

HEWLETT PACKARD CO

FORM 10-K (Annual Report)

Filed 12/17/09 for the Period Ending 10/31/09

Address	3000 HANOVER ST MS 1050 PALO ALTO, CA 94304
Telephone	6508571501
CIK	0000047217
Symbol	HPQ
SIC Code	3570 - Computer And Office Equipment
Industry	Computer Peripherals
Sector	Technology
Fiscal Year	10/31

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Stock-Based Compensation Expense

We recognize stock-based compensation expense for all share-based payment awards, net of an estimated forfeiture rate. We recognize compensation cost for only those shares expected to vest on a straight-line basis over the requisite service period of the award.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. We utilize the Black-Scholes option pricing model to value the stock options granted under our principal option plans. To implement this model, we examined our historical pattern of option exercises to determine if there were any discernable activity patterns based on certain employee populations. From this analysis, we identified three employee populations to which to apply the Black-Scholes model. We determined that implied volatility calculated based on actively traded options on HP common stock is a better indicator of expected volatility and future stock price trends than historical volatility. Therefore, expected volatility used in the Black-Scholes option pricing model in fiscal years 2009, 2008 and 2007 was based on market-based implied volatility.

We issue performance-based restricted units ("PRUs") representing hypothetical shares of HP common stock. Each PRU award reflects a target number of shares that may be issued to the award recipient. We determine the actual number of shares the recipient receives at the end of a three-year performance period based on results achieved versus goals based on our annual cash flow from operations as a percentage of revenue and average total shareholder return ("TSR") relative to the S&P 500 over the performance period. We use historic volatility for PRU awards as implied volatility.

Note 2: Stock-Based Compensation

HP's stock-based compensation plans include incentive compensation plans and an employee stock purchase plan ("ESPP").

Stock-based Compensation Expense and the Related Income Tax Benefits

Total stock-based compensation expense before income taxes for fiscal 2009, 2008 and 2007 was \$635 million, \$606 million and \$629 million, respectively. The resulting income tax benefit for fiscal 2009, 2008 and 2007 was \$199 million, \$178 million and \$182 million, respectively.

Note 2: Stock-Based Compensation (Continued)

Cash received from option exercises and purchases under the ESPP in fiscal 2009 was \$1.8 billion. The actual tax benefit realized for the tax deduction from option exercises of the share-based payment awards in fiscal 2009 totaled \$252 million. Cash received from option exercises and purchases under the ESPP in fiscal 2008 was \$1.8 billion. The actual tax benefit realized for the tax deduction from option exercises of the share-based payment awards in fiscal 2008 totaled \$412 million.

Incentive Compensation Plans

HP's incentive compensation plans include principal option plans adopted in 2004, 2000, 1995 and 1990 ("principal option plans"), as well as various stock option plans assumed through acquisitions under which stock-based awards are outstanding. Stock-based awards granted from the principal option plans include performance-based restricted units ("PRUs"), stock options and restricted stock awards. Employees meeting certain employment qualifications were eligible to receive stock-based awards in fiscal 2009. There were approximately 91,000 employees holding stock-based awards under one or more of the option plans as of October 31, 2009.

In fiscal 2008, HP implemented a program that provides for the issuance of PRUs representing hypothetical shares of HP common stock that may be issued under the Hewlett-Packard Company 2004 Stock Incentive Plan. PRU awards may be granted to eligible employees, including HP's principal executive officer, principal financial officer and other executive officers. Each PRU award reflects a target number of shares that may be issued to the award recipient. The actual number of shares the recipient receives is determined at the end of a three-year performance period based on results achieved versus company performance goals. Those goals are based on HP's annual cash flow from operations as a percentage of revenue and average total shareholder return ("TSR") relative to the S&P 500 over the performance period. Depending on HP's results during the three-year performance period, the actual number of shares that a grant recipient receives at the end of the period may range from 0% to 200% of the targeted shares granted, based on the calculations described below.

Cash flow performance goals are established at the beginning of each year. At the end of each year, a portion of the target number of shares may be credited in the award recipient's name depending on the achievement of the cash flow performance goal for that year. The number of shares credited varies between 0% if performance is below the minimum level and 150% if performance is at or above the maximum level. For performance between the minimum level and the maximum level, a proportionate percentage between 30% and 150% is applied based on relative performance between the minimum and the maximum levels.

Following the expiration of the three-year performance period, the number of shares credited to the award recipient during the performance period is adjusted by a TSR modifier. The TSR modifier, which is determined at the beginning of each performance period, varies between 0%, if the minimum level is not met, resulting in no payout under the PRU award, and 133%, if performance is at or above the maximum level. For performance between the minimum level and the maximum level, a proportionate TSR modifier between 66% and 133% is applied based on relative performance between the minimum and the maximum levels. The number of shares, if any, received by the PRU award recipient equals the number of shares credited to the award recipient during the performance period multiplied by the TSR modifier.

Recipients of PRU awards generally must remain employed by HP on a continuous basis through the end of the applicable three-year performance period in order to receive any portion of the shares

Note 2: Stock-Based Compensation (Continued)

subject to that award. Target shares subject to PRU awards do not have dividend equivalent rights and do not have the voting rights of common stock until earned and issued following the end of the applicable performance period.

Stock options granted under the principal option plans are generally non-qualified stock options, but the principal option plans permit some options granted to qualify as "incentive stock options" under the U.S. Internal Revenue Code. Stock options generally vest over four years from the date of grant. The exercise price of a stock option is equal to the fair market value of HP's common stock on the option grant date (as determined by the reported sale prices of HP's common stock when the market closes on that date). The contractual term of options granted since fiscal 2003 was generally eight years, while the contractual term of options granted prior to fiscal 2003 was generally ten years. Under the principal option plans, HP may choose, in certain cases, to establish a discounted exercise price at no less than 75% of fair market value on the grant date. HP has not granted any discounted options since fiscal 2003.

Under the principal option plans, HP granted certain employees cash-settled awards, restricted stock awards, or both. Restricted stock awards are non-vested stock awards that may include grants of restricted stock or grants of restricted stock units. Cash-settled awards and restricted stock awards are independent of option grants and are generally subject to forfeiture if employment terminates prior to the release of the restrictions. Such awards generally vest one to three years from the date of grant. During that period, ownership of the shares cannot be transferred. Restricted stock has the same cash dividend and voting rights as other common stock and is considered to be currently issued and outstanding. Restricted stock units have dividend equivalent rights equal to the cash dividend paid on restricted stock. Restricted stock units do not have the voting rights of common stock, and the shares underlying the restricted stock units are not considered issued and outstanding. HP expenses the fair market value of restricted stock awards, as determined on the date of grant, ratably over the period during which the restrictions lapse.

Performance-based Restricted Units

HP estimated the fair value of a target PRU share using the Monte Carlo simulation model, as the TSR modifier contains a market condition. The following weighted-average assumptions were used to determine the weighted-average fair values of the PRU awards for fiscal years ended October 31:

	2009	2008
Weighted-average fair value of grants per share	\$ 40.56 ⁽¹⁾	\$ 40.21 ⁽²⁾
Expected volatility ⁽³⁾	35%	26%
Risk-free interest rate	1.34%	3.13%
Dividend yield	0.88%	0.70%
Expected life in months	30	33

- (1) Reflects the weighted-average fair value for the second year of the three-year performance period applicable to PRUs granted in fiscal 2008 and for the first year of the three-year performance period applicable to PRUs granted in fiscal 2009. The estimated fair value of a target share for the third year for PRUs granted in fiscal 2008 and for the second and third years for PRUs granted in

Note 2: Stock-Based Compensation (Continued)

fiscal 2009 will be determined when the annual cash flow goals are approved, and the expense will be amortized over the remainder of the applicable three-year performance period.

- (2) Reflects the weighted-average fair value for the first year of the three-year performance period applicable to PRUs granted in fiscal 2008.
- (3) HP uses historic volatility for PRU awards as implied volatility cannot be used when simulating multivariate prices for companies in the S&P 500.

Outstanding PRUs as of October 31, 2009 and 2008 and changes during fiscal 2009 and 2008 were as follows:

	2009	2008
	Shares in thousands	
Outstanding at beginning of year	10,965	—
Granted	13,966	8,783
Vested	—	—
Change in units due to performance and market conditions	1,193	2,492
Forfeited	(1,401)	(310)
Outstanding at end of year	24,723	10,965
PRUs assigned a fair value at end of year	13,426	5,292

At October 31, 2009, there was \$193 million of unrecognized pre-tax stock-based compensation expense related to PRUs with an assigned fair value, which HP expects to recognize over the remaining weighted-average vesting period of 1.5 years. At October 31, 2008, there was \$108 million of unrecognized pre-tax stock-based compensation expense related to PRUs with an assigned fair value, which HP expected to recognize over the remaining weighted-average vesting period of 2.0 years.

Stock Options

HP utilized the Black-Scholes option pricing model to value the stock options granted under its principal option plans. HP examined its historical pattern of option exercises in an effort to determine if there were any discernable activity patterns based on certain employee populations. From this analysis, HP identified three employee populations on which to apply the Black-Scholes model. The table below presents the weighted-average expected life in months of the combined three identified employee populations. The expected life computation is based on historical exercise patterns and post-vesting termination behavior within each of the three populations identified. The risk-free interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

Note 2: Stock-Based Compensation (Continued)

The weighted-average fair value of stock options was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Stock Options ⁽¹⁾		
	2009	2008	2007
Weighted-average fair value of grants per share	\$ 13.04	\$ 15.26	\$ 13.01
Implied volatility	43%	34%	28%
Risk-free interest rate	2.07%	3.09%	4.68%
Dividend yield	0.92%	0.69%	0.75%
Expected life in months	61	60	59

(1) The fair value calculation was based on stock options granted during the period.

Option activity as of October 31 during each fiscal year was as follows:

	2009				2008			
	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
		\$		\$		\$		\$
Outstanding at beginning of year	307,728	\$ 34			367,339	\$ 33		
Granted and assumed through acquisitions	2,190	\$ 29			10,849	\$ 49		
Exercised	(55,784)	\$ 28			(54,949)	\$ 26		
Forfeited/cancelled/expired	(20,920)	\$ 57			(15,511)	\$ 45		
Outstanding at end of year	233,214	\$ 33	2.6	\$ 3,643	307,728	\$ 34	3.4	\$ 2,752
Vested and expected to vest at end of year	231,134	\$ 33	2.6	\$ 3,623	304,198	\$ 34	3.3	\$ 2,731
Exercisable at end of year	207,757	\$ 32	2.2	\$ 3,399	252,049	\$ 34	2.8	\$ 2,423

In fiscal 2008, approximately 8 million stock options with a weighted-average exercise price of \$50 per share were assumed through the acquisition of EDS.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value that option holders would have received had all option holders exercised their options on October 31, 2009 and 2008. The aggregate intrinsic value is the difference between HP's closing stock price on the last trading day of fiscal 2009 and fiscal 2008 and the exercise price, multiplied by the number of in-the-money options. Total intrinsic value of options exercised in fiscal 2009, 2008 and 2007 was \$0.8 billion, \$1.1 billion and \$2.0 billion, respectively. Total fair value of options vested and expensed in fiscal 2009, 2008 and 2007 was \$172 million, \$264 million and \$297 million, respectively, net of taxes.

Note 2: Stock-Based Compensation (Continued)

Information about options outstanding at October 31, 2009 was as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Shares Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price Per Share	Shares Exercisable	Weighted-Average Exercise Price Per Share
	In thousands	In years		In thousands	
\$0-\$9.99	415	6.9	\$ 6	172	\$ 5
\$10-\$19.99	24,129	1.8	\$ 16	24,117	\$ 16
\$20-\$29.99	77,523	2.7	\$ 23	76,685	\$ 23
\$30-\$39.99	53,094	3.3	\$ 33	42,853	\$ 33
\$40-\$49.99	56,997	2.8	\$ 45	43,307	\$ 45
\$50-\$59.99	15,953	0.9	\$ 57	15,520	\$ 57
\$60 and over	5,103	1.2	\$ 69	5,103	\$ 69
	<u>233,214</u>	2.6	\$ 33	<u>207,757</u>	\$ 32

At October 31, 2009, there was \$188 million of unrecognized pre-tax stock-based compensation expense related to stock options, which HP expects to recognize over the remaining weighted-average vesting period of 1.1 years. As of October 31, 2008, there was \$425 million of unrecognized pre-tax stock-based compensation expense related to stock options, which HP expected to recognize over a weighted-average of 1.6 years.

Restricted Stock Awards

Non-vested restricted stock awards as of October 31, 2009 and 2008 and changes during fiscal 2009 and 2008 were as follows:

	2009		2008	
	Shares In thousands	Weighted-Average Grant Date Fair Value Per Share	Shares In thousands	Weighted-Average Grant Date Fair Value Per Share
Outstanding at beginning of year	12,930	\$ 44	5,698	\$ 29
Granted and assumed through acquisitions	836	\$ 36	12,712	\$ 45
Vested	(5,631)	\$ 44	(4,010)	\$ 32
Forfeited	(1,271)	\$ 43	(1,470)	\$ 28
Outstanding at end of year	<u>6,864</u>	\$ 44	<u>12,930</u>	\$ 44

Note 2: Stock-Based Compensation (Continued)

The details of restricted stock awards granted and assumed through acquisitions were as follows:

	2009		2008		2007	
	Shares In thousands	Weighted- Average Grant Date Fair Value Per Share	Shares In thousands	Weighted- Average Grant Date Fair Value Per Share	Shares In thousands	Weighted- Average Grant Date Fair Value Per Share
Restricted stock	493	\$ 36	1,393	\$ 46	1,469	\$ 43
Restricted stock units	343	\$ 35	11,319	\$ 45	151	\$ 45
	<u>836</u>	<u>\$ 36</u>	<u>12,712</u>	<u>\$ 45</u>	<u>1,620</u>	<u>\$ 44</u>

In fiscal 2008, approximately 11 million restricted stock units with a weighted-average grant date fair value of \$45 per share were assumed through the acquisition of EDS.

The details of non-vested restricted stock awards at fiscal year end were as follows:

	2009	2008	2007
	Shares in thousands		
Non-vested at October 31:			
Restricted stock	1,771	2,835	4,763
Restricted stock units	5,093	10,095	935
	<u>6,864</u>	<u>12,930</u>	<u>5,698</u>

As of October 31, 2009, there was \$117 million of unrecognized pre-tax stock-based compensation expense related to non-vested restricted stock awards, which HP expects to recognize over a weighted-average vesting period of 1.6 years. As of October 31, 2008, there was \$263 million of unrecognized pre-tax stock-based compensation expense related to non-vested restricted stock awards, which HP expected to recognize over a weighted-average vesting period of 1.2 years.

Employee Stock Purchase Plan

HP sponsors the Hewlett-Packard Company 2000 Employee Stock Purchase Plan, also known as the Share Ownership Plan (the "ESPP"), pursuant to which eligible employees may contribute up to 10% of base compensation, subject to certain income limits, to purchase shares of HP's common stock. For purchases made on or before April 30, 2009, employees purchased stock pursuant to the ESPP semi-annually at a price equal to 85% of the fair market value on the purchase date, and HP recognized expense based on a 15% discount of the fair market value for those purchases. Effective May 1, 2009, HP modified the ESPP to eliminate the 15% discount applicable to purchases made under the ESPP.

Note 2: Stock-Based Compensation (Continued)

The ESPP activity as of October 31 during each fiscal year was as follows:

	2009	2008	2007
	In millions, except weighted-average purchase price per share		
Compensation expense, net of taxes	\$ 24	\$ 58	\$ 56
Shares purchased	6.16	9.68	8.74
Weighted-average purchase price per share	\$ 33	\$ 36	\$ 39

	2009	2008	2007
	In thousands		
Employees eligible to participate	260	164	161
Employees who participated	49	50	51

Shares Reserved

Shares available for future grant and shares reserved for future issuance under the ESPP and incentive compensation plans were as follow

	2009	2008	2007
	Shares in thousands		
Shares available for future grant at October 31:			
HP plans	95,311 ⁽¹⁾	117,655	136,392
Assumed Compaq and EDS plans	82,449 ⁽²⁾	73,147	45,312
	<u>177,760</u>	<u>190,802</u>	<u>181,704</u>
Shares reserved for future issuance under all stock-related benefit plans at October 31	<u>410,977</u>	<u>498,574</u>	<u>549,045</u>

(1) Includes 24,267,000 shares that expired in November 2009.

(2) In November 2009, HP retired the assumed Compaq and EDS plans for purposes of granting new awards. The shares that had been reserved for future awards under those plans were returned to HP's pool of authorized shares and will not be available for issuance under any other HP plans.

HP had 21,494,000 shares of common stock reserved at October 31, 2007 for future issuances related to conversion of its zero-coupon subordinated notes, which were redeemed in March 2008.

of Hewlett-Packard Company of our reports dated December 17, 2009, with respect to the consolidated financial statements and schedule of Hewlett-Packard Company and the effectiveness of Hewlett-Packard Company's internal control over financial reporting included in this Annual Report (Form 10-K) for the year ended October 31, 2009.

/s/ ERNST & YOUNG LLP

San Jose, California
December 17, 2009