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THE WELSH CORPORATION

Annual Report

1970
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DIRECTORS

Richard A. Setter

Eric R. Haessler

Lou Nagy

J. David A. McGrath

Larry W. Wells

OFFICERS

Richard A. Setter, *President*

Arthur L. Abel, *Executive Vice-President*

Walter G. Tharl, *Treasurer*

Mark G. Copeland, *Secretary*

TRANSFER AGENT

Registrar & Transfer Company

15 Exchange Place

Jersey City, New Jersey

AUDITORS

Arthur Young & Company

Seattle, Washington

GENERAL COUNSEL

Keane, Haessler, Harper & Pearlman

Portland, Oregon

To the Shareholders:

During the year ended December 31, 1970, your Company had net sales of \$5,789,908 compared with net sales of \$5,883,249 during the prior year. For 1970, your Company had a profit from continuing operations of \$10,737, but a net loss from all operations of \$78,173 compared with a net loss of \$38,996 during 1969. The difference resulted from expenses associated with the development, operation and disposition of the Company's Xercon Division. This division was sold for \$150,000 in cash and notes following the death in an airplane crash in September, 1970 of Clifford E. Myers, a valued Company scientist who was developing the Xercon product line.

The outlook for your Company's panel business will continue to be influenced by prospects for the building materials industry. The industry has been depressed during the past two years, but may benefit from a decline in interest rates and an increase in the money supply. Your Company's operations during the last six months of 1970 benefited from market acceptance of new panels and from manufacturing economies due to plant improvements made last spring, but prefinished panel markets are still highly competitive.

Progress has also been made on the Company's fire retardant program. In September, 1970, certain sizes of panels treated on a test basis with the Company's fire retardant process received a Class 1 resistant rating from a national testing laboratory. In February, 1971, the Company was granted a patent covering certain areas of its process. The first sales of products manufactured under your Company's furniture process were also accomplished during the last half of 1970. These products accounted for only 1% of your Company's 1970 sales, but do represent a step from research to manufacturing activities.

Respectfully submitted,



R. A. Setter, President

THE WELSH CORPORATION

Report of Certified Public Accountants

The Board of Directors
The Welsh Corporation

We have examined the accompanying balance sheet of The Welsh Corporation at December 31, 1970 and the related statements of operations, stockholders' equity and source and application of funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the financial position of The Welsh Corporation at December 31, 1970, and the results of its operations and the source and application of its funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

ARTHUR YOUNG & COMPANY

Seattle, Washington
January 22, 1971

THE WELSH CORPORATION

Statement of Operations

Years ended December 31, 1970 and 1969

	1970	1969
Revenues:		
Net sales	\$5,789,908	\$5,883,249
Royalties and other	67,706	66,819
	<u>5,857,614</u>	<u>5,950,068</u>
Operating costs and expenses:		
Cost of sales	5,063,237	5,210,318
Administrative and selling	719,453	729,056
Interest on long-term debt	10,275	12,043
Amortization of debt discount and expense	6,036	10,592
Other interest	47,876	27,055
	<u>5,846,877</u>	<u>5,989,064</u>
Income (loss) from continuing operations	10,737	(38,996)
(Loss) from discontinued operations (Note 7)	(138,910)	—
(Loss) before extraordinary credit	(128,173)	(38,996)
Life insurance proceeds (Note 7)	50,000	—
Net (loss) (Note 6)	<u>\$ (78,173)</u>	<u>\$ (38,996)</u>
Common shares (Note 8)	<u>631,418</u>	<u>590,699</u>
Per common share (Notes 6 and 8):		
Income (loss) from continuing operations	\$.02	\$ (.07)
(Loss) from discontinued operations (Note 7)	(.22)	—
Extraordinary credit	<u>.08</u>	<u>—</u>
Net (loss)	<u><u>\$ (.12)</u></u>	<u><u>\$ (.07)</u></u>

See accompanying notes.

THE WELSH CORPORATION

Balance Sheet

December 31, 1970 and 1969

Assets	1970	1969
Current assets:		
Cash	\$ 93,010	\$ 97,748
Receivables:		
Trade (\$992,349 pledged in 1970), less allowance of \$17,000 in 1970 for doubtful accounts	1,007,142	979,538
Notes	22,214	3,844
Other	138,408	65,593
	<u>1,167,764</u>	<u>1,048,975</u>
Inventories (\$475,658 pledged in 1970) (Note 1)	579,943	849,174
Prepaid expenses	69,773	37,394
Total current assets	<u>1,910,490</u>	<u>2,033,291</u>
Equipment and improvements, at cost:		
Machinery and equipment	1,126,745	860,450
Office equipment	26,423	26,855
Leasehold improvements	25,401	28,591
Construction in progress	49,600	107,545
	<u>1,228,169</u>	<u>1,023,441</u>
Less accumulated depreciation and amortization computed principally on the straight-line method	377,929	355,012
Net equipment and improvements	<u>850,240</u>	<u>668,429</u>
Deferred charges, intangible and other assets:		
Deferred research and development costs (Notes 2 and 7)	87,538	244,736
8% notes receivable	80,000	—
Deposits, at cost (\$62,020 pledged under leases)	73,625	50,650
Patents, at cost less \$21,653 amortization	30,157	29,072
Unamortized debt discount and expense, amortization on the bonds outstanding method	21,368	27,404
Cash held by sinking fund trustee (Note 3)	27,000	16,860
Total deferred charges, intangible and other assets	<u>319,688</u>	<u>368,722</u>
	<u>\$3,080,418</u>	<u>\$3,070,442</u>

See accompanying notes.

Liabilities and Stockholders' Equity	1970	1969
Current liabilities:		
Notes payable to bank (trade receivables and inventories pledged as collateral)	\$ 799,080	\$ 678,654
Trade accounts payable	522,857	535,928
Accrued liabilities	100,138	88,598
Customer deposit	—	29,900
Long-term debt due within one year	26,145	23,145
Total current liabilities	<u>1,448,220</u>	<u>1,356,225</u>
Long-term debt:		
6¾% convertible subordinated debentures due October 1976 (Note 3)	136,500	139,500
Equipment contracts, due \$12,644 annually, including interest, to September 1972	5,706	18,351
Total long-term debt	<u>142,206</u>	<u>157,851</u>
Commitments and contingencies (Note 4)		
Stockholders' equity (Notes 3 and 5):		
Preferred stock, \$100 par value; 6% cumulative dividends, 1,000 shares authorized and none issued.		
Convertible preferred stock, \$10 par value; 500,000 shares authorized and none issued.		
Common stock, \$.25 par value; 3,000,000 shares authorized, 158,911 shares reserved, 634,137 shares issued (628,699 in 1969)	158,534	157,175
Capital in excess of par value	1,819,886	1,809,446
Deficit	(488,428)	(410,255)
Total stockholders' equity	<u>1,489,992</u>	<u>1,556,366</u>
	<u>\$3,080,418</u>	<u>\$3,070,442</u>

See accompanying notes.

THE WELSH CORPORATION

Statement of Stockholders' Equity

Two years ended December 31, 1970

	Common stock	Capital in excess of par value	Deficit	Total
Balance, December 31, 1968	\$ 146,175	\$1,712,308	\$ (371,259)	\$1,487,224
Net loss, year ended December 31, 1969	—	—	(38,996)	(38,996)
Exercise of option on 4,000 shares of common stock at \$1.94 per share	1,000	6,760	—	7,760
Conversion of 8% sub- ordinate convertible note into 40,000 shares of common stock at \$2.50 per share	10,000	90,000	—	100,000
Sale of 37,750 warrants at \$.01 per warrant	—	378	—	378
Balance, December 31, 1969	157,175	1,809,446	(410,255)	1,556,366
Net loss, year ended December 31, 1970	—	—	(78,173)	(78,173)
Issuance of 5,438 shares of common stock under the 1968 Employee Stock Bonus Plan (Note 5)	1,359	10,440	—	11,799
Balance, December 31, 1970 (Notes 3 and 5)	<u>\$ 158,534</u>	<u>\$1,819,886</u>	<u>\$ (488,428)</u>	<u>\$1,489,992</u>

See accompanying notes.

THE WELSH CORPORATION

Statement of Source and Application of Funds

Years ended December 31, 1970 and 1969

	<u>1970</u>	<u>1969</u>
Source of funds:		
Operations:		
Net (loss)	\$ (78,173)	\$ (38,996)
Charges against operations not involving working capital:		
Depreciation and amortization	136,127	84,749
Amortization of debt discount and expense	6,036	10,592
Net asset amount of retirements:		
Unamortized research and development cost applicable to Xercon division (Note 7)	40,145	—
Equipment	9,120	4,006
Patents	2,348	—
Total provided by operations	115,603	60,351
Issuance of common stock	11,800	108,138
Increase in long-term debt	—	6,671
Reduction of deferred research and development costs (Note 2)	134,262	—
	<u>261,665</u>	<u>175,160</u>
Disposition of funds:		
Additions to equipment and improvements	310,875	233,214
Additions to deferred research and development costs (Note 2)	32,469	169,532
Increase in 8% notes receivable	80,000	—
Addition to deposits	22,000	—
Additions to patents	4,356	7,130
Payment to sinking fund trustee (Note 3)	10,140	9,360
Decrease in long-term debt	15,645	—
Other	976	6,450
	<u>476,461</u>	<u>425,686</u>
Decrease in working capital (Note 9)	<u>\$ 214,796</u>	<u>\$ 250,526</u>

See accompanying notes.

THE WELSH CORPORATION

Notes to Financial Statements

December 31, 1970

1. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market. Market for prefinished plywood is determined on the basis of current selling prices, less cost of disposal. Market for other inventories is determined on the basis of current replacement cost.

Inventories consist of the following:

	1970	1969
Prefinished plywood (pledged) . .	\$406,542	\$407,801
Unfinished plywood (pledged) . . .	69,116	328,176
Supplies	104,285	113,197
	<u>\$579,943</u>	<u>\$849,174</u>

2. Deferred research and development costs

The Company follows the policy of deferring costs associated with research and development of new manufacturing processes and products. The costs of completed projects are amortized over a three-year period or the life of the process or product, whichever is shorter, and costs relative to abandoned projects are charged to expense in the year of abandonment (\$13,059 in 1970).

Costs aggregating \$121,203 relating to the furniture project were transferred in 1970 to machinery and equipment and to construction in progress representing the cost of three machines being used in operations and one machine under construction, respectively; the portion thereof representing research and development costs is not determinable.

The recovery of research and development costs in the amount of \$87,538 relative to the fire retardant process is dependent upon future development of the process.

3. Long-term debt

The 6¾% convertible subordinated debentures are convertible into common stock until October 31, 1976 at \$7.26 per share. At December 31, 1970, 20,661 shares of common stock were reserved for this conversion. Sinking fund payments are required each October 31, with \$13,500 due in 1971 and increasing to \$27,000 in 1976. Under terms of the indenture, when sinking fund cash exceeds \$25,000, the trustee is required to call (on October 31) for redemption at par, plus accrued interest, a sufficient number of debentures to use the amount in the fund. The indenture also contains, among other restrictions, provisions limiting payments for cash dividends

on and redemption or other acquisition of the Company's common stock, except for stockholder approved bonus plans, until retained earnings exceed \$250,000.

The conversion price is subject to downward adjustment with a resulting increase in the number of shares to be issued upon conversion in the event of a stock split, stock dividend or any issuance of additional shares or right to acquire additional shares at a price below the conversion price.

4. Commitments and contingencies

The Company's panel manufacturing operations are conducted on premises leased from the Port of Longview. The rent commitment per year under these noncancellable leases, exclusive of payments for maintenance and insurance, is \$48,000 through 1972; \$56,000 in 1973; \$62,000 for 1974 through 1982; and \$35,000 in 1983. The Company has an option to renew these leases at rentals to be determined for five-year periods to a maximum of thirty years.

The laboratory premises are under an assignable lease calling for payments, exclusive of maintenance and insurance, of \$19,200 per year until December 1978, with an option to renew the lease at approximately the same rental for two five-year periods.

Several patents and processes are being used under a licensing agreement requiring minimum royalty payments of \$12,000 per year to 1973. Royalty payments were \$21,754 and \$12,000 for the two years ended December 31, 1970, respectively.

5. Stockholders' equity

Stock purchase warrants:

At December 31, 1970, warrants were outstanding and exercisable for the purchase of one share each of common stock as follows:

Number of shares	Price per share	Expiration date
5,500	\$ 2.75	July 31, 1971
14,250	9.50	October 16, 1973
7,500	9.63	October 22, 1973
3,500	10.75	November 15, 1973
12,500	13.25	November 20, 1973
<u>43,250</u>		

Stock plans:

At December 31, 1970, outstanding options granted in 1968 under an Executive Stock Option Plan to purchase 35,000 and 10,000 shares of common stock at \$7.00 and \$8.25 per share, respectively (market value on the date of grant), aggregating \$327,500 were exercisable and expire in 1973. The market values on the dates first exercisable were approximately \$17.25 and \$16.50 per share, respectively (aggregating \$768,750). There are no additional options available for grant under this plan.

In July 1970, the Board of Directors adopted, subject to stockholder approval, a Qualified Stock Option Plan covering 50,000 shares of common stock. The Board of Directors may establish the terms of each option provided the exercise price is not less than market value of the common stock at date of grant; the option term may not exceed five years from date of grant and the option may not be exercised prior to the expiration of the first six months of its term. On July 17, 1970, options were granted to purchase 24,000 shares of common stock at \$2.07 per share (market value at that date) aggregating \$49,680. These granted options become exercisable 20% per year on a cumulative basis beginning with the date of grant.

In July 1970, the administrative committee issued 5,438 shares, including 1,728 shares subject to cancellation in the event of termination of employment expiring as to 864 shares in January 1972 and 1973, of common stock under the 1968 Employee Stock Bonus Plan which was terminated in October 1970. The shares were valued at the then current market of \$2.17 per share and \$4,781, the undistributed portion of the 1968 provision, was credited to income.

6. Federal income tax

At December 31, 1970, net operating loss deductions were available to reduce future taxable income in the aggregate amount of approximately \$418,000, of which \$89,000 expires in 1971, \$167,000 in 1972, \$26,000 in 1974 and \$136,000 in 1975 and an investment tax credit of approxi-

mately \$27,000 may be carried over for tax purposes through 1976.

7. Loss from discontinued operations

Included in the loss on discontinued operations are the 1970 net sales applicable to the Xercon Division (operations began in 1970) of \$131,000 which resulted in a loss on operations of \$147,352 less a \$8,442 gain (\$150,000 selling price) from the sale of the division's assets and the write-off of \$40,145 unamortized research and development costs. These assets were sold following the death of the division's scientist, whose life was insured by the Company for \$50,000.

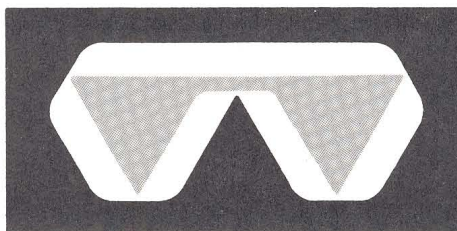
8. Per common share

Per share computations are based on the weighted average number of shares of common stock outstanding. Contingently issuable shares were anti-dilutive in 1969 and 1970. Shares issuable upon conversion of the 6¾% convertible subordinated debentures were not common stock equivalents at date of issue.

9. Working capital

The net increase (decrease) in the elements of working capital are as follows:

	<u>December 31,</u>	
	<u>1970</u>	<u>1969</u>
Current assets:		
Cash	\$ (4,738)	\$ (2,294)
Receivables	118,789	160,455
Inventories	(269,231)	188,043
Prepaid expenses	32,379	1,138
	<u>(122,801)</u>	<u>347,342</u>
Current liabilities:		
Notes payable to bank ...	120,426	471,726
8% subordinate convertible note	—	(100,000)
Trade accounts payable ..	(13,071)	189,063
Accrued liabilities	11,540	(3,364)
Customer deposit	(29,900)	29,900
Long-term debt due within one year	3,000	10,543
	<u>91,995</u>	<u>597,868</u>
Net (decrease)	<u>\$(214,796)</u>	<u>\$(250,526)</u>



THE WELSH CORPORATION / LONGVIEW, WASHINGTON