

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended July 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from to

Commission file number: 1-4423

HEWLETT-PACKARD COMPANY

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

3000 Hanover Street, Palo Alto, California

(Address of principal executive offices)

(650) 857-1501

(Registrant's telephone number, including area code)

94-1081436

(IRS Employer
Identification No.)

94304

(Zip Code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at August 31, 2003
Common Stock, \$0.01 par value	3,049,140,000 shares

Results of operations for the combined company in dollars and as a percentage of net revenue were as follows:

	Nine months ended July 31,			
	2003		2002	
	Dollars	% of Revenue (Dollars in millions)	Dollars	% of Revenue
Net revenue	\$ 53,208	100.0 %	\$ 54,298	100.0 %
Cost of sales (1)	39,053	73.4	40,931	75.4
Gross margin	14,155	26.6	13,367	24.6
Research and development	2,745	5.2	2,974	5.5
Selling, general and administrative	8,305	15.6	8,272	15.2
Amortization of purchased intangible assets and goodwill	420	0.8	513	0.9
Restructuring charges	610	1.1	1,630	3.0
Acquisition-related charges	252	0.5	627	1.2
In-process research and development charge	—	—	793	1.5
Earnings (loss) from operations	1,823	3.4	(1,442)	(2.7)
Interest and other, net	41	0.1	(48)	(0.1)
Losses on investments and other, net	(41)	(0.1)	(18)	—
Earnings (loss) before taxes	1,823	3.4	(1,508)	(2.8)
Provision for (benefit from) taxes	146	0.2	(189)	(0.4)
Net earnings (loss)	\$ 1,677	3.2	\$ (1,319)	(2.4)

(1)
Cost of products, cost of services and financing interest.

Net Revenue

On a combined company basis, net revenue declined 2% (7% on a constant currency basis) in the first nine months of fiscal 2003 to \$53.2billion, down from \$54.3billion in the corresponding period of the prior year. In the first nine months of fiscal 2003, U.S. revenue declined 1% compared to the prior-year period to \$21.4billion, while international revenue decreased 3% compared to the same period a year ago to \$31.8billion.

In the first nine months of fiscal 2003, on a weighted percentage point basis, PSG, ESG, HPS and HPFS accounted for 3.0, 1.6, 0.3 and 0.2percentage points, respectively, of the overall combined company net revenue decline. A net revenue increase in IPG of 2.9percentage points, on a weighted basis, moderated the decline.

Overall, declines in sales volumes across many business units combined with lower average selling prices due to competitive pricing pressures, a shift in sales mix to lower-priced products and service offerings and the consolidation of product offerings as a result of post-acquisition product roadmap decisions impacted negatively combined company net revenue for the first nine months of fiscal 2003. The overall decline in net revenue was moderated by favorable currency impacts resulting from the weakening of the dollar against the euro. The net revenue decline in PSG resulted primarily from lower average selling prices due to competitive pricing pressure and, to a lesser extent, a decline in volumes in consumer desktops. Additionally, the commercial desktop PC and handheld volume declines in the period were due to the execution of post-acquisition product roadmap decisions. The ESG revenue decline was attributable primarily to a revenue decrease in business critical servers due to the ongoing weakness in enterprise capital spending and competitive pricing, as well as decreased volumes in certain storage products resulting from product roadmap decisions. HPS net revenue decreased due

primarily to declines in the consulting and integration business resulting from the overall market decline for consulting services across all regions, moderated by increases in managed services and customer support revenue. The HPFS net revenue decline was due primarily to a decrease in revenue-generating assets. A revenue increase in IPG, particularly driven by strong growth in printer supplies resulting from a rise in volumes reflecting continued expansion of the printer hardware installed base, offset in part the overall net revenue decline.

Gross Margin

Combined company gross margin as a percentage of combined company net revenue was 26.6% in the first nine months of fiscal 2003 compared to 24.6% in the corresponding period of the prior year. Overall, cost savings resulting from improved cost structures, continued expense control measures and stabilizing component prices impacted favorably gross margin, partially offsetting the decline in net revenue for the first nine months of fiscal 2003. In addition, the overall gross margin was impacted favorably by a 0.2percentage point improvement attributable primarily to inventory adjustments of \$137million in the third quarter of fiscal 2002 resulting from product roadmap decisions. Of the 2.0percentage point increase in the combined company gross margin for the first nine months of fiscal 2003, PSG and IPG accounted for 0.9 and 0.5percentage points of the increase on a weighted basis, respectively. ESG and HPFS each accounted for 0.2percentage points of the increase on a weighted basis, and HPS did not have a significant impact on the overall gross margin percentage. The gross margin improvement in PSG was due primarily to reduced direct and indirect procurement costs reflecting synergies associated with our acquisition of Compaq. The improvement in IPG was due mainly to revenue growth in the higher-margin supplies business and continued operational efficiencies resulting from higher manufacturing volumes and cost saving initiatives, as well as favorable currency impacts on revenue resulting primarily from the strengthening of the euro. ESG gross margin improvement reflected primarily cost reductions in storage and industry standard server products as a result of the Compaq acquisition, offset in part by the product mix shift away from higher-margin business critical servers toward lower-margin industry standard servers. The gross margin improvement in HPFS was due primarily to reduced bad debt expense.

Operating Expenses

Research and Development

Combined company research and development expense as a percentage of combined company net revenue was 5.2% in the first nine months of fiscal 2003 compared to 5.5% in the first nine months of fiscal 2002. Research and development expense decreased by 8% during the first nine months of fiscal 2003. Overall, the decrease in research and development expense resulted primarily from our workforce reduction efforts and expense control measures. Research and development expense decreased in each of our business segments, except for IPG, which increased by 11% in the first nine months of fiscal 2003. The most significant decrease was in PSG, which decreased by 24% due to cost control measures. IPG's increase in research and development spending due to activities associated with emerging inkjet technology moderated the overall decrease.

Selling, General and Administrative

Combined company selling, general and administrative expense as a percentage of combined company net revenue was 15.6% in the first nine months of fiscal 2003 compared to 15.2% in the first nine months of fiscal 2002. Selling, general and administrative expense increased by less than 1% in the first nine months of fiscal 2003 compared to the corresponding period in fiscal 2002. Overall, the increase in selling, general and administrative expense in the first nine months of fiscal 2003 was attributable primarily to unfavorable currency impacts driven mainly by the weakening of the dollar against the euro, increased sales and marketing costs associated with a company-wide product branding

Historical Quarterly Results

PSG's net revenue increased 5% in the third quarter of fiscal 2003 compared to the same period in fiscal 2002. On a constant currency basis, revenue decreased in the third quarter of fiscal 2003 by 2% for the year-over-year period. The favorable currency impact in the period was due primarily to the weakening of the dollar against the euro. Of the overall 5% revenue increase in the third quarter of fiscal 2003, notebook PCs and consumer desktop PCs accounted for 8.0 and 3.0 percentage points of the increase, respectively, on a weighted basis. Declines in commercial desktop PCs and handhelds of 6.0 and 0.5 percentage points, respectively, offset these increases.

The revenue increase in the third quarter of fiscal 2003 resulted from an increase in volumes across all business units within PSG, with the exception of commercial desktop PCs, offset in part by a decline in average selling prices across all PSG business units, attributable mainly to a competitive pricing environment resulting from the realignment of product prices. Consumer notebook volumes increased as a result of the continued mix shift from desktops to notebooks, as well as a broader product portfolio as compared to the corresponding period in the prior year. The volume increase in commercial notebook PCs was attributable to market share gains due to increased product competitiveness, as well as the introduction of new products focused on the growing small and medium business market. Consumer desktop PC volumes increased due to higher back-to-school shipments to major retailers, as well as new product introductions. Handheld volumes grew slightly due to new product launches, although handheld revenue was down overall due to decreased average selling prices. Commercial desktop PC volumes decreased in the period due to market softness, as well as the execution of the post-acquisition product roadmap decision to discontinue the HP Vectra product line.

The loss from operations as a percentage of net revenue was 1.1% for the third quarter of fiscal 2003 compared to a loss from operations of 2.9% for the same period in fiscal 2002. In the third quarter of fiscal 2003, declines in operating expenses as a percentage of revenue represented 1.3 percentage points of the 1.8 percentage point improvement, while an improvement in gross margin as a percentage of net revenue represented the remaining 0.5 percentage points. Operating expenses as a percentage of revenue decreased in the third quarter of fiscal 2003 compared to the prior year due to cost control measures and our workforce reduction initiatives. The gross margin improvement in the period resulted from our reduced direct and indirect procurement costs reflecting synergies associated with our acquisition of Compaq, moderated by the declining average selling prices described above.

Historical Year-to-Date Results

The fluctuations in PSG's segment performance in the first nine months of fiscal 2003 as compared to the same period in fiscal 2002 were due substantially to the acquisition of Compaq. Although the acquisition of Compaq resulted in an increase in unit sales across all business units, the continued competitive pricing environment impacted unfavorably average selling prices in the first nine months of fiscal 2003. The execution of post-acquisition product roadmap decisions, which included the discontinuance of the HP Vectra and Jornada product lines, impacted unfavorably commercial desktop PC and handheld volumes. Earnings from operations as a percentage of net revenue increased during the first nine months of fiscal 2003 due to an improvement in gross margin, primarily the result of our reduced direct and indirect procurement costs reflecting synergies associated with our acquisition of Compaq, as well as a shift toward our lower-cost direct business. Operating expenses as a percentage of revenue remained essentially flat during the first nine months of fiscal 2003, as compared to the prior-year period. We present a supplementary discussion of PSG's results for the first nine months of fiscal 2003 as compared to the same period in fiscal 2002, including trends that impacted historical as well as combined company results, below in the combined company discussion.

Combined Company Year-to-Date Results

PSG's combined company net revenue declined 10% in the first nine months of fiscal 2003 compared to the same period in fiscal 2002. The revenue decrease in the first nine months of fiscal 2003 was 14% on a constant currency basis compared to the corresponding period in fiscal 2002. The favorable currency impact was due primarily to the weakening of the dollar against the euro. Of the overall 10% revenue decrease in the first nine months of fiscal 2003, consumer and commercial desktop PCs accounted for 10.0percentage points of the decline on a weighted basis, while handhelds and workstations each contributed slightly to the decline. An increase in notebook PCs revenue of 1.5percentage points on a weighted basis offset in part these declines. Continued soft demand unfavorably impacted net revenue in the period.

The combined company revenue decline in the first nine months of fiscal 2003 resulted from a decline in average selling prices across all businesses within PSG and, to a lesser extent, a decline in volumes in consumer and commercial desktop PCs and handhelds. The decline in average selling prices in the period was attributable to the realignment of product prices. The continued mix shift from desktops to notebooks impacted unfavorably consumer and commercial desktop PC volumes. Additionally, the commercial desktop PC and handheld volume declines in the period were due to the execution of post-acquisition product roadmap decisions, which included the discontinuance of the HP Vectra and Jornada product lines. An increase in notebook PCs volumes in the first nine months of fiscal 2003 compared to the prior year due to increased product competitiveness, a broader product portfolio, and the previously mentioned mix shift from desktops to notebooks, offset in part the desktop PC and handheld volume decreases.

Combined company earnings from operations as a percentage of net revenue was break-even for the first nine months of fiscal 2003 compared to a loss from operations of 1.8% for the same period in fiscal 2002. In the first nine months of fiscal 2003, an improvement in gross margin as a percentage of net revenue represented 2.0percentage points of the 1.8percentage point increase, offset in part by an increase in the operating expense ratio. The gross margin improvement resulted from our reduced direct and indirect procurement costs, reflecting synergies associated with our acquisition of Compaq, moderated by the declining average selling prices described above.

Enterprise Systems Group

	For the three months ended July31,(a)	
	2003	2002
	(Dollars in millions)	
Net revenue	\$ 3,708	\$ 3,690
Loss from operations	\$ (70)	\$ (322)
Loss from operations as a percentage of net revenue	(1.9)%	(8.7)%

earnings from operations ratio in the period. We present a supplementary discussion of HPS' results for the first nine months of fiscal 2003 as compared to the same period in fiscal 2002, including trends that impacted historical as well as combined company results, below in the combined company discussion.

Combined Company Year-to-Date Results

HPS' combined company net revenue decreased 2% in the first nine months of fiscal 2003 compared to the same period in fiscal 2002. On a constant currency basis, the revenue decrease in the first nine months of fiscal 2003 was 7% compared to the corresponding period in the prior year. The favorable currency impact was due primarily to the weakening of the dollar against the euro. Of the overall 2% revenue decline in the first nine months of fiscal 2003, the consulting and integration business accounted for 5.0percentage points of the decline on a weighted basis, moderated by revenue growth in the managed services and customer support businesses, which contributed 2.0 and 1.0percentage points on a weighted basis, respectively.

A decline in core consulting and integration services and a decrease in sales of complementary third-party products drove the combined company net revenue decrease in the consulting and integration business in the first nine months of fiscal 2003. The decline in core consulting and integration revenue reflected competitive pricing pressures and weak demand, particularly in the telecommunications industry, while the decrease in sales of complementary third-party products resulted from a heightened focus on sales of critical solution requirements. An increase in new and existing large outsourcing deals, reflecting the ongoing mix shift toward larger comprehensive deals as customers outsourced substantial portions of their IT infrastructure to HP, as well as favorable currency impacts mentioned above, drove the growth in managed services revenue in the first nine months of fiscal 2003. The growth in customer support revenue in the first nine months of fiscal 2003 was due primarily to favorable currency impacts resulting from the strengthening of the euro.

Combined company earnings from operations as a percentage of net revenue was 10.8% for the first nine months of fiscal 2003 compared to 10.9% for the same period in fiscal 2002. An operating profit ratio decline in the customer support business drove the decrease. Competitive pricing pressures and a shift in mix towards lower-margin services had a negative impact on the customer support operating margins. Higher pension and post-retirement costs resulting from fiscal 2003 changes in underlying assumptions, including a decrease in expected portfolio performance, a decrease in discount rates and an increase in medical cost trend rates, as well as the extension of participation in pension and post-retirement benefit plans to eligible pre-acquisition Compaq employees in the United States not covered by such plans prior to January 1, 2003, additionally impacted the overall segment operating profit ratio decline in the first nine months of fiscal 2003. A favorable business mix shift away from the consulting and integration business, which typically has an operating profit ratio lower than the segment average, moderated the overall segment operating profit ratio decline in the first nine months of fiscal 2003. The expense control measures and workforce reductions initiated in fiscal 2002, as well as reduced costs reflecting synergies associated with our acquisition of Compaq, further moderated the operating profit decline in the period.

HP Financial Services

	For the three months ended July 31, (a)	
	2003	2002
	(Dollars in millions)	
Net revenue	\$ 442	\$ 510
Earnings (loss) from operations	\$ 18	\$ (21)
Earnings (loss) from operations as a percentage of net revenue	4.1 %	(4.1) %

due between 2003 and 2005, approximately \$3.4billion is due between 2006 and 2008 and the remainder is due at various dates through 2023. For a description of our outstanding debt, see Note 8 to the Consolidated Condensed Financial Statements, which is incorporated herein by reference.

We may issue future long-term borrowings under our shelf registration statement that was declared effective in March 2002 (the "2002 Shelf Registration Statement"). At September 5, 2003, we have issued \$2.0billion of Global Notes under the 2002 Shelf Registration Statement, which mature on various dates between 2007 and 2012, and we have future borrowing capacity of \$1.0billion under this registration statement.

We also may issue future long-term borrowings under our Euro Medium-Term Note Programme, filed with the Luxembourg Stock Exchange, which originally allowed us to offer up to \$3.0billion of Medium-Term Notes. These notes can be denominated in any currency including the euro. However, these notes have not been and will not be registered in the United States. At September 5, 2003, we have approximately \$831million outstanding under the Euro Medium-Term Note Programme, which matures in July 2006, and we have future borrowing capacity of approximately \$2.2billion.

We do not have any rating downgrade triggers that would accelerate the maturity of a material amount of our debt, other than the HSBC-CCF debt described above. However, a downgrade in our credit rating would increase the cost of borrowings under our credit facilities. Also, a downgrade in our credit rating could limit, or in the case of a significant downgrade, preclude our ability to issue commercial paper under our current programs. Should this occur, we would seek alternative sources of funding, including the issuance of notes under our existing shelf registration statements and our Euro Medium-Term Note Programme. In addition, we have the option to draw upon our senior unsecured credit facilities totaling \$3.0billion.

The vast majority of total outstanding debt was issued or assumed by HP and not by our financing business, HPFS. However, HPFS is a financial services organization and, like other financial services companies, has a business model that is asset-intensive in nature and therefore is more debt-dependent than our other business segments. At July 31, 2003, HPFS had approximately \$6.8billion in net financing assets, which include short- and long-term financing receivables and operating lease assets.

FACTORS THAT COULD AFFECT FUTURE RESULTS

Because of the following factors, as well as other variables affecting our operating results, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

The competitive pressures we face could harm our revenue, gross margin and prospects.

We encounter aggressive competition from numerous and varied competitors in all areas of our business, and we compete primarily on the basis of technology, performance, price, quality, reliability, brand, distribution, range of products and services, account relationships, customer service and support, security, and availability of application software. If our products, services, support and cost structure do not enable us to compete successfully based on any of those criteria, it could harm our operations, results and prospects. Further, we may have to continue to lower the prices of many of our products and services to stay competitive, while at the same time trying to maintain or improve revenue and gross margin. Because our business model is based on providing innovative and high quality products, we may spend a proportionately greater amount on research and development than some of our competitors. If we cannot proportionately decrease our cost structure on a timely basis in response to competitive price pressures, our gross margin and therefore our profitability could be adversely affected. In addition, if our pricing and other factors are not sufficiently competitive, or if there is an adverse reaction to our product decisions, we may lose market share in certain areas, which could adversely affect our revenue and prospects. Even if we are able to maintain or increase market share

for a particular product, revenue could decline due to increased competition from other types of products or because the product is in a maturing industry. For example, as the desktop computer industry continues to mature, customers may not purchase new desktop computers as frequently as they have in the past. Industry consolidation may affect competition by creating larger, more homogeneous and potentially stronger competitors in the markets in which we compete, and our competitors also may affect our business by entering into exclusive arrangements with existing or potential customers or suppliers.

If we cannot continue to develop, manufacture and market products and services that meet customer requirements for innovation and quality, our revenue and gross margins may suffer.

The process of developing new high technology products and services and enhancing existing products and services is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. We must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. After we develop a product, we must be able to manufacture appropriate volumes quickly and at low costs. To accomplish this, we must accurately forecast volumes, mix of products and configurations that meet customer requirements, and we may not succeed at all or within a given product's life cycle. Any delay in the development, production or marketing of a new product could result in our not being among the first to market, which could further harm our competitive position. In addition, in the course of conducting our business, we must adequately address quality issues associated with our products and services, including defects in our engineering, design and manufacturing processes, as well as defects in third party components included in our products. In order to address quality issues, we work extensively with our customers and suppliers and engage in product testing to determine the root cause of the problem and to determine appropriate solutions. However, we may have limited ability to control quality issues, particularly with respect to faulty components manufactured by third parties. If we are unable to determine the cause, find an appropriate solution or offer a temporary fix (or "patch"), we may delay shipment to customers, which would delay revenue recognition and could adversely affect our revenues and reported results. Finding solutions to quality issues can be expensive and may result in additional warranty, replacement and other costs, adversely affecting our profits. In addition, quality issues can impair our relationships with new or existing customers and adversely affect our reputation, which could have a material adverse effect on our revenue and operating results.

If we do not effectively manage our product and services transitions, our revenue may suffer.

Many of the industries in which we compete are characterized by rapid technological advances in hardware performance, software functionality and features; the frequent introduction of new products; short product life cycles; and continual improvement in product price characteristics relative to product performance. If we do not make an effective transition from existing products and services to future offerings, our revenue may decline. Among the risks associated with the introduction of new products and services are delays in development or manufacturing, variations in costs, delays in customer purchases in anticipation of new introductions, difficulty in predicting customer demand for the new offerings and effectively managing inventory levels in line with anticipated demand, risks associated with customer qualification and evaluation of new products and the risk that new products may have quality or other defects or may not be adequately supported by application software. Our revenue and gross margin also may suffer due to the timing of product or service introductions by our suppliers and competitors. This is especially challenging when a product has a short life cycle or a competitor introduces a new product just before our own product introduction. Furthermore, sales of our new products and services may replace sales of, or result in discounting of, some of our current offerings, offsetting the benefit of even a successful introduction. There may also be overlaps in the current

products and services of HP and portfolios acquired through mergers and acquisitions that must be managed. In addition, it may be difficult to ensure performance of new customer contracts in accordance with our revenue, margin and cost estimates, and to achieve operational efficiencies embedded in our estimates. Given the competitive nature of our industry, if any of these risks materializes, future demand for our products and services and our results of operations may suffer.

Any failure by us to manage acquisitions, divestitures and other significant transactions successfully could harm our financial results, business and prospects.

As part of our business strategy, we frequently engage in discussions with third parties regarding, and enter into agreements relating to, possible acquisitions, strategic alliances, joint ventures, divestitures and outsourcing transactions in order to further our business objectives, and, in many cases, to manage our product and technology portfolios. In order to pursue this strategy successfully, we must identify suitable candidates for these transactions, complete these transactions, some of which may be large and complex, and manage post-closing issues such as the integration of acquired companies or employees. Integration and other risks of acquisitions, strategic alliances, joint ventures and outsourcing deals can be more pronounced for larger and more complicated transactions, or if multiple transactions are pursued simultaneously. However, if we fail to identify and successfully complete transactions that further our strategic objectives, we may be required to expend resources to develop products and technology internally, we may be at a competitive disadvantage or we may be adversely affected by negative market perceptions, any of which may have a material effect on our revenue and selling, general and administrative expenses.

Integration issues are complex, time-consuming and expensive and, without proper planning and implementation, could significantly disrupt our business. The challenges involved in integration include:

- combining product offerings or entering into new markets in which we are not experienced and preventing customers and distributors from deferring purchasing decisions or switching to other suppliers, which could result in our incurring additional obligations in order to address customer uncertainty;
- demonstrating to customers and distributors that the transaction will not result in adverse changes in client service standards or business focus and coordinating sales, marketing and distribution efforts;
- consolidating and rationalizing corporate IT infrastructure, which may include multiple legacy systems from various acquisitions, including implementing information management and system processes that enable increased customer satisfaction, improved productivity, lower costs, accurate financial reporting, more direct sales and improved inventory management;
- minimizing the diversion of management attention from ongoing business concerns;
- persuading employees that business cultures are compatible, maintaining employee morale and retaining key employees, integrating employees into HP, correctly estimating employee benefit costs and implementing restructuring programs;
- coordinating and combining administrative, manufacturing, research and development and other operations, subsidiaries, facilities and relationships with third parties in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures;
- achieving savings from supply chain integration; and
- managing integration issues shortly after or pending the completion of other independent transactions.

In fiscal 2002, we completed our acquisitions of Compaq and Indigo N.V., and acquired Inria in fiscal 2003. In fiscal 2003, we also entered into several large outsourcing transactions to manage IT infrastructure and provide related products and services to Ericsson, The Procter & Gamble Company and Telecom Italia Group. We evaluate and enter into other acquisition, alliance, joint venture, outsourcing and divestiture transactions on an ongoing basis. We may not successfully address the challenges associated with these transactions in a timely manner, or at all, and we may not fully realize all of the anticipated benefits or synergies of any transaction to the extent, or in the timeframe, anticipated. Moreover, the timeframe for achieving benefits may depend partially upon the actions of employees, suppliers or other third parties.

Managing acquisitions, alliances, joint ventures, divestitures and outsourcing transactions requires varying levels of management resources, which may divert our attention from other business operations. These transactions also have resulted and in the future may result in significant costs and expenses and charges to earnings, including those related to severance pay, early retirement costs, employee benefit costs, asset impairment charges, charges from the elimination of duplicative facilities and contracts, in-process research and development charges, inventory adjustments, legal, accounting and financial advisory fees, and required payments to executive officers and key employees under retention plans. Moreover, HP has incurred and will incur additional depreciation and amortization expense over the useful lives of certain assets acquired in connection with transactions, and, to the extent the value of goodwill or intangible assets with indefinite lives acquired in connection with a transaction becomes impaired, we may be required to incur additional material charges relating to the impairment of those assets. In order to complete an acquisition, we may issue common stock, potentially creating dilution for existing stockholders, or borrow, affecting our financial condition and potentially our credit ratings. Any prior or future downgrades in our credit rating associated with an acquisition could adversely affect our ability to borrow and result in more restrictive borrowing terms. In addition, HP's effective tax rate on an ongoing basis is uncertain and extraordinary transactions could impact our effective tax rate. As a result, any completed, pending or future transactions may contribute to financial results that differ from the investment community's expectations in a given quarter.

Our revenue, cost of sales, and expenses may suffer if we cannot continue to license or enforce the intellectual property rights on which our business depends or if third parties assert that we violate their intellectual property rights.

We rely upon patent, copyright, trademark and trade secret laws in the United States and similar laws in other countries, and agreements with our employees, customers, partners and other parties, to establish and maintain our intellectual property rights in technology and products used in our operations. However, any of our direct or indirect intellectual property rights could be challenged, invalidated or circumvented, or such intellectual property rights may not be sufficient to permit us to take advantage of current market trends or otherwise to provide competitive advantages, which could result in costly product redesign efforts, discontinuance of certain product offerings or other competitive harm. Further, the laws of certain countries do not protect our proprietary rights to the same extent as do the laws of the United States. Therefore, in certain jurisdictions we may be unable to protect our proprietary technology adequately against unauthorized third-party copying or use, which could adversely affect our competitive position. Also, because of the rapid pace of technological change in the information technology industry, much of our business and many of our products rely on key technologies developed or licensed by third parties, and we may not be able to obtain or to continue to obtain licenses and technologies from these third parties at all or on reasonable terms, or such third parties may demand cross-licenses. Third parties also may claim that we are infringing upon their intellectual property rights. Even if we do not believe that our products or businesses are infringing upon third parties' intellectual property rights, the claims can be time-consuming and costly to defend and divert management's attention and resources away from our business. Claims of intellectual property infringement also might require us to enter into costly settlement or license agreements, pay

costly damage awards or redesign affected products. If we cannot or do not license the infringed technology at all or on reasonable terms or substitute similar technology from another source, our operations could suffer. In addition, it is possible that as a consequence of a merger or acquisition transaction third parties may obtain licenses to some of our intellectual property rights or our business may be subject to certain restrictions that were not in place prior to the transaction. Consequently, we may lose a competitive advantage with respect to these intellectual property rights or we may be required to enter into costly arrangements in order to terminate or limit these agreements.

Economic weakness has adversely affected, and could continue to affect adversely, our revenue, gross margin and expenses.

Our revenue and gross margin depend significantly on general economic conditions and the demand for computing and imaging products and services in the markets in which we compete. Softened demand for our products and services caused by ongoing economic weakness over the past several years has resulted, and may result, in decreased revenue, gross margin, earnings or growth rates and problems with our ability to manage inventory levels and realize customer receivables. Economic and market conditions continue to be challenging. As a result, individuals and companies have delayed or reduced expenditures, including those for information technology. In addition, if our customers experience financial difficulties, we could experience increases in bad debt write-offs and additions to reserves in our receivables portfolio, our lessees may be unable to make required lease payments and leased equipment may be worth less upon its return to us than was estimated at lease inception. We have also experienced gross margin declines in certain businesses, reflecting the effect of items such as competitive pricing pressures, inventory write-downs, charges associated with the cancellation of planned production line expansion, and increases in pension and post-retirement benefit expenses. The economic situation also has led to restructuring actions and associated expenses and impairment of our investment portfolio. Continued uncertainty about future economic conditions makes it difficult to forecast operating results and to make decisions about future investments. Further delays or reductions in information technology spending could have a material adverse effect on demand for our products and services and consequently our results of operations, prospects and stock price.

Terrorist acts, international conflicts and acts of war may seriously harm our business and revenue, costs and expenses and financial condition and stock price.

Terrorist acts or acts of war (wherever located around the world) may cause damage or disruption to HP, our employees, facilities, partners, suppliers, distributors, resellers or customers, which could significantly impact our revenue, costs and expenses and financial condition. The terrorist attacks that took place in the United States on September 11, 2001 and subsequent large-scale terrorist attacks in other countries were unprecedented events that have created many economic and political uncertainties, some of which may materially harm our business and results of operations. The potential for future terrorist attacks, the national and international responses to terrorist attacks or perceived threats to national security, and other actual or potential conflicts or acts of war, including the ongoing military operations in Iraq, have created many economic and political uncertainties that could adversely affect our business, results of operations and stock price in ways that we cannot presently predict. In addition, as a major multi-national company with headquarters and significant operations located in the United States, actions against or by the United States may impact our business. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war.

If we fail to manage distribution of our products and services properly, or if our distributors' financial condition or operations weaken, our revenue, gross margin and profitability could suffer.

We use a variety of different distribution methods to sell our products and services, including third-party resellers and distributors and both retail and direct sales to both enterprise accounts and

consumers. Since each distribution method has distinct risks and gross margins, our failure to implement the most advantageous balance in the delivery model for our products and services could adversely affect our revenue and gross margins and therefore profitability. Moreover, our distribution channel mix may limit our willingness or ability to quickly adjust prices and otherwise to respond to pricing changes by competitors. Other distribution risks include alienating channel partners, financial weakness of competitors and inventory management problems, as described below.

- *As we continue to increase our commitment to direct sales, we could risk alienating channel partners and adversely affecting our distribution model.*

Since direct sales may compete with the sales made by third-party resellers and distributors, these third-party resellers and distributors may elect to use other suppliers that do not directly sell their own products or to reduce the retail shelf space available for our products. Because not all of our customers will prefer to purchase directly, any increase in our commitment to direct sales could alienate some of our channel partners. As a result, we may lose some of our customers who purchase from third-party resellers or distributors.

- *Some of our wholesale and retail distributors may be unable to withstand changes in business conditions.*

Some of our wholesale and retail distributors may have insufficient financial resources and may not be able to withstand changes in business conditions, including economic weakness and industry consolidation. Revenue from indirect sales could suffer and we could experience disruptions in distribution if our distributors' financial condition or operations weaken.

- *Our inventory management will be complex as we continue to sell a significant mix of products through distributors.*

We must manage inventory effectively, particularly with respect to sales to distributors. Distributors may increase orders during periods of product shortages, cancel orders if their inventory is too high, or delay orders in anticipation of new products. Distributors also may adjust their orders in response to the supply of our products and the products of our competitors and seasonal fluctuations in end-user demand. If we have excess inventory, we may have to reduce our prices and write down inventory, which in turn could result in lower gross margins.

We depend on third party suppliers, and our revenue and gross margin could suffer if we fail to manage supplier issues properly.

Our manufacturing operations depend on our ability to anticipate our needs for components and products and our suppliers' ability to deliver sufficient quantities of quality components and products at reasonable prices in time to meet critical manufacturing and distribution schedules. Given the wide variety of systems, products and services that we offer, the large number of our suppliers and contract manufacturers that are dispersed across the globe, and the long lead times that are required to manufacture, assemble and deliver certain components and products, problems could arise in planning production and managing inventory levels that could seriously harm us. We also rely on third party suppliers for the provision of contingent workers and our failure effectively to manage our use of such workers could adversely affect our results of operations. We could also be exposed to various legal claims relating to their status. Other supplier problems that we could face include component shortages, excess supply and risks related to fixed-price contracts that would require us to pay more than the open market price, as described below.

- *Supply shortages . Occasionally we may experience a short supply of, or a delay in receiving, certain component parts as a result of strong demand, capacity constraints or other problems experienced by suppliers. If shortages or delays persist, the price of these components may increase, we may be exposed to quality issues or the components may not be available at all. We*