compatible, offering users industry standard personal computing, plus the ability to share information with other VAXmates, with larger Digital systems and, through gateways, with IBM SNA networks.

大日本印刷株式会社



“Our customers look to us, as one of the largest printing and design firms in the world, for innovation and cost savings. We developed PACREATE, an automated package design system, to operate on a network of VAX and MicroVAX II computers. Using more than 6,000 package types, we can custom design all aspects of packaging, from size, shape, and materials to labeling, manufacture, and retail display. The final design is sent over our network to production facilities, cutting design development time from an average of one month to one-half day.”

Yasuo Kubota (seated), Manager, Engineering Research Laboratory; Dai Nippon Printing Co., Ltd., Tokyo

From the beginning, customer satisfaction has been a primary corporate goal at Digital. We recognize that all efforts to apply the latest technologies, design the best products and provide the best solutions are meaningless unless Digital's customers are satisfied with the results they get from using our products. They must feel satisfied, too, with the level of our commitment to help them be successful, not just by being responsive to their current needs but by anticipating future needs, as well.

More recently, Digital has made the commitment to be the world's leading supplier of computer networks. This means offering the best networking strategy supported by

the best hardware, software and communications products. It also means providing the best network support services. Delivering on this latter commitment has also become a primary corporate goal at Digital.

One of our major challenges is to confront increasingly complex product designs and rapidly decreasing life cycles between the introduction of major systems. To succeed here—that is, to meet customer expectations—requires sophisticated maintenance and support systems, even though the inherent reliability of these products is very high and getting higher all the time.





In support of Digital's commitment to its customers around the quality and quantity of support services and the ease with which they can be accessed, Digital maintains a worldwide customer support organization of more than 30,000 maintenance and software support personnel deployed at more than 650 locations in 54 countries on five continents. Their goal is to maximize computer availability to our customers and minimize cost of ownership.

Because different customers have different needs, Digital offers a comprehensive array of support services from which customers can choose. These include 24-hour, full service and as-needed contract coverage; automated tele-

phone diagnosis of hardware and software products; and call-in centers for software consulting. Carry-in centers and a fleet of fully equipped mobile units provide service for small systems and terminals.

For customers whose needs are not met by Digital's standard products, the company maintains Special Systems facilities around the world that provide customized services in hardware and software design, applications programming, systems engineering, project management and networking.

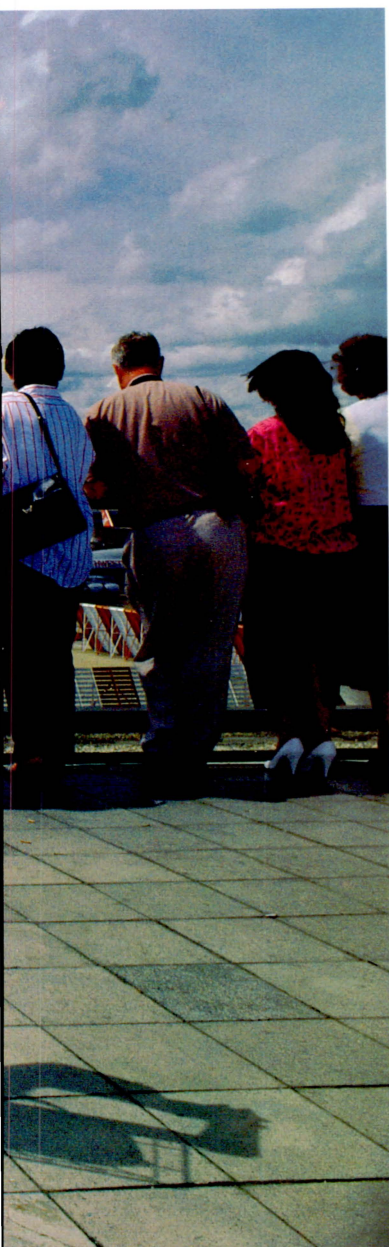


To support the new DECconnect wiring system, we developed a flexible set of coordinated services to assist U.S. and Canadian users in analyzing their computer environment and data communications wiring needs. Called DECsite, the program helps in the planning, designing and building of new computer facilities and in the renovation of existing sites.

Recognizing that most of Digital's customers maintain computer networks that include equipment from other vendors, the company has instituted NETcare, an integrated service program that provides customers with a single point of contact for all multivendor networks that

include Digital systems, regardless of the mixture of hardware, vendors or technologies involved.

An early-warning system is available that monitors the performance of single VAX systems, VAX networks and VAXclusters and warns system managers of hardware problems before they occur, thereby averting the expense and inconvenience of unexpected downtime. This monitoring system, called VAXsim, allows one operator at a terminal to trace imminent hardware problems down to the device level. VAXsim pinpoints them, allowing system managers to schedule preventive maintenance and avoid costly downtime.



Starting with a single PDP-11 computer nearly five years ago, Intasun Travel (International Leisure Group PLC) delivered instant reservation confirmations to travel agents. The company, headquartered in London, now operates its own airline and confirms reservations for two million travelers annually to more than 1,300 resorts and hotels around the world. With one of the largest VAXclusters in Europe at the heart of its system, Intasun has become one of the world's leading travel wholesalers.

Digital offers what it believes to be the most comprehensive portfolio of disaster recovery services available from any major vendor. One program, called Recover-all, provides subscribers with back-up computing capabilities to replace their systems lost to storms, power outages or other disasters. Digital was the first – and we believe still the only – vendor to offer such a program.

To ensure that its employees and customers are kept abreast of the latest technologies, products and applications, Digital maintains one of the world's largest private educational services organizations. Its curriculum encompasses more than 500 courses offered in 18 languages by

600 instructors at 40 training centers around the world. Self-paced courses, computer-based instruction and classes at customer sites are also offered.

Again this year, Digital's customer service organization was rated by an independent survey and several industry consultants as the best among the major computer vendors. We are gratified by this recognition, and are challenged by it to continue to work as hard as we can to ensure that our customers' needs are met and that Digital's Customer Services group does, indeed, remain the best in the industry in the view of those whose opinions of us matter most: our customers.

“Our organization is a network of women—175,000 members, living in more than 2,000 communities around the U.S., who share common concerns. With the VAX computer in our Washington, D.C., headquarters, we provide instantaneous and broad-based networking to keep in touch with our members and put them in contact with each other, revolutionizing the way women communicate with one another on issues important to themselves, their communities, and the nation.”

Sarah Harder (seated), President, American Association of University Women (AAUW) and Chairman of the Board, AAUW Educational Foundation; Elsie M. Smith (left), Chairman of Research and Projects Awards Panel, AAUW Educational Foundation; Maureen O'Hara, recipient of 1986 Recognition Award for Young Scholars from the AAUW Educational Foundation.



Digital recognizes that it has important obligations to many people whose reasonable expectations the company must strive to meet. Customers expect Digital to be a reliable supplier of high quality products and services. Shareholders expect the company to work hard to make their investments grow. Our employees expect the company to be a sensitive and supportive employer. The community at large expects Digital to be a thoughtful neighbor and responsible corporate citizen. The company is firmly committed to meeting all of these expectations.

Digital is very proud of the dedication of its employees around the world, who now number 95,000. The company seeks to recognize their accomplishments by promoting their personal and professional growth through support of such programs as continuing education, job enlargement training, management development, personal skills workshops, tuition refunds, scholarships and university courses at company facilities. All of these programs were expanded during the year to accommodate the steadily growing numbers of employees at all levels of the organization who seek to learn and grow, and we will continue to encourage and support their initiatives.



Digital remains seriously committed to programs which ensure that all employees have equal opportunities for hiring and advancement. The company has continued to aggressively pursue affirmative action programs to attract and develop minority and female employees. One of the most successful programs in this area involves partnerships with a number of minority universities to which Digital provided computer equipment and other resources to support the development of state-of-the-art science and technology curricula. Another related program provided individual scholarships to almost 100 female and minority college students.

Digital encourages outside initiatives at the national, regional and local levels in all the areas of the world where our employees live and work. During the year, the company broadened its community involvement through increased grants of cash and equipment to hundreds of educational, social, civic, cultural and health care programs. The following programs typify the company's involvements.

Digital continued to support the Florida-based Adam Walsh Child Resource Center and its national initiatives in behalf of missing and exploited children. Grants of

DECtalk voice-synthesis equipment were made to 230 not-for-profit organizations around the world to provide the disabled with access to technology. Other grants provided support in such areas as research and therapy for children, homeless shelters, AIDS research, and the President's Committee for the Employment of the Handicapped.

Digital made major underwriting commitments to a number of important national and local programs, headed by its support for the sixth consecutive year of "Evening At Pops," the top-rated PBS Television concert series featuring the Boston Pops Orchestra. The company also became a major underwriter of the aerospace exhibit in the Smithsonian's National Air & Space Museum, the national tour of an exhibit of Artificial Intelligence being staged in Boston's Museum of Science, and a major new travelling exhibition of American watercolors assembled by the Worcester, Mass. Art Museum. Digital also donated equipment to the fund-raising auctions at 30 public television stations. And, as part of its "Valuing Differences" program, the company provided major funding for a first-ever ethnic summer festival in Boston.

In the area of education, the company made grants to scores of graduate schools, colleges and universities as a way of encouraging research in specific areas and keeping abreast of other areas which may be critical to the company's future. This involvement is also meant to encourage the technological advancement of women and minorities.

A major grant to the Springfield, Mass. public school system will help create a computer network in its high school to promote development of student skills in such areas as creative writing, special and bilingual education and laboratory experiments.

Digital also made more than 400 scholarship grants to children of employees, to women and minorities pursuing careers in science and technology, and to college-bound students in Digital communities. Thirty-one children of employees received National Merit Scholarship support from the company, making Digital's National Merit program the third largest in the nation.

Digital has always encouraged its employees to become involved in the community by matching dollar-for-dollar their individual gifts to schools, hospitals, other not-for-profit organizations and United Way programs. Donations by individual employees to more than 3,000 qualifying organizations and 307 United Way campaigns, combined with matching funds from the company, exceeded \$6 million.

Digital takes seriously its obligations to its customers, its shareholders, its employees and to the community at large. As we grow, we look forward to increasing our support for the initiatives they take, and the company remains strongly committed to mounting its own initiatives, as well, in meeting its corporate responsibilities.

- This year marks the 25th anniversary of the Digital Equipment Computer Users Society (DECUS), the industry's largest, most active and, we're proud to say, most thoughtful and supportive user group. DECUS members, now more than 90,000 strong around the world, are a great help in keeping our product strategies on course and we look forward to continuing that partnership.

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ELEVEN-YEAR FINANCIAL SUMMARY

Operations <i>(in millions except per share data)</i>	1986	1985	1984	1983
Revenues				
Equipment sales	\$4,961.9	\$4,534.2	\$3,831.1	\$2,867.5
Service and other revenues	2,628.5	2,152.1	1,753.3	1,404.4
Total operating revenues	7,590.4	6,686.3	5,584.4	4,271.9
Costs and Expenses				
Cost of equipment sales, service and other revenues	4,282.1	4,087.5	3,379.6	2,606.0
Research and engineering expenses	814.2	717.2	630.7	472.4
Selling, general and administrative expenses	1,665.4	1,431.8	1,179.5	830.6
Operating income	828.7	449.8	394.6	362.9
Interest expense	88.1	82.0	35.1	13.1
Interest income	(116.9)	(63.0)	(41.5)	(61.2)
Income before income taxes	857.5	430.8	401.0	411.0
Provision for income taxes	240.1	(15.9) ²	72.2	127.4
Net income	\$ 617.4	\$ 446.7	\$ 328.8	\$ 283.6
Net income per share ¹	\$ 4.81	\$ 3.71	\$ 2.87	\$ 2.50
Weighted average shares outstanding	130.8	124.1	114.7	113.4
Financial Position <i>(in millions except per share data)</i>				
Inventories	1,199.8	1,756.2	1,852.2	1,353.8
Accounts receivable, net of allowances	1,903.3	1,539.0	1,527.3	1,125.0
Working capital	4,222.7	3,694.2	3,001.4	2,377.0
Property, plant and equipment, at cost	3,262.7	2,827.6	2,351.8	1,961.4
Total assets	7,173.3	6,368.9	5,593.3	4,541.1
Long-term debt	333.2	836.9	441.3	92.8
Stockholders' equity	5,727.8	4,554.6	3,979.2	3,541.3
Stockholders' equity per share	\$ 44.54	\$ 38.43	\$ 34.42	\$ 31.42
General Information and Ratios <i>(dollars in millions)</i>				
Current ratio	4.9:1	4.9:1	3.8:1	3.9:1
Quick ratio	3.5:1	2.8:1	1.9:1	2.0:1
Additions to property, plant and equipment	\$ 564.2	\$ 571.8	\$ 452.1	\$ 419.2
Depreciation	\$ 384.0	\$ 315.1	\$ 252.6	\$ 203.2
Debt to debt plus equity ratio	5.5%	15.5%	10.0%	2.6%
Operating income as a percentage of total operating revenues	10.9%	6.7%	7.1%	8.5%
Income before income taxes as a percentage of total operating revenues	11.3%	6.4%	7.2%	9.6%
Effective tax rate	28.0%	(3.7%) ²	18.0%	31.0%
Net income as a percentage of total operating revenues	8.1%	6.7%	5.9%	6.6%
Net income as a percentage of average stockholders' equity	12.0%	10.5%	8.7%	8.5%
Net income as a percentage of average total assets	9.1%	7.5%	6.5%	6.6%
Number of days sales of accounts receivable outstanding	79	75	83	82
Inventory turns	2.9	2.3	2.1	2.1
Number of employees at year-end	94,700	89,000	85,600	73,000
Common shares outstanding <i>(in thousands)</i>	128,591	59,253	57,811	56,357
Shareholders at year-end	76,860	68,810	44,389	40,903
Common stock yearly high and low sales prices	\$ 94-46	\$ 63-39	\$ 50-33	\$ 65-32

¹See Note E of Notes to Consolidated Financial Statements.

²Includes elimination of DISC taxes of \$63M accrued prior to 1984.

1982	1981	1980	1979	1978	1977	1976
\$2,793.7	\$2,384.2	\$1,779.4	\$1,381.8	\$1,128.1	\$ 847.5	\$ 586.7
1,087.1	813.9	588.6	422.3	308.5	211.1	149.6
3,880.8	3,198.1	2,368.0	1,804.1	1,436.6	1,058.6	736.3
2,187.6	1,778.7	1,319.9	1,012.3	802.3	595.1	424.3
349.8	251.2	186.4	138.3	115.7	79.7	58.4
758.6	632.2	478.9	370.1	281.0	205.9	136.1
584.8	536.0	382.8	283.4	237.6	177.9	117.5
14.8	29.2	27.0	24.3	22.4	11.7	9.9
(102.8)	(60.6)	(53.8)	(35.8)	(12.3)	(10.2)	(11.8)
672.8	567.4	409.6	294.9	227.5	176.4	119.4
255.6	224.1	159.7	116.5	85.3	67.9	46.0
\$ 417.2	\$ 343.3	\$ 249.9	\$ 178.4	\$ 142.2	\$ 108.5	\$ 73.4
\$ 3.76	\$ 3.35	\$ 2.73	\$ 2.05	\$ 1.70	\$ 1.39	\$ 0.99
110.9	105.1	94.3	89.9	86.5	78.0	74.1
1,137.4	1,102.2	819.9	513.5	428.1	375.0	218.8
807.6	758.1	629.1	475.1	375.2	323.1	219.3
2,181.2	2,029.8	1,658.2	1,076.9	887.0	574.2	499.0
1,605.4	1,128.4	772.3	582.1	507.8	352.4	215.8
4,024.0	3,456.1	2,666.1	1,863.2	1,501.4	1,070.4	856.0
92.4	88.4	489.7	340.7	341.6	90.6	91.4
3,164.5	2,679.7	1,651.7	1,120.2	904.8	735.5	606.0
\$ 28.65	\$ 24.65	\$ 18.12	\$ 13.79	\$ 11.35	\$ 9.37	\$ 7.80
4.1:1	4.2:1	4.5:1	3.8:1	4.7:1	3.5:1	4.3:1
2.3:1	2.3:1	2.6:1	2.3:1	2.8:1	1.8:1	2.8:1
\$ 511.2	\$ 398.5	\$ 209.9	\$ 93.9	\$ 167.0	\$ 143.2	\$ 54.5
\$ 152.6	\$ 102.1	\$ 69.8	\$ 57.7	\$ 50.2	\$ 28.5	\$ 22.0
2.8%	3.2%	22.9%	23.3%	27.4%	11.0%	13.1%
15.1%	16.8%	16.2%	15.7%	16.5%	16.8%	16.0%
17.3%	17.7%	17.3%	16.4%	15.8%	16.7%	16.2%
38.0%	39.5%	39.0%	39.5%	37.5%	38.5%	38.5%
10.7%	10.7%	10.6%	9.9%	9.9%	10.3%	10.0%
14.3%	15.9%	18.0%	17.6%	17.3%	16.2%	14.7%
11.2%	11.2%	11.0%	10.6%	11.1%	11.3%	10.3%
73	73	81	82	82	88	85
2.0	1.9	2.0	2.2	2.0	2.0	2.2
67,100	63,000	55,500	44,200	39,000	36,700	25,700
55,227	54,348	45,568	40,606	39,873	39,259	12,944
44,706	39,948	35,144	28,835	25,868	22,738	15,442
\$ 55-34	\$ 55-29	\$ 41-27	\$ 29-22	\$ 28-19	\$ 30-20	\$ 30-18

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS

Income and Expense Items as a
Percentage of Total Operating Revenues

			Percentage Changes			
1984	1985	1986	Income and Expense Items	1985-86	1984-85	1983-84
68.6%	67.8%	65.4%	Equipment sales	9%	18%	34%
31.4%	32.2%	34.6%	Service and other revenues	22%	23%	25%
100.0%	100.0%	100.0%	Total operating revenues	14%	20%	31%
60.5%	61.1%	56.5%	Cost of sales, service and other revenues	5%	21%	30%
11.3%	10.8%	10.7%	Research and engineering expenses	14%	14%	34%
21.1%	21.4%	21.9%	Selling, general and administrative expenses	16%	21%	42%
7.1%	6.7%	10.9%	Operating income	84%	14%	9%
0.6%	1.2%	1.1%	Interest expense	7%	134%	168%
(0.7%)	(0.9%)	(1.5%)	Interest income	86%	52%	(32%)
7.2%	6.4%	11.3%	Income before income taxes	99%	7%	(2%)
1.3%	(0.3%)	3.2%	Income taxes	1614%	(122%)	(43%)
5.9%	6.7%	8.1%	Net income	38%	36%	16%

As an aid to understanding the Company's operating results, the above tables indicate the percentage relationships of income and expense items included in the

Consolidated Statements of Income for the three fiscal years ended June 28, 1986 and the percentage changes in those items for such years.

Revenues

The Company's total operating revenues for fiscal year 1986 increased by 14% compared with increases of 20% in 1985 and 31% in 1984. The Company continued to be affected by a protracted downturn in the computer industry. Customer spending was cautious, particularly in the U.S. manufacturing sector. However, many new products and a growing recognition of the Company's networking capabilities led to an increase in market share. The Company now has the products and skills required to build high-speed local networks anywhere in an organization. It is the Company's goal to tie together every part of an organization from the desktop to the data center.

Demand from customers overseas remained strong throughout the year. Non-U.S. revenues accounted for 42% of total operating revenues in 1986 compared with 40% in 1985 and 35% in 1984.

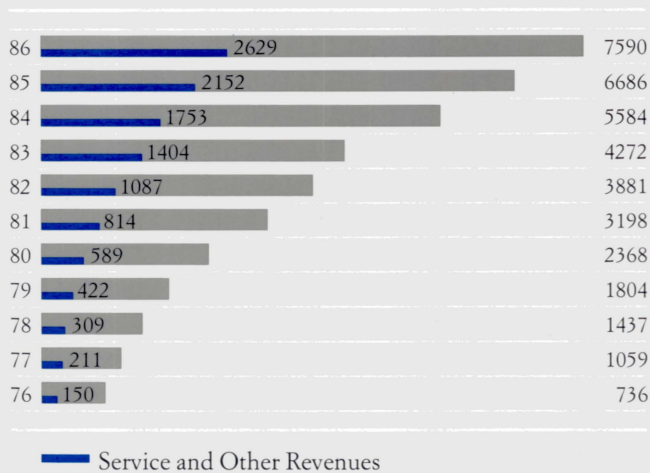
An important factor in the Company's revenue growth in fiscal 1986 was the extension of the range of compatible VAX computer systems provided by several new products introduced during the year. Excellent customer acceptance and immediate availability of the new products were reflected in the fiscal year's results.

Another factor contributing to revenue growth was the Company's ability to supply simple, cost effective solutions to its expanding customer base. All of the Company's hardware and software products have been designed within the same modular architecture. This allows them to work together in networks in virtually any combination and to work with products from other major computer vendors. Customers value this unique product feature because it provides them with considerable flexibility and cost effectiveness in implementing their computer strategies.

In fiscal 1986, service and other revenues, which principally include maintenance service, software revenues, customer training and the sale of replacement parts, grew by 22%. Service and other revenues comprised 35% of total revenues in fiscal 1986, compared with 32% in 1985 and 31% in 1984.

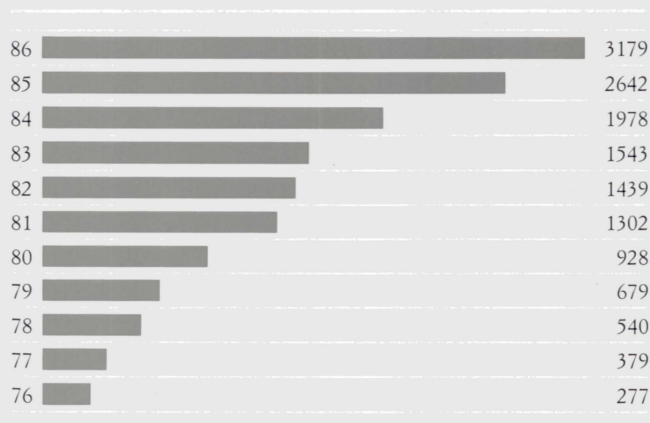
Total Operating Revenues

\$ Millions



Non-United States Revenues

\$ Millions



Expenses and Profit Margins

The cost of sales as a percentage of operating revenues decreased in fiscal 1986 compared with the prior two years. This reflected a higher proportion of revenues from new products, increased manufacturing efficiencies, cost reductions, reduced inventory levels and an improved mix of service and other revenues. As a result, operating income increased by 84%, compared with increases of 14% and 9% in the two preceding fiscal years.

Research and engineering expenses grew 14% in fiscal 1986 and comprised 10.7% of total operating revenues compared with 10.8% in 1985 and 11.3% in 1984. The Company is primarily involved with applied research and engineering and has approximately 5,700 professional employees involved in various research, engineering and programming activities.

The Company's investment in research and engineering, over \$2 billion in the last three years, resulted in the introduction of several new hardware, software, and service products in 1986. Among them were the VAX 8800, the Company's highest performance VAX system, which is designed to solve problems in such areas as seismic analysis, image processing, artificial intelligence and high-energy physics. Also announced were the VAX 8500, 8300 and 8200, second generation mid-range offerings, which have extensive applications, including commercial and office automation. The introduction of the VAX 8550 and VAX 8700 computer systems shortly after the close of the fiscal year completed Digital's systematic replacement of its 11/700-series of VAXes.

The Company also introduced during the year a series of workstation products including the AI VAXstation, a Micro-VAX-based system for artificial intelligence applications, and the entry-level VAXstation II/RC, which provides compute-intensive performance and networking. These complement other members of the VAXstation family, the VAXstation II, VAXstation II/GPX and the VAXstation 500 series, which were also introduced during the year.

The attractiveness of these products lies in the networking capabilities that allow customers to tie together computers in one global network and in the volume of VMS software available for VAX computers. The Company offers the ability to interconnect personal computers and workstations, mid-range systems and large mainframes into a single network that ties together an entire organization.

Research and Engineering

\$ Millions

Year	Research and Engineering (\$ Millions)
86	814
85	717
84	631
83	472
82	350
81	251
80	186
79	138
78	116
77	80
76	58

Net Income

\$ Millions

Year	Net Income (\$ Millions)
86	617
85	447
84	329
83	284
82	417
81	343
80	250
79	178
78	142
77	109
76	73

Employee Population

Thousands

Year	Employee Population (Thousands)
86	95
85	89
84	86
83	73
82	67
81	63
80	56
79	44
78	39
77	37
76	26

Expenses and Profit Margins (continued)

Selling, general and administrative expenses increased to 21.9% of total operating revenues in fiscal 1986 compared with 21.4% in 1985 and 21.1% in 1984. Additions to sales and service personnel accounted for most of the increases over fiscal 1985.

Interest income increased in fiscal 1986 from fiscal 1985 levels due to a higher level of cash available for investment. Interest expense increased somewhat, reflecting an \$11 million premium for the early redemption of \$100 million of 13% Sinking Fund Debentures issued in fiscal 1984.

The Company's effective tax rate for fiscal 1986 was 28%. Excluding a one-time DISC (Domestic International Sales Corporation) benefit of \$63 million, the fiscal 1985 effective tax rate was 11%. In fiscal 1984 the effective tax rate

was 18%. The increase in the effective tax rate for fiscal 1986 resulted primarily from improved profitability in the U.S. and the scheduled expiration of certain U.S. tax credits.

During the year, the total number of employees increased by 5,700, bringing the total number of employees at year end to 94,700. The increase in the employee population took place primarily in the sales and service organization. As was the case in fiscal 1985, the number of employees in manufacturing declined while the number of employees in the engineering organization increased slightly.

The ratio of net income to average stockholders' equity (ROE) was 12% in fiscal 1986, 10.5% in fiscal 1985, and 8.7% in fiscal 1984.

Inflation and Changing Prices

The preceding discussion and analysis are based on the Company's financial statements presented in historical dollars. See pages 51 and 52 for supplementary information on the Company's historical financial data adjusted for the effects of inflation and changing prices.

Total Stockholders' Equity	\$ Millions
86	5728
85	4555
84	3979
83	3541
82	3165
81	2680
80	1652
79	1120
78	905
77	736
76	606

Availability of Funds to Support Current and Future Operations

The requirement for funds to support the Company's operations has historically been met with internally generated funds supplemented with external financing. During fiscal 1986, internally generated funds were more than sufficient to support operations.

During the three year fiscal period 1984-1986, funds generated from operations exceeded funds used to support operations by \$391 million. In 1986, funds generated from operations were \$793 million, compared with \$101 million generated in 1985. In 1984, \$503 million was required for operations. The higher level of funds generated from operations in 1986 was a result of improvements in the Company's profitability and asset management.

The Company reduced long-term debt during fiscal 1986 by \$500 million through the call and subsequent conversion to equity of \$400 million of 8% Convertible Subordinated Debentures and the redemption of \$100 million of 13% Sinking Fund Debentures.

Cash and temporary cash investments rose to \$1,911 million at the end of fiscal 1986 from \$1,080 million at the end of 1985. Unused lines of credit at the end of fiscal 1986 were \$379 million, including revolving credit agreements of \$240 million.

The Company believes its improved profitability coupled with its low debt to debt-plus-equity ratio and high credit rating leave it well positioned to obtain funds sufficient to meet future requirements.

Common Stock Information

The Company's common stock is listed and traded on the New York Stock Exchange, Pacific Stock Exchange and several European stock exchanges. There were 76,944 stockholders of record as of August 1, 1986. The high and low quarterly sales prices for the past two fiscal years are presented below. The 1985 stock prices have been adjusted to reflect the two-for-one stock split effected May 9, 1986.

		1986	
Fiscal Quarter	High	Low	
First	\$56	\$45⁷/₈	
Second	68³/₈	51¹/₄	
Third	86⁷/₈	65⁷/₈	
Fourth	93⁵/₈	76	
		1985	
Fiscal Quarter	High	Low	
First	\$50 ³ / ₄	\$38 ⁵ / ₈	
Second	55 ¹ / ₂	44 ⁵ / ₈	
Third	62 ⁷ / ₈	48 ³ / ₄	
Fourth	54 ⁷ / ₈	41 ¹ / ₈	

Spending for Operations

Fiscal year-end inventories declined 32% from the prior year. Average year inventory turns of 2.9 times improved from the 2.3 times and 2.1 times recorded in 1985 and 1984, respectively. Accounts receivable grew 24%, reflecting a rise in equipment sales and the effects of currency translation. The increase in days sales in accounts receivable outstanding to 79 from 75 in fiscal 1985 is more than accounted for by currency translation. Days sales outstanding improved in the United States.

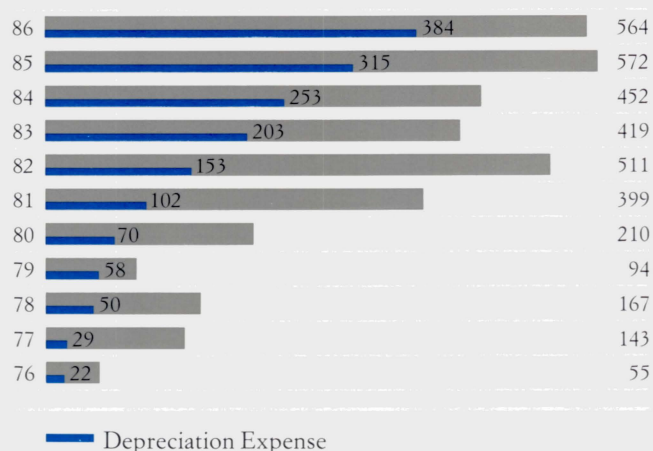
Capital spending in fiscal 1986 totaled \$564 million, down slightly from the \$572 million spent in 1985. In fiscal 1986, \$423 million of the capital spending was for equipment as the Company continued to invest in support of new products and technology development. Spending for land and building additions totaled \$92 million, and leasehold improvements totaled \$49 million.

The ratio of net income to average net total assets (ROA) was 9.1% in fiscal 1986, 7.5% in 1985 and 6.5% in 1984.

The Company added approximately 3 million square feet of building space worldwide in fiscal 1986, bringing the total amount of space to 32.3 million square feet, compared with 29.3 million square feet in 1985 and 24.5 million square feet in 1984. Most of the new space in 1986 was added overseas to support a higher level of sales.

The Company's actual capital spending level in fiscal 1987 will be dependent on a variety of factors, including general economic conditions and the growth in demand for its products and services.

Additions to Property, Plant & Equipment Depreciation Expense



Net Income Per Common Share



Report of Management

The Company's management is responsible for the preparation of the financial statements in accordance with generally accepted accounting principles and for the integrity of all the financial data included in this Annual Report. In preparing the financial statements, management makes informed judgments and estimates of the expected effects of events and transactions that are currently being reported.


Management maintains a system of internal accounting controls that is designed to provide reasonable assurance that assets are safeguarded and that transactions are executed and recorded in accordance with management's policies for conducting its business. This system includes policies which require adherence to ethical business standards and compliance with all laws to which the Company is subject. The internal controls process is continuously monitored by direct management review and an internal audit program under which periodic independent reviews are made.

The Board of Directors, through its Audit Committee, is responsible for determining that management fulfills its responsibility with respect to the Company's financial statements and the system of internal accounting controls.

The Audit Committee meets periodically with representatives of management, the independent accountants and the Company's internal auditors to review audits, financial reporting, and internal control matters, and also meets with the Company's outside counsel on related matters. The independent accountants and the internal auditors have full and free access to the Audit Committee and periodically meet privately with the Audit Committee.

Coopers & Lybrand, independent Certified Public Accountants, have been engaged by the Board of Directors, with the approval of the stockholders, to examine the Company's financial statements. Their report appears below.


Kenneth H. Olsen
President


James M. Osterhoff
Vice President, Finance

Report of Independent Certified Public Accountants

To The Stockholders and Directors,
Digital Equipment Corporation

We have examined the consolidated balance sheets of Digital Equipment Corporation as of June 28, 1986 and June 29, 1985 and the related consolidated statements of income, stockholders' equity and changes in financial position for each of the three fiscal years in the period ended June 28, 1986. 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 above present fairly the consolidated financial position of Digital Equipment Corporation as of June 28, 1986 and June 29, 1985, and the consolidated results of its operations and the consolidated changes in its financial position for each of the three fiscal years in the period ended June 28, 1986 in conformity with generally accepted accounting principles applied on a consistent basis.

Boston, Massachusetts
July 28, 1986


Coopers & Lybrand

CONSOLIDATED STATEMENTS OF INCOME

(in thousands except per share data)

	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
Revenues (Notes A and B)			
Equipment sales	\$4,961,861	\$4,534,165	\$3,831,073
Service and other revenues	2,628,496	2,152,151	1,753,353
Total operating revenues	7,590,357	6,686,316	5,584,426
Costs and Expenses (Notes A and I)			
Cost of equipment sales, service and other revenues	4,282,099	4,087,475	3,379,632
Research and engineering expenses	814,138	717,273	630,696
Selling, general and administrative expenses	1,665,411	1,431,769	1,179,529
Operating income	828,709	449,799	394,569
Interest expense	88,079	82,003	35,096
Interest income	(116,899)	(63,026)	(41,477)
Income before income taxes	857,529	430,822	400,950
Income Taxes (Notes A and C)			
Provision for income taxes	240,109	47,390	72,171
Reversal of DISC taxes	-	(63,250)	-
Total income taxes	240,109	(15,860)	72,171
Net income	\$ 617,420	\$ 446,682	\$ 328,779
Net income per share (Note E)	\$ 4.81	\$ 3.71	\$ 2.87
Weighted average shares outstanding (Note E)	130,792	124,112	114,728

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

CONSOLIDATED BALANCE SHEETS

(in thousands)

June 28, 1986

June 29, 1985

Assets

Current Assets

Cash and temporary cash investments (Note D)	\$1,910,933	\$1,080,180
Accounts receivable, net of allowance of \$52,439 and \$40,930	1,903,287	1,538,955
Inventories (Note A)		
Raw materials	339,308	512,670
Work-in-process	523,863	545,765
Finished goods	336,585	697,732
Total Inventories	1,199,756	1,756,167
Prepaid expenses	85,274	64,569
Net deferred Federal and foreign income tax charges	206,998	197,957
Total Current Assets	5,306,248	4,637,828

Property, Plant and Equipment, at cost (Note A)

Land	118,074	97,492
Buildings	809,245	745,825
Leasehold improvements	232,021	190,692
Machinery and equipment	2,103,339	1,793,623
Gross Property, Plant and Equipment	3,262,679	2,827,632
Less accumulated depreciation	1,395,601	1,096,603
Net Property, Plant and Equipment	1,867,078	1,731,029
Total Assets	\$7,173,326	\$6,368,857

Liabilities and Stockholders' Equity

Current Liabilities

Loans payable to banks (Note F)	\$ 18,697	\$ 12,251
Accounts payable	259,565	185,202
Federal, foreign and state income taxes	137,558	267,900
Salaries, wages and related items	151,160	165,933
Deferred revenues and customer advances (Note A)	253,790	160,105
Current portion of long-term debt	3,500	1,411
Other current liabilities	259,265	150,807
Total Current Liabilities	1,083,535	943,609
Net deferred Federal and foreign income tax credits	28,809	33,704
Long-term debt (Note G)	333,155	836,945
Total Liabilities	1,445,499	1,814,258

Stockholders' Equity (Notes G, J and K)

Common stock, \$1.00 par value; authorized 225,000,000 shares; issued and outstanding 128,591,361 and 59,252,782 shares	128,591	59,253
Additional paid-in capital	2,224,304	1,737,834
Retained earnings	3,374,932	2,757,512
Total Stockholders' Equity	5,727,827	4,554,599
Total Liabilities and Stockholders' Equity	\$7,173,326	\$6,368,857

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

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<i>(in thousands)</i>	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Stock- holders' Equity
July 2, 1983	\$ 56,357	\$1,509,781	\$1,975,144	\$3,541,282
Shares issued under stock option and purchase plans <i>(Note J)</i>	1,454	75,065		76,519
Restricted stock plans, charge to operations <i>(Note J)</i>		17,499		17,499
Stock option and purchase plans—excess Federal income tax benefits <i>(Note J)</i>		8,230		8,230
Effect of exchange rate changes on net deferred income tax charges/credits			6,907	6,907
Net income—1984			328,779	328,779
June 30, 1984	\$ 57,811	\$1,610,575	\$2,310,830	\$3,979,216
Shares issued under stock option and purchase plans <i>(Note J)</i>	1,442	93,786		95,228
Restricted stock plans, charge to operations <i>(Note J)</i>		20,420		20,420
Stock option and purchase plans—excess Federal income tax benefits <i>(Note J)</i>		13,053		13,053
Net income—1985			446,682	446,682
June 29, 1985	\$ 59,253	\$1,737,834	\$2,757,512	\$4,554,599
Shares issued under stock option and purchase plans <i>(Note J)</i>	2,125	116,285		118,410
Restricted stock plans, charge to operations <i>(Note J)</i>		21,155		21,155
Stock option and purchase plans—excess Federal income tax benefits <i>(Note J)</i>		20,522		20,522
Two-for-One stock split in form of 100% stock dividend <i>(Note K)</i>	60,200	(60,200)		—
8% Convertible Subordinated Debentures converted into Common stock <i>(Note G)</i>	7,013	388,708		395,721
Net income—1986			617,420	617,420
June 28, 1986	\$128,591	\$2,224,304	\$3,374,932	\$5,727,827

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

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

(in thousands)

	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
Funds from Operations			
Net income	\$ 617,420	\$ 446,682	\$ 328,779
Add—expenses not requiring funds in current period:			
Depreciation (Note A)	384,044	315,075	252,631
Disposal of property, plant and equipment	44,112	37,020	27,894
Restricted stock plans— charge to operations (Note J)	21,155	20,420	17,499
Deferred income tax provision (Note C)	(13,936)	(87,125)	(23,725)
Total funds from operations	1,052,795	732,072	603,078
Funds Used to Support Operations			
Increase (decrease) in working capital:			
Accounts receivable	364,332	11,698	402,220
Inventories	(556,411)	(96,001)	498,338
Prepaid expenses	20,705	7,539	18,546
Accounts payable	(74,363)	92,909	(64,383)
Income taxes	130,342	44,971	(91,051)
Other current liabilities	(189,459)	(1,875)	(102,459)
	(304,854)	59,241	661,211
Additions to property, plant and equipment	564,205	571,784	452,139
Effect of exchange rate changes on net deferred income tax charges/credits			(6,907)
Total funds used to support operations	259,351	631,025	1,106,443
Net increase (decrease) in funds from operations	793,444	101,047	(503,365)
Funds Provided by Financing Sources			
Increase (decrease) in:			
Loans payable to banks (Note F)	6,446	(930)	(1,716)
Long-term debt (Note G)	(144)	(14)	2,503
9 ³ / ₈ % Debentures due 2000 (Note G)	(3,646)	(4,354)	(4,000)
11 ³ / ₄ % Overseas Notes due 1989 (Note G)			150,000
13% Debentures due 2014 (Note G)	(100,000)		100,000
12 ⁵ / ₈ % Notes due 1994 (Note G)			100,000
8% Conv Sub Debentures due 2009 (Note G)	(400,000)	400,000	
Common stock issued under stock option and purchase plans (Note J)	138,932	108,281	76,519
Common stock issued upon conversion of 8% Convertible Subordinated Debentures (Note G)	395,721		
Total funds from financing sources	37,309	502,983	423,306
Net increase (decrease) in cash and temporary cash investments	830,753	604,030	(80,059)
Cash and temporary cash investments at beginning of year	1,080,180	476,150	556,209
Cash and temporary cash investments at end of year	\$1,910,933	\$1,080,180	\$ 476,150

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

Note A—Significant Accounting Policies

Principles of Consolidation • The consolidated financial statements of the Company include the financial statements of the parent and its domestic and foreign subsidiaries. All significant intercompany accounts and profits have been eliminated.

Translation of Foreign Currencies • For foreign operations, the U.S. dollar continues to be the functional currency. Assets and liabilities of foreign subsidiaries are translated into U.S. dollars at current exchange rates, except that inventories and property, plant and equipment are translated at historical rates. Income and expense items are translated at average rates of exchange prevailing during the year, except that cost of sales and depreciation are translated at historical rates. Exchange gains and losses arising from translation are included in income currently.

The Company enters into forward exchange contracts to reduce the impact of foreign currency fluctuations on operations and the asset and liability positions of foreign subsidiaries. The gains or losses on these contracts are included in income when the operating revenues and expenses are recognized and for assets and liabilities in the period in which the exchange rates change.

Revenue Recognition • Revenues from equipment sales are recognized at the time the equipment is shipped. Service and other revenues are recognized ratably over the contractual period or as the services are performed.

Research and Engineering and Warranty Costs • Research and engineering and warranty costs are expensed as incurred. The Company's accounting policies with respect to warranty costs result in approximately the same charge to expense as would be incurred if such warranty costs were accrued at the time of sale.

Taxes • In general, the Company's practice is to reinvest the earnings of its foreign subsidiaries in those operations and repatriation of retained earnings is done only when it is advantageous to do so. Applicable taxes are provided only on amounts planned to be remitted. Investment tax credits are treated as reductions of income taxes in the year in which the credits arise.

Inventories • Inventories are stated at the lower of cost (first-in, first-out) or market.

Property, Plant and Equipment • Depreciation expense is computed principally on the following basis:

Classification	Depreciation Lives and Methods
Buildings	33 years (straight-line)
Leasehold improvements . .	Life of assets or term of lease, whichever is shorter (straight-line)
Machinery and equipment	8 and 10 years (sum-of-years), 4 and 5 years (double-declining balance)

Note B—International Operations

(in thousands)

	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
Revenues			
United States customers	\$ 4,472,195	\$ 4,078,286	\$ 3,628,594
Intercompany	1,354,339	1,373,578	1,136,030
	5,826,534	5,451,864	4,764,624
Europe customers	2,259,743	1,944,999	1,462,319
Intercompany	82,649	33,382	9,137
	2,342,392	1,978,381	1,471,456
Canada, Far East, Americas customers	858,419	663,031	493,513
Intercompany	577,934	545,968	718,324
	1,436,353	1,208,999	1,211,837
Eliminations	(2,014,922)	(1,952,928)	(1,863,491)
Net revenue	\$ 7,590,357	\$ 6,686,316	\$ 5,584,426
Income			
United States	\$ 342,657	\$ 224,464	\$ 230,522
Europe	405,636	202,646	137,763
Canada, Far East, Americas	207,187	102,837	123,364
Eliminations	(126,771)	(80,148)	(97,080)
Income from operations	828,709	449,799	394,569
Interest income	116,899	63,026	41,477
Interest expense	(88,079)	(82,003)	(35,096)
Income before income taxes	\$ 857,529	\$ 430,822	\$ 400,950
Assets			
United States	\$ 3,911,491	\$ 4,277,296	\$ 4,287,682
Europe	1,817,584	1,419,708	1,166,193
Canada, Far East, Americas	815,067	834,295	819,735
Corporate assets (temporary cash investments)	2,035,557	982,655	449,319
Eliminations	(1,406,373)	(1,145,097)	(1,129,676)
Total assets	\$ 7,173,326	\$ 6,368,857	\$ 5,593,253

Industry The Company's business consists of the design, manufacture, sale and service of computers and associated peripheral equipment, and related software and supplies.

International Operations Sales and marketing operations outside the United States are conducted principally through sales subsidiaries in Canada, Europe, Central and South America and the Far East; by direct sales from the parent corporation and through various representative and distributorship arrangements. The Company's international manufacturing operations include plants in Canada, the Far East and Western Europe. The products of these manufacturing plants are sold to the Company's international sales subsidiaries, the parent corporation or other international manufacturing plants for further processing.

Intercompany transfers between geographic areas are accounted for at prices which are designed to be representative of unaffiliated party transactions.

Sales to unaffiliated customers outside of the United States, including U.S. export sales, were \$3,179,143,000 for the year ended June 28, 1986, \$2,641,863,000 for the year ended June 29, 1985, and \$1,977,794,000 for the year ended June 30, 1984, which represented 42%, 40%, and 35%, respectively, of total operating revenues. The retained earnings of substantially all of the Company's international subsidiaries have been reinvested to support operations. These accumulated retained earnings, before elimination of intercompany transactions, aggregated \$1,473,081,000 at June 28, 1986, \$1,090,299,000 at June 29, 1985, and \$939,891,000 at June 30, 1984.

Note C—Income Taxes

Income before income taxes for domestic and foreign operations was as follows:

<i>(in thousands)</i>	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
Domestic	\$382,708	\$210,970	\$219,908
Foreign	474,821	219,852	181,042
Total	\$857,529	\$430,822	\$400,950

The total provisions for income taxes were at rates less than the U.S. Federal statutory tax rate for the following reasons:

	1986	1985	1984
U.S. Federal statutory tax rate	46.0%	46.0%	46.0%
Tax benefit of manufacturing operations in (a):			
Puerto Rico	(3.9)	(5.6)	(5.7)
Ireland	(7.4)	(11.8)	(12.4)
Singapore	(1.4)	(2.4)	(1.4)
Investment tax credits	(2.8)	(5.7)	(4.0)
Research and engineering credit	(0.9)	(5.3)	(5.4)
DISC	—	(17.5)	(2.2)
Other	(1.6)	(1.4)	3.1
	28.0%	(3.7)% (b)	18.0%

(a) Consolidated net income includes income of a domestic manufacturing subsidiary operating in Puerto Rico and of foreign manufacturing subsidiaries operating in Ireland and Singapore. Under Puerto Rican law, the subsidiary is subject to tax at a rate of approximately 9% on its manufacturing earnings through fiscal 1995. Remitted earnings are not subject to U.S. Federal income taxes, but are subject to Puerto Rican withholding taxes at rates not in excess of 10%, less a partial credit for taxes paid to Puerto Rico. Under Irish law, the income from products manufactured for export is exempt from Irish taxes through April 1990. Under Singaporean law, the income from manufacturing certain products is wholly exempt from Singaporean taxes through March 1991 and partially exempt through December 1996. The income

tax benefits per common share attributable to the tax status of these subsidiaries for the years ended June 28, 1986, June 29, 1985, and June 30, 1984 were \$.83, \$.69, and \$.68, respectively.

(b) The Deficit Reduction Act of 1984 provides that no U.S. taxes will be charged on the undistributed earnings of the DISC. Prior to fiscal year 1984, the Company had provided for income taxes in connection with its DISC earnings. As a result of the change in the law eliminating the taxes on DISC earnings prior to 1984, the Company's 1985 fiscal year income tax expense was reduced by \$63,250,000. The effective tax rate for fiscal year 1985 would have been 11% exclusive of the adjustment for the benefit of prior years' DISC taxes.

Note C—Income Taxes (continued)

The components of the provisions for U.S. Federal and foreign income taxes were as follows:

<i>(in thousands)</i>	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
U.S. Federal:			
Currently payable	\$ 93,028	\$ 3,761	\$35,526
Deferred	15,310	13,483	4,968
Reversal of DISC deferred taxes	—	(63,250)	—
Total	\$108,338	\$(46,006)	\$40,494
Foreign:			
Currently payable	\$123,727	\$54,055	\$35,225
Deferred	(10,147)	(32,230)	(18,584)
Total	\$113,580	\$21,825	\$16,641
State income taxes	\$ 18,191	\$ 8,321	\$15,036
Total income taxes	\$240,109	\$(15,860)	\$72,171

Deferred tax expense results from timing differences in the recognition of revenues and expenses for tax and financial reporting purposes. The sources of these

timing differences in the years ended June 28, 1986, June 29, 1985 and June 30, 1984, and the tax effect of each were as follows:

<i>(in thousands)</i>	Year Ended		
	June 28, 1986	June 29, 1985	June 30, 1984
Inventory related transactions	\$ 5,686	\$(50,924)	\$(60,660)
Installment sales, principally intercompany, and financing leases	6,572	12,999	(1,640)
DISC profits	(2,975)	(68,540)	241
Depreciation	4,075	17,940	17,997
Tax benefit transfers	26,745	28,296	28,946
Other	(34,940)	(21,768)	1,500
Total	\$ 5,163	\$(81,997)	\$(13,616)

In connection with its normal examinations of the Company's 1980 through 1981 tax returns, the Internal Revenue Service has proposed adjustments. The Company believes its judgments in these matters have been appropriate and intends to contest certain of the adjustments proposed by the IRS. In addition, the Company believes any adjustments which might result would not have a material effect on the financial statements.

During 1982, the Company entered into "Safe Harbor" leases as defined under the Economic Recovery Tax Act of 1981. Payments are recorded as investments in tax benefits and are reduced by permanent tax savings. There is no significant impact on net income but there is a cash flow benefit.

See Note A of Notes to Consolidated Financial Statements for further explanation of the Company's income tax accounting policies.

Note D—Cash and Temporary Cash Investments

Temporary cash investments are valued at cost, which approximates market, and principally include certificates of deposit, time deposits, commercial paper and repur-

chase agreements. None of the cash reflected in the balance sheets at June 28, 1986 and June 29, 1985 was required as compensating balances.

Note E—Net Income Per Share and Dividends

Net income per share is based on the weighted average number of common shares and, if their aggregate dilutive effect is material, common share equivalents outstanding during the year, after giving retroactive effect to a two-for-one stock split effected May 9, 1986. In fiscal 1986 and

1985, common share equivalents were attributable to convertible debt and stock options. In fiscal 1984 common share equivalents were attributable to stock options.

Cash dividends have never been paid by the Company.

Note F—Short-Term Debt

Short-term debt and related interest rates were as follows:

<i>(in thousands)</i>	June 28, 1986		June 29, 1985	
		Average Interest Rate		Average Interest Rate
Loans payable to banks	\$18,697	21.4%	\$12,251	12.7%

Short-term debt at year-end was principally denominated in foreign currencies. High interest rates on Brazilian and Mexican short-term debt were a major influence on the year-end interest rate. The maximum aggregate short-term debt outstanding at any month-end was \$64,203,000 during fiscal 1986, and \$37,854,000 during fiscal 1985. Average short-term borrowings during these

years, computed on a month-end basis, were \$33,544,000 and \$21,905,000, respectively. The average interest rate based on a weighted average of the stated month-end rates was 13.0% in fiscal 1986 and 11.6% in fiscal 1985.

The Company has revolving credit agreements totaling \$240,000,000. There were no borrowings under these agreements. These commitments are available on a revolving basis until March 1987. At that time the Company can choose to convert any outstanding balances into term loans with final maturities in March 1991.

Additionally, the Company had unused lines of credit for short-term financing of \$138,682,000 at June 28, 1986 and \$125,436,000 at June 29, 1985.

Note G—Long-Term Debt

Long-term debt, exclusive of current maturities, consisted of the following:

<i>(in thousands)</i>	June 28, 1986	June 29, 1985
Lease obligations payable 1986-2000 (7.5%-9.00%) (a)	\$ 6,607	\$ 7,215
Collateralized obligations maturing serially to 1993 (5.4%) (b)	4,695	5,340
Sinking Fund Debentures due 2000 (9 ³ / ₈ %) (c)	63,000	66,646
Sinking Fund Debentures due 2014 (13%) (d)	—	100,000
Notes due 1994 (12 ⁵ / ₈ %) (e)	100,000	100,000
Overseas Finance Notes due 1989 (11 ³ / ₄ %) (f)	150,000	150,000
Convertible Subordinated Debentures due 2009 (8%) (g)	—	400,000
Other	8,853	7,744
	\$333,155	\$836,945

Principal payments required during the next five fiscal years are as follows: 1987—\$3,500,000; 1988—\$6,478,000; 1989—\$156,560,000; 1990—\$6,608,000; 1991—\$6,131,000.

(a) Weighted average interest rate at June 28, 1986 and June 29, 1985 of 7.9%.

(b) Interest rate shown is the weighted average rate at June 28, 1986 and June 29, 1985.

(c) Sinking Fund Debentures were issued by the Company in March 1975. Sinking fund payments of \$4 million are required in each of the fiscal years 1985-1999. The Company at its option may increase the sinking fund payments up to an additional \$4 million in each such year. The Debentures are currently redeemable at the option of the Company at any time, as a whole or in part, at 104.219% of the principal amount and at declining percentages each year thereafter until 1995 when they are redeemable at par. The Indenture for the Debentures also contains certain restrictions on future borrowings and dividend distributions.

(d) Sinking Fund Debentures were issued by the Company in April 1984. The Company called the Debentures for redemption on June 19, 1986 at the call price of 111.267% of the principal amount plus accrued interest. The premium of \$11.3 million was charged to interest expense.

(e) Notes were issued by the Company in April 1984. The Notes are redeemable on or after April 15, 1991, as a whole or in part, at a redemption price equal to the principal amount plus accrued interest. The Indenture for the Notes also contains certain restrictions on future borrowings and sales and leasebacks.

(f) Notes were issued in March 1984 by Digital Equipment Overseas Finance N.V.. The Notes are unconditionally guaranteed by Digital Equipment Corporation. They are not redeemable unless certain events occur involving United States or Netherlands Antilles tax laws.

(g) On September 13, 1984 the Company issued \$400,000,000 of 8% Convertible Subordinated Debentures. The Company called the Debentures for redemption on April 17, 1986 at the call price of 107.2% of the principal amount plus accrued interest. At the election of the Debentureholders, substantially all of the Debentures were converted into shares of Common Stock of the Company at the conversion rate (without giving effect to the stock split referred to in Note K) of one share of Common Stock for each \$114 principal amount of Debentures.

Note H—Leases

Minimum annual rentals under noncancelable leases (which are principally for leased real estate, vehicles and equipment) for the fiscal years listed are as follows:

Fiscal Years	(in thousands)
1987	\$167,925
1988	\$139,421
1989	\$103,075
1990	\$ 74,651
1991	\$ 57,602
Later years	\$286,770
Total minimum lease payments	\$829,444

Total rental expense for the fiscal years ended June 28, 1986, June 29, 1985, and June 30, 1984 amounted to \$257,695,000, \$223,434,000, and \$175,055,000, respectively.

Note I—Pension Plans and Other Retirement Benefits

The Company and its subsidiaries have pension plans covering substantially all of their employees. Total pension expense was \$111,778,000 in fiscal 1986, \$114,053,000 in fiscal 1985, and \$95,463,000 in fiscal 1984. In fiscal 1986 the Company revised certain actuarial assumptions of its domestic plan to more closely reflect recent past and expected future experience. The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 6.5% in 1986 and 6.0% in 1985. Effective July 1, 1985 the company improved the past service benefits for participants of the domestic plan. It is the Company's policy to make contributions to the plans to the extent that such contributions are tax deductible. There was no unfunded past service liability as of June 28, 1986.

A comparison of accumulated plan benefits and plan net assets for the Company's domestic defined benefit plans and for those foreign subsidiaries with defined benefit plans, determined as of the beginning of each respective fiscal year is presented in the accompanying table. Foreign subsidiaries with insured plans have been excluded from this information.

(in thousands)	1986	1985
Actuarial present value of accumulated plan benefits:		
Vested	\$223,298	\$158,417
Nonvested	41,923	38,190
	\$265,221	\$196,607
Net assets available for benefits	\$667,669	\$461,600

In addition to providing pension benefits, the Company provides certain medical, dental and life insurance benefits for retired employees. Substantially all of the Company's domestic employees may become eligible for those benefits if they reach normal retirement age while working for the Company. The cost of retiree health care and life insurance benefits is recognized as an expense as claims are paid. For fiscal 1986 and 1985, these costs totaled \$422,519 and \$436,000 respectively. The majority of the Company's foreign subsidiaries do not offer such benefits to retirees. Of those that do, the amounts are immaterial.

Note J – Stock Plans

Restricted Stock Options • Under its Restricted Stock Option and Purchase Plans, the Company has granted certain officers and key employees options, which are exercisable upon grant, to purchase common stock at a price determined by the Board of Directors. Shares purchased under the plans are generally subject to repurchase options and restrictions on sales which lapse over an extended time period not exceeding 10 years.

On November 8, 1985, the Company's stockholders approved the 1985 Restricted Stock Option Plan (the "1985 Plan") providing for the issuance of 18,000,000 shares of Common Stock under the Plan through December 31, 1990. The granting of additional options under the 1976 Plan terminated upon approval of the 1985 Plan.

Information concerning activity during the three fiscal years ended June 28, 1986 follows:

	Shares Reserved For Future Grants	Options Outstanding	
		Shares	Average Price Per Share
July 2, 1983	8,329,258	8,748,426	\$22.74
Options granted	(3,416,180)	3,416,180	31.51
Options exercised	–	(879,208)	12.11
Options cancelled	618,026	(618,026)	23.09
Options terminated	(39,360)	–	–
June 30, 1984	5,491,744	10,667,372	\$26.40
Options granted	(2,961,920)	2,961,920	34.50
Options exercised	–	(981,976)	16.30
Options cancelled	432,464	(432,464)	26.87
Options terminated	(11,828)	–	–
June 29, 1985	2,950,460	12,214,852	\$29.16
Options granted	(580,900)	580,900	38.54
Options exercised	–	(1,086,786)	22.57
Options cancelled	243,186	(243,186)	30.14
Options terminated	(2,675,046)	–	–
Options authorized	18,000,000	–	–
June 28, 1986	17,937,700	11,465,780	\$30.24

Note K – Common Stock Split

On May 9, 1986 the Company effected a two-for-one stock split in the form of a 100% stock dividend to shareholders of record at the close of business on April 18,

At the time these options are exercised, the common stock account is increased by the par value (\$1 per share) of the shares sold and the remaining portion of the proceeds is credited to additional paid-in capital. The excess of the fair market value of the shares on the grant date over the option price is charged to operations each year as the restrictions lapse. Such charges to operations amounted to \$21,155,000 in fiscal 1986, \$20,420,000 in fiscal 1985, and \$17,499,000 in fiscal 1984. The amount deductible for Federal income taxes exceeds the amount charged to income for book purposes. The Federal income tax benefits relating to this difference have been credited to additional paid-in capital.

Employee Stock Purchase Plans • Under the Company's Employee Stock Purchase Plans, all United States and certain international employees may be granted options to purchase common stock at 85% of market value on the first or last business day of the six month payment period, whichever is lower. On November 8, 1985, the shareholders amended the Employee Stock Purchase Plan to increase the number of shares subject to options by 5,000,000 shares. Common stock reserved for future grants aggregated 5,358,655 shares at June 28, 1986, and 2,186,388 shares at June 29, 1985. There were 1,827,733 shares issued at an average price of \$47.73 in fiscal 1986 and 1,736,992 shares at \$40.80 in fiscal 1985. There have been no charges to income in connection with the options other than incidental expenses related to the issuance of the shares. Federal income tax benefits relating to such options have been credited to additional paid-in capital.

Employee Stock Ownership Plan • The Employee Stock Ownership Plan (ESOP) and a related trust were established in 1982. Federal tax law generally allows a tax credit for the Company equal to 1/2% of the base salaries (not in excess of \$100,000 salary for any single employee) of substantially all U.S. employees. The Company's contributions of stock or cash to the trust equal the amount allowed as a Federal tax credit.

1986. These financial statements have been restated, where appropriate, to show the retroactive effect of the stock split.

SUPPLEMENTARY FINANCIAL INFORMATION

Quarterly Financial Data (unaudited)

Selected quarterly financial data for the years ended June 28, 1986 and June 29, 1985 is set forth below:

<i>(in millions except per share data)</i>	Total Operating Revenues	Gross Profit	Income Before Income Taxes	Income	Net Income Per Share
1986					
First Quarter	\$1,623.9	\$ 659.6	\$ 97.7	\$ 72.3	\$0.60
Second Quarter	1,862.5	773.8	183.9	136.1	1.08
Third Quarter	1,928.3	851.2	237.2	170.4	1.32
Fourth Quarter	2,175.7	1,023.7	338.7	238.6	1.81
Total Year	\$7,590.4	\$3,308.3	\$857.5	\$617.4	\$4.81
1985					
First Quarter	\$1,515.3	\$ 598.2	\$103.8	\$144.2	\$1.22 ¹
Second Quarter	1,628.0	653.8	134.9	110.3	0.90
Third Quarter	1,691.1	658.9	98.6	91.7	0.76
Fourth Quarter	1,851.9	687.9	93.5	100.5	0.83
Total Year	\$6,686.3	\$2,598.8	\$430.8	\$446.7	\$3.71

¹Includes elimination of DISC taxes of \$63 million, or \$.53 per share.

Information on the Effects of Inflation (unaudited)

The following information required and prepared in accordance with standards of the Financial Accounting Standards Board is intended to help users of financial statements understand the effects of general price changes (inflation) and changes in specific prices, on the Company's operations.

The effect of changes in specific prices is estimated by valuing inventories and property, plant and equipment at currently prevailing prices, using external and internally developed price indexes and recent production cost experience.

Net Monetary Assets • The purchasing power of the Company's net monetary assets (cash and temporary cash investments and fixed dollar claims to money) declined because of inflation by \$30.1 million in fiscal 1986, as measured by the change in the Consumer Price Index.

Inventories and Property, Plant and Equipment •

The current cost of inventories and property, plant and equipment, net of accumulated depreciation and the corresponding historical cost amounts at June 28, 1986 were as follows:

<i>(in millions)</i>	Inventories	Property, Plant and Equipment, Net
Current Cost	\$1,156.8	\$2,261.4
Historical Cost	\$1,199.8	\$1,867.1
Difference	\$ (43.0)	\$ 394.3

Information on the Effects of Inflation (unaudited) (continued)

The current cost method assumes replacement of all the Company's property, plant and equipment as of June 28, 1986. However, the Company's property, plant and equipment are relatively new, with 77% of it having been acquired in the last 5 fiscal years. Consequently, the Company's future capital expenditures will be principally to expand, rather than to replace, existing capacity.

Statement of Income The income statement shown below has been restated in average fiscal 1986 dollars after reflecting depreciation and cost of sales at the current costs prevailing in each respective year. Although the adjustments for depreciation expense and the inventory component of cost of sales affected the pretax income amounts, no adjustments have been made to the respective provisions for income taxes. Giving effect to these adjustments, 1986 net income was \$232.2 million more than net income as reported.

Five Year Comparison of Selected Financial Data Adjusted for the Effects of Inflation

<i>(in millions except per share data)</i>	As Reported		In Average Fiscal 1986 Dollars			
	1986	1986	1985	1984	1983	1982
Total operating revenues	\$7,590.4	\$ 7,590.4	\$6,880.2	\$5,969.7	\$4,733.3	\$4,486.2
Cost of equipment sales, service and other revenues	4,060.5	3,794.9	3,991.4	3,322.1	2,690.2	2,498.0
Depreciation expense	384.0	417.4	334.2	282.3	239.0	178.2
Other expenses	2,288.4	2,288.4	2,115.5	1,818.5	1,283.0	1,098.2
Provision for income taxes	240.1	240.1	(16.3)	77.1	141.2	295.6
Net income	\$ 617.4	\$ 849.6	\$ 455.4	\$ 469.7	\$ 379.9	\$ 416.2
Net income per share	\$ 4.81	\$ 6.58	\$ 3.78	\$ 4.09	\$ 3.35	\$ 3.75
Loss from decline in purchasing power of net monetary assets		\$ 30.1	\$ 34.8	\$ 36.4	\$ 26.3	\$ 70.2
Change in specific prices—net of general inflation		\$ (161.8)	\$ 109.0	\$ (377.4)	\$ (170.4)	\$ (214.9)
Stockholders' equity at end of year . .	\$5,727.8	\$6,042.8	\$4,825.8	\$4,163.7	\$3,987.7	\$3,698.4
Actual market price per common share at end of year		\$85.69	\$47.32	\$42.00	\$60.75	\$33.00
Average Consumer Price Index (1967 = 100)		326.0	316.8	304.9	294.1	281.9

Note: All per share data for prior years has been adjusted to reflect a two-for-one stock split distributed on May 9, 1986 to shareholders of record at the close of business on April 18, 1986.

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Telex: 53-4955 Digital KAN

Investor Information

The Company's common stock is listed and traded on the:

New York Stock Exchange
Pacific Stock Exchange
(Ticker Symbol "DEC")

In Europe: Swiss Stock Exchanges of Zurich, Geneva, and Basel; and the German Stock Exchanges of Frankfurt, Munich, and Berlin.

Unlisted trading privileges have been granted by the:

Boston Stock Exchange
Cincinnati Stock Exchange
Midwest Stock Exchange
Philadelphia Stock Exchange
In Europe: Luxembourg Stock Exchange

The Company maintains an Investor Relations office to assist shareholders. Investors' inquiries are welcome, by telephone or letter.

Inquiries relating to investment in Digital Equipment Corporation should be directed to:

Albert E. Mullin, Jr.
Vice President, Corporate Relations
Digital Equipment Corporation
111 Powdermill Road (N9)
Maynard, MA 01754
(617) 493-5350

Digital Equipment Corporation's Annual Report on Form 10-K for the fiscal year ended June 28, 1986, including schedules thereto, which is filed with the Securities and Exchange Commission, will be sent without charge upon written request. The Company's annual report, filings with the Securities and Exchange Commission, interim reports and additional information about the Company and its products can be obtained by addressing:

Digital Equipment Corporation
Inquiry Section
10 Forbes Road NR02-1/H3
Northboro, MA 01532
(617) 351-4401

Financial community information and requests to be placed on the Company's mailing list should be directed to:

Digital Equipment Corporation
Investor Relations—ML
111 Powdermill Road (K10)
Maynard, MA 01754
(617) 493-8246

Investor Information (continued)

Inquiries of an administrative nature relating to shareholder accounting records, stock transfer, change of address, and employee purchases should be directed to:

Digital Equipment Corporation
Investor Services
111 Powdermill Road (L12)
Maynard, MA 01754
(617) 493-5213

Transfer Agent and Registrar
for Common Stock

Morgan Guaranty Trust Company is the principal stock transfer agent and registrar, and maintains the shareholder accounting records. The agent will respond to questions on change of ownership, lost stock certificates, consolidation of accounts and change of address.

A change of address should be reported promptly by sending a signed and dated note or postcard to Morgan Shareholder Services Trust Company. Shareholders should state the name in which the stock is registered, account number, as well as the old and new addresses.

Morgan Shareholder Services Trust Company
30 West Broadway
New York, NY 10007

Digital Equipment Corporation customers who have questions and/or problems relating to their account should contact the Customer Assistance Department at (617) 493-7161.

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For 12⁵/₈% Notes due 1994
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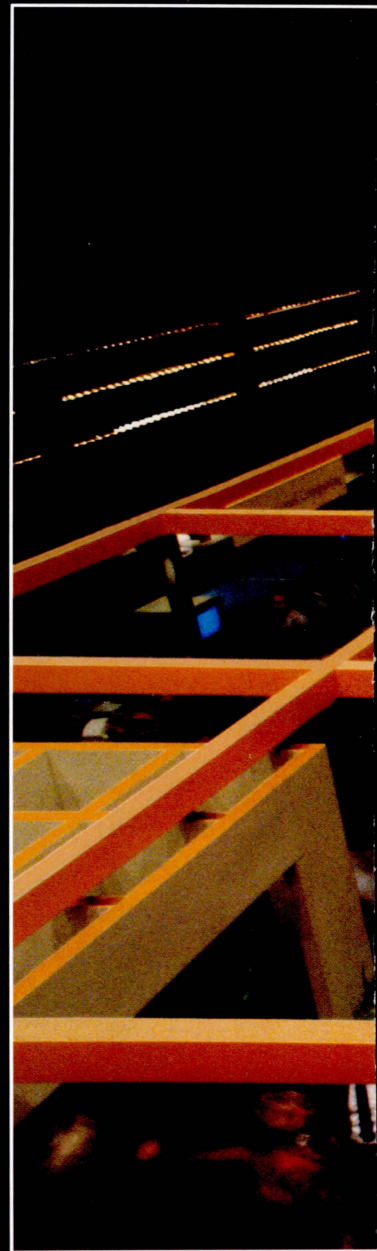
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