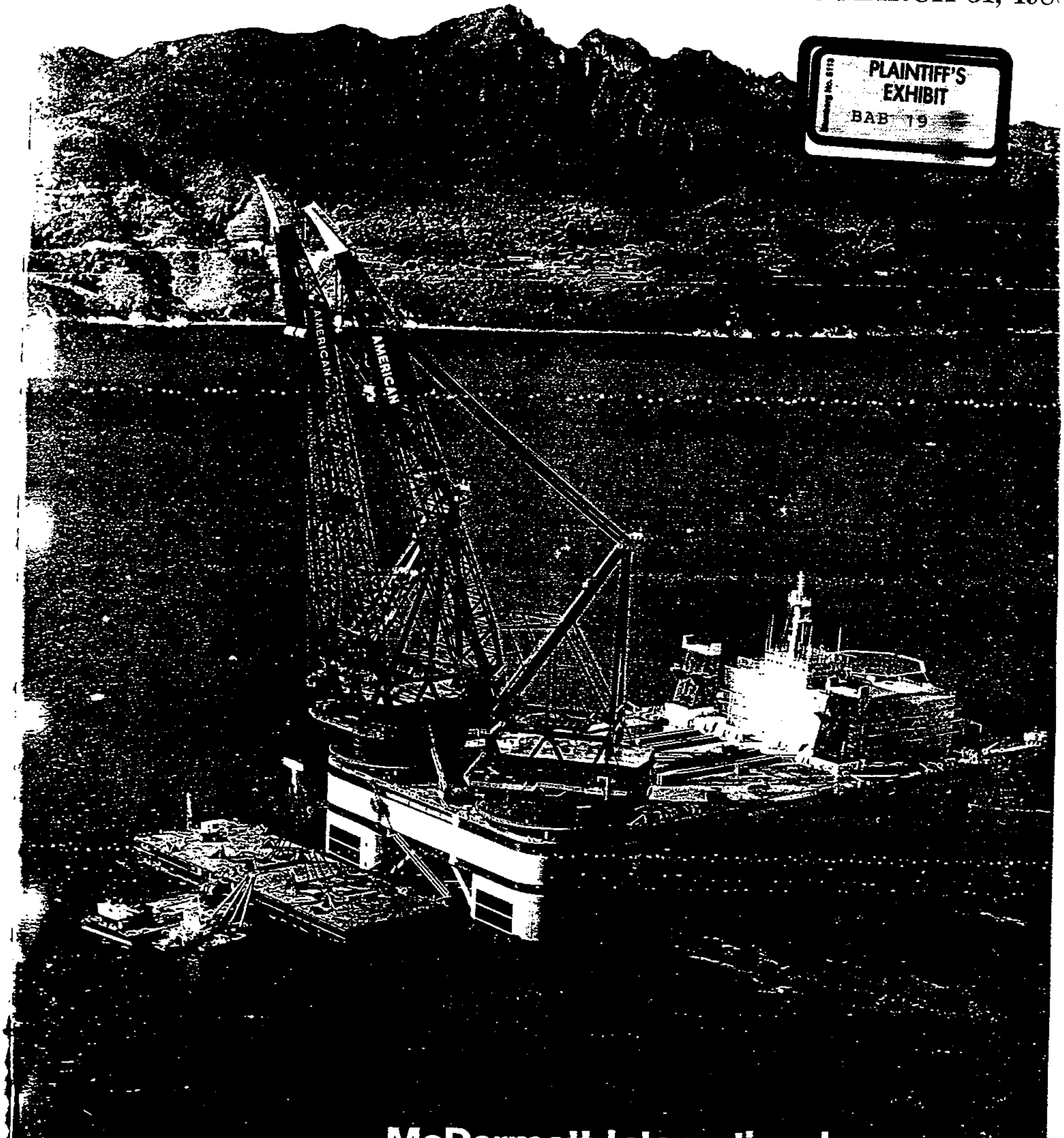
ANNUAL REPORT FOR THE FISCAL YEAR ENDED MARCH 31, 198



PLAINTIFF'S EXHIBIT
BAB 19

McDermott International, inc.

Results at a Glance

McDermott International, Inc. for the Fiscal Years ended March 31, 1986 and 1985
In thousands of dollars except per share amounts and number of employees

	1986	1985
Revenues	**$ 3,257,095**	$ 3,233,871
Operating loss	**(88,288)**	(108,779)
Net income	**59,089**	30,667
Net earnings per common and common equivalent share	**1.60**	0.83
Stockholders' equity per common share	**32.57**	32.57
Cash dividends — common	**66,533**	66,473
Cash dividends per common share	**1.80**	1.80
Working capital	**1,258**	117,966
Capital expenditures	**298,884**	172,349
Backlog	**4,085,509**	4,003,556
Number of employees including subcontract labor	**35,000**	40,000

The operations described in this publication include those of certain subsidiary and affiliated companies.

The cover: *First of a new generation of ultra-heavy-lift semisubmersible crane vessels, McDermott's* Derrick Barge 102 *is seen here in sea trials off Japan. With a total lift capacity of 13,000 tons – more than twice the heaviest lift offshore to date –* DB 102 *can install small jackets and more fully integrated topsides unassisted by other vessels. The versatile barge can also perform many decommissioning and salvage operations unaided, work deep waters or congested shallow waters using an advanced dynamic positioning system, support subsea completion work, and accommodate up to 1,500 pesonnel. The barge is expected to substantially reduce the cost of fabricating, installing, or decommissioning offshore structures.* DB 102 *is now at work in the North Sea.*

To Our Stockholders

Intense competition characterized all of our markets during fiscal 1986. This competition was especially evident in our marine construction operations due to the worldwide surplus of oil and natural gas. The market for power generation systems and equipment also remained depressed, and the engineered materials group, as expected, continued to lose money. Trading also incurred a loss, although the loss was less than the one recorded last year.

Revenues for fiscal 1986 were $3.3 billion, up slightly from the $3.2 billion reported in fiscal 1985. Net income for the year was $59.1 million, or $1.60 a share, compared with $30.7 million, or $0.83 a share a year ago. Our loss from operations was smaller by $20.5 million this year than in fiscal 1985. However, operating results were enhanced by a significant reduction in pension expense. In addition, net income benefited from higher nonoperating income, primarily realized gains from the sale of government obligations, and a tax benefit for the year. These factors more than offset provisions made for the settlement of certain antitrust civil litigation. Claims settled during fiscal 1986 were the last of the antitrust actions filed against the Company.

Our financial position remains strong, which has aided our flexibility. We have consolidated operations, cut general and administrative expenses, and reduced employment more than 10 percent during the fiscal year. As a result of these ongoing efforts, we have strengthened, and we will continue to strengthen, the foundations of our core businesses, a key ingredient in our strategy to be the market leader.

Marine Construction Services

Marine Construction Services had revenues of $908.2 million in fiscal 1986, compared with $1.0 billion in fiscal 1985. The operating loss in fiscal 1986 was $30.2 million compared with a loss of $8.3 million in fiscal 1985.

The lower marine construction results were due to foreign operations and reflect a decrease in utilization of marine construction equipment and a decline in fabrication activity. Domestic operations improved during the year, primarily due to higher margins, better contract performance, and more favorable offshore working conditions. Results also benefited from the settlement of certain claims, the reversal of provisions taken in prior years, and reduced pension expense.

In fiscal 1986, we added *Derrick Barge 102* to our marine construction fleet. This vessel, which has an unsurpassed lifting capacity of 13,000 tons, is working in the Ekofisk Field in the North Sea. Another major vessel, *Derrick Barge 101*, is offshore southern California where it will install jackets, decks, and pipelines for Chevron's Gail and Hidalgo platforms. We continued to upgrade and convert the remainder of our fleet from single-purpose barges to combination vessels. These conversions have helped us maintain the highest utilization rate in the marine construction industry.

At our Morgan City, Louisiana fabrication yard, we built two deepwater jackets for the Gulf of Mexico during the year. One was installed in June 1986 in 750 feet of water. The other will be installed at a depth of 860 feet this summer. In addition, we received a contract from the U.S. Navy to fabricate and install eight offshore structures that will be used as electronic targets for fighter pilot training. In the Middle East, we relocated our yard to the port of Jebel Ali in Dubai, and we are fabricating 21 replacement decks and helidecks for Aramco. In Indonesia, our Batam Island fabrication yard was awarded a turnkey contract for three platforms for Taiwan's Chinese Petroleum Corporation.

We completed our Computer Aided Design, Analysis and Drafting (CADAD) system in fiscal 1986. CADAD allows engineers to work from interactive structural and process databases. This new technology enhances productivity by eliminating problems that develop when structural, electrical, and process engineering are done separately.

Despite the projects currently underway, the dramatic decline in oil and gas prices has created many uncertainties that will persist through fiscal 1987 and beyond. As a result, we expect that the marine construction market will continue to shrink, and competitive pressures, which are already quite severe, will intensify even further. We will monitor these conditions on an ongoing basis and take whatever steps are necessary to survive this difficult period.

Power Generation Systems and Equipment

Revenues from the Power Generation Systems and Equipment segment in fiscal 1986 were $1.4 billion, unchanged from the prior year. However, operating income increased to $37.7 million compared with $15.3 million in fiscal 1985.

Operating results benefited from a significant reduction in pension expense. The segment also experienced improved results from power plant service activities and microprocessor-based control systems, as well as from higher shipments of nuclear and other components to the U.S. Government. These positive factors were partially offset by lower volume and reduced profit margins on fossil steam and environmental control systems, and increased development and marketing expenses.

Demand for new equipment by the domestic utility industry remains low and is not expected to increase substantially over the next several years. Accordingly, we have shifted our focus to small power plants and cogeneration facilities. These efforts are beginning to yield results. In fiscal 1986, we assumed an equity position in two wood-fired 25 megawatt power plants in Maine that we will build and operate.

Although there is no significant demand for new utility generating capacity, existing facilities all require ongoing maintenance and upgrades. We are aggressively pursuing these markets for replacement parts, field engineering, and construction services. The service business represents an active and expanding market for an entire range of power generation products. In addition to boilers, these markets include Bailey Controls power plant system upgrades, Hudson Products heat transfer devices, and Diamond Power boiler-cleaning equipment.

Although more than a half a million tons of refuse is generated each day in the United States, less than 5 percent is burned in refuse facilities. This ratio is expected to increase significantly over the next several years as landfill disposal becomes more difficult. We fully intend to participate in this rapidly expanding market through strategies that utilize our expertise and quality products.

In the commercial nuclear business, there has been an absence of new plant orders since 1978. Nonetheless, existing facilities require engineering, computer services, training, maintenance, and fuel replacement. We continue to be very successful in providing these services to utilities with plants designed by Babcock & Wilcox (B&W) as well as by our competitors. A major milestone in fiscal 1986 was a contract to supply Duke Power Company with 21 batches of reload fuel for B&W and Westinghouse designed units. In addition, we are extending our service business into low level radioactive waste management and decontamination, a market of growing significance. We have also been awarded contracts as part of a project to convert the William H. Zimmer Generating Station in Ohio from a nuclear-powered to a coal-powered facility.

While the U.S. market for power generation equipment has remained at a low level, the international market is showing some strength. During the year we completed construction of our boiler manufacturing facility in Indonesia. In addition, B&W Canada was part of a consortium that contracted with Huaneng International Power Development Corporation to export four 350 megawatt coal-fired units to the People's Republic of China (PRC). We also entered into a joint venture with Beijing Boiler Works in the PRC forming Babcock & Wilcox Beijing Company (China) Ltd.

At Bailey Controls, market conditions remain robust, largely due to the ongoing influx of new orders for Network 90®. Since its introduction in 1980, this advanced microprocessor-based control system has been installed at almost 5,000 facilities in the United States and abroad. We are especially pleased by the success of Network 90® in the overseas market. During fiscal 1986, we received significant bookings from the PRC for process control and power applications. In addition, Network 90® will completely automate the Mongstadt refinery for Statoil, the Norwegian national oil company.

The market for power generation systems and equipment will remain competitive for the foreseeable future. Orders for new generation equipment should rise slowly as growth in the general economy absorbs the current excess of generating capacity. We fully intend to pursue these new orders as they develop. In the meantime, our strong position in the service market will provide us with a profitable foundation for our near term business.

Engineered Materials

In fiscal 1986, our Engineered Materials segment had revenues of $310.8 million compared with $385.6 million in fiscal 1985. The operating loss for the year was $31.3 million compared with a loss of $39.8 million the prior year.

Shipments of alloy, mechanical, and stainless tubing were lower in fiscal 1986, and shipments of most other tubular product lines were either down or flat. Tubular results were further depressed by very competitive pricing conditions. Insulating products' sales were somewhat higher during the year, but operating income was lower because of a strike at our Canadian operations, which ended in November 1985. The segment's smaller operating loss in fiscal 1986 was primarily due to a significant reduction in pension expense.

Major markets for tubular products remain very depressed. Demand is weak and foreign competition continues to affect all operations adversely. Although pressure and mechanical tubing are severely influenced by these developments, the situation is even more dismal in the case of the oilfield market. The recent decline in the price of oil and natural gas has virtually eliminated the demand for oilfield tubing, and we are not optimistic about the prospects for recovery in this market during the next few years.

Trading

Revenues for the Trading segment in fiscal 1986 increased to $655.1 million from $435.9 million in fiscal 1985. An operating loss of $0.5 million in fiscal 1986 compared with an operating loss of $4.1 million in fiscal 1985.

Results were enhanced in fiscal 1986 by the inclusion of Coutinho, Caro & Co. AG for a full 12 months compared with only nine months in fiscal 1985. Revenues also benefited from the addition of a new petrochemical and plastics trading unit, as well as an increase in steel and metal trading. This increase in revenues was partially offset by reduced volume from Coutinho's construction and engineering business. The smaller operating loss was due to favorable cost adjustments and the settlement of outstanding claims on certain construction contracts, partially offset by lower margins in steel and metal trading, and the start-up costs associated with the new petrochemical trading operations. As Coutinho's trading business is heavily related to steel, this new activity will provide a much broader trading base.

Coutinho's construction and engineering unit received a major contract to construct protective shelters for aircraft in Abu Dhabi. In addition, we were awarded contracts for the construction of various facilities in the PRC. In support of these projects, Trading signed its first countertrade contract.

Our ability to source steel on a global basis enabled this segment to support other McDermott operating units during the year. We intend to enhance this synergy between operations and further strengthen our competitive position in the international marketplace.

Outlook

Business conditions within the domestic manufacturing sector are beginning to improve as a result of the continued decline in the value of the U.S. dollar. Compared to the peak level at the end of fiscal 1985, the value of our currency has fallen 30 percent against the British pound and 35 percent against the Japanese yen and the German mark.

As a direct consequence of the weakening dollar, American goods and services have become more competitive in the international marketplace. More importantly, they have become more competitive in our own domestic economy, which accounts for 30 percent of free world GNP. No longer do Japanese steel and automobile producers enjoy a dominant cost advantage over their U.S. counterparts. The 50 percent appreciation of the yen has resulted in a corresponding increase in Japanese production costs when expressed in terms of U.S. dollars. In a similar manner, dollar denominated production costs have also increased for the Germans, the British, the French, and the Italians, to name a few of our major trading partners.

As a first reaction to higher dollar denominated costs, foreign manufacturers held prices constant and accepted lower margins, thereby protecting their share of the U.S. market. This marketing ploy is becoming more difficult to achieve. Margins have already been reduced by such an extent that the majority of imported goods are approaching the point of unprofitability. Foreign producers have therefore shifted their focus. They have raised prices and made their products relatively more expensive for the American consumer. As a result of this marketing strategy, we anticipate that American goods and services will gain market share at the expense of the foreign producers during the current fiscal year.

The B&W operating unit is expected to benefit from the declining value of the dollar. The Power Generation Group should experience a relative reduction in operating costs compared with their foreign competitors. As a result, we should be more successful in winning additional contracts in the overseas markets.

The outlook is not so positive in the case of marine construction. As a result of increased OPEC production, the price of crude oil fell by more than 50 percent during the last four months of fiscal 1986. We now appear to have price stability as the market awaits a new OPEC agreement on future production levels. We expect this agreement to be finalized during the summer months, and the market should come into balance by November or December. Consequently, by the end of the fiscal year, we expect oil prices to rebound to a range of $20 to $22 a barrel.

Even with this rebound, the demand for marine construction services will remain weak over the next several quarters. New business will continue to be scarce, and competition for the available market will be fierce. Due to these severe conditions, widespread dislocations are occurring within the marine construction industry on virtually a daily basis. Although this shakeout is progressing rapidly and has already been quite severe, we anticipate that it will continue for at least another twelve months.

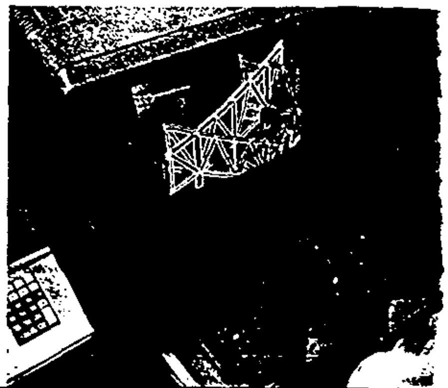
We have every intention of surviving this very difficult period. The attention of management and employees is singularly focused on this objective, and we are all committed to further increases in productivity and reductions in costs.

Through these ongoing efforts, all our operations — Marine Construction, Babcock & Wilcox, and Trading — will remain cost efficient, highly competitve, and in a position to respond to the ultimate rebound in market conditions. By focusing on this long term strategy, we will maintain and improve our position as a premier producer of goods and services in the global marketplace.

J.E. Cunningham
Chairman of the Board and Chief Executive Officer

left: *McDermott International's CADAD System employs a 3D plant modeler that creates an electronic model with data from facilities and structural databases.* **middle:** *Coutinho, Caro & Co. AG was responsible for contracting, project management and execution, commissioning, after sales service, personnel training, and marketing counseling for this Bangkok Glass Industry LTD. facility in Thailand.* **right:** *At Bailey Controls' Williamsport, Pennsylvania facility, multiple Network 90® circuit boards are drilled using highly automated equipment.*

below: *At McDermott Marine Construction's Morgan City, Louisiana facility, a newly installed flat panel fabrication line helps automate fabrication.* **below right:** *Scheduled for installation in summer 1986, Standard Oil Production Company's East Breaks jacket takes shape at McDermott's Morgan City, Louisiana fabrication yard.*



Marine Construction Services

Marine Construction Services designs, builds, and installs facilities for the oil and natural gas industry. Our engineers, located in Houston, London, and Singapore, specialize in designing offshore drilling, production, and process platforms, underwater pipelines, and onshore processing plants. McDermott's fabrication yard near Morgan City, Louisiana is one of the largest in the world. At this location, as well as at eight other facilities around the world, we fabricate jackets, deck sections, and modules. Supported by the world's largest and most modern fleet of marine construction vessels, we transport, install, hookup, commission, and maintain offshore structures and pipelines.

Our operations also include the engineering and construction of oil and natural gas production facilities in marsh and shoreline areas, as well as in remote offshore locations. In addition, we operate a shipyard in Morgan City, Louisiana, which builds and repairs tugboats, supply boats, packaged drilling rigs, dredges, barges, and various other vessels, including oceanographic research and ocean-going work vessels.

All of these activities enhance our international reputation, strengthen our expertise, and allow us to undertake a variety of projects with imagination and efficiency.

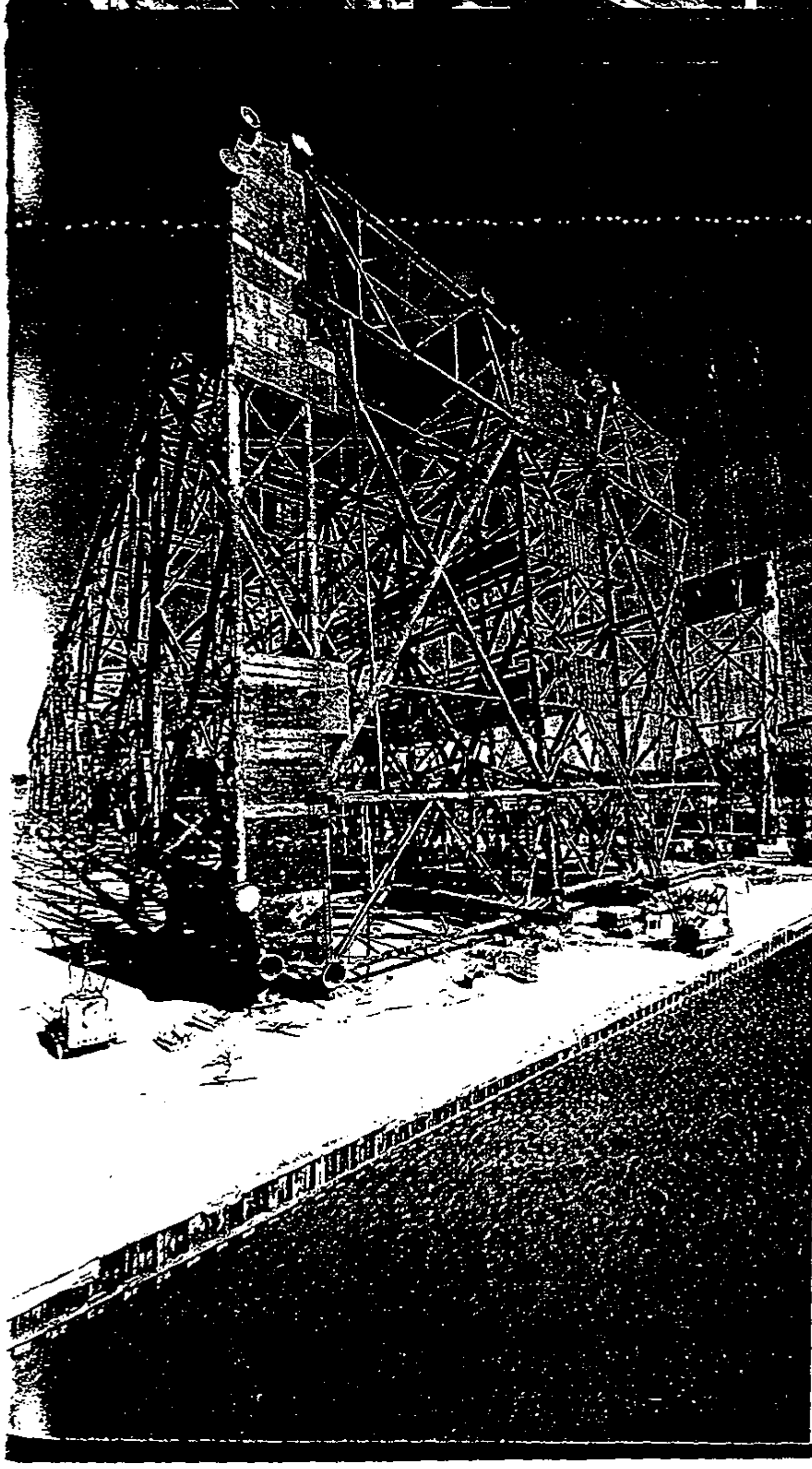
Power Generation Systems and Equipment

Innovative, high-quality products, as well as a full line of services, characterize Power Generation Systems and Equipment. The focus of our operations is on the engineering, manufacture, and erection of fossil-fueled and nuclear steam systems. In addition, we are actively involved in the emerging market of providing power through cogeneration, refuse, and other small power units with non-traditional fuel burning capabilities. We are participating in these markets as an equipment supplier, as well as equity participant in build-own-operate projects.

We also provide ongoing support to the overall power generation industry. Our services include task and project management, testing and inspection, replacement parts, maintenance, operator training, and engineered modifications to steam systems for electric utility and industrial applications. As a result of these products and services, we continue to improve the productivity of our customers' facilities and equipment, which enhances their ability to operate at peak efficiency.

We design and build air heaters, fans, precipitators, cleaning equipment, control and performance computers, and reflective metallic insulation. Our support of the power industry is further strengthened by the Company's construction unit, which undertakes the erection, repair, and alteration of power generation systems and equipment.

We are also actively involved in military projects. Our defense business is the premier producer of components for nuclear propulsion systems. In addition, we are pursuing new opportunities in the defense market related to aircraft engine parts, penetrators, rocket motor casings, and self-contained military power plants.



For The Fiscal Year Ended March 31,	1986	1985
	In thousands	
Revenues	$ 908,186	$ 1,045,938
Operating Loss	(30,196)	(8,293)

For The Fiscal Year Ended March 31,	1986	1985
	In thousands	
Revenues	$ 1,447,394	$ 1,413,481
Operating Income	37,747	15,345

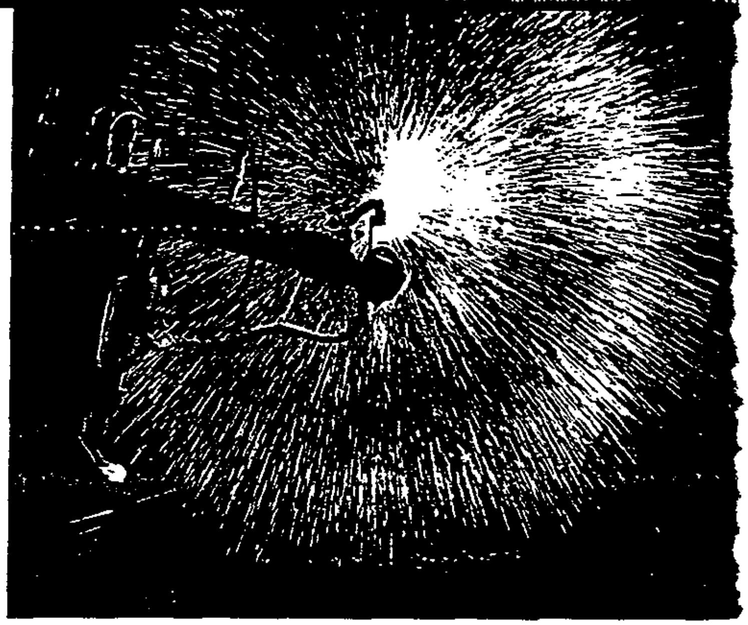
For The Fiscal Year Ended March 31,	1986	1985
	In thousands	
Revenues	$ 310,814	$ 385,592
Operating Loss	(31,289)	(39,843)

For The Fiscal Year Ended March 31,	1986	1985
	In thousands	
Revenues	$ 655,145	$ 435,924
Operating Loss	(536)	(4,137)

Engineered Materials

Engineered Materials manufactures seamless and welded specialty steel tubing, round steel bars, and insulating products. Tubular products are produced from carbon and alloy steel, designed for severe applications, and extensively utilized in deep oil and natural gas wells that are characterized by high pressure and a corrosive environment. Other markets for tubular products include power generation, automotive, rail transportation, farm equipment, and metal-working industries. In addition, specialty alloy tubing is used in various nuclear applications.

Insulating products are used in high temperature furnaces for various heating and heat treating purposes. They are also used in other applications where the temperatures and rates of combustion or chemical reactions are unusually demanding. In these operations, we produce kaolin clay products, engineered and vacuum-formed ceramic fibers, and insulating and specialty firebrick. Other product lines include plastics, mortars, castables, and special oxide refractories.

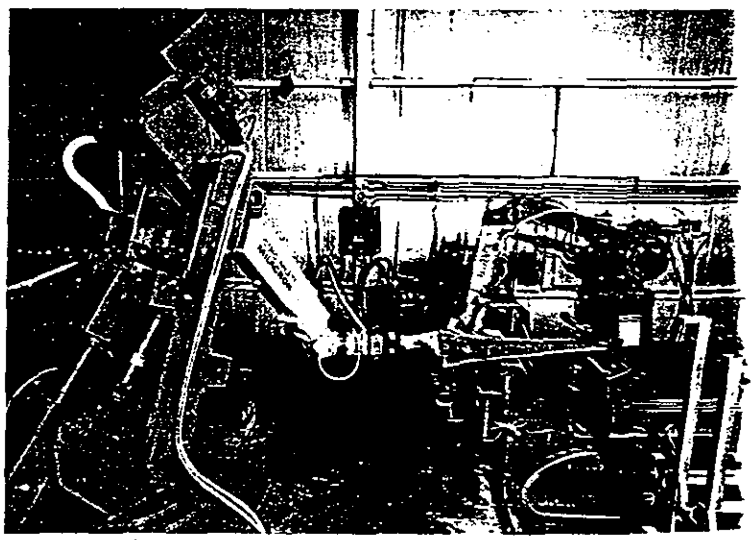


Trading

Trading is conducted through a worldwide network of offices managed by McDermott International Trading Co., Inc., as well as Coutinho, Caro & Co. AG, which is headquartered in Hamburg, West Germany. Our trading activities include iron and steel products, non-ferrous materials, cables and equipment for electric power distribution, and petrochemicals. We also engage in waterborne commerce through chartered vessels, and we assist customers in arranging insurance and financing requirements.

This segment enhances the performance of other McDermott operating units in the purchase and shipment of materials. Trading also provides improved access to raw materials, particularly steel, which enables the Company's other operations to compete more effectively in their respective markets.

As a result of the Coutinho, Caro acquisition, McDermott has broadened its role in the engineering and construction field. Coutinho designs, constructs, and erects industrial plants, office buildings, business centers, and other large building complexes.



above left: *The decision by Duke Power Company to power all seven of its nuclear plants with Babcock & Wilcox fuel positioned B&W as a leading domestic supplier of pressurized water reactor fuel.* **above right:** *As primary supplier for Colorado UTE Electric Association's Craig Station, B&W provided three 470-megawatt boilers, pulverizers, and other auxiliary equipment.* **middle:** *At B&W's Nuclear Equipment Division in Barberton, Ohio, a thermal machining robot is used to fabricate components.* **below:** *At Hudson Products Corporation's Beasley, Texas plant, fan blades are manufactured utilizing multi-tasking industrial robots.*

Directors and Management

Officer-Directors

J.E. Cunningham [2]
Chairman of the Board and
Chief Executive Officer

Robert E. Howson
President and Chief Operating Officer,
McDermott Marine Construction

John A. Lynott
Executive Vice President,
Chief Financial and Administrative Officer

Walter M. Vannoy
President and Chief Operating Officer,
Babcock & Wilcox

Directors

Thomas D. Barrow
Retired Vice Chairman of the Board,
The Standard Oil Company -
integrated petroleum company

James L. Dutt [1]
Retired Chairman of the Board and
Chief Executive Officer,
Beatrice Foods Co. -
producer of food, chemical, and
manufactured products

James A. Hunt [1,2,3,4]
Partner,
Kalb, Voorhis & Co. -
securities brokers

J. Howard Macdonald
Chairman of the Board and
Chief Executive Officer,
Dome Petroleum Limited -
oil and gas exploration and production

John A. Morgan [1,2,3]
Partner,
Morgan, Lewis, Githens & Ahn -
investment bankers

John D. Ritchie [2,3]
Consultant and Director of various
corporations

William T. Seawell [2,3,4]
Retired Chairman of the Board and
Chief Executive Officer,
Pan American World Airways, Inc. -
commercial air transportation

Walter B. Shaw [1,4]
Retired Chairman of the Board and
Chief Executive Officer,
Turner Construction Company -
general construction contractors

Walter O. Spencer [3]
Former Dean,
The Graduate School of Business,
Tulane University of Louisiana

John B. Tweedy [1,4]
Attorney and
Former Executive Vice President and Director,
Tosco Corporation -
oil refining and marketing

Russell L. Wagner [1,2,3]
Retired Chairman of the Board and
Chief Executive Officer,
NLT Corporation -
insurance holding company

[1] *Audit Committee*
[2] *Directors Nominating Committee*
[3] *Officers Salary and Supplemental Compensation Committees*
[4] *Career Executive Stock Plan Committee*

Staff Organizaton

K.J. Gilly
Vice President and General Counsel, and
Corporate Secretary

C.F. Kraus
Vice President,
Tax Administration

E.A. Robidoux
Vice President and Controller

R.A. Jolliff
Treasurer

N.E. Mezey
President,
McDermott International
Investments Co., Inc.

J. Tusa
Vice President,
Information Services

G.A. Stoddart
Vice President,
Financial Relations

R.E. Woolbert
Vice President,
Employee and Public Relations

G.F. Ellis
Vice President,
Government Operations

Operating Organization

McDermott Marine Construction

W.L. Higgins
Vice President and Group Executive, North and South America, and West Africa Operations

J.E. Franklin
Vice President and General Manager, Fabrication and Shipyard Operations

R.V. Joffrion
Vice President and General Manager, North and South America, and West Africa Offshore Operations

S.P. Victory
Vice President, Houston, Lafayette, and New Orleans Engineering

J.J. Stewart
Vice President and Group Executive, Europe Operations

R.E. Curtis
Vice President, London Engineering

M.H. Lam
Vice President and General Manager, Europe Marine Operations

B.J. McDonald
Vice President and General Manager, McDermott Scotland

R.J. Machen
Vice President and Group Executive, Middle East and Southeast Asia Operations

E.S. Gaffney
Vice President and General Manager, Middle East/Southeast Asia Commercial Services and Projects

L.E. Walker
Vice President and General Manager, Middle East/Southeast Asia Operations

R.D. Miller
Vice President, Marine Construction Services

Babcock & Wilcox

D.R. Brown
Senior Vice President and Group Executive, Power Generation

C.J. Baroch
Vice President, Advanced Energy Systems

R.E. Donovan
Vice President and General Manager, Babcock & Wilcox International

D.H. Roy
Vice President, Engineering and Systems Development

H.K. Smith
Vice President, Marketing

H.R. Reeves
Senior Vice President and Group Executive, Construction and Tubular Products

E.O. Hooker
Vice President and General Manager, Americon, Inc.

R.C. Angell
Vice President and General Sales Manager, Tubular Products

J.P. Eckert
Vice President and Group Executive, Defense

W.F. Heer
Vice President and General Manager, Nuclear Equipment Division

R.E. Tetrault
Vice President and General Manager, Naval Nuclear Fuel Division

J.H. MacMillan
Senior Vice President and Group Executive, Nuclear Power and Advanced Technology

R.E. Kosiba
Vice President, Quality and Technology

C.W. Pryor
Vice President and General Manager, Nuclear Power Division

E.A. Womack, Jr.
Vice President, Research & Development and Contract Research Divisions

M.A. Keyes
Vice President and Group Executive, Industrial Products and Services

D. Cannon
President, Bailey Controls Company

J.B. Given
Vice President and General Manager, Insulating Products Division

J.A. Pittman
Vice President and General Manager, Hudson Products Corporation
President, TLT-Babcock, Inc.

R.C. Scamehorn
President, Diamond Power Specialty Company

A. Salem
Vice President, Marketing

McDermott International Trading

K.C.M. Thyssen
President and Chief Operating Officer
Chairman, Board of Management, Continho, Caro & Co. AG

K. Hummel
Board of Management, Continho, Caro & Co. AG

H. Mamsch
Board of Management, Continho, Caro & Co. AG

J.J. Schütt
Board of Management, Continho, Caro & Co. AG

F.C. Seifarth
Board of Management, Continho, Caro & Co. AG

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

Form 10-K

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

For the fiscal year ended March 31, 1986 — Commission file number 1-8430

McDermott International, *inc.*

(Exact name of Registrant as specified in its Charter)

Republic of Panama **(State or Other Jurisdiction of Incorporation or Organization)**	**72-0593134** **(I.R.S. Employer Identification No.)**
1010 Common Street, New Orleans, Louisiana **(Address of Principal Executive Offices)**	**70112** **(Zip Code)**

Registrant's Telephone Number, including area code (504) 587-5400

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock $1 Par Value	New York Stock Exchange
Warrants to Purchase Common Stock $1 Par Value	New York Stock Exchange
Rights to Purchase Common Stock (Currently Traded with Common Stock)	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:

None

(Title of Class)

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, and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

The aggregate market value of voting stock held by non-affiliates of the Registrant was $602,042,153 as of May 2, 1986.

The number of shares outstanding of the Company's common stock at May 2, 1986 was 37,073,724.

The Proxy Statement for the 1986 Annual Meeting of Shareholders is incorporated by reference into Part III of this report.

McDERMOTT INTERNATIONAL, INC.

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PART IV

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PART I

Items 1. and 2. BUSINESS AND PROPERTIES

A. GENERAL

McDermott International, Inc. ("International") was incorporated under the laws of the Republic of Panama in 1959. Under a reorganization during the fiscal year ended March 31, 1983, International became the parent company of the McDermott group of companies which includes McDermott Incorporated (the "Delaware Company") which prior to the reorganization was the parent company. International's common shares and the Delaware Company's Series A $2.20 Cumulative Convertible Preferred Stock and Series B $2.60 Cumulative Preferred Stock are publicly held.

Unless the context otherwise requires, hereinafter "International" will be used to mean McDermott International, Inc., a Panama corporation, the "Delaware Company" will be used to mean McDermott Incorporated, a Delaware corporation, and "McDermott International" will be used to mean the consolidated enterprise.

During fiscal year 1985, International acquired the international trading business of Coutinho, Caro & Co. KGaA ("Coutinho"), which is headquartered in Hamburg, West Germany.

McDermott International operates in four business segments:

- Marine Construction Services performs activities for the oil and gas industry for offshore development drilling and for the production and transportation of oil and gas on a world-wide basis.

- Power Generation Systems and Equipment principally serves the electric utility industry and the U.S. Government.

- Engineered Materials produces metal tubular products for mechanical and pressure applications, and insulating products for a variety of industries.

- Trading comprises the world-wide trading, engineering and construction operations of Coutinho as well as other trading services of International.

The business of the Power Generation Systems and Equipment and Engineered Materials segments are conducted primarily through a subsidiary of the Delaware Company, The Babcock & Wilcox Company ("B&W"), which was acquired in 1978.

McDermott International has a continuing program of reviewing acquisition opportunities.

The following tables show revenues, operating income and their respective percentage contributions for the business segments of McDermott International for the three fiscal years ended March 31, 1986. See Note 10 of notes to consolidated financial statements for additional information with respect to McDermott International's business segments and operations in different geographic areas.

REVENUES AND PERCENT OF REVENUES

(Dollars in Millions)

	For Fiscal Years Ended March 31,					
	1986		1985		1984	
Marine Construction Services	$ 908.2	28%	$ 1,045.9	32%	$ 1,191.3	39%
Power Generation Systems and Equipment	1,447.4	44%	1,413.5	44%	1,579.3	51%
Engineered Materials	310.8	10%	385.6	12%	373.8	12%
Trading	655.1	20%	435.9	13%	—	—
Intersegment Transfer Eliminations	(64.4)	(2%)	(47.0)	(1%)	(55.8)	(2%)
Total	$ 3,257.1	100%	$ 3,233.9	100%	$ 3,088.6	100%

OPERATING INCOME (LOSS)[1] AND PERCENT OF OPERATING INCOME

(Dollars in Millions)

	For Fiscal Years Ended March 31,					
	1986		1985		1984	
Marine Construction Services	$ (30.2)	124%	$ (8.3)	22%	$ 91.1	44%
Power Generation Systems and Equipment	37.7	(155%)	15.3	(41%)	135.5	65%
Engineered Materials	(31.3)	129%	(39.8)	108%	(19.2)	(9%)
Trading	(0.5)	2%	(4.1)	11%	—	—
Total	$ (24.3)	100%	$ (36.9)	100%	$ 207.4	100%

(1) Reconciling items between Operating Income (Loss) and Income (Loss) before Provision for Income Taxes, Minority Interest and Extraordinary Items are General Corporate Expenses and Other Income (Expense).

B. MARINE CONSTRUCTION SERVICES

General

The Marine Construction Services segment consists of the design, construction and installation of specialized offshore fixed platforms and marine pipelines used for development drilling, production and transportation of oil and gas. Marine construction services also includes engineering and construction services for oil production in shoreline and marshland areas (principally in Louisiana and Texas); operation of a shipyard for the construction, repair and maintenance of tugboats, barges and other small vessels; and the engineering and construction of processing plants for the oil, gas and petrochemical and mineral industries, primarily for offshore installation.

Fixed platforms, which are fastened to the seafloor by pilings driven through their structural legs, have been installed by McDermott International in water depths of more than 1,000 feet. These platforms have been engineered to withstand increasingly greater weights and stresses as the search for oil and gas has expanded into deeper water and into areas subject to severe weather conditions.

McDermott International, a world leader (based upon industry standards) in the fabrication of offshore structures, has a principal fabrication yard located on approximately 1,300 acres of land, under lease, near Morgan City, Louisiana. This segment also operates fabrication yards on leased property in Indonesia at Batam Island; in the Middle East at Dubai, Abu Dhabi, and Ras Al Khaimah of the United Arab Emirates and Ain Soukhna, Egypt and has fabrication capabilities on leased property in South East Asia at Singapore and in West Africa at Warri, Nigeria. McDermott International also operates a fabrication yard on company owned property in Scotland, near Inverness. The equipment used at these yards, which is capable of fabricating a full range of offshore structures, consists principally of cranes, welding equipment, machine tools and other fabrication equipment, most of which is movable. This segment also operates a shipyard on approximately 58 acres of leased land in Morgan City, Louisiana.

Expiration dates, including renewal options of leases covering land for the shipyard and fabrication yards are as follows:

Morgan City, Louisiana	Years 1989-2032
Batam Island, Indonesia	Year 2008
Dubai, U. A. E.	Year 2005
Abu Dhabi, U. A. E.	Year 1995
Ras Al Khaimah, U. A. E.	Year 1986
Ain Soukhna, Egypt	Year 2001
Singapore	Year 1999
Warri, Nigeria	Year 2065

This segment operates one of the largest fleets of marine equipment used in offshore construction. The nucleus of a "construction spread" is a large derrick barge, pipelaying barge or combination derrick-pipelaying barge capable of offshore operations for an extended period of time in remote locations. The lifting capacities of McDermott International's derrick and combination derrick-pipelaying barges range from 700 tons to 13,000 tons. These barges, which range in length from 300 feet to 660 feet, are fully equipped with revolving cranes, auxiliary cranes, welding equipment, pile driving hammers, anchor winches and a variety of additional gear. The largest of the existing vessels provides quarters for approximately 750 workers. Included in the above is the DB102, the world's largest semi-submersible derrick barge in both size and lifting capacity, which this segment took delivery of in December 1985.

This segment owns and operates 5 derrick barges, 2 pipelaying barges, 11 combination derrick-pipelaying barges and 2 pipeburying barges. These include 4 semi-submersible vessels presently assigned to the North Sea and the Gulf of Mexico, of which 3 are derrick barges capable of lifting 2,000 to 13,000 tons, 2 of which are self-propelled. The other semi-submersible vessel is a lay barge capable of laying 72 inch diameter pipe and is operable in water depths up to 2,000 feet. McDermott International also owns or leases a substantial number of other vessels such as tugs, utility boats and cargo barges to support the major marine vessels. Major spreads of equipment are in the Gulf of Mexico, the Middle East, South East Asia, the North Sea, and West Africa.

Underwater pipelaying operations conducted by this segment have required the development of new techniques and equipment as water depths have increased. McDermott International has the capability of installing pipelines with an outside diameter (including concrete coating) of up to 72 inches. This segment has installed several of the world's deepest marine pipelines including one from a platform in the Gulf of Mexico at depths greater than 1,000 feet and two which cross the Norwegian Trench in the North Sea at depths approaching 1,000 feet.

In connection with its construction and pipelaying activities, this segment conducts diving operations which, because of the water depths involved, require sophisticated equipment, including diving bells and an underwater habitat.

This segment is strengthening its competitive position through an aggressive program for automation and modernization of engineering, welding equipment, pipemill facilities and pipelaying operations and increased lifting capacity of its derricks.

McDermott International owns a 49% interest in a Mexican joint venture that operates 3 self-propelled combination barges and one pipelaying barge. Of these, 2 barges are capable of lifting 2,000 tons.

This segment's shipyard facility supplies complete maintenance and construction facilities and is a builder of large tugs, packaged rigs, dredges, and oceanographic research and ocean-going work vessels.

Foreign Operations

The amounts of marine construction's revenues and operating income derived from operations outside of the United States, and approximate percentages of those revenues and operating income to McDermott International's total revenues and operating income (loss) were as follows:

	REVENUES		OPERATING INCOME	
Fiscal Year	Amount	Percent	Amount	Percent
	(In thousands of dollars)			
1986	$ 603,532	19	$ 18,657	—
1985	758,169	23	73,029	—
1984	947,819	31	165,596	80

Raw Materials

The raw materials used by this segment such as carbon and alloy steel in various forms, welding gases, concrete, fuel oil and gasoline, are available from many sources and this segment is not dependent upon any single supplier or source. Although shortages in certain raw materials and fuels required to be purchased by this segment have existed from time to time, no serious shortage exists at the present time.

Customers and Competition

This segment's principal customers are the larger oil and gas companies and foreign governments. Customers generally contract with this segment for the design, construction and installation of specific platforms, pumping stations, marine pipelines, and production networks. Contracts are usually awarded on a competitive bid basis.

McDermott International's main competitor in offshore construction has operations comparable in size to those of McDermott International but is a subsidiary of a major company that also provides other services to the oil and gas industry. A number of other companies also compete effectively with McDermott International in various parts of the world, but none has the geographical distribution or the extent of capabilities of McDermott International and its main competitor.

Backlog

As of March 31, 1986 and 1985 the Marine Construction Services' backlog amounted to $735,765,000 and $662,927,000, respectively, an increase of approximately 11%. Of the March 31, 1986 backlog, $722,620,000 is expected to be recognized in fiscal 1987, and $13,145,000 in fiscal years 1988-1991.

Work is performed on a fixed price, cost plus or day rate basis or combinations thereof. Almost all contracts call for progress payments and McDermott International attempts to cover increased costs of anticipated changes in general labor rates and material costs on long-term contracts, either through an estimation of such changes, which is reflected in the original fixed price, or through price escalation clauses. This segment's contracts for work in foreign areas generally provide for payment in United States dollars, with exceptions for payments in foreign currencies in amounts approximately equal to expenses to be incurred by this segment in those currencies.

Factors Affecting Demand

Marine Construction Services activity has traditionally been a cyclical industry depending mainly on the capital expenditure outlay of major oil and gas companies and foreign governments for developmental construction. These expenditures are influenced by the price of oil, the sale and expiration dates of offshore leases in the United States and abroad, the discovery rates of new oil and gas reserves in offshore areas, local and international political and economic conditions, and the ability of the oil and gas industry to generate capital.

The price of oil and its uncertainty in the future has a strong effect on exploration and production which ultimately affects the demand for Marine Construction Services activity. The oil surplus which the world has been experiencing has a depressing impact on oil prices, which will continue until consumption exceeds available production. The current level of oil prices and their future uncertainty have led the oil industry, including many of this segment's customers, to reduce capital expenditure budgets, resulting in lower levels of demand for marine construction services. Over the long-term, however, McDermott International expects an end to the current oil surplus and an improved level of demand for its Marine Construction Services.

C. POWER GENERATION SYSTEMS AND EQUIPMENT

General

The Power Generation Systems and Equipment segment, which business is primarily performed through B&W, is a supplier of individually engineered complete fossil fuel boilers, nuclear steam systems, nuclear fuel and nuclear fuel assemblies for the electric utility industry, as well as fossil fuel boilers for industrial processes and power generation. Power Generation Systems and Equipment also provides replacement parts, customer services and engineered modifications of existing fossil and nuclear steam systems, and specially engineered accessories and components, such as air heaters and precipitators, cleaning systems for heat transfer surfaces, nuclear reactor components, control and performance computers, automatic controls and instruments and nuclear control rod drives. It also supplies process recovery boilers and pollution control systems for the process and utility industries, heavy pressure vessels and air and water-cooled heat exchangers, fans, hollow forgings for steam piping and other uses and reflective metallic thermal insulation. This segment also provides nuclear reactor and fuel components and other components for the U.S. Department of Energy and the U.S. Department of Defense. It also is engaged in the erection of utility plants and industrial facilities and the repair and alteration of such existing equipment.

In addition, B&W is actively involved in the emerging market for providing power through cogeneration, refuse and other small power units with non-traditional fuel burning capability. It is participating in this market both as an equipment supplier and in build-own-operate projects as an equity participant. Fluid bed combustors are often the preferred boiler design for these projects and B&W offers both circulating and bubbling fluidized bed combustors to service this and the boiler retrofit market. B&W is also developing pressurized fluid bed combustors for large scale commercial applications.

In regard to commercial nuclear power generation, utilities have delayed certain construction programs and in many cases have cancelled orders for nuclear steam generating systems. No contracts for domestic nuclear steam systems have been awarded in several years. As a consequence, engineering, computer and other customer services, and fuel assemblies for refueling existing nuclear reactors have become the major part of this segment's commercial nuclear activity.

Business with the U.S. Government related to the U.S. Navy's nuclear shipbuilding operations has become an increasingly important part of the segment's results. In each of the fiscal years 1986, 1985 and 1984, revenues from the U.S. Government related to this activity were approximately 12% of McDermott International's total revenues. This activity has contributed significant operating income to McDermott International in all three fiscal years and the Power Generation Systems and Equipment segment would have had an operating loss in the last two fiscal years without the contribution from this program. A decline in this business could have a significant impact on this segment's profitability.

In addition, to capitalize on its highly specialized manufacturing and welding capabilities, B&W is actively pursuing new opportunities in the defense market related to such items as aircraft engine parts, penetrators, rocket motor casings and self-contained military power plants.

The principal plants of B&W manufacturing power generation systems and equipment are situated at Barberton, Lancaster and Wickliffe, Ohio; Lynchburg, Virginia; Paris and Beasley, Texas; West Point, Mississippi; Williamsport, Pennsylvania; and Cambridge, Ontario. These plants and properties are owned by B&W and are well maintained, have suitable equipment, and are of adequate size.

In response to the reduction in orders for power stations by electric utilities, B&W closed certain of its manufacturing plants and facilities to balance its capacity with current market expectations. Provisions were made in the accounts in fiscal 1984 to cover the costs of certain of these closings. B&W has an ongoing program for automating and modernizing this segment's engineering and manufacturing facilities.

Raw Materials

The principal raw materials used by B&W to construct power generation systems and equipment consist of carbon and alloy steels in various forms, such as plate, structurals, bars, sheet, strip, heavy wall pipe and tubes. Significant amounts of components are also purchased for assembly into the equipment. These raw materials and components generally are purchased by B&W as needed for individual contracts except that requirements for tubes are supplied mainly from within B&W.

The principal raw materials used by B&W in the manufacture of nuclear fuel components and assemblies consist of uranium (customer furnished), zircalloy and specialized stainless steel.

Although shortages in certain raw materials and fuels required to be purchased by B&W have existed from time to time, no serious shortage exists at the present time.

Customers and Competition

The principal customers of this business segment are the electric utility industry (including government-owned utilities), the U.S. Government, and the pulp and paper, and other process industries. The electric utility industry (including government-owned utilities) accounted for 19%, 21% and 29% of McDermott International's total revenues for fiscal years 1986, 1985 and 1984, respectively. The U.S. Government accounted for approximately 13% of McDermott International's total revenues for each of the fiscal years 1986, 1985 and 1984.

Power Generation Systems and Equipment orders are customarily awarded in response to competitive bids submitted pursuant to proposals based on the estimated cost of each job. Domestically, a relatively small number of companies specializing in large steam generating equipment compete with B&W in the utility fossil fuel steam system business. In international markets, these companies plus several foreign based companies compete with B&W. In the sale of nuclear steam systems, B&W competes with a small number of companies. In the sale of nuclear fuel and nuclear fuel assemblies, B&W competes with the other manufacturers of nuclear steam systems, as well as with one petroleum company which is a supplier of nuclear fuel and nuclear fuel assemblies. In the controls and instrumentation market, B&W competes with several broad line suppliers and a great number of specialty suppliers. A number of companies are in competition with B&W in industrial and cogeneration boilers. Other suppliers of fossil and nuclear fuel steam systems, as well as many other businesses in the case of fossil fuel systems, compete in repair and alterations and other services required for backfitting and maintaining existing systems. In the supply of nuclear fuel assemblies and nuclear components to the U.S. Navy, there are a small number of suppliers with B&W being the largest based upon revenues.

Backlog

Backlog as of March 31, 1986 was $3,035,061,000 or approximately 74% of McDermott International's backlog. Backlog at March 31, 1985 was $3,089,000,000. Of the March 31, 1986 backlog, it is expected that approximately $964,967,000 will be recorded in revenues in fiscal 1987, $1,519,362,000 in fiscal years 1988-1991, and $550,732,000 thereafter. If in management's judgment it becomes doubtful whether contracts will proceed, the backlog is adjusted accordingly.

Reduced electric demand growth, excess generating capacity, environmental restraints and financial pressures on the utility industry have resulted in continued delays, suspensions and cancellations of steam systems and environmental control systems. At March 31, 1986 delayed and suspended fossil fuel utility boiler and environmental control system contracts included in the backlog constituted approximately 12% of McDermott International's total backlog. B&W, at the present time, believes that these fossil fuel utility boiler and environmental control system contracts will proceed after the period of delay or suspension. If contracts are delayed, suspended or cancelled, B&W is usually entitled to a financial settlement related to the individual circumstances of the contract. This segment's backlog with the U.S. Government, primarily for the U.S. Navy's nuclear shipbuilding operations, was approximately 25% of McDermott International's total backlog at March 31, 1986.

B&W attempts to cover increased costs of anticipated changes in labor, material and service costs of long-term contracts either through an estimation of such changes which is reflected in the original price or through price escalation clauses. Most long-term contracts have provisions for progress payments.

Factors Affecting Demand

New orders by the U.S. electric utility industry have been at extremely low levels during recent years because of the decline in electrical demand growth and resultant increased reserve margins, primarily due to cost induced conservation, and a decreased dependence on energy by U.S. industry. Fiscal 1984 saw the start of a moderate resumption in electrical demand growth due primarily to the economic recovery, although existing capacity continues to be adequate to meet current demand. Two domestic orders for new electric utility power plants were placed in fiscal 1986, one of which (involving the conversion of a partially constructed nuclear power plant to a fossil power plant) was placed with B&W. Accordingly, B&W has continued its efforts to obtain orders outside the United States and expand its business in backfitting of existing power plants requiring replacement parts, repair and alteration, and other services. In fiscal 1986 B&W received an order for four utility boilers in the People's Republic of China.

D. ENGINEERED MATERIALS

General

Engineered Materials consists of tubular and insulating products designed and manufactured by B&W.

Tubular products include stainless, alloy and carbon steel, seamless and welded tubes, tubular and solid shapes, extrusions, special metal tubes and seamless rolled rings. These are principally "specialty" products of high quality and engineered for special mechanical and pressure tubing applications, including high quality tubing for petroleum production operations.

Insulating products include specially engineered and vacuum formed ceramic fibers, insulating and specialty firebrick, fire protection insulation, plastics, mortars, castables and special oxide refractories. These insulating products are used in high temperature furnaces for various heating and heat treating purposes and in other applications where the temperatures and rates of combustion or chemical reactions are unusually demanding.

B&W's principal plants manufacturing tubular products are located at Beaver Falls and Ambridge, Pennsylvania; Alliance, Ohio; and Bryan, Texas. B&W manufactures insulating products principally at Augusta, Georgia; Emporia, Kansas; and Burlington, Ontario. All of these plants and properties are owned by B&W, are well maintained, have suitable equipment, and are of adequate size. In response to reduced demand for mechanical and pressure tubing, B&W permanently closed its Milwaukee, Wisconsin plant in fiscal 1984. Provisions were made in the accounts in fiscal 1986, 1985 and 1984 to cover the costs associated with this closing. B&W has an ongoing program to automate and modernize this segment's facilities. In fiscal 1984, B&W commissioned a new steel making facility, which includes a continuous caster, at its Beaver Falls location and, in fiscal 1985, began an extensive two-year modernization of its welded tube facility in Alliance, Ohio.

Raw Materials

The principal raw materials used by B&W in the manufacture of tubular products consist of steel, steel scrap, special metals and alloying materials. Most of the steel and special metals used for seamless tubemaking purposes are produced by B&W's own electric furnace facilities, except that B&W purchases its requirements for strip steel in the open market. Most of the steel scrap and all alloying materials utilized in the manufacturing process are also purchased in the open market.

The principal raw material used to produce this segment's insulating products is kaolin clay which it obtains under a long-term supply contract. Also used are bauxite, alumina, silicon carbide, gypsum, plaster and wood chips, all of which are purchased on the open market.

Significant amounts of natural gas and oil are used in the manufacture of tubular and insulating products.

Although shortages in certain raw materials and fuels required to be purchased by this B&W segment have existed from time to time, no serious shortage exists at the present time.

Customers and Competition

The principal users of the tubular products portion of this business segment are the bearing, automotive, agricultural and construction machinery, petroleum and petrochemical, primary metal, fabricated metal, process, and power generation industries. This segment services these users through both direct sales and sales to distributors. In addition, material quantities of tubes are manufactured by this segment for B&W's own requirements for power generation systems and equipment.

The principal customers of the insulating products portion of this business segment are the iron and steel, chemical process, ceramic and foundry and furnace builders industries.

Many companies, both domestic and foreign, are in competition with B&W with respect to tubular and insulating products.

Backlog

As of March 31, 1986 the Engineered Materials' backlog was $37,898,000 compared with $58,000,000 as of March 31, 1985, reflecting the reduced demand by user industries for this segment's products. Substantially all of this segment's backlog is expected to be recorded in revenues in fiscal 1987.

Factors Affecting Demand

Purchases of tubular products by industries served by this segment were at severely depressed levels throughout fiscal years 1986, 1985 and 1984, in nearly all user industries. This segment supplies pressure tubing to makers of steam generating equipment for use in power plants, refineries, chemical and petrochemical plants and pulp and paper and other process industries. Demand for such tubing is closely tied to capital spending of these industries or their ultimate customers, and such spending levels are depressed. In addition to the reduced demand for tubular products in general, this segment has experienced significant foreign competition in many of its tubular product lines. Demand for insulating products is dependent upon capital spending for modernization and expansion, production levels and energy conservation in user industries and such demand continued the moderate upturn that began in fiscal 1984.

E. TRADING

General

This segment conducts its operations through a network of offices located in the United States, Continental Europe, the United Kingdom, West Africa, South America and South East Asia. The business is provided through Coutinho, Caro & Co., headquartered in Hamburg, West Germany and through McDermott International Trading.

This segment buys and sells primarily iron and steel products, wire and wire products, non-ferrous materials, chemical products, cables and equipment for electric power distribution, tools, machinery and utility vehicles, aromatics, olefins, plastics, and fine chemicals. The operations of this segment also include inland and ocean transport as well as assisting customers in arranging insurance and financing. While this segment ordinarily functions as a principal in its trading activities, it also acts as agent under certain circumstances. In addition, this segment regularly enters into substantial forward purchases and sales of all materials handled. These are not normally maintained over periods longer than three months.

This segment also provides certain engineering and construction services consisting of the design, construction and erection of industrial plants, primarily for the cement, glass, pulp and paper, and food industries as well as hotels, hospitals, office buildings, business centers and other large building complexes.

This segment does not produce any of the materials in which it trades, but purchases them from others in the open market. No long-term contractual supply arrangements are in place. This segment has access to and purchases these materials on a worldwide basis.

Customers and Competition

The principal customers of this segment are warehousing and stockholding companies, steel producers and end-users of steel products such as construction companies, large chemical companies, and a number of other industrial consumers. These customers are mainly commercial organizations although some are partially or wholly government owned or controlled.

This segment's competitors in international trade include many large trading organizations and producers or end-users of the products in which the segment trades. No one competitor is dominant, although many have greater financial and other resources than McDermott International. Of the factors affecting competition in this business, the most significant are expertise, service and reliability. Management believes that it possesses adequate resources in these areas to enable it to compete effectively in this marketplace.

This segment's customers for engineering and construction services include various process industries and development companies, some of which are owned or partly controlled by governments of the countries in which contracts are performed. Customers generally contract with this segment for the design and construction of specific industrial plants or high-rise buildings. Contracts are normally awarded on a competitive bid basis and, particularly at the present time, are heavily dependent upon the conclusion of related project financing arrangements. Competition in the engineering and construction business is present on a worldwide basis, from companies based in all major developed countries, none of which are dominant.

Backlog

As of March 31, 1986, Trading segment backlog was $276,785,000 compared with $192,950,000 as of March 31, 1985. The increase in backlog is due primarily to a construction contract being performed in the Middle East. Of the March 31, 1986 backlog, $197,764,000 is expected to be recognized in fiscal 1987, and $79,021,000 in fiscal years 1988 and 1989.

The majority of trades are completed within three months. Payment is usually based on normal commercial terms and is normally settled using letters of credit arranged through various banks. Payment terms may be extended under certain circumstances. Credit insurance is purchased for the majority of trade accounts receivable.

Engineering and construction work is principally performed on a fixed price or cost plus basis or a combination thereof. Almost all contracts call for progress payments and the segment attempts to cover increased costs on long-term contracts either through an estimation of such charges which is reflected in the agreed fixed price or through price escalation clauses.

Trades are primarily settled and major contracts normally call for payment in U.S. Dollars or Deutschmarks. The segment enters into substantial forward currency exchange contracts as a means of hedging its commitments in various currencies.

Factors Affecting Demand

Demand for this segment's services is influenced by a variety of constantly changing market factors which affect supply and demand for the materials in which the segment trades. In addition, local and international political and economic conditions influence the capital and industrial development budgets of developing nations and their ability to obtain financing for projects or trading.

Due to the present uncertainty in the funding of industrial expansion programs of developing nations and delays in completing project financing arrangements, few contracts are being awarded at the present time. These factors are considered likely to affect the segment's engineering and construction activities until world demand and credit conditions become more favorable.

F. PATENTS AND LICENSES

Many U. S. and foreign patents have been issued to McDermott International and it has many pending patent applications. Patents and licenses have been acquired and licenses have been granted to others when advantageous to McDermott International. While McDermott International regards its patents and licenses to be of value, no single patent or license or group of related patents or licenses is believed to be material in relation to its business as a whole.

G. RESEARCH AND DEVELOPMENT ACTIVITIES

McDermott International maintains research and development activities in Alliance, Ohio; Lynchburg, Virginia; and Houston, Texas; and also conducts development activities at its various manufacturing plants and engineering and design offices. During the fiscal years ended March 31, 1986, 1985 and 1984, approximately $88,000,000, $82,700,000 and $61,600,000, respectively, was spent by McDermott International on research and development activities, of which approximately $53,400,000, $41,600,000 and $27,000,000, respectively, was paid for by customers of McDermott International. Research and development activities were related to development and improvement of new and existing products and equipment and conceptual and engineering evaluation for translation into practical applications. Approximately 408 employees were engaged full time in this activity.

H. INSURANCE

McDermott International maintains liability and property insurance that it considers normal in the industry. It does not maintain insurance covering certain risks for which insurance is not available or is only available at rates which McDermott International considers uneconomical. Among such risks are war and confiscation in certain areas of the world at certain times, and pollution liability. Depending on competitive conditions and other factors, McDermott International endeavors to obtain contractual protection against uninsured risks from its customers.

McDermott International has coverage under commercially available nuclear liability and property insurance for its five nuclear facilities. Two of these facilities are also subject to the indemnity and limitations of liability provisions of the Price-Anderson Act. This Act limits the public liability of manufacturers and operators of licensed nuclear facilities and other parties who may be liable, in respect of, and indemnifies them against all claims in excess of an amount which is determined by the sum of commercially available nuclear liability insurance plus certain retrospective premium assessments payable by operators of commercial nuclear reactors. One additional facility is covered by a contractual indemnity from the U.S. Government whereby the Government has assumed the risks of public liability claims.

McDermott International's insurance policies do not cover liability and property damage losses resulting from nuclear incidents at facilities of its utility customers. To protect against such losses McDermott International has obtained contractual indemnification from such customers and waivers of their insurers' rights of subrogation and generally has been named as an additional insured under its customers' nuclear property insurance policies. In addition, McDermott International's third-party nuclear liability is an insured risk under such customers' nuclear liability policies and the Price-Anderson Act indemnity discussed above.

McDermott International's offshore construction business is subject to the usual risks of operations at sea, with additional exposure due to the utilization of expensive construction equipment, sometimes under extreme weather conditions and often in remote areas of the world. In addition, McDermott International operates in many cases on or in proximity to existing offshore facilities which are subject to damage by McDermott International and such damage could result in the escape of oil and gas into the sea.

McDermott International has two wholly-owned insurance subsidiaries. To date, these subsidiaries have written policies concerning general liability, builders' risk within certain limits, marine hull, and workmen's compensation for McDermott International. No significant amounts of insurance have been written for unrelated parties.

I. EMPLOYEES

At March 31, 1986, McDermott International employed, under its direct supervision, approximately 35,000 persons compared with 40,000 at March 31, 1985. Approximately 8,000 employees were members of labor unions at March 31, 1986 compared with 9,000 employees at March 31, 1985. Approximately 1,300 union employees engaged in the tubular products operations are represented by United Steelworkers of America and have a labor contract expiring in August 1986. McDermott International considers its relations with its employees to be satisfactory.

J. GOVERNMENT REGULATIONS

McDermott International's compliance with U.S. federal, state and local environmental protection regulations necessitated capital expenditures of $474,000 in fiscal 1986, and it expects to spend another $5,487,000 over the next five years. However, McDermott International cannot predict all the environmental requirements or circumstances which will exist in the future. The recurring costs of complying with environmental regulations was a charge against income before taxes of approximately $1,580,000 in fiscal 1986. In addition, McDermott International incurred a charge against income in fiscal 1986 of approximately $4,500,000 in connection with a plant shutdown.

McDermott International performs significant amounts of work for the U.S. Government under both prime contracts and subcontracts and operates certain nuclear facilities and thus is subject to continuing reviews by governmental agencies including the Environmental Protection Agency and the Nuclear Regulatory Commission.

Compliance with government regulations controlling the discharge of materials into the environment, or otherwise relating to the protection of the environment, does not have, nor is it expected to have a material effect upon the competitive position of McDermott International.

K. INTERCOMPANY AGREEMENT

In November 1982, International and the Delaware Company entered into a Stock Purchase and Sale Agreement (the "Intercompany Agreement"), pursuant to which the Delaware Company has the right to sell to International and International has the right to buy from the Delaware Company units of stock, each unit consisting of one share of International Common Stock and one share of International Series A Preferred Stock. If a unit is purchased by International upon the Delaware Company's exercise of its right to sell under the Intercompany Agreement, the purchase price of such unit will be 90% of the then current value of the unit, as defined in the agreement (the "unit value"). If a unit is purchased by International pursuant to an exercise of its right to purchase under the Intercompany Agreement, the purchase price of such unit will be 110% of the unit value. As of March 31, 1986 the unit value was $7,031 and the aggregate unit value of the Delaware Company's 100,000 units was $703,149,000.

Item 3. LEGAL PROCEEDINGS AND PROPOSED TAX DEFICIENCY

The Internal Revenue Service (the "IRS") has examined the U.S. federal income tax returns of the Delaware Company for its fiscal years ended March 31, 1976 through March 31, 1982, and those of International for its fiscal years ended November 30, 1976 through November 30, 1982; and those of B&W for its fiscal years ended December 31, 1977 and March 31, 1978, the latter being the year ended on the day B&W was acquired by the Delaware Company. The IRS has issued notices which propose additions to the U.S. federal income tax liability of the Delaware Company and International in respect of each of these years. Such notices assert among other things that the Delaware Company is subject to U.S. federal income tax on unremitted earnings of International on the ground that the portion thereof which constituted "Subpart F" income under Sections 951 through 964 of the Internal Revenue Code substantially exceeded the portion so classified by the Delaware Company in its U.S. federal income tax returns. Additional U.S. federal income taxes asserted by the notices in question which are allocable to Subpart F income items from International are approximately $210,000,000.

In the notices issued by it, the IRS does not state specifically the grounds upon which additional taxes under Subpart F are asserted. Revenue Agents' reports delivered in connection with such notices assert that the income of International constituted Subpart F income because it was realized from the performance of services on behalf of the Delaware Company. These reports assert, in the alternative, that International was engaged in the business of manufacturing rather than in the construction business, with consequential effects on the calculation of Subpart F income. The Delaware Company is contesting the additional U.S. federal income taxes with respect to Subpart F income items proposed in the notices and believes it will succeed with respect thereto.

The notices to International essentially represent alternative grounds for asserting a deficiency with respect to a portion of the aforesaid Subpart F income. International believes it will succeed in contesting these deficiencies.

The notices also propose additional U.S. federal income taxes for the years in question on grounds other than the Subpart F rules, including additional taxes arising out of transactions done and contracts entered into by B&W before its acquisition by the Delaware Company and the consequential effects thereof on the Delaware Company for its fiscal years ended March 31, 1979, 1980 and 1981. The additional U.S. federal income taxes which the IRS has asserted on these grounds are substantial. The Delaware Company, however, believes that any U.S. federal income taxes ultimately assessed on the basis of such notices will not exceed reserves established with respect thereto.

For the fiscal year ended March 31, 1983 the IRS has issued a draft report of income tax examination changes. The draft report indicates, among other things, that the IRS will propose to treat the reorganization in that fiscal year in which International became the parent of the McDermott group of companies as a taxable event on which the Delaware Company owes approximately $300,000,000 in U.S. federal income taxes. This amount is duplicative to the extent of income taxes asserted under Subpart F for prior years through March 31, 1982. If a notice of deficiency is issued on this basis, the Delaware Company will contest any amounts asserted therein and it believes it will succeed with respect thereto.

In March 1986, the legal action involving claims by Exxon Corporation and affiliated companies against Brown & Root, Inc. and the Delaware Company (Case No. 80-1402, E.D. La.) under Sections 1 and 2 of the Sherman Act was settled. This was the last of 79 actions which were filed in or (unless earlier terminated) transferred to the United States District Court for the Eastern District of Louisiana, instituted by or on behalf of purchasers and alleged purchasers of marine construction services in the United States and abroad, alleging a combination and conspiracy to restrain or eliminate competition in marine construction in violation of Sections 1 and 2 of the Sherman Act and various state laws through a conspiracy to allocate contracts, fix prices and contract terms and other means. The Delaware Company and International have paid a total of approximately $52,000,000 and $42,000,000, respectively, in settlement of purchasers' claims.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

PART II

Item 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED SECURITY HOLDER MATTERS

International's Common Stock is traded on the New York Stock Exchange. High and low stock prices and dividends declared for the years ended March 31, 1986 and 1985 were as follows:

	FISCAL 1986		
	SALES PRICE		CASH DIVIDENDS
QUARTER ENDED	HIGH	LOW	DECLARED
June 30, 1985	28¼	23⅜	$0.45
September 30, 1985	26	16⅝	$0.45
December 31, 1985	20¼	16⅜	$0.45
March 31, 1986	19⅛	13⅝	$0.45

	FISCAL 1985		
	SALES PRICE		CASH DIVIDENDS
QUARTER ENDED	HIGH	LOW	DECLARED
June 30, 1984	31⅝	25	$0.45
September 30, 1984	31	23⅞	$0.45
December 31, 1984	30¾	23¾	$0.45
March 31, 1985	30⅛	23½	$0.45

As of March 31, 1986, the approximate number of record holders of common stock was 9,460.

Item 6. SELECTED FINANCIAL DATA

	For The Fiscal Years Ended March 31,				
	1986	1985	1984	1983	1982
	(In thousands except for per share amounts)				
Revenues	$ 3,257,095	$ 3,233,871	$ 3,088,583	$ 3,707,767	$ 4,843,186
Income Before Extraordinary Items	$ 56,300	$ 18,980	$ 120,856	$ 50,522	$ 183,589
Net Income	$ 59,089	$ 30,667	$ 120,856	$ 55,664	$ 183,589
Earnings Per Share:					
Primary -					
Before Extraordinary Items	$ 1.52	$ 0.51	$ 3.06	$ 1.37	$ 4.98
Net Earnings	$ 1.60	$ 0.83	$ 3.06	$ 1.51	$ 4.98
Fully Diluted -					
Before Extraordinary Items	$ 1.52	$ 0.51	$ 2.95	$ 1.37	$ 4.56
Net Earnings	$ 1.60	$ 0.83	$ 2.95	$ 1.51	$ 4.56
Total Assets	$ 4,350,942	$ 4,180,684	$ 3,981,114	$ 3,820,689	$ 4,063,484
Long-Term Obligations	$ 913,260	$ 732,248	$ 621,045	$ 525,086	$ 419,259
Subsidiary's Redeemable Preferred Stocks	204,693	204,693	204,709	204,783	393,763
Total	$ 1,117,953	$ 936,941	$ 825,754	$ 729,869	$ 813,022
Cash Dividends per common share	$ 1.80	$ 1.80	$ 1.80	$ 1.80	$ 1.65

See Note 2 of notes to consolidated financial statements regarding the acquisition of Coutinho during fiscal year 1985, which was accounted for as a purchase and Note 4 regarding changes in actuarial assumptions for domestic pension plans during fiscal year 1986.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Results of Operations

1986 VS 1985

Marine Construction Services' revenues decreased by $137,752,000 to $908,186,000 and operating loss increased by $21,903,000 to $30,196,000. The decreased revenues resulted from lower utilization of marine construction equipment worldwide and fabrication facilities in the foreign operations offset to a significant extent by favorable settlements of outstanding claims in foreign operations and increased fabrication revenues from domestic operations. The increase in operating loss resulted from foreign operations and was primarily due to the decreased revenues and lower profit margins, offset primarily by approximately $29,000,000 relating to the settlement of an outstanding claim and the reversal of certain provisions no longer required. This decline was further offset by an increase in domestic operating income due primarily to improved profit margins, improved contract performance and favorable offshore working conditions. Marine Construction Services benefited from reduced operating costs due to implementation of a cost reduction program and reduced pension expense of approximately $12,200,000, resulting from a change in actuarial assumptions for domestic pension plans.

A surplus of oil and natural gas and uncertainty regarding the future prices of these resources resulted in continued reduced demand for Marine Construction Services. Consequently, overcapacity continued in all major activities and asset utilization remained at low levels.

Power Generation Systems and Equipment revenues of $1,447,394,000 were $33,913,000 higher than last year. This was principally due to higher revenues from fossil plant enhancement and replacement parts, repair and alterations as well as higher revenues from microprocessor-based control systems and nuclear and other components for the U.S. Government. These higher revenues were partially offset by reduced activity on fossil steam and environmental control system fabrication and erection for electric utilities, lower revenues from nuclear fuel and services, heat exchangers and boiler-cleaning equipment. This segment reported operating income of $37,747,000 which was $22,402,000 higher than last year. The higher operating results were primarily due to a change in actuarial assumptions for domestic pension plans which reduced pension expense by approximately $27,500,000 (net of cost sharing formulas on certain contracts with the U.S. Government). In addition, operating income in fiscal 1986 improved from the contribution to profits as a result of the increased revenues from the utility parts and plant enhancement business and from microprocessor-based controls. Also, there was lower spending on coal-water fuel development and improved operating results on heat exchangers despite their lower volume. These positive factors were partially offset by the lower volume with reduced operating margins on fossil steam and environmental control systems and erection, significant costs associated with prototype small power plants, and the lower revenues from boiler-cleaning equipment. Also, there were increased expenditures related to development and marketing of cogeneration and refuse boilers, microprocessor-based control systems and construction services and an increase in insurance costs. In addition, in fiscal 1985 there were favorable contract adjustments to remaining nuclear steam systems as well as a favorable nuclear termination settlement.

Engineered Materials' revenues of $310,814,000 decreased $74,778,000 compared to last year primarily due to lower shipments of alloy, mechanical and stainless tubing. Shipments were lower or flat in most other tubular product lines and revenues were depressed by pricing pressures in many of these product lines. Revenues from insulating products were higher due to increased ceramic fiber sales. An operating loss of $31,289,000 was incurred in fiscal year 1986 compared to a loss of $39,843,000 last year. Pension expense in fiscal 1986 was reduced approximately $11,400,000 due to a change in actuarial assumptions for domestic pension plans. In addition, in fiscal 1986 there were reductions in steel production, tube finishing and certain raw material costs and lower claims expense on welded tubing. These were more than offset by the lower volume and continuing pricing pressure for tubular products. Insulating products' profit was lower due to a strike in its Canadian operations which ended late in November and higher selling and administrative expenses. A cost-price squeeze induced by competitive pricing policies in the tubular markets that this segment serves and the lack of demand for pressure, mechanical, stainless and heat resistant tubing continues to be responsible for loss operations in tubular products.

The Trading segment had revenues of $655,145,000 and operating losses of $536,000 compared to revenues of $435,924,000 and losses of $4,137,000 for last year. The revenue and operating results of Coutinho for the current year are included for a full twelve months as opposed to only a nine month period in the previous year as Coutinho was not consolidated until the quarter ended September 30, 1984. After allowing for the above, Trading segment revenues increased over last year due primarily to the addition of the new petrochemical business in the current fiscal year as well as an increase in steel and metal trading. These increased revenues were partially offset by reduced volume in the construction/engineering business. The decrease in operating loss was due primarily to favorable cost adjustments and the settlement of outstanding claims on certain construction contracts, partially offset by lower margins in steel and metal trading and start-up costs associated with the new petrochemical trading operations.

Interest income as reported for fiscal year 1986 decreased $18,964,000 from fiscal year 1985 and interest expense increased $20,602,000 over the same period. The primary reason for the decline in interest income was $10,160,000 of interest income that was received from a joint-venture company in fiscal 1985. The remainder of the decrease was consistent with changes in McDermott International's investment portfolio during fiscal 1986 and changes in the interest rates that prevailed during the two year period. The increase in interest expense in fiscal 1986 over fiscal 1985 was consistent with McDermott International's debt and the interest rates prevailing thereon in the respective periods, as well as being affected by an increase of $6,173,000 during fiscal 1986 in the provision for interest on estimated income taxes.

Other-net income for fiscal 1986 increased $76,546,000 over fiscal 1985. The primary reason for the increase was a $94,695,000 increase in the gain recognized from the sale of government obligations. In addition, the increase was affected by the payment in fiscal 1985 of $5,450,000 for fees relating to the termination of an agency agreement and a decrease in bad debt expense from fiscal 1985 to fiscal 1986 of $4,510,000. The increase was partially offset by a $21,078,000 decline in gains from the disposal of assets, a $8,715,000 decrease from fiscal 1985 to fiscal 1986 in the amount realized from receivables previously deemed restricted because of foreign exchange controls. Expense for the settlement of certain antitrust civil litigation was $29,510,000 in fiscal 1986 compared with $31,299,000 in fiscal 1985.

In fiscal 1986, benefit from income taxes decreased by $18,379,000 to $71,234,000. The decreased tax benefit arose primarily because International experienced lower pre-tax losses in jurisdictions where tax benefits exist.

Extraordinary items net of tax were $2,789,000 in fiscal 1986 and $11,687,000 in fiscal 1985, due primarily to differences in utilization of certain operating loss carryforwards and a gain on extinguishment of certain debt.

1985 VS 1984

Marine Construction Services' revenues declined by $145,411,000 to $1,045,938,000 and operating income declined $99,414,000 to a loss of $8,293,000. These declines, were principally in the foreign operations and resulted from lower utilization of marine construction equipment. In addition, domestic operating income for fiscal 1985 was affected by significantly lower depreciation expenses due to the accelerated depreciation of certain construction equipment in the prior period due to its technical obsolescence and diminished cost effectiveness. This was offset by unfavorable offshore working conditions and terms of certain contracts, lower profit margins on certain other contracts, and high mobilization costs. Operating income was also adversely affected by unfavorable cost performance on certain fabrication contracts in both domestic and foreign operations.

Power Generation Systems and Equipment revenues of $1,413,481,000 were $165,846,000 lower than in fiscal 1984. This was principally due to reduced activity on fossil systems fabrication and erection, and lower service activity related to nuclear systems partially offset by higher revenues from nuclear fuel assemblies and fossil service and replacement parts business. Operating income of $15,345,000 was $120,132,000 lower than the same period in fiscal 1984. The lower operating results were primarily due to the lower volume with reduced operating margins particularly on fossil system fabrication and erection contracts, lower nuclear services volume, increased expenditures related to development and marketing of coal-water fuel and microprocessor-based control systems, higher expenses related to automation projects, and increased provisions required for worker's compensation benefits. These were partially offset by the higher utility and industrial parts business and improved margins from nuclear and other components for the U.S. Government.

Engineered Materials' revenues of $385,592,000 increased $11,814,000 compared to fiscal 1984, due primarily to higher revenues for seamless oil country tubular products and mechanical tubing partially offset by a decrease in pressure tubing. Revenues from insulating products were modestly higher primarily due to increased ceramic fiber sales. An operating loss of $39,843,000 was incurred in fiscal year 1985 compared to a loss of $19,222,000 in fiscal 1984. A cost-price squeeze induced by competitive pricing policies in the steel markets that this segment serves and the lack of demand for pressure, stainless and heat resistant tubing were responsible for the continuation of loss operations in tubular products. In addition, in fiscal 1985 tubular products experienced higher claims expense and additional provisions for worker's compensation benefits. These unfavorable factors were partially offset by a reduction in steel production costs and an improvement in insulating products margins. In addition, in fiscal 1984 certain expenses were incurred related to streamlining and modernization of certain tube making facilities and McDermott International obtained a favorable settlement of $5,750,000 for a business interruption insurance claim.

Trading revenues were $435,924,000, primarily attributable to Coutinho whose results of operations for the period April 1, 1984 through December 31, 1984 have been included in the results of McDermott International for fiscal 1985. Revenues from trading activities reflected a strong demand for commercial steel, non-precious metals, paper, and chemical products. However, competition in the market for construction and engineering projects and difficulties in arranging financing for available projects in certain developing countries, have resulted in a low volume of orders booked. The operating loss of $4,137,000 was primarily attributable to losses on certain turnkey engineering contracts partially offset by positive operating income from trading activities primarily in steel products.

Interest income for fiscal year 1985 increased by $31,315,000 over fiscal year 1984 and interest expense for the fiscal year 1985 increased by $15,028,000 during the same period. The increase in interest income was consistent with changes in McDermott International's investment portfolio and the interest rates prevailing thereon as well as recognition of $10,160,000 for interest income on a note from a joint-venture company and $6,198,000 interest income on investments acquired in the Coutinho acquisition during fiscal 1985. The increase in interest expense was consistent with McDermott International's debt and the interest rates prevailing thereon in the respective periods. In addition there was $8,990,000 interest expense on debt incurred due to the acquisition of Coutinho.

Other-net expense decreased by $16,156,000 in fiscal year 1985 over fiscal year 1984. This was primarily due to a decrease between periods of $37,591,000 in provisions for facility closings and disposition of product lines, most of which related to facilities in power generation systems and equipment and engineered materials. In addition, in fiscal 1985 there was income of $25,570,000 related to the net gain on disposal of assets, the realization of $9,825,000 from receivables previously deemed restricted because of foreign exchange controls, and a decrease in expense related to foreign exchange transactions of $9,688,000. These increases were partly offset by a net decrease between the periods of $40,198,000 in net gain on the sale of securities, a net increase in expense in fiscal year 1985 of $14,710,000 for the settlement of certain antitrust civil litigation and a decrease between the two periods of $9,813,000 due to income which was recorded in fiscal year 1984 for the settlement of pending litigation and claims involving a certain nuclear fuel contract. In addition there was a decrease of $4,724,000 in royalty income in fiscal year 1985 and other-net expense for fiscal year 1985 included $5,450,000 for fees relating to the termination of an agency agreement.

In fiscal 1985, benefit from income taxes was $89,613,000 compared with a provision for income taxes of $4,542,000 in the previous year. The increased tax benefit arose because International experienced tax benefits in jurisdictions where pre-tax losses occurred, and decreased profits which were dispersed among jurisdictions with varying rates of taxation.

Net income from extraordinary items increased by $11,687,000 in fiscal 1985 as compared to fiscal 1984 due primarily to a gain on extinguishment of certain debt and utilization of certain operating loss carryforwards.

Impact of Changing Prices on Revenues and Net Income

As a result of inflation, historical dollar accounting (as reflected in the financial statements) does not reflect the cumulative effect of increasing costs and changes in the purchasing power of the dollar.

The effects of changing prices and their impact upon McDermott International and its reported results are shown pursuant to FASB Statement No. 33 (as amended by FASB Statement No. 82) in Note 12 of notes to the consolidated financial statements.

Liquidity and Capital Resources

At March 31, 1986, McDermott International's working capital was $1,258,000, a decrease of $116,708,000 from March 31, 1985. Principal movements in working capital were an increase of $117,728,000 in notes payable and current maturities of long-term debt due primarily to conversion of the Delaware Company's revolving credit agreement to term debt and $61,434,000 of short-term reverse repurchase agreements which were entered into during the fiscal year. In addition, there was a decrease of $35,308,000 in accounts and notes receivable reflecting reduced activity in marine construction services and a decrease of $16,611,000 in inventories due primarily to completion of a planned inventory reduction program in tubular products. These negative movements in working capital were partially offset by a decrease of $43,305,000 in accrued liabilities-other due primarily to payment of certain antitrust civil litigation expense which was accrued at March 31, 1985 and a net increase of $41,428,000 in contracts in progress and advance billings on contracts.

International has available to it a short-term line of credit with various banks which was reduced from $90,000,000 to $85,000,000 during fiscal 1986. As of March 31, 1986 there were no borrowings against this line of credit.

During fiscal 1986, International entered into a $51,422,000 short-term reverse repurchase borrowing agreement whereby $44,150,000 par value of its portfolio of government obligations was committed, and the Delaware Company entered into a similar agreement for $10,012,000 whereby $8,600,000 par value of its portfolio of government obligations was committed. Proceeds from these agreements were used to pay down existing balances on short-term lines of credit and for general corporate purposes.

In fiscal 1985, McDermott International arranged a short-term line of credit facility totalling $100,539,000 with a foreign bank in connection with the acquisition of Coutinho. Borrowings against this line of credit at March 31, 1986 were $93,531,000. In addition, Coutinho has available to it various short-term lines of credit from various banks which increased from approximately $121,000,000 to $136,000,000 during fiscal 1986. At March 31, 1986, the amounts outstanding on these facilities totalled $19,957,000, a decrease of $11,537,000 from March 31, 1985.

The Delaware Company has available to it from various banks a short-term line of credit which was reduced from $93,000,000 to $60,000,000 during fiscal 1986. As of March 31, 1986, borrowings against this line of credit totalled $6,700,000 a decrease of $15,900,000 from March 31, 1985. During fiscal 1986, the Delaware Company's revolving credit agreement with various banks converted to a $200,000,000 term loan. The term loan is repayable in sixteen equal quarterly installments on March 31, June 30, September 30, and December 31. The first such installment was paid on December 31, 1985 and the final installment is due September 30, 1989. The term loan bears interest at the applicable rate of ¼ of 1% plus the prime rate, ¾ of 1% plus LIBOR or ¾ of 1% plus the certificate of deposit rate, as elected by the Delaware Company. As of March 31, 1986, $175,000,000 was outstanding under the facility at an interest rate of 8.31%. The Delaware Company and its subsidiaries are limited, principally as a result of credit agreement covenants, in their ability to transfer funds to International in intercompany loans, advances or cash dividends. At March 31, 1986 approximately $811,995,000 of the net assets of the Delaware Company and its subsidiaries were subject to such restrictions. It is not expected that these restrictions will have any significant effect on International's liquidity.

During the fiscal year ended March 31, 1986, McDermott International's outstanding borrowings under its short-term lines of credit averaged $198,476,000.

During fiscal 1985, McDermott International arranged a $157,000,000 fourteen and one half-year term loan facility at an interest rate of 10.375% which has been used to finance certain capital expenditures. The loan is secured by a portion of McDermott International's portfolio of government obligations which must amount to a fair market value of at least $108,645,000. At March 31, 1986, this facility was fully drawn down, an increase of $139,005,000 during the fiscal year.

During fiscal 1986, International entered into two separate long-term debt arrangements with two banks totalling $26,500,000 and $25,250,000 at interest rates of ¾ of 1% plus LIBOR, and ½ of 1% plus LIBOR respectively. During fiscal 1986, these facilities were fully drawn down and proceeds were used to finance certain foreign operations. Also, during fiscal 1986, the Delaware Company entered into a $50,000,000 long-term floating rate debt agreement with a U.S. bank at an interest rate equal to the daily Federal Funds Rate plus 0.75%. Proceeds from this loan were applied against exisiting debt.

During fiscal 1986, the Delaware Company obtained the approval of the holders of over 66⅔% principal amount of its 9⅝% Debentures Due March 15, 2004 to amend the Indenture under which such Debentures were issued. In conjunction therewith, approximately $46,697,000 principal amount of Debentures were tendered at a price of $980 net per $1,000 principal amount, plus accrued interest in cash. The amendment to the Indenture altered the restrictions on payment by the Delaware Company of dividends and other payments with respect to its capital stock.

McDermott International has committed to make capital expenditures of $80,236,000 during fiscal 1987. These proposed expenditures are principally to increase capacity and upgrade and modernize McDermott International's marine fleet and its fabrication facilities. McDermott International expects to obtain funds for these expenditures from its operations and through borrowings.

For the fiscal year ended March 31, 1986, working capital provided from operations was $109,318,000. During this same period, McDermott International expended $298,884,000 for additions to property, plant and equipment and $66,533,000 for cash dividends on common stock.

McDermott International maintains an investment portfolio of primarily government obligations which is held for long-term investment purposes. During the year, McDermott International increased this portfolio (net) by $121,586,000 to an amortized cost at March 31, 1986 of $1,098,792,000 with a market value of $1,334,343,000.

At March 31, 1986 the ratio of long-term debt to total common stock and other stockholders' equity was .76 as compared with .61 at March 31, 1985 and .50 at March 31, 1984.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Company Report on Consolidated Financial Statements

McDermott International has prepared the consolidated financial statements and related financial information included in this report. McDermott International has the primary responsibility for the financial statements and other financial information and for ascertaining that the data fairly reflect the financial position and results of operations of McDermott International. The financial statements were prepared in accordance with generally accepted accounting principles appropriate in the circumstances, and necessarily reflect estimates and judgments by appropriate officers of McDermott International with appropriate consideration given to materiality.

McDermott International believes that it maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and that the financial records are adequate and can be relied upon to produce financial statements in accordance with generally accepted accounting principles. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control must not exceed the related benefits. Although accounting control procedures are designed to achieve these objectives, it must be recognized that errors or irregularities may nevertheless occur. McDermott International seeks to assure the objectivity and integrity of its accounts by its selection of qualified personnel, by organizational arrangements that provide an appropriate division of responsibility and by the establishment and communication of sound business policies and procedures throughout the organization. McDermott International believes that its accounting controls provide reasonable assurance that errors or irregularities that could be material to the financial statements are prevented or would be detected.

McDermott International's accompanying consolidated financial statements have been examined by its certified public accountants, who provide McDermott International with expert advice on the application of U.S. generally accepted accounting principles to McDermott International's business and also provide an objective assessment of the degree to which McDermott International meets its responsibility for the fairness of financial reporting. They regularly evaluate the system of internal accounting controls and perform such tests and other procedures as they deem necessary to reach and express an opinion on the fairness of the financial statements. The report of the certified public accountants appears elsewhere herein.

The Board of Directors pursues its responsibility for McDermott International's consolidated financial statements through its Audit Committee which is composed solely of directors who are not officers or employees of McDermott International. The Audit Committee meets periodically with the certified public accountants, management and the internal auditors to review matters relating to the quality of financial reporting and internal accounting control and the nature, extent and results of the audit effort. In addition, the Audit Committee is responsible for recommending to the Board of Directors the engagement of certified public accountants for McDermott International, who in turn submit the engagement to the stockholders for their approval. The certified public accountants, as well as the internal auditors, have free access to the Audit Committee.

May 23, 1986

Report of Certified Public Accountants

The Board of Directors and Stockholders
McDermott International, Inc.

We have examined the accompanying consolidated balance sheet of McDermott International, Inc. at March 31, 1986 and 1985, and the related consolidated statements of income and retained earnings and changes in financial position for each of the three years in the period ended March 31, 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 report dated May 28, 1985, our opinion on the 1985 consolidated balance sheet was qualified as being subject to the effects of such adjustments, if any, as might have been required had the outcome of certain litigation been known. As explained in Note 7 to the financial statements, the litigation was settled during 1986. Accordingly, our present opinion on the 1985 consolidated balance sheet, as presented herein, does not include the qualification.

In our opinion, the financial statements mentioned above present fairly the consolidated financial position of McDermott International, Inc. at March 31, 1986 and 1985, and the consolidated results of operations and changes in financial position for each of the three years in the period ended March 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

ARTHUR YOUNG & COMPANY

New Orleans, Louisiana
May 23, 1986

McDERMOTT INTERNATIONAL, INC.
CONSOLIDATED BALANCE SHEET
MARCH 31, 1986 and 1985

ASSETS

	1986	1985
	(In thousands)	
Current Assets:		
Cash	$ 21,272	$ 20,341
Short-term investments, principally time deposits at cost which approximates market	85,127	91,752
Accounts and notes receivable	817,064	852,372
Income taxes refundable	8,753	94,644
Contracts in progress	296,811	268,692
Inventories	236,692	253,303
Prepaid expenses	33,883	22,034
Total Current Assets	1,499,602	1,603,138
Property, Plant and Equipment, at Cost:		
Land	30,101	30,037
Buildings	258,933	247,545
Machinery and equipment	2,036,901	1,771,250
Property under construction	90,358	91,451
	2,416,293	2,140,283
Less accumulated depreciation and amortization	1,110,361	986,625
Net Property, Plant and Equipment	1,305,932	1,153,658
Investments in Government Obligations, at Amortized Cost	1,098,792	977,206
Excess of Cost Over Fair Value of Net Assets of Purchased Businesses Less Accumulated Amortization of $80,604,000 at March 31, 1986 and $69,315,000 at March 31, 1985	345,257	345,590
Other Assets	101,359	101,092
TOTAL	$ 4,350,942	$ 4,180,684

See accompanying notes to consolidated financial statements.

LIABILITIES AND STOCKHOLDERS' EQUITY

	1986	1985
	(In thousands)	
Current Liabilities:		
Notes payable and current maturities of long-term debt	$ 263,549	$ 145,821
Accounts payable	282,806	286,967
Accrued employee benefits	118,266	127,840
Accrued interest payable	123,204	98,395
Accrued liabilities - other	307,554	350,859
Advance billings on contracts	176,305	189,614
Provision for warranty expense	69,513	78,027
U. S. and foreign income taxes	140,509	191,027
Dividends payable	16,638	16,622
Total Current Liabilities	1,498,344	1,485,172
Deferred and Non-Current Income Taxes	391,916	414,252
Long-Term Debt	913,260	732,248
Other Liabilities	133,949	135,970
Contingencies		
Minority Interest:		
Subsidiary's Redeemable Preferred Stocks:		
Series A $2.20 cumulative convertible, $1.00 par value; at redemption value	88,300	88,300
Series B $2.60 cumulative, $1.00 par value; at redemption value	116,393	116,393
Other minority interest	4,407	5,440
Total Minority Interest	209,100	210,133
Preferred Stock	—	—
Common Stock and Other Stockholders' Equity:		
Common stock, par value $1.00 per share, authorized 150,000,000 shares; outstanding 36,973,724 at March 31, 1986 and 36,936,524 at March 31, 1985	36,974	36,936
Capital in excess of par value	313,990	313,223
Retained earnings	885,436	892,880
Cumulative foreign exchange translation adjustments	(32,027)	(40,130)
Total Common Stock and Other Stockholders' Equity	1,204,373	1,202,909
TOTAL	$ 4,350,942	$ 4,180,684

McDERMOTT INTERNATIONAL, INC.
CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS
FOR THE THREE FISCAL YEARS ENDED MARCH 31, 1986

	1986	1985	1984
		(In thousands)	
Revenues	$ 3,257,095	$ 3,233,871	$ 3,088,583
Costs and Expenses:			
Cost of operations	2,879,638	2,892,930	2,488,718
Depreciation and amortization	157,798	148,946	180,985
Selling, general and administrative expenses	307,947	300,774	297,997
	3,345,383	3,342,650	2,967,700
Operating Income (Loss)	(88,288)	(108,779)	120,883
Other Income (Expense):			
Interest income	126,697	145,661	114,346
Interest expense	(116,371)	(95,769)	(80,741)
Equity in earnings of joint-venture companies	2,126	4,488	3,218
Other-net	75,652	(894)	(17,050)
	88,104	53,486	19,773
Income (Loss) Before Provision For Income Taxes, Minority Interest and Extraordinary Items	(184)	(55,293)	140,656
Provision for (Benefit from) Income Taxes:			
Current	(48,242)	(80,372)	(87,044)
Deferred	(22,992)	(9,241)	91,586
	(71,234)	(89,613)	4,542
Income Before Minority Interest and Extraordinary Items	71,050	34,320	136,114
Minority Interest:			
Dividends on preferred stock of subsidiary	15,900	15,901	15,905
Other minority interest	(1,150)	(561)	(647)
Income Before Extraordinary Items	56,300	18,980	120,856
Extraordinary Items, net of income taxes	2,789	11,687	—
Net Income	59,089	30,667	120,856
Retained Earnings, Beginning of Year	892,880	928,686	874,209
Deduct:			
Cash dividends - common (per share, $1.80 in 1986, 1985 and 1984)	66,533	66,473	66,379
Retained Earnings, End of Year	$ 885,436	$ 892,880	$ 928,686
Earnings Per Common and Common Equivalent Share:			
Primary -			
Before Extraordinary Items	$ 1.52	$ 0.51	$ 3.06
Extraordinary Items	0.08	0.32	—
Net Earnings	$ 1.60	$ 0.83	$ 3.06
Fully Diluted -			
Before Extraordinary Items	$ 1.52	$ 0.51	$ 2.95
Extraordinary Items	0.08	0.32	—
Net Earnings	$ 1.60	$ 0.83	$ 2.95

See accompanying notes to consolidated financial statements.

McDERMOTT INTERNATIONAL, INC.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE THREE FISCAL YEARS ENDED MARCH 31, 1986

	1986	1985	1984
SOURCE OF FUNDS:		(In thousands)	
Operations:			
Income before extraordinary items	$ 56,300	$ 18,980	$ 120,856
Charges (credits) not affecting working capital:			
Depreciation and amortization	157,798	148,946	180,985
Deferred income taxes	(6,718)	70,823	26,908
Equity in earnings of joint-venture companies, net of dividends received of $2,795,000 in 1986, $5,835,000 in 1985, and $4,260,000 in 1984	669	1,347	1,042
Tax benefit of operating loss carryforwards	2,579	1,725	—
Gain on sales of government obligations	(94,712)	(17)	(40,216)
Other-net	(6,598)	(38,447)	36,582
Working capital provided from operations excluding extraordinary gain	109,318	203,357	326,157
Extraordinary gain	210	9,962	—
Issuance of common stock	627	798	916
Proceeds from sale and exchange of property, plant and equipment	11,965	39,428	16,863
Long-term borrowing (including fluctuations under the revolving credit agreement)	386,068	431,183	175,506
Reduction in non-current assets and liabilities resulting from exchange rate changes	—	20,131	22,235
Foreign currency translation adjustments	8,103	—	—
Other - net	5,553	9,599	36,375
	521,844	714,458	578,052
APPLICATION OF FUNDS:			
Purchase of government obligations - net	26,874	80,727	167,661
Additions to property, plant and equipment	298,884	172,349	147,875
Reduction of long-term debt (including fluctuations under the revolving credit agreement)	205,879	343,585	80,187
Reduction of non-current income taxes	15,618	23,327	2,268
Cash dividends	66,533	66,473	66,379
Increase in non-current assets and liabilities resulting from exchange rate changes	24,764	—	—
Acquisition of Coutinho:			
Non-current assets, principally property, plant and equipment and goodwill	—	99,690	—
Non-current liabilities, principally long-term debt and pension liability	—	(36,775)	—
Foreign currency translation adjustments	—	14,409	25,721
	638,552	763,785	490,091
NET INCREASE (DECREASE) IN WORKING CAPITAL	$ (116,708)	$ (49,327)	$ 87,961
CHANGES IN COMPONENTS OF WORKING CAPITAL:			
Increase (decrease) in current assets:			
Cash and short-term investments	$ (5,694)	$ (58,707)	$ 27,242
Accounts, notes and income tax refund receivable	(121,199)	48,050	123,153
Contracts in progress	28,119	28,658	(19,928)
Inventories	(16,611)	19,143	(33,108)
Prepaid expenses	11,849	4,628	2,109
	(103,536)	41,772	99,468
Increase (decrease) in current liabilities:			
Notes and accounts payable and accrued liabilities	85,497	225,957	36,417
Advance billings on contracts	(13,309)	(35,308)	(97,243)
Provision for warranty expense	(8,514)	(22,892)	4,556
U.S. and foreign income taxes	(50,518)	(76,676)	67,761
Dividends payable	16	18	16
	13,172	91,099	11,507
NET INCREASE (DECREASE) IN WORKING CAPITAL	$ (116,708)	$ (49,327)	$ 87,961

See accompanying notes to consolidated financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements are presented in U.S. Dollars in accordance with accounting principles generally accepted in the United States and include the accounts of McDermott International, Inc. and all significant subsidiaries. Investments in joint-venture companies (20% to 50% owned) are accounted for on the equity method. All significant intercompany transactions and accounts have been eliminated.

Unless the context otherwise requires, hereinafter "International" will be used to mean McDermott International, Inc., a Panama corporation, the "Delaware Company" will be used to mean McDermott Incorporated, a Delaware corporation, which is a subsidiary of International, and "McDermott International" will be used to mean the consolidated enterprise.

Certain amounts previously reported have been reclassified to conform with the presentation at March 31, 1986.

Contracts and Revenue Recognition

Contract revenues and related costs for marine construction services, power generation systems and equipment, and the engineering and construction services of the trading segment of McDermott International are principally recognized on a percentage of completion method for individual contracts or components thereof based upon work performed or the ratio of costs incurred to total estimated costs, as applicable to the product or activity involved. Revenues and related costs so recorded, plus accumulated contract cost that exceeds amounts invoiced to customers under the terms of the contract are included in contracts in progress. Billings that exceed accumulated contract costs and revenues and costs recognized under percentage of completion are included in advance billings. Most long-term contracts have provisions for progress payments. Contract price and cost estimates are reviewed periodically as the work progresses and adjustments proportionate to the percentage of completion are reflected in income in the period when such estimates are revised. There are no unbilled revenues which will not be billed. Provisions are made currently for all known or anticipated losses. Claims for extra work or changes in scope of work are included in contract revenues when collection is probable. International and certain of its subsidiaries keep books and file tax returns on the completed contract method of accounting.

	1986	1985
Included in Contracts in Progress are:	(In thousands)	
Costs incurred less cost of revenue recognized	$ 188,907	$ 153,985
Revenues recognized less billings to customers	107,904	114,707
Contracts in Progress	$ 296,811	$ 268,692
Included in Advance Billings on Contracts are:		
Billings to customers less revenues recognized	$ 221,776	$ 226,056
Cost of revenues recognized less costs incurred	(45,471)	(36,442)
Advance Billings on Contracts	$ 176,305	$ 189,614

McDermott International is usually entitled to financial settlements relative to the individual circumstances of deferrals or cancellations of power generation systems and equipment contracts. McDermott International does not recognize such settlements or claims for additional compensation until final settlement is reached.

Included in accounts and notes receivable are amounts representing retainages on contracts as follows:

	1986	1985
	(In thousands)	
Retainages	$ 179,346	$ 172,093
Retainages expected to be collected after one year	$ 74,131	$ 72,859

Revenues for trading are recognized as individual trades are completed. For trades-in-progress, provisional billings to customers net of costs incurred are carried in the current liabilities section of the balance sheet as advance billings on contracts.

Depreciation, Maintenance and Repairs and Drydocking Expenses

Property, plant and equipment is depreciated on the straight-line method, using estimated economic useful lives of 8 to 40 years for buildings and 2 to 28 years for machinery and equipment.

Maintenance, repairs and renewals which do not materially prolong the useful life of an asset are expensed as incurred except for drydocking costs for the marine fleet, which are estimated and accrued over the period of time between drydockings, and such accruals are charged to operations currently.

Investments in Government Obligations

At March 31, 1986 McDermott International held $1,098,792,000 (amortized cost) of primarily government securities as a long-term investment, as compared to $977,206,000 (amortized cost) at March 31, 1985. The market value of these securities was $1,334,343,000 and $965,361,000 at March 31, 1986 and March 31, 1985, respectively. The face amount at March 31, 1986 was $1,077,300,000.

Amortization of Excess of Cost Over Fair Value of Net Assets of Purchased Businesses

The excess of the cost of McDermott International's investments in The Babcock & Wilcox Company (B&W) and Coutinho, Caro & Co. KGaA ("Coutinho") over the fair value of net assets acquired is being amortized on a straight-line basis over forty years and twenty years, respectively. Excess cost arising from business combinations prior to 1971 which amounts to $6,264,000, is not being amortized because, in the opinion of management, there has been no diminution in value.

Warranty Expense

McDermott International provides for estimated future warranty expense which may be required to satisfy contractual requirements, primarily of the power generation systems and equipment segment. Such provisions are accrued relative to revenue recognition on the respective contracts. In addition, specific provisions are made where the costs of warranty are expected to significantly exceed such accruals.

Research and Development

The cost of research and development which is not performed on specific contracts is charged to operations as incurred. Such expense was $34,600,000, $41,100,000 and $34,600,000 in fiscal 1986, 1985 and 1984, respectively. In addition, expenditures on research and development activities of approximately $53,400,000, $41,600,000 and $27,000,000 in fiscal 1986, 1985 and 1984, respectively, were paid for by customers of McDermott International.

Capitalization of Interest Cost

In fiscal 1986, 1985 and 1984 total interest cost incurred was $130,258,000, $100,036,000 and $88,159,000, respectively, of which $13,887,000, $4,267,000 and $7,418,000 was capitalized.

Foreign Currency Translation

Effective April 1, 1983, McDermott International adopted FASB Statement No. 52, on Foreign Currency Translation. Under that Statement, for certain foreign operations, all balance sheet accounts other than stockholders' equity are translated into U.S. Dollars at current exchange rates, and income statement items are translated at average exchange rates for the year; resulting translation adjustments are recorded in a separate component of stockholders' equity. Certain other foreign currency transaction adjustments continue to be reported in income. The impact of adopting FASB Statement No. 52 in fiscal 1984 was not material. Included in other income (expense) are transaction losses of $9,028,000, $5,645,000 and $15,334,000 for fiscal 1986, 1985 and 1984, respectively.

Adoption of the Statement resulted in establishing a cumulative foreign exchange translation adjustments account as part of stockholders' equity. The analysis of changes in this account is as follows:

	(In thousands)
Balance March 31, 1983	$ —
Adjustments to opening balance at April 1, 1983	(17,885)
Translation adjustments for fiscal 1984	(7,836)
Balance March 31, 1984	(25,721)
Translation adjustments for fiscal 1985	(14,409)
Balance March 31, 1985	(40,130)
Translation adjustments for fiscal 1986	8,103
Balance March 31, 1986	$ (32,027)

Earnings Per Share

Primary earnings per share are based on the weighted average number of common and common equivalent shares outstanding during the year. Fully diluted earnings per share include the dilutive effect of convertible preferred stock, debentures and warrants.

NOTE 2 - ACQUISITION

On April 10, 1984, International acquired Coutinho in a business combination accounted for as a purchase. The total cost of acquisition was $80,798,000, which exceeded the fair value of the net assets of Coutinho by $42,646,000, based on exchange rates in effect at March 31, 1984. In order to provide for a timely consolidation, Coutinho's assets and liabilities at December 31, 1985 and 1984 have been included in McDermott International's Consolidated Balance Sheets at March 31, 1986 and 1985, respectively. The operations of Coutinho for the periods January 1, 1985 through December 31, 1985 and April 1, 1984 through December 31, 1984 have been included in McDermott International's Consolidated Statement of Income and Retained Earnings for the fiscal years 1986 and 1985, respectively.

Assuming that Coutinho had been acquired at the beginning of fiscal 1984, unaudited proforma combined revenues would have been $3,348,189,000 and $3,669,124,000 in fiscal 1985 and 1984, respectively. Combined proforma earnings and earnings per share would not have been materially different from the reported amounts.

NOTE 3 - INVENTORIES

Inventories are carried at the lower of cost or market. Cost is determined on an average cost basis except for certain materials inventories, for which the last-in first-out (LIFO) method is used. The cost of approximately 35% and 6% of total inventories was determined using the LIFO method at March 31, 1986 and March 31, 1985, respectively. Consolidated inventories at March 31, 1986 and 1985 are summarized below:

	1986	1985
	(In thousands)	
Raw Materials and Supplies	$ 64,686	$ 82,419
Work in Progress	97,414	112,192
Finished Goods	74,592	58,692
	$ 236,692	$ 253,303

NOTE 4 - PENSION PLANS AND POSTRETIREMENT BENEFITS

Pension Plans - McDermott International provides retirement benefits, primarily through non-contributory pension plans, for substantially all of its regular full-time employees, except certain non-resident alien employees of foreign subsidiaries who are not citizens of a European Common Market country or who do not earn income in the United States, Canada, or the United Kingdom. McDermott International's policy had been to fund the amounts expensed. Its current policy is to fund applicable pension plans to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 (ERISA) and, generally, to fund other pension plans as recommended by the respective plan actuary and in accordance with applicable law. Total pension expense was $1,970,000, $68,657,000 and $72,194,000 in fiscal 1986, 1985 and 1984, respectively, which includes amortization of prior service costs over periods of 30 and 40 years.

Based upon a comprehensive study of actuarial assumptions, effective January 1, 1985 (the beginning of each ERISA plan's fiscal year), the actuarial investment rate of return assumptions and the actuarial salary increase assumptions were changed to reflect more closely the past and expected experience of such ERISA plans. The effect of the above changes was to reduce fiscal 1986 pension expense by approximately $56,300,000, which includes $15,895,000 accrued in fiscal year 1985, and to increase net income by approximately $29,300,000 or $0.79 per share.

The following table presents information regarding the financial condition of McDermott International's pension plans as defined in FASB No. 36 and estimated by McDermott International and its consulting actuaries on that basis:

	January 1, 1985	January 1, 1984
	(In thousands)	
Actuarial present value of accumulated plan benefits:		
Vested	$ 653,089	$ 618,132
Nonvested	66,867	76,182
Total	$ 719,956	$ 694,314
Net assets available for benefits	$ 1,032,165	$ 944,724

In the above table, the assumed rate of return used in determining the actuarial present value of accumulated plan benefits was principally 9½% at January 1, 1985 and principally 9% at January 1, 1984.

In December 1985, the two principal ERISA pension plans were amended to provide that, subject to certain limitations, any excess assets in such plans would be used to increase pension benefits if certain events occurred within a 60 month period following a change in control of International.

Postretirement Health Care and Life Insurance Benefits - McDermott International offers postretirement health care and life insurance benefits to substantially all of its retired regular full-time employees, except certain non-resident alien retired employees who are not citizens of a European Common Market country or who, while employed, did not earn income in the United States, Canada or the United Kingdom. McDermott International shares the cost of providing these benefits with all affected retirees. McDermott International's cost of providing such benefits is recognized by expensing the insurance programs' premiums and the self-insured programs' claims as paid. The aggregate amount so expensed totalled $10,755,000, $8,503,000 and $6,754,000 in fiscal years 1986, 1985 and 1984, respectively. McDermott International has made no provision for recognizing the cost of postretirement benefits which may eventually be paid to employees who have not yet retired.

NOTE 5 - INCOME TAXES

Income taxes have been provided based upon the tax laws and rates in the countries in which operations are conducted. All income has been earned outside of Panama and McDermott International is not subject to income tax in Panama on income earned outside of Panama. Therefore, there is no expected relationship between the provision for, or benefit from, income taxes and income, or loss, before income taxes. The major reasons for the variations in such relationships is that income is earned within and subject to the taxation laws of various countries, each of which has a regime of taxation which varies from that of any other country (not only with respect to nominal rate but also with respect to the allowability of deductions, credits and other benefits) and because the proportional extent to which income is earned in, and subject to tax by, any particular country or countries varies from year to year.

The provision for (benefit from) income taxes consists of:

	1986		1985		1984	
	Current	Deferred	Current	Deferred	Current	Deferred
			(In thousands)			
U.S. - Federal	$ (49,789)	$ (31,232)	$ (108,851)	$ 9,133	$ (131,657)	$ 69,199
U.S. - State & Local	(4,510)	4,042	2,239	(3,926)	(6,815)	10,589
Other than U.S.	6,057	4,198	26,240	(14,448)	51,428	11,798
	$ (48,242)	$ (22,992)	$ (80,372)	$ (9,241)	$ (87,044)	$ 91,586

The provision for (benefit from) income taxes is based on income before provision for income taxes as follows:

	1986	1985	1984
		(In thousands)	
U.S.	$ (194,785)	$ (224,916)	$ (128,431)
Other than U.S.	194,601	169,623	269,087
	$ (184)	$ (55,293)	$ 140,656

U.S. Federal tax credits, principally investment tax credits, are accounted for on the flow-through method. Amounts utilized in fiscal 1986, 1985 and 1984, were $9,916,000, $6,445,000 and $12,609,000, respectively. For U.S. Federal income tax purposes, a net operating loss of $11,100,000 and tax credits, principally investment tax credits, of $58,600,000 at March 31, 1986 are available to reduce taxes payable through 2001.

Extraordinary items in 1986 and 1985 include tax benefits of $2,579,000 and $1,725,000, respectively, arising from the utilization of operating loss carryforwards. See Note 6 regarding income taxes provided on extraordinary gains arising from extinguishment of debt.

Deferred income taxes are provided in the financial statements due to timing differences between financial and taxable income. The principal timing differences in recognizing certain revenues, expenses and tax credits for tax return and financial statement purposes and their effect on the provision for deferred income taxes were:

	1986	1985	1984
		(In thousands)	
Excess tax over financial depreciation	$ 35,495	$ 33,612	$ 21,615
Interest capitalized on self-constructed assets	1,196	1,408	3,517
Long-term contracts, primarily on the completed contract method for tax purposes	(11,421)	(22,061)	71,482
Warranty expense	2,107	8,903	(7,650)
Reserve for loss on facility closings and dispositions	4,258	5,600	(8,647)
Interest on proposed tax deficiencies	(11,659)	(6,990)	(10,831)
Self insurance	(3,936)	(9,295)	(840)
Antitrust settlements	133	—	4,074
Supplemental compensation	(4,203)	552	(1,721)
Pension expense	8,848	(25,574)	11,471
Purchased tax benefits	4,284	6,520	10,856
Deferred loss on casualty	—	—	(8,015)
State tax loss carryforwards net of federal tax	1,071	(3,207)	—
Tax credits	(50,047)	—	—
Other	882	1,291	6,275
	$ (22,992)	$ (9,241)	$ 91,588

The Internal Revenue Service has issued notices for years prior to March 31, 1983 and a draft report for the year ended March 31, 1983 all of which propose substantial additional taxes. McDermott International believes that the outcome of any income taxes ultimately assessed will not have a material adverse effect on its consolidated financial statements.

NOTE 6 - LONG-TERM DEBT AND NOTES PAYABLE

Long-term debt consists of:

	1986	1985
	(In thousands)	
Unsecured Debt:		
8.27% Note due 1991 with annual sinking fund installments of $15,000,000 beginning 1989	$ 45,000	$ 45,000
10.20% Sinking fund debentures due 1999 with annual sinking fund installments of $2,500,000	37,450	37,550
10% Subordinated debentures ($149,921,000 face amount in 1986) due 2003 with annual sinking fund installments of $15,000,000 beginning 1994	126,247	125,426
9⅝% Debentures due 2004	6,718	53,415
6.80% Pollution control revenue bonds due 2009 with annual sinking fund installments of $4,250,000 beginning 2006	17,000	17,000
8½% Note payable $3,960,000 annually to 1997	44,160	48,120
9% Note payable $3,300,000 annually to 1991	20,300	23,600
9% Note payable $1,650,000 annually to 1996	18,400	20,050
Floating rate note, due four hundred calendar days after demand, interest at daily federal funds rate plus 1.10% (9.16% inclusive at March 31, 1986)	35,000	35,000
Floating rate notes ($150,000,000 face value), interest at LIBOR plus 0.125% (7.625% inclusive at March 31, 1986) due 1992	149,522	149,438
Floating rate note, due four hundred calendar days after demand, interest at daily federal funds rate plus 0.75% (8.75% inclusive at March 31, 1986)	50,000	—
Floating rate note, interest at LIBOR plus 0.75% (8.75% inclusive at March 31, 1986) due 1989	26,500	—
Floating rate note, interest at LIBOR plus 0.5% (8.50% inclusive at March 31, 1986) due 1988	25,250	—
Term loan (line of credit revolver loan in fiscal 1985)	175,000	124,000
Other notes payable through 2009	21,568	17,017
Secured Debt:		
10.375% Note payable	157,000	17,995
Capitalized lease obligations	17,514	18,496
Other notes payable through 1996	13,387	14,192
	986,016	746,299
Less due within one year	72,756	14,051
	$ 913,260	$ 732,248

During fiscal 1986, the Delaware Company's revolving credit agreement with various banks converted to a $200,000,000 term loan. The term loan is repayable in sixteen equal quarterly installments on March 31, June 30, September 30, and December 31. The first such installment was paid on December 31, 1985 and the final installment is due September 30, 1989. The term loan bears interest at the applicable rate of ¼ of 1% plus the prime rate, ¾ of 1% plus LIBOR or ¾ of 1% plus the certificate of deposit rate, as elected by the Delaware Company. As of March 31, 1986, $175,000,000 was outstanding, at an interest rate of 8.31%.

McDermott International's $157,000,000 long-term loan at an interest rate of 10.375% is secured by a portion of McDermott International's portfolio of government obligations which must amount to a fair market value of at least $108,645,000. The principal is repayable in twenty ascending payments commencing in fiscal 1989.

During fiscal 1986, the Delaware Company redeemed at a discount $46,697,000 principal amount of its 9⅝% Debentures. This purchase in fiscal 1986 resulted in an extraordinary gain of $210,000, net of current income taxes of $179,000. A purchase of 9⅝% Debentures together with a minor debt extinguishment in fiscal 1985 resulted in an extraordinary gain of $9,962,000 net of current taxes of $8,486,000.

Maturities of long-term debt during the five fiscal years subsequent to March 31, 1986 are as follows: 1987 - $72,756,000; 1988 - $68,966,000; 1989 - $112,305,000; 1990 - $92,263,000; 1991 - $41,985,000.

Certain consolidated subsidiaries and affiliated companies are restricted, principally as a result of credit agreement covenants, in their ability to transfer funds to International through intercompany loans, advances or cash dividends. At March 31, 1986, approximately $811,995,000 of the net assets of such subsidiaries and affiliated companies were subject to such restrictions. It is not expected that these restrictions will have any significant practical effect on International's liquidity.

A certain debt agreement contains among other things, requirements as to maintenance of net worth and limitations on the incurrence of future borrowings. Under the most restrictive of these requirements at March 31, 1986, future borrowings were restricted in an amount equal to $60,499,000.

International and certain of its subsidiaries at March 31, 1986 had available unused short-term lines of credit from various banks totalling approximately $288,213,000.

Current notes payable to banks at March 31, 1986 and 1985 were $129,359,000 and $131,770,000, respectively. At March 31, 1986, other current notes payable of $61,434,000 were secured by $52,750,000 par value of government obligations.

NOTE 7 - CONTINGENCIES AND COMMITMENTS

Litigation - In March 1986, legal action involving claims by Exxon Corporation and affiliated companies against Brown & Root, Inc. and the Delaware Company under Sections 1 and 2 of the Sherman Act was settled. This was the last of 79 actions which were filed in or (unless earlier terminated) transferred to the United States District Court for the Eastern District of Louisiana, instituted by or on behalf of purchasers and alleged purchasers of marine construction services in the United States and abroad, alleging a combination and conspiracy to restrain or eliminate competition in marine construction in violation of Sections 1 and 2 of the Sherman Act and various state laws through a conspiracy to allocate contracts, fix prices and contract terms and other means. The Delaware Company and International have paid a total of approximately $94,000,000 in settlement of purchasers' claims.

International and certain of its officers, directors and subsidiaries are defendants in numerous legal proceedings. Management and general counsel believe that the outcome of these proceedings will not have a material adverse effect upon the consolidated financial statements.

Operating Leases - Future minimum payments required under operating leases that have initial or remaining noncancellable lease terms in excess of one year at March 31, 1986 are as follows: 1987 - $19,600,000; 1988 - $16,100,000; 1989 - $11,800,000; 1990 - $8,500,000; 1991 - $7,200,000; and thereafter - $51,000,000. Future minimum lease payments and leased property under capital leases are not material. Total rental expense for fiscal 1986, 1985 and 1984 was $76,944,000, $116,644,000 and $105,939,000, respectively. These expense figures include contingent rentals and are net of sublease income, both of which are not material.

Other - McDermott International performs significant amounts of work for the U.S. Government under both prime contracts and subcontracts and thus is subject to continuing reviews by governmental agencies.

Firm and contemplated commitments for capital expenditures amounted to approximately $87,861,000 at March 31, 1986.

Cost reduction programs are being undertaken which may cause near-term operating results to be adversely affected by additional expenses and possible write-downs in operating assets.

McDermott International is contingently liable under standby letters of credit totalling $277,177,000 at March 31, 1986 issued in the normal course of business.

NOTE 8 - SUBSIDIARY'S REDEEMABLE PREFERRED STOCKS

At March 31, 1986 and 1985, 13,000,000 shares of Delaware Company preferred stock, with a par value of $1 per share, were authorized. Of the authorized shares, 2,825,554 and 3,724,629 shares of Series A and Series B Preferred Stock, respectively, were outstanding at March 31, 1986 and 2,825,556 and 3,724,629 shares, respectively, were outstanding at March 31, 1985. The outstanding shares are entitled to $31.25 per share in liquidation.

The outstanding shares were issued in connection with the acquisition of B&W and are stated at the mandatory redemption value which approximated market value at the time the shares were issued. Both series of preferred stock are entitled to general voting rights of one-half vote for each share. The Board of Directors of the Delaware Company may authorize additional series of preferred stock and may set terms of each new series except that the Delaware Company cannot create any series of stock senior to the existing Series A and Series B Preferred Stock without the consent of the holders of at least 50% of the shares of such preferred stock.

Each share of the outstanding Series A Preferred Stock is convertible into one share of common stock of International plus $0.10 cash. The shares are redeemable at the option of the Delaware Company on or after March 31 of each of the following years, at the following prices, plus accrued dividends: 1986 - $32.35; 1987 - $31.97; 1988 - $31.62; and 1989 through 2008 - $31.25. On March 31, 1989 and on March 31 of each subsequent year through 2008, the Delaware Company is obligated to redeem, at a redemption price of $31.25 plus accrued dividends, 5% of the number of shares which are issued at December 31, 1988. Based on the number of shares issued at March 31, 1986, the obligation to redeem Series A Preferred Stock is $9,804,000 for each of the fiscal years 1989 through 1991.

Series B Preferred Stock is redeemable at the option of the Delaware Company on or after March 31 of each of the following years, at the following prices plus accrued dividends: 1986 - $31.50; and 1987 through 2008 - $31.25. On March 31 of each of the fiscal years 1987 through 1995, March 31 of each of the fiscal years 1996 through 2006, and March 31 of each of the fiscal years 2007 and 2008, the Delaware Company is obligated to redeem 315,877, 252,702 and 189,526 shares of Series B Preferred Stock issued, respectively. The obligation to redeem Series B Preferred Stock is $9,950,000 in fiscal year 1987 and $9,871,000 for each of the fiscal years 1988 through 1991. The Delaware Company applied 315,877 shares of Series B Preferred Stock that it owned to satisfy the March 31, 1986 mandatory sinking fund obligation.

Additional shares of Series A or Series B Preferred Stock, equal to the number of shares the Delaware Company is obligated to redeem, may be redeemed on each mandatory redemption date by the Delaware Company, on a non-cumulative basis. The Delaware Company may apply to the mandatory sinking fund obligations any Series A or B Preferred Stock owned, previously redeemed or surrendered for conversion which have not been previously credited against the mandatory sinking fund obligations. At March 31, 1986, 42,863 shares of Series A Preferred Stock have been converted and the Delaware Company owned 3,449,128 and 2,277,039 shares of Series A and Series B Preferred Stock, respectively.

NOTE 9 - CAPITAL STOCK

Common Stock - Changes in common stock during the three years ended March 31, 1986 are summarized as follows:

	Shares	Par Value	Capital in Excess of Par Value
	(In thousands except for share data)		
Balance, March 31, 1983	36,861,493	$ 36,861	$ 310,242
Shares issued upon conversion of Series A $2.20 cumulative convertible preferred stock	2,260	2	72
Shares issued upon exercise of stock options	39,368	40	796
Shares issued upon exercise of warrants	1,330	1	29
Deferred career executive stock plan expense (net of forfeitures)	(880)	(1)	736
Balance, March 31, 1984	36,903,571	$ 36,903	$ 311,875
Shares issued upon conversion of Series A $2.20 cumulative convertible preferred stock	609	1	18
Shares issued upon exercise of stock options	31,284	31	739
Shares issued upon exercise of warrants	2,600	2	53
Deferred career executive stock plan expense (net of forfeitures)	(1,540)	(1)	538
Balance, March 31, 1985	36,936,524	$ 36,936	$ 313,223
Shares issued upon conversion of Series A $2.20 cumulative convertible preferred stock	2	—	—
Shares issued upon exercise of stock options	37,118	38	542
Shares issued upon exercise of warrants	80	—	2
Deferred career executive stock plan expense	—	—	223
Balance, March 31, 1986	36,973,724	$ 36,974	$ 313,990

At March 31, 1986 and 1985, 58,535,582 and 10,773,021 shares of common stock, respectively, were reserved for issuance in connection with exercise of warrants, exercise of rights, the 1974 Career Executive Stock Plan, exercise of stock options, the 1983 Long-Term Performance Incentive Compensation Program and conversion of Series A Preferred Stock.

International Rights - On December 30, 1985, each holder of common stock received a dividend distribution of one Right for each outstanding share of common stock. The Rights currently trade with the common stock and at March 31, 1986 International had outstanding Rights to purchase 37,073,724 shares of its common stock at a price of $50 per share subject to anti-dilution adjustments. The Rights will become exercisable and will detach from the common stock 10 days after a person or a group either becomes the beneficial owner of 20 percent or more of the outstanding common stock, or commences or announces an intention to commence a tender or exchange offer for 30 percent or more of the outstanding common stock. If thereafter the acquiring person or group engages in certain self-dealing transactions, holders of Rights may purchase at the exercise price that number of shares of common stock having a market value equal to twice the exercise price. In the event International merges with or transfers 50 percent or more of its assets or earnings to any person after the Rights become exercisable, holders of Rights may purchase at the exercise price that number of shares of common stock of the acquiring entity having a market value equal to twice the exercise price. The Rights are redeemable by International and expire on December 30, 1995.

International Warrants - At March 31, 1986 and March 31, 1985, International had outstanding warrants to purchase 5,995,990 shares and 5,996,070 shares, respectively, of its common stock exercisable by the payment per share of $25 cash or $25 principal amount of the Delaware Company's 10% Subordinated debentures due 2003. The International warrants expire on April 1, 1990 or as early as April 1, 1988 if the International common stock trades at not less than 125% of the warrant exercise price for a specified period of time.

Stock Options - In connection with the acquisition of B&W, options granted under a B&W stock option plan became options to purchase two shares of the Delaware Company's common stock. Effective March 15, 1983, this plan was adopted as a plan of International. During fiscal 1986, 1985 and 1984, 35,625, 11,460 and 23,755 non-qualified stock options were exercised at a price of $6.813 or $9.688 per share. No further options can be granted under the plan and at March 31, 1986 no options were outstanding.

Long-Term Performance Incentive Compensation Programs - Under the program which was adopted February 8, 1983, the Career Executive Stock Plan Committee (the "Committee") may grant to the officers and key employees options to purchase in the aggregate up to 2,000,000 shares of common stock at 100% of the fair market value on the date of grant. Options are exercisable not less than one year and not more than ten years after the date of grant. The Committee may grant stock appreciation rights in connection with the granting of options under the program. Such stock appreciation rights permit the holders thereof to surrender exercisable options in exchange for shares of common stock having a fair market value on the date of such surrender equal to the excess (up to, but not greater than, the fair market value of the underlying shares on the date of grant) of the fair market value on such date of the shares to which such surrendered option relates over the aggregate option price under the related options. The Committee may, at its discretion, grant holders of stock appreciation rights the right to receive up to 50% of such excess in cash in lieu of shares of common stock. The program also authorizes the Committee to grant performance unit awards which are earned by the achievement of performance standards established by the Committee. Performance units are paid in cash or shares of common stock or both at the discretion of the Committee. At March 31, 1986, 1985 and 1984 stock option and stock appreciation rights awards of 1,031,560, 309,590 and 362,165 shares, respectively, were awarded and outstanding at an average price of $18.3467 per share. During fiscal 1986, 733,320 stock options and stock appreciation rights were awarded. During fiscal 1985 and 1984, no stock options or stock appreciation rights were awarded. Awards relating to 3,755, 2,030 and 15,935 shares were forfeited during fiscal 1986, 1985 and 1984, respectively. Charges (credits) to income with respect to stock appreciation rights and performance units were $(2,257,000), $(1,891,000) and $5,030,000 during fiscal 1986, 1985 and 1984, respectively.

Career Executive Stock Plan - This plan, which was adopted as a plan of International effective March 15, 1983, originally authorized 600,000 shares of common stock to be issued to eligible employees in consideration of their services. Employees granted stock under the plan pay $1.00 per share as the option purchase price. Restrictions with respect to issued shares lapse in approximately equal amounts on the second through tenth anniversary dates of the date of issuance. The cost of the plan, based on fair market value on the date of issuance of common stock, is amortized over a ten year period following the date of issuance. Unamortized career executive stock plan expense included in capital in excess of par value at March 31, 1986, 1985 and 1984 amounted to $742,000, $965,000 and $1,548,000, respectively. Upon forfeiture of stock by employees, previous expense attributable to unvested stock is credited to income. During 1986 no shares were forfeited under the plan. During 1985 and 1984, 1,540 and 880 shares, respectively, were forfeited under the plan. As of June 30, 1984, no further awards could be made under the plan. Charges to income under the plan were $223,000, $538,000 and $736,000 during fiscal 1986, 1985 and 1984, respectively.

International Preferred Stock - At March 31, 1986 and 1985, 25,000,000 shares of preferred stock were authorized and International had issued 100,000 shares of Series A participating preferred stock (the "Participating Preferred Stock") and 100,000 shares of Series B non-voting preferred stock (the "Non-Voting Preferred Stock"), all of which are owned by the Delaware Company. The annual per share dividend rates for the Participating Preferred Stock and the Non-Voting Preferred Stock are $10 (but no more than ten times the amount of the per share dividend on International common shares) and $20, respectively, payable quarterly, and dividends on such shares are cumulative to the extent not paid. In addition, shares of Participating Preferred Stock are entitled to receive additional dividends whenever dividends in excess of $3.00 per International Share are declared (or deemed to have been declared) in any fiscal year. The Participating Preferred Stock, as a class, shall be entitled to an aggregate number of votes equal to 10% of the total number of votes entitled to be cast on any matter by the stockholders of International.

The issuance of additional International preferred stock in the future and the specific terms thereof, such as the dividend rights, conversion rights, voting rights, redemption prices and similar matters, may be authorized by the Board of Directors of International without stockholder approval, except to the extent such approval may be required by applicable rules of the New York Stock Exchange or applicable law. If additional preferred stock is issued, such additional shares will rank senior to International common stock as to dividends and upon liquidation.

NOTE 10 - SEGMENT REPORTING

McDermott International operates primarily in four industry segments — Marine Construction Services; Power Generation Systems and Equipment; Engineered Materials; and Trading.

Marine Construction Services principally involves the construction of specialized offshore platforms and marine pipelines used for development drilling, production and transportation of oil and gas.

Power Generation Systems and Equipment includes individually engineered complete fossil fuel boilers, nuclear steam systems, nuclear fuel and nuclear fuel assemblies, specially engineered accessories and components, control and performance computers, replacement parts and customer services and associated equipment for electric utility applications as well as fossil fuel boilers for industrial processes and power generation.

Engineered Materials consists of tubular and insulating products designed and manufactured from basic and raw materials. Tubular products include stainless, alloy and carbon steel, seamless and welded tubes, tubular and solid shapes, extrusions, special metal tubes, and seamless rolled rings. Insulating products include specially engineered and vacuum formed ceramic fibers, insulating and specialty firebrick, fire protection insulation, plastics, mortars, castables and special oxide refractories.

Trading consists primarily of buying and selling iron and steel products, non-ferrous materials, chemical products, cables and equipment for electric power distribution, tools, machinery and utility vehicles, aromatics, olefins, plastics and fine chemicals, as well as the engineering and construction operations of Coutinho.

Identifiable assets by industry segment are those assets that are used in operations in each segment. Corporate assets are principally cash, short-term investments and marketable securities.

Intersegment sales are accounted for at prices which are generally established by reference to similar transactions with unaffiliated customers.

Revenues attributable to transactions with unconsolidated joint-venture companies were $53,403,000, $22,327,000 and $20,172,000 in fiscal 1986, 1985 and 1984, respectively. In addition, interest income of $10,160,000 on a note from a joint-venture company and a gain of approximately $5,100,000 on the sale of certain fixed assets to joint-venture companies were recognized in fiscal year 1985.

In each of the fiscal years 1986, 1985 and 1984, the U.S. Government accounted for approximately 13% of total revenues. These revenues are included in the Power Generation Systems and Equipment segment.

Operating income (loss) does not reflect provisions of $5,290,000, $3,807,000 and $41,398,000 made by McDermott International in fiscal 1986, 1985 and 1984, respectively, to cover the closing of certain of its marine, power generation systems and equipment and engineered materials facilities. Such provisions are included in the other income (expense) section of the income statement as other-net.

Operating income (loss) in fiscal 1984 includes amounts of $27,996,000 in marine construction services and $3,560,000 in engineered materials, for accelerated depreciation on equipment which was considered to be obsolete and have diminished cost effectiveness.

Segment Information For the Three Fiscal Years Ended March 31, 1986.

1. Information about McDermott International's Operations in Different Industry Segments.

	(In thousands)		
	1986	1985	1984
Revenues[1]			
Marine Construction Services	$ 908,186	$ 1,045,938	$ 1,191,349
Power Generation Systems & Equipment	1,447,394	1,413,481	1,579,327
Engineered Materials	310,814	385,592	373,778
Trading	655,145	435,924	—
Intersegment Transfer Eliminations	(64,444)	(47,064)	(55,871)
Total Revenues	$ 3,257,095	$ 3,233,871	$ 3,088,583
Operating Income (Loss)[2]			
Marine Construction Services	$ (30,196)	$ (8,293)	$ 91,121
Power Generation Systems & Equipment	37,747	15,345	135,477
Engineered Materials	(31,289)	(39,843)	(19,222)
Trading	(536)	(4,137)	—
Total Operating Income (Loss)	$ (24,274)	$ (36,928)	$ 207,376

(1) Segment revenues include intersegment transfers as follows:

Marine Construction Services	$ 12,028	$ —	$ —
Power Generation Systems & Equipment	2,809	607	334
Engineered Materials	34,036	41,961	55,537
Trading	15,571	4,496	—
Total	$ 64,444	$ 47,064	$ 55,871

(2) Reconciling items between Operating Income (Loss) and Income (Loss) Before Provision for Income Taxes, Minority Interest and Extraordinary Items are General Corporate Expenses and Other Income (Expense).

(In thousands)

	1986	1985	1984
Capital Expenditures			
Marine Construction Services	$ 231,408	$ 107,514	$ 54,158
Power Generation Systems & Equipment	36,102	39,212	28,049
Engineered Materials	21,791	21,693	62,436
Trading	2,376	550	—
Corporate	7,207	3,380	3,232
Total Capital Expenditures	$ 298,884	$ 172,349	$ 147,875
Depreciation and Amortization			
Marine Construction Services	$ 90,008	$ 83,184	$ 116,288
Power Generation Systems & Equipment	35,119	32,678	35,709
Engineered Materials	23,471	22,928	21,616
Trading	4,123	2,656	—
Corporate	5,077	7,500	7,372
Total Depreciation and Amortization	$ 157,798	$ 148,946	$ 180,985
Identifiable Assets			
Marine Construction Services	$ 1,166,129	$ 1,039,835	$ 1,015,057
Power Generation Systems & Equipment	1,179,135	1,177,221	1,174,994
Engineered Materials	504,521	525,682	535,703
Trading	285,683	229,780	—
Corporate	1,215,474	1,208,166	1,255,360
Total Identifiable Assets	$ 4,350,942	$ 4,180,684	$ 3,981,114

2. Information about McDermott International's Operations in Different Geographic Areas.

(In thousands)

		1986	1985	1984
Revenues (1)	- United States	$ 1,956,842	$ 1,967,866	$ 1,975,232
	- Europe and West Africa	812,446	697,709	433,697
	- Other Foreign	487,807	568,296	679,654
	- Total	$ 3,257,095	$ 3,233,871	$ 3,088,583
Operating Income (Loss) (2)	- United States	$ (53,510)	$ (109,314)	$ 37,263
	- Europe and West Africa	32,611	30,455	64,772
	- Other Foreign	(3,375)	41,931	105,341
	- Total	$ (24,274)	$ (36,928)	$ 207,376
Identifiable Assets	- United States	$ 1,898,988	$ 1,894,195	$ 1,853,895
	- Europe and West Africa	857,293	653,344	482,671
	- Other Foreign	379,187	424,979	389,188
	- Corporate	1,215,474	1,208,166	1,255,360
	- Total	$ 4,350,942	$ 4,180,684	$ 3,981,114

(1) Transfers between geographic areas are immaterial and not separately stated.

(2) Reconciling items between Operating Income (Loss) by Geographic Areas and Income (Loss) Before Provision for Income Taxes, Minority Interest and Extraordinary Items are General Corporate Expenses and Other Income (Expense).

NOTE 11 - QUARTERLY FINANCIAL DATA

The following tables set forth selected unaudited quarterly financial information for the years ended March 31, 1986 and 1985:

	1986 Quarter Ended			
	June 30, 1985	Sept. 30, 1985	Dec. 31, 1985	March 31, 1986
	(In thousands except for per share amounts)			
Revenues	$ 773, 530	$ 802,944	$ 829,117	$ 851,504
Operating income (loss)	(48,852)	(23,191)	(1,415)	(14,830)
Income (loss) before extraordinary items	(1,077)	357	38,750	18,270
Net income (loss)	(1,077)	357	38,750	21,059
Earnings (loss) per share:				
Primary				
Before extraordinary items	(0.03)	0.01	1.05	0.49
Net income (loss)	(0.03)	0.01	1.05	0.57
Fully Diluted				
Before extraordinary items	(0.03)	0.01	1.01	0.49
Net income (loss)	(0.03)	0.01	1.01	0.57

For the quarter ended March 31, 1986, net income includes charges of $15,386,000 relating to the settlement of certain antitrust civil litigation and gains of $24,340,000 for sale of government obligations.

	1985 Quarter Ended			
	June 30, 1984	Sept. 30, 1984	Dec. 31, 1984	March 31, 1985
	(In thousands except for per share amounts)			
Revenues	$ 707,319	$ 812,823	$ 823,855	$ 889,874
Operating income (loss)	2,813	(29,529)	(14,664)	(67,399)
Income (loss) before extraordinary items	22,952	2,094	48,544	(54,610)
Net income (loss)	22,952	2,094	48,544	(42,923)
Earnings (loss) per share:				
Primary				
Before extraordinary items	0.58	0.06	1.18	(1.48)
Net income (loss)	0.58	0.06	1.18	(1.16)
Fully Diluted				
Before extraordinary items	0.58	0.06	1.14	(1.48)
Net income (loss)	0.58	0.06	1.14	(1.16)

For the quarter ended March 31, 1985, net loss includes charges of $22,289,000 relating to the settlement of certain antitrust civil litigation, $6,102,000 for unfavorable performance on a major contract in domestic marine operations and $3,815,000 for increased workers' compensation benefits due primarily to increased liabilities in certain self insured programs. Net loss also reflects higher than anticipated operating costs in most areas of McDermott International's business. Net loss also reflects an extraordinary gain of $11,687,000 resulting primarily from the extinguishment of certain debt (see Note 6).

NOTE 12 - EFFECTS OF CHANGING PRICES (Unaudited)

In compliance with FASB Statement No. 33, "Financial Reporting and Changing Prices" (as amended by FASB Statement No. 82), certain supplementary information relating to the effects of changing prices is presented below. The information adjusted for changes in specific prices is calculated by adjusting cost of sales and depreciation expense for changes in those prices that relate to property, plant and equipment, and inventory being used in the activities of the business. No other items of revenue or expense in the Condensed Consolidated Statement of Income are adjusted.

Depreciation expense included in income adjusted for changes in specific prices is computed using the same depreciation methods and depreciable lives as are used for conventional financial statements.

Any comparison between the conventional financial statements and the required supplemental disclosures must be viewed with caution. The amounts shown adjusted for changes in specific prices include the use of estimates and assumptions. Changes in individual prices are caused in part by changes in the general purchasing power of the dollar and in part by other supply and demand factors including technological change.

The benefit from income taxes remains unchanged because tax laws do not allow McDermott International to claim tax deductions related to these adjustments.

The gain from the decline in purchasing power of net amounts owed reflects the fact that total liabilities having a future fixed cash settlement exceeded total assets with similar characteristics. This unrealized gain theoretically represents the fact that net liabilities can be repaid with dollars having a lesser value than at the beginning of the year due to inflation.

The increase (decrease) in specific prices of inventories and property, plant and equipment represents the difference between the current cost amounts at the beginning of the year and the end of the year. Part of the difference is attributable to inflation in general and part is attributable to economic factors affecting the individual prices of the particular assets owned. To the extent that the difference has been realized by a sale during the year, it is included in income from operations on a current cost basis. The unrealized portion does not represent receipt (disbursement) of cash and should not be considered as providing (reducing) funds for reinvestment or dividend distribution in the current period.

The net assets shown under changes in specific prices are adjusted only for changes in inventory and property, plant and equipment.

CONDENSED CONSOLIDATED STATEMENT OF INCOME ADJUSTED FOR EFFECTS OF CHANGING PRICES FISCAL YEAR ENDED MARCH 31, 1986

(In thousands except for per share amounts)

	As Reported in the Conventional Financial Statements	Adjusted for Changes in Specific Prices (Current Costs)
Revenues	$ 3,257,095	$ 3,257,095
Cost and Expenses		
Cost of operations	2,879,638	2,887,029
Depreciation and amortization	157,798	199,526
Selling, general and administrative expenses	307,947	307,947
Other Income	88,104	88,104
Income (Loss) Before Provision for Income Taxes, Minority Interest and Extraordinary Items	(184)	(49,303)
Benefit from Income Taxes	71,234	71,234
Minority Interest	(14,750)	(14,750)
Extraordinary Gain, Net of Tax	2,789	2,789
Net Income	$ 59,089	$ 9,970
Income per common and common equivalent share (Primary)	$ 1.60	$ 0.27
Gain from decline in purchasing power of net amounts owed		$ 11,573
Increase in current cost of inventory and property, plant and equipment held during the year (based on specific price changes)*		$ 66,125
Effects of increase in general price level		$ (39,202)
Increase in current cost of inventory and property, plant and equipment held during the year (based on specific price changes) net of changes in the general price level		$ 26,923
Net assets at year end	$ 1,204,373	$ 1,508,811

* At March 31, 1986 current cost of inventory was $248,917 and current cost of property, plant and equipment, net of accumulated depreciation was $1,598,145.

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES

(In thousands except for indices and per share amounts)

(In average for the year dollars)

	For Fiscal Year Ended March 31, 1986	1985	1984	1983	1982
	Adjusted for Changes in Specific Prices (Current Costs)				
Net income (loss)	$ 9,970	$ (20,685)	$ 33,709	$ (9,472)	$ 101,119
Net income (loss) per common and common equivalent share	.27	(0.56)	.98	(0.26)	2.73
Net assets at year end	1,508,811	1,590,777	1,733,005	1,854,566	1,996,261
Increase (decrease) in current cost of inventory and property, plant and equipment held during the year, (based on specific price changes) net of changes in the general price level	26,923	85,924	(1,175)	(30,055)	31,474
Other information:					
Gain from decline in purchasing power of net amounts owed	11,573	16,407	24,083	26,160	54,113
Cash dividends per common share	1.80	1.86	1.93	2.01	1.91
Market price per common share at year end	16⅝	26⅝	33⅞	20⅝	25⅞
Average consumer price index	324.7	313.9	301.7	291.7	277.4

Item 9. DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

There are no family relationships between any of the executive officers, directors or persons nominated to be such, and no executive officer was elected to his position pursuant to any arrangement or understanding between himself and any other person.

Information required by this item with respect to directors and executive officers is incorporated by reference to the material appearing under the headings "Election of Directors" in the Proxy Statement for the 1986 Annual Meeting of Shareholders.

Item 11. EXECUTIVE COMPENSATION

Information required by this item is incorporated by reference to the material appearing under the heading "Cash Compensation of Executive Officers and Certain Relationships and Related Transactions" in the Proxy Statement for the 1986 Annual Meeting of Shareholders.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information required by this item is incorporated by reference to the material appearing under the heading "Election of Directors" in the Proxy Statement for the 1986 Annual Meeting of Shareholders.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information required by this item is incorporated by reference to the material appearing under the heading "Cash Compensation of Executive Officers and Certain Relationships and Related Transactions" in the Proxy Statement for the 1986 Annual Meeting of Shareholders.

PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

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Consolidated Financial Statements

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Consolidated Financial Schedules

All required schedules will be filed by amendment to this Form 10-K on Form 8.

Exhibit Index

3 Articles of Incorporation and By-Laws (Items 3(a) and 3(b) are incorporated by reference to Exhibit 3 to the Company's annual report on Form 10-K, as amended, for the fiscal year ended March 31, 1983).
(a) The Company's Restated Certificate of Incorporation
(b) The Company's By-Laws

4(a) Warrant Agreement (incorporated by reference to Exhibit 4 to the Company's annual report on Form 10-K, as amended, for the fiscal year ended March 31, 1983).

4(b) Rights Agreement (incorporated by reference to Exhibit 1 to the Company's registration statement on Form 8-A, dated December 27, 1985).

10 Material Contracts (Exhibits 10(a) through 10(b) and 10(d) through 10(g) are incorporated by reference to Exhibit 10 to the Company's annual report on Form 10-K, as amended, for the fiscal year ended March 31, 1983 and Exhibit 10(c) is incorporated by reference to Exhibit 10 to the Company's annual report on Form 10-K, as amended, for the fiscal year ended March 31, 1984).

(a) Supplemental Executive Retirement Plan
(b) 1983 Long-Term Performance Incentive Compensation Program
(c) Supplemental Compensation Plan
(d) Restoration of Retirement Income Plan for Certain Participants in the Retirement Plan for Employees of McDermott International, Inc.
(e) Career Executive Stock Plan — 1974
(f) 1972 Stock Option Plan
(g) Intercompany Agreement
(h) Trust for Supplemental Executive Retirement Plan (including employment agreement with J.E. Cunningham) will be filed by amendment to this Form 10-K on Form 8.

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FORM 8-K REPORTS

Report on Form 8-K, Item 5 was reported, but no financial statements were filed in connection with International's current report on Form 8-K dated April 4, 1986.

EXHIBIT 11

McDERMOTT INTERNATIONAL, INC.
STATEMENT RE COMPUTATION OF PER SHARE EARNINGS
FOR THE THREE FISCAL YEARS ENDED MARCH 31, 1986

(In thousands, except shares and per share amounts)

Primary

	1986	1985	1984
Net Income	$ 59,089	$ 30,667	$ 120,856
Interest and amortization of debt expense on 10% Subordinated debentures due 2003 (net of taxes)	—	—	6,337
Net income for primary computation	$ 59,089	$ 30,667	$ 127,193
Weighted average number of common shares outstanding during the year	36,958,187	36,926,227	36,902,499
Common stock equivalents of stock options, stock appreciation rights and performance units based on "treasury stock" method	24,056	137,262	111,855
Shares applicable to warrants	—	—	4,507,515
Weighted average number of common and common equivalent shares outstanding during the year	36,982,243	37,063,489	41,521,869
Earnings per common and common equivalent share	$ 1.60	$ 0.83	$ 3.06

Fully Diluted

	1986	1985	1984
Net income	$ 59,089	$ 30,667	$ 120,856
Interest and amortization of debt expense on 10% Subordinated debentures due 2003 (net of taxes)	—	—	8,445
Dividends on Subsidiary's Series A $2.20 Cumulative Convertible Preferred Stock assuming conversion to Common Stock	—	—	6,221
Net income for fully diluted computation	$ 59,089	$ 30,667	$ 135,522
Weighted average number of common shares outstanding during the year	36,958,187	36,926,227	36,902,499
Common stock equivalents of stock options, stock appreciation rights and performance units based on "treasury stock" method	24,071	143,310	191,458
Shares applicable to warrants	—	—	5,998,670
Shares applicable to Subsidiary's Series A $2.20 Cumulative Convertible Preferred Stock	—	—	2,827,995
Weighted average number of common and common equivalent shares outstanding during the year, assuming full dilution	36,982,258	37,069,537	45,920,622
Earnings per common and common equivalent shares assuming full dilution	$ 1.60	$ 0.83	$ 2.95

Fully diluted earnings per share includes only computations which cause dilution.

McDERMOTT INTERNATIONAL, INC.
SIGNIFICANT SUBSIDIARIES OF THE REGISTRANT
FISCAL YEAR ENDED MARCH 31, 1986

Name of Company	Organized Under the Laws of	Percentage of Voting Shares Owned
McDermott International Investments Co., Inc.	Panama	100
Northern Marine Services, Inc.	Panama	100
McDermott Incorporated	Delaware	92
Marine Contractors, Inc.	Panama	100
The Babcock & Wilcox Company	Delaware	100

The subsidiaries omitted from the foregoing list do not, considered in the aggregate, constitute a significant subsidiary.

CONSENT OF CERTIFIED PUBLIC ACCOUNTANTS

We consent to the incorporation by reference in the Registration Statement (Form S-3 No. 33-4631 and 22-15078) of McDermott Incorporated and in the related Prospectus and in the Registration Statement (Form S-8 No. 2-83692) of McDermott International, Inc. and in the related Prospectus of our report dated May 23, 1986 with respect to the consolidated financial statements of McDermott International, Inc. included in this Annual Report (Form 10-K) for the year ended March 31, 1986.

ARTHUR YOUNG & COMPANY

New Orleans, Louisiana
May 23, 1986

SIGNATURES OF THE REGISTRANT

Pursuant to the requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

McDERMOTT INTERNATIONAL, INC.
(Registrant)

May 28, 1986	By: s/J. E. Cunningham J. E. Cunningham Chairman of the Board and Chief Executive Officer
May 28, 1986	By: s/John A. Lynott John A. Lynott Executive Vice President, Chief Financial and Administrative Officer
May 28, 1986	By: s/E. A. Robidoux E. A. Robidoux Vice President and Controller

SIGNATURES OF DIRECTORS

Pursuant to the requirements of the Securities Exchange Act of 1934, this report is signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

s/T. D. Barrow

T. D. Barrow
Director

May 28, 1986

s/J. E. Cunningham

J. E. Cunningham
Chairman of the Board and
Chief Executive Officer,
and Director

May 28, 1986

s/James L. Dutt

James L. Dutt
Director

May 28, 1986

s/R. E. Howson

R. E. Howson
President and Chief Operating
Officer, McDermott Marine
Construction, and Director

May 28, 1986

s/James A. Hunt

James A. Hunt
Director

May 28, 1986

s/John A. Lynott

John A. Lynott
Executive Vice President,
Chief Financial and
Administrative Officer,
and Director

May 28, 1986

s/J. H. Macdonald

J. H. Macdonald
Director

May 28, 1986

s/John A. Morgan

John A. Morgan
Director

May 28, 1986

s/John D. Ritchie

John D. Ritchie
Director

May 28, 1986

s/William T. Seawell

William T. Seawell
Director

May 28, 1986

s/Walter B. Shaw

Walter B. Shaw
Director

May 28, 1986

s/Walter O. Spencer

Walter O. Spencer
Director

May 28, 1986

s/John B. Tweedy

John B. Tweedy
Director

May 28, 1986

s/Walter M. Vannoy

Walter M. Vannoy
President and
Chief Operating Officer,
Babcock & Wilcox, and
Director

May 28, 1986

s/Russell L. Wagner

Russell L. Wagner
Director

May 28, 1986

Transfer Agents and Registrars

Morgan Guaranty Trust Company
of New York
30 West Broadway
New York, New York 10015

First City National Bank
of Houston
Post Office Box 809
Houston, Texas 77002

- Common Stock of McDermott International, Inc.
- Series A $2.20 Cumulative Convertible Preferred Stock of McDermott Incorporated
- Series B $2.60 Cumulative Preferred Stock of McDermott Incorporated

Trustees and Paying Agents

Morgan Guaranty Trust Company
of New York
30 West Broadway
New York, New York 10015

- 9⅝% Debentures Due March 15, 2004
- 10.20% Sinking Fund Debentures Due December 1, 1999
- Floating Rate Notes Due March 1992

Pittsburgh National Bank
Post Office Box 340747
Pittsburgh, Pennsylvania 15230

- 6.80% Pollution Control Revenue Bonds, Series A Due February 1, 2009

Trustee, Paying Agent, Warrant Agent, and Exchange Agent

Bankers Trust Company
Post Office Box 318
Church Street Station
New York, New York 10015

- 10% Subordinated Debentures Due April 1, 2003
- Warrants to purchase Common Stock of McDermott International, Inc.

Certified Public Accountants

Arthur Young & Company
1340 Poydras Street
New Orleans, Louisiana 70112
(504) 581-3131

Annual Meeting

The Annual Meeting of the Stockholders of McDermott International, Inc. for the fiscal year ended March 31, 1986 will be held at the Royal Orleans Hotel, New Orleans, Louisiana on Tuesday, August 12, 1986 at 9:30 a.m. local time.

Information

Additional information about the company, including financial statement schedules and exhibits to the Annual Report to shareholders on Form 10-K for the fiscal year ended March 31, 1986, may be obtained, without charge, by writing:
Corporate Secretary
McDermott International, Inc.
1010 Common Street
New Orleans, Louisiana 70112
(504) 587-5400

Inquiries regarding stockholder account matters should be addressed to:
Morgan Guaranty Trust Company
of New York
30 West Broadway
New York, New York 10015
(212) 587-6515

McDermott International, *inc.*
1010 Common Street
New Orleans, LA 70112
(504) 587-5400