

Timberland

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A Building Products Company

*ANNUAL REPORTS*

1985 Annual Report

*STACK*





**Timberland Industries manufactures and distributes building products for residential and commercial new construction and remodeling markets. Three manufacturing divisions produce wood kitchen and bath cabinets, wood commercial and residential doors, and wood-framed windows.**

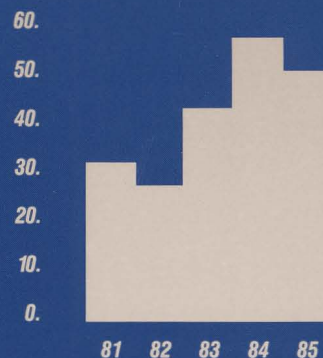
**Overseas sales of company products are the responsibility of Timberland International, Inc. which also offers architectural products made by others. Two other non-manufacturing operations serve residential and commercial builders with lighting fixtures, hardware, metal doors and frames, and specialty items.**

**ON THE COVER:**

Under-counter kitchen units await final inspection prior to packaging for shipment. Western Cabinet is the largest producer of kitchen and bathroom cabinetry in Washington state and distributes its products throughout the West and internationally.

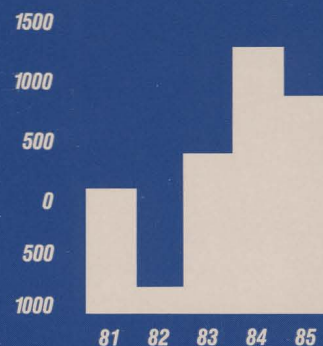
**Net Sales**

*In millions of dollars*



**After-tax Earnings**

*In thousands of dollars*



|                                                                   | Year ended December 31,                           |          |          |           |           |
|-------------------------------------------------------------------|---------------------------------------------------|----------|----------|-----------|-----------|
|                                                                   | 1985                                              | 1984     | 1983     | 1982      | 1981      |
|                                                                   | <i>(000's except per share and dividend data)</i> |          |          |           |           |
| Net sales                                                         | \$51,651                                          | \$57,910 | \$44,121 | \$28,063  | \$32,428  |
| Income (loss) from continuing operations                          | \$ 852 <sup>(1)</sup>                             | \$ 1,249 | \$ 481   | \$ (730)  | \$ (93)   |
| Income (loss) from discontinued operations                        | —                                                 | —        | —        | —         | 153       |
| Net earnings (loss)                                               | \$ 852                                            | \$ 1,249 | \$ 481   | \$ (730)  | \$ 60     |
| Weighted average common and common equivalent shares outstanding* | 1,360                                             | 1,334    | 1,332    | 1,316     | 1,384     |
| Net earnings (loss) per share:*                                   |                                                   |          |          |           |           |
| Continuing operations                                             | \$ 0.63                                           | \$ 0.94  | \$ 0.36  | \$ (0.55) | \$ (0.07) |
| Discontinued operations                                           | —                                                 | —        | —        | —         | 0.11      |
| Net earnings (loss) per share                                     | \$ 0.63                                           | \$ 0.94  | \$ 0.36  | \$ (0.55) | \$ 0.04   |
| Stock dividends                                                   | 20%                                               | 20%      | Nil      | Nil       | Nil       |

\*Restated for 20% stock dividends paid September 9, 1985 and September 20, 1984.

<sup>(1)</sup>Includes \$321,000 after-tax gain from the sale of real estate.

|                      |          |          |          |          |          |
|----------------------|----------|----------|----------|----------|----------|
| At year end:         |          |          |          |          |          |
| Total assets         | \$24,973 | \$21,233 | \$22,740 | \$16,985 | \$16,616 |
| Long-term debt       | \$ 5,456 | \$ 4,957 | \$ 3,372 | \$ 3,603 | \$ 3,955 |
| Working capital      | \$ 4,774 | \$ 5,089 | \$ 3,123 | \$ 2,764 | \$ 3,430 |
| Shareholders' equity | \$ 8,584 | \$ 7,714 | \$ 6,466 | \$ 5,954 | \$ 6,748 |



### ***To Our Shareholders:***

Despite lower demand in our primary market, 1985 was the second best sales year in Timberland's recent history. Sales of \$52.0 million resulted in after-tax earnings of \$852,000, including \$321,000 received from the sale of excess real estate. Both sales and earnings are down from record 1984 levels due primarily to slower international sales. An order for 26,000 doors shipped to the Middle East in 1984 was a big part of the difference.

While these results are no more than satisfactory, we believe they confirm that we are headed in the right direction. In recent years, Company policy has emphasized the growth of markets outside residential construction to protect earnings from the inevitable ups and downs in the housing industry. Following this policy, Western Cabinet, the Company's largest operating division, managed to match 1984 sales volume. Window Visions, the other manufacturing division with sales concentrated in the Northwest, actually increased volume.

For the future we see home remodelling as an increasingly important market. We also foresee higher quality new construction as builders compete for a smaller number of new home sales. All divisions of Timberland

have focused on the changes necessary to accommodate these shifts in our markets.

In 1985, Western Cabinet, the largest supplier of kitchen and bath cabinets in Washington state, substantially redesigned both its product and its production line. Cabinet interiors are brighter, smoother and easier to clean. Wood-grained exterior side panels provide a crisper appearance on the showroom floor while an upgraded drawer slide system enhances customer acceptance.

To support dealer sales, Western Cabinet opened a new 11,000 square foot distribution center in 1985 that allows cabinet delivery off-the-shelf rather than in weeks. The center allows dealers to promise the rapid service retail customers demand without increasing inventory.

While builders will always be the most important customers of Western Cabinet, the remodelling market represents a major diversification and one that we will continue to support aggressively. In 1985, over one-quarter of the division's cabinet production went to retail markets through more than 50 dealers and distributors in Washington, Oregon, California, Alaska and Hawaii. As recently as 1979, the division sold exclusively to builders of new houses, condominiums and apartments.

Western Cabinet operates from a 140,000 square foot plant built in 1980. It is one of the ten

largest cabinet plants in the country and one of the most efficient.

Cal-Wood Door, the Company's second primary profit center, is based in Rohnert Park, California and concentrates its efforts in commercial construction. Sales follow worldwide demand for hotels, hospitals, schools, embassies, offices and many other sorts of large public buildings and are less impacted by conditions in any one region. In 1985, 80% of Cal-Wood Door's product went to commercial projects, up from just 50% in 1980. The remainder is sold for residential construction through building materials distributors.

Cal-Wood Door is one of the largest manufacturers of architectural doors in the United States, and the largest on the west coast. With the exception of residential doors which are sometimes built for inventory, all production is built to order. Doors are custom-built to meet applicable fire protection codes as well as architects' specifications for wood specie, finish, and machining for special hardware.

To maintain the cost-effectiveness of its products, Cal-Wood Door consolidated operations that had been scattered in five locations to a single 6-acre site with a \$1.7 million, 33,000



square foot addition to its existing 85,000 square foot plant in 1985. The plant operated at near-capacity throughout the year.

Overseas sales are generated by Timberland International, Inc. Established in 1984 on the heels of a \$6.4 million order, Timberland International was able to add approximately \$3 million in new orders in its first year of operation. International contracts traditionally take longer to bid, award, and begin work than domestic projects and much of the hard work performed in 1985 by the division's sales and bidding departments will not be apparent until 1986.

For 1985, international sales totalled \$3.25 million and we look forward to an improved year in 1986.

Timberland Industries acquired WindowVisions in 1983 to participate in the growing market for wood windows in new construction and to complement our offerings of wood building products. When acquired, the firm manufactured fir-framed windows for contemporary-style homes.

A new line of pine windows, announced in November, 1985, broadens the division's offerings to include traditional window styles for new construction and remodelling of existing homes. The pine products require just ten different wood component profiles compared to as

many as 50 in the complete line of fir windows products.

In recent years the use of wood windows has increased to approximately 25% of all new construction in the Northwest, from as low as 10% just a few years ago. Recent energy code changes requiring "thermally broken" aluminum frames have reduced the price differential between aluminum and wood windows and we expect to see more builders specifying wood windows in order to provide their houses with an important quality edge.

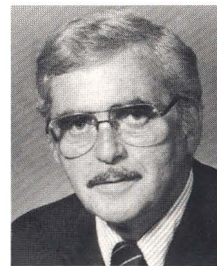
Two other Company operations, Brennan Commercial and Brennan Lighting, serve residential and commercial builders with lighting, hardware, metal doors and frames and specialty items. Brennan Lighting, which had experienced difficulties in a very competitive market, rounded the corner and was profitable in 1985.

During the past five years, Timberland Industries has positioned itself for continued leadership in our primary new construction markets. We have also made a great deal of progress in developing counter-cyclical retail and remodelling markets. Our plants and equipment are in excellent condition. Our products lead their markets for quality and price.

In 1985, we invested \$2.9 million in the capital improvements described above. \$1.25 million is budgeted for 1986, the bulk of which will go to create productivity improvements at Western Cabinet.

With the market opportunities available to us, such capital improvements generate solid shareholder value in the years ahead. For the second year in a row, the Board of Directors declared a 20% stock dividend, payable to shareholders of record as of August 22, 1985.

The heaviest phase of plant improvement is now behind us. The economy in our home market is strong and housing starts appear to be making up for lost time. Mortgage interest rates are at their lowest point in this decade. All of these trends, combined with the quality of our products, the experience of our



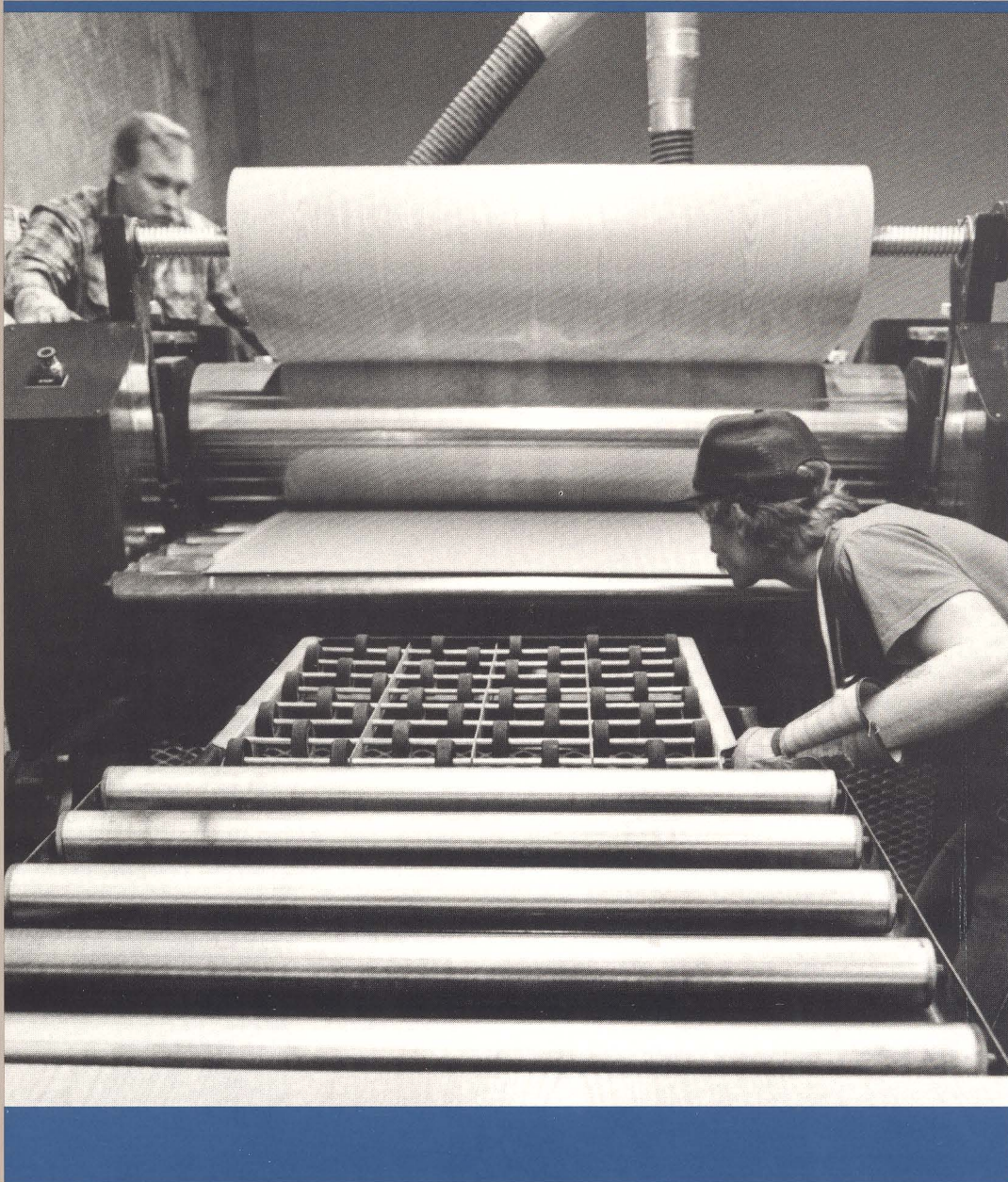
people and the efficiency of our plants, give us reason to be confident of 1986 results as well as the long run.

A handwritten signature in dark ink that reads "J. Allan MacDonald". The signature is written in a cursive, flowing style.

J. Allan MacDonald  
President



*Western Cabinet*





*New laminating machinery coats cabinet panels with a tough melamine surface.*

*In addition to lowering the cost of materials, inhouse laminating allows production of a superior product that will withstand the close scrutiny given cabinets on the retail showroom floor and provide builders with a quality advantage in a highly competitive market.*



Western Cabinet, the largest division of Timberland Industries, is the dominant supplier of kitchen and bath cabinetry, pre-hung door moldings, trim and associated millwork for new residential construction in Washington state. Its cabinet products are also sold in other western states, particularly Alaska, California and Hawaii, and internationally.

While direct sales to builders of single family homes and apartments account for the bulk of production, dealer sales of cabinets for use in remodelling have received increased emphasis. In 1985 they accounted for over one-quarter of cabinet production. Newly redesigned cabinets and an 11,000 square foot distribution center opened in 1985 support dealer/distributor sales.

Western Cabinet operates from a 140,000-square foot plant built in 1980 in Woodinville, Washington, a suburb of Seattle.

*Newly redesigned cabinets offer brighter interiors, surfaces that are easier to clean, wood-grained exterior panels and improved drawer hardware for smoother operation.*



*Cal-Wood Door*

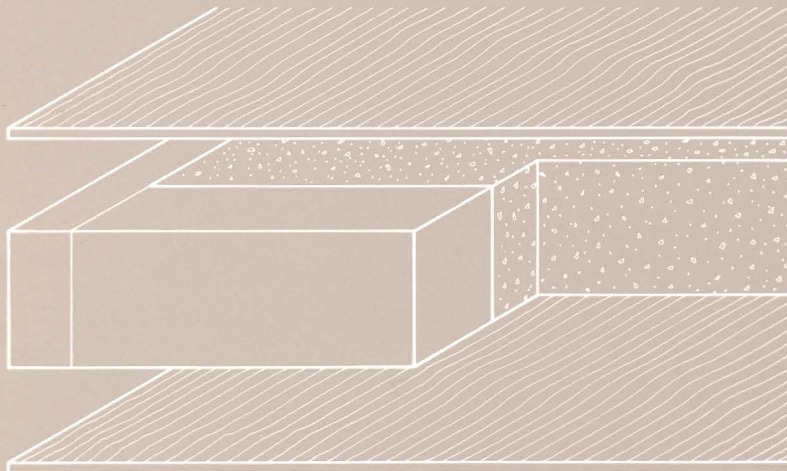




***Computerized door trimming equipment installed in 1981 at a cost of \$500,000 makes Cal-Wood Door one of the most efficient flush door manufacturers in the world and one of the few U.S. plants able to offer metric sizes for international markets.***

*Cal-Wood's patented SLM door edge combines excellent fire test performance with greatly improved hardware retention. In recent slam cycle tests, 300,000 cycles produced no sign of screw loosening or other failures often seen in other fire doors after 10,000 to 25,000 cycles.*

*Cal-Wood's patented fire retarding door core edge is licensed to other door manufacturers.*



Cal-Wood Door is the largest manufacturer of architectural flush wood doors in the western United States and serves national and international markets. Cal-Wood Door products are built to the architect's specifications regarding wood specie, finish and internal configuration. Fire protection and sound proofing features are available along with radiation protection for use in hospitals and clinics. Sophisticated prefinishing and pre-machining is available.

In 1985, Cal-Wood Door added 33,000-square feet to its modern facility, bringing it to 123,000 square feet. The plant, located in Rohnert Park, California, is just 40 miles from San Francisco docks, an important factor since the majority of exotic veneers used—and a growing market for finished doors—are to be found in Pacific Rim countries.

Cal-Wood Door products are sold to building materials distributors and distributors of commercial hardware through Company salespeople located in San Francisco, Seattle, Salt Lake City and Los Angeles covering eleven western states. Sales outside the West are handled by commissioned sales representatives. Overseas sales are the responsibility of Timberland International, Inc.







***A major part of the job performed by Timberland International involves working with manufacturers both inside and outside the Company, coordinating shipping arrangements, expediting, troubleshooting and, if necessary, inspecting components on site around the world and demonstrating assembly techniques.***

***By offering and supporting a wide range of architectural products, the firm adds significant value to contractors preparing bids for work overseas.***

*Timberland has supplied commercial contractors overseas for more than 25 years.*

Timberland International, the newest division of the Timberland family, was incorporated in January, 1984, to help manage a \$6.4 million door and millwork order and to expand the international sale of Company products. Today the firm is a primary customer of Cal-Wood Door and Western Cabinet divisions and offers architectural products made by others as well.

While a formal trading arm is new, overseas sales are a part of Timberland tradition that goes back twenty-five years to the first sale of architectural doors for a major Waikiki hotel. That initial contract led to a continued presence in the Hawaiian market and to projects in the Middle East, Europe, the Pacific Rim, the Caribbean and Central and South America.

Head offices for Timberland International are located in Santa Rosa, California, with an additional sales office in Hawaii.





*WindowVisions*





*Pine windows added to the WindowVisions line in November, 1985 expand the division's sales beyond fir windows used in contemporary-style construction to include traditional house styles and the substantial window replacement market.*

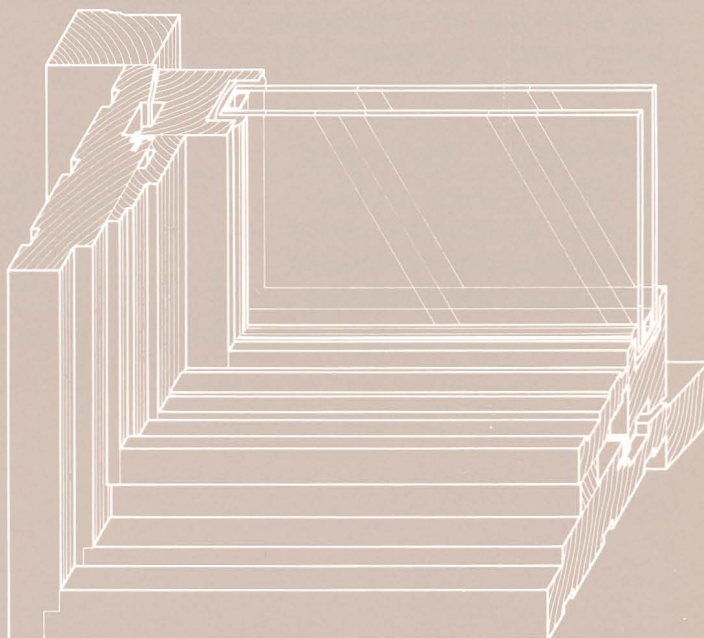
*Because pine mills readily, more elaborate frames can be constructed with fewer components—ten profiles replace as many as fifty required to offer a complete line of contemporary fir windows. The new windows are available primed for painting or bare, in finger-jointed or clear finish-grade pine stock.*

*The new Tradition pine window line incorporates a "booted" glaze system in which insulated glass, assembled on-site, is wrapped in vinyl to assure a weather-tight seal. The system ensures a top quality product while offering builders a lead time shorter than that available from competitors.*

WindowVisions manufactures a complete line of wood frame windows, patio doors and specialty window units such as skylights, solariums and skywalls. Until recently, all WindowVision products were built of clear fir in contemporary styles, primarily for use in new construction.

In November 1985, a new line of pine windows in traditional styles was introduced for sale in both new construction and retail remodelling markets.

Because of the expense of shipment, window manufacture is a highly territorial industry. The new line of pine windows increases WindowVisions' penetration in its territory. All products are manufactured in a modern 36,000 square foot facility in Kirkland, Washington.





***Brennan Commercial and  
Brennan Lighting***

Brennan Lighting distributes lighting fixtures, finish hardware, specialty systems such as built-in vacuuming and low-voltage intercom and security systems. Sales are made directly to residential and commercial builders as well as to retail customers through two showroom/distribution centers located in Seattle and Redmond, Washington.

The 1983 decision to divide Brennan Lighting from its sister company to serve the public with a more clearly defined product line proved successful in 1985.

Brennan Commercial supplies metal doors and frames, wood doors, commercial hardware, bathroom accessories and similar products to general contractors for use in commercial and institutional construction. Trained specialists with knowledge of code and security considerations work closely with architects and contractors in meeting the specific needs of hotels, hospitals, schools, shopping centers, prisons and office buildings. One central location in Kirkland, Washington, serves as a base for sales and distribution.



#### **RESULTS OF OPERATIONS—1985 COMPARED TO 1984**

Due mainly to a drastic cutback in construction in the Middle East, sales for the year ended December 31, 1985 decreased by \$6.2 million or 10.8% from \$57.9 million in 1984 to \$51.7 million in 1985. The cutback in oil production oriented Middle East construction adversely affected the sales volumes at both Cal-Wood Door and Timberland International. The majority of sales by Timberland International in 1984 were to Middle East projects. Sales of cabinets and windows both increased modestly in 1985, while sales of lighting fixtures and hardware decreased modestly.

Despite the decline in sales, gross margin as percent of sales improved by 1% overall from 23.4% in 1984 to 24.4% in 1985. These improvements were principally in the export and door operations with an increase in gross margins of 1.8%, and on lighting and hardware sales where gross margins improved by 3.6%. Gross margins on cabinets and windows decreased by .45% and 1.65%, respectively. The decrease in margins on windows was due in large part to the development of a new product line of pine framed windows, where the costs of research and development were expensed in 1985.

Selling and administrative expenses rose by \$690,000 or 6.75% in 1985 over 1984. This includes an increase in depreciation of \$133,000 over 1984 due to increased expenditures for plant and equipment. Other items increasing selling and administrative expenses were casualty and liability insurance, salaries and wages, payroll taxes and medical insurance.

Interest expense decreased by 14% in 1985 due to lower average short-term borrowing and lower interest rates. Interest on short-term borrowing decreased \$198,000 while interest on long-term borrowing rose by \$47,000. The Company moved \$1.6 million of short-term debt to long-term debt late in 1984 for expansion of its door plant but did not use these funds until late in 1985. In 1985 an additional \$0.5 million was moved from short-term to long-term for equipment financing.

A portion of 1985 income was derived from the gain on the sale of real estate which totaled \$446,000 before taxes. There has been no material effect on sales and income from inflation and changing prices.

#### **RESULTS OF OPERATIONS—1984 COMPARED TO 1983**

As housing and construction continued to be strong during 1984, the Company's sales rose by \$13.8 million to \$57.9 million, representing an increase of 31.3%. Several positive factors contributed to this sales increase: a relatively high level of housing starts during 1984; sales generated by the Company's new subsidiary, Timberland International; and further penetration into broader geographic areas in the U.S. Gross margin dollars increased substantially, and the gross margin percentage increased from 22.2% to 23.4%. Additionally, indirect overhead increased only 5.6% indicating further increases in productivity and plant utilization. Sales expense, although increasing by \$351,000, declined as a percent of sales from 7.4% to 6.2%.

General and administrative overhead increased substantially in terms of dollars from \$3.8 million to \$5.6 million. However, in terms of percent of sales the increase was only from 8.6% to 9.6%. These increases are, to a large degree, attributable to incentive compensation plans at the Company's various divisions as a result of achieving targeted profit levels. Despite the increased sales activity, interest expense for the year only increased by \$63,000 overall. This was the result of declining short-term interest rates during 1984, and better use of working capital. Pretax earnings increased from \$828,000 to \$2,304,000 or an increase of 178%. As a percent of sales this increase was also very positive from 1.9% to 4%.

There has been no material effect on sales and income from inflation and changing prices.

#### **LIQUIDITY AND CAPITAL RESOURCES**

Working capital decreased \$315,000 from \$5,089,000 at December 31, 1984 to \$4,774,000 at December 31, 1985. The primary reason for the decline was the expansion of the Company's door plant near Santa Rosa, California and the acquisition of new equipment. New long-term borrowings of \$840,000 helped finance a portion of these asset additions. Disposition of land, buildings and equipment totaled \$603,000 in 1985 and included the sale of a distribution facility. The Company sold the distribution facility for \$910,000 and recognized a gain of \$446,000 before taxes. Under terms of this sale, the Company received \$180,000 cash and a promissory note for \$730,000 due December 31, 1991.

The Company had borrowings of \$5,205,000 under its \$8 million line of credit at December 31, 1985. The continued availability of the credit line should provide the Company with adequate liquidity in the foreseeable future.



|                                                                                         | December 31, |              |
|-----------------------------------------------------------------------------------------|--------------|--------------|
|                                                                                         | 1985         | 1984         |
| <b>Assets</b>                                                                           |              |              |
| Current assets:                                                                         |              |              |
| Cash                                                                                    | \$ 36,000    | \$ 193,000   |
| Accounts receivable, less allowance<br>of \$672,000 and \$682,000 for doubtful accounts | 6,082,000    | 5,307,000    |
| Inventories                                                                             | 7,668,000    | 6,387,000    |
| Prepaid expenses                                                                        | 316,000      | 282,000      |
| Prepaid employee benefits                                                               | 851,000      | 900,000      |
| Total current assets                                                                    | 14,953,000   | 13,069,000   |
| Land, buildings and equipment:                                                          |              |              |
| Land                                                                                    | 374,000      | 474,000      |
| Buildings                                                                               | 5,858,000    | 4,935,000    |
| Equipment                                                                               | 8,140,000    | 7,205,000    |
|                                                                                         | 14,372,000   | 12,614,000   |
| Less accumulated depreciation                                                           | (5,625,000)  | (5,097,000)  |
|                                                                                         | 8,747,000    | 7,517,000    |
| Note receivable                                                                         | 730,000      |              |
| Other assets                                                                            | 543,000      | 647,000      |
| Total assets                                                                            | \$24,973,000 | \$21,233,000 |
| <b>Liabilities and Shareholders' Equity</b>                                             |              |              |
| Current liabilities:                                                                    |              |              |
| Note payable to bank                                                                    | \$ 5,205,000 | \$ 2,700,000 |
| Accounts payable                                                                        | 2,181,000    | 1,924,000    |
| Accrued liabilities—                                                                    |              |              |
| Wages and fringe benefits                                                               | 984,000      | 1,291,000    |
| Payroll taxes and related liabilities                                                   | 523,000      | 410,000      |
| Other                                                                                   | 410,000      | 319,000      |
| Income taxes payable                                                                    | 35,000       | 579,000      |
| Current portion of deferred taxes                                                       | 392,000      | 414,000      |
| Current portion of long-term debt                                                       | 449,000      | 343,000      |
| Total current liabilities                                                               | 10,179,000   | 7,980,000    |
| Long-term debt, net of current portion                                                  | 5,456,000    | 4,957,000    |
| Deferred taxes, net of current portion                                                  | 754,000      | 582,000      |
| Shareholders' equity:                                                                   |              |              |
| Common stock par value, \$.16 per share—                                                |              |              |
| Authorized, 2,500,000 shares                                                            |              |              |
| issued and outstanding 1,328,500 and 1,102,900 shares                                   | 213,000      | 176,000      |
| Additional paid-in capital                                                              | 5,043,000    | 3,788,000    |
| Retained earnings                                                                       | 3,328,000    | 3,750,000    |
| Total shareholders' equity                                                              | 8,584,000    | 7,714,000    |
| Total liabilities and shareholders' equity                                              | \$24,973,000 | \$21,233,000 |

See notes to consolidated financial statements.



|                                            | Year ended December 31, |              |              |
|--------------------------------------------|-------------------------|--------------|--------------|
|                                            | 1985                    | 1984         | 1983         |
| Net sales                                  | \$51,651,000            | \$57,910,000 | \$44,121,000 |
| Costs and expenses:                        |                         |              |              |
| Cost of sales                              | 39,037,000              | 44,327,000   | 34,324,000   |
| Selling and administrative expenses        | 10,908,000              | 10,218,000   | 7,971,000    |
| Interest                                   | 910,000                 | 1,061,000    | 998,000      |
| Total costs and expenses                   | 50,855,000              | 55,606,000   | 43,293,000   |
| Operating earnings                         | 796,000                 | 2,304,000    | 828,000      |
| Gain on sales of real estate               | 446,000                 |              |              |
| Earnings before income tax expense         | 1,242,000               | 2,304,000    | 828,000      |
| Income tax expense                         | 390,000                 | 1,055,000    | 347,000      |
| Net earnings                               | \$ 852,000              | \$1,249,000  | \$ 481,000   |
| Weighted average common shares outstanding | 1,360,000               | 1,334,000    | 1,332,000    |
| Net earnings per share                     | \$0.63                  | \$0.94       | \$0.36       |

**Consolidated Statements of Shareholders' Equity**

|                                         | Common Stock |           | Additional      | Retained    |
|-----------------------------------------|--------------|-----------|-----------------|-------------|
|                                         | Shares       | Amount    | Paid-In Capital | Earnings    |
| BALANCE at January 1, 1983              | 911,300      | \$146,000 | \$2,800,000     | \$3,008,000 |
| Exercise of stock options               | 8,000        | 1,000     | 30,000          |             |
| Net earnings                            |              |           |                 | 481,000     |
| BALANCE at December 31, 1983            | 919,300      | 147,000   | 2,830,000       | 3,489,000   |
| Dividend—20% stock                      | 183,600      | 29,000    | 958,000         | (988,000)   |
| Net earnings                            |              |           |                 | 1,249,000   |
| BALANCE at December 31, 1984            | 1,102,900    | 176,000   | 3,788,000       | 3,750,000   |
| Exercise of stock options               | 1,800        | 300       | 3,800           |             |
| Shares issued for acquisition of assets | 2,600        | 400       | 14,500          |             |
| Dividend—20% stock                      | 221,200      | 36,300    | 1,236,700       | (1,274,000) |
| Net earnings                            |              |           |                 | 852,000     |
| BALANCE at December 31, 1985            | 1,328,500    | \$213,000 | \$5,043,000     | \$3,328,000 |

See notes to consolidated financial statements.



|                                                   | Year ended December 31, |                  |                  |
|---------------------------------------------------|-------------------------|------------------|------------------|
|                                                   | 1985                    | 1984             | 1983             |
| Source of funds:                                  |                         |                  |                  |
| Operations—                                       |                         |                  |                  |
| Net earnings                                      | \$ 852,000              | \$1,249,000      | \$ 481,000       |
| Items not requiring the use of working capital    |                         |                  |                  |
| Depreciation and amortization                     | 1,124,000               | 988,000          | 878,000          |
| Deferred Federal income taxes                     | 208,000                 | (114,000)        | 175,000          |
| Funds provided by operations                      | 2,184,000               | 2,123,000        | 1,534,000        |
| Proceeds from long-term debt                      | 840,000                 | 1,931,000        |                  |
| Disposition of land, buildings and equipment, net | 603,000                 | 242,000          | 196,000          |
| Decrease in other assets                          | 79,000                  | 25,000           |                  |
| Issuance of new shares                            | 18,000                  |                  | 31,000           |
| <b>TOTAL FUNDS PROVIDED</b>                       | <b>3,724,000</b>        | <b>4,321,000</b> | <b>1,761,000</b> |
| Application of funds:                             |                         |                  |                  |
| Acquisition of land, buildings and equipment      | 2,932,000               | 2,011,000        | 979,000          |
| Reduction of long-term debt                       | 341,000                 | 344,000          | 231,000          |
| Increase in note receivable                       | 730,000                 |                  |                  |
| Acquisition of WindowVisions, Inc.                |                         |                  | 113,000          |
| Other                                             | 36,000                  |                  | 79,000           |
| <b>TOTAL FUNDS APPLIED</b>                        | <b>4,039,000</b>        | <b>2,355,000</b> | <b>1,402,000</b> |
| Increase (decrease) in working capital            | \$ (315,000)            | \$1,966,000      | \$ 359,000       |
| Changes in components of working capital:         |                         |                  |                  |
| Cash                                              | \$ (157,000)            | \$ 193,000       | \$ —             |
| Accounts receivable, net                          | 775,000                 | (1,506,000)      | 2,293,000        |
| Refundable Federal income taxes                   |                         |                  | (560,000)        |
| Inventories                                       | 1,281,000               | (1,928,000)      | 3,921,000        |
| Prepaid expenses                                  | 34,000                  | 128,000          | 20,000           |
| Prepaid employee benefits                         | (49,000)                | 900,000          |                  |
| Note payable                                      | (2,505,000)             | 4,080,000        | (2,870,000)      |
| Accounts payable                                  | (257,000)               | 1,307,000        | (1,477,000)      |
| Accrued liabilities                               | 103,000                 | (375,000)        | (710,000)        |
| Current portion long-term debt                    | (106,000)               | (12,000)         | (86,000)         |
| Income taxes payable                              | 566,000                 | (821,000)        | (172,000)        |
| Increase (decrease) in working capital            | \$ (315,000)            | \$1,966,000      | \$ 359,000       |

See notes to consolidated financial statements.



**THREE YEARS ENDED DECEMBER 31, 1985****Note A—Summary of Significant Accounting Policies:****Principles of consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All significant intercompany balances and transactions have been eliminated in consolidation.

**Prepaid employee benefits**

In 1984 the Company formed a Voluntary Employee Benefit Association (VEBA) and contributed \$900,000 to the Trust. The VEBA is a qualified plan with the Internal Revenue Service and permits the Company to prepay certain employee fringe benefits. The benefits will be paid from the Trust as they come due and will be expensed as incurred. An additional \$675,000 was contributed to the Trust in 1985 to cover benefits to be paid in 1986.

**Land, buildings and equipment**

Land, buildings and equipment are recorded at cost. Depreciation of buildings and equipment is computed using the straight-line method over the estimated useful lives of the assets.

**Reclassifications**

Certain reclassifications have been made in the 1983 and 1984 financial statements to conform with the 1985 classifications.

**Note B—Inventories:**

Inventories consist of the following—

|                            | December 31, |             |
|----------------------------|--------------|-------------|
|                            | 1985         | 1984        |
| Distribution merchandise   | \$1,108,000  | \$1,112,000 |
| Manufacturing inventories: |              |             |
| Finished goods             | 1,250,000    | 993,000     |
| Work-in-process            | 1,485,000    | 720,000     |
| Raw materials              | 3,825,000    | 3,562,000   |
|                            | \$7,668,000  | \$6,387,000 |

Inventories are valued at the lower of cost (average cost and first-in, first-out basis) or market.

**Note C—Note Payable to Bank:**

The Company has an \$8 million line of credit bearing interest at bank prime rate plus ½ % (10% as of December 31, 1985). Borrowings are collateralized by accounts receivable, inventories and equipment, and are subject to provisions of loan agreement and certain other restrictive covenants with which the Company has complied.

Under terms of the note, cash dividends are restricted to 20% of prior year net earnings.



**Note D—Long-Term Debt:**

Long-term debt consists of the following—

|                                                                                                    | December 31, |             |
|----------------------------------------------------------------------------------------------------|--------------|-------------|
|                                                                                                    | 1985         | 1984        |
| Mortgage note, 12%, payable in monthly installments including interest through July 2014           | \$1,692,000  | \$1,698,000 |
| Other mortgage and promissory notes, 7% to 19%, payable in monthly installments including interest | 2,205,000    | 1,574,000   |
| Mortgage note, 10 1/4%, 29-year amortization, callable in 1995                                     | 2,008,000    | 2,028,000   |
|                                                                                                    | 5,905,000    | 5,300,000   |
| Less current portion                                                                               | (449,000)    | (343,000)   |
|                                                                                                    | \$5,456,000  | \$4,957,000 |

Substantially all of the Company's land, buildings and equipment are pledged as collateral for the above debt.

Annual principal payments on long-term debt during each of the next five years are as follows—

|      |           |
|------|-----------|
| 1986 | \$449,000 |
| 1987 | 331,000   |
| 1988 | 359,000   |
| 1989 | 353,000   |
| 1990 | 307,000   |

**Note E—Operating Leases:**

The Company leases various manufacturing and distribution facilities in Washington, California and Hawaii.

Minimum annual lease payments for the next five years are as follows—

|      |           |
|------|-----------|
| 1986 | \$491,000 |
| 1987 | 305,000   |
| 1988 | 203,000   |
| 1989 | 26,000    |
| 1990 | —         |

Rent expense for the Company was \$374,000 in 1985, \$323,000 in 1984 and \$336,000 in 1983.

**Note F—Employee Benefit Plans:**

The Company and its subsidiaries have defined benefit pension plans covering substantially all employees. The Company makes annual contributions to these plans equal to the amounts accrued for pension expense, plus amortization of past service cost over 30 years.

Accumulated plan benefits, assuming a 7.3% rate of return, and plan net assets determined as of the latest actuarial valuation dates are presented below—

|                                                       | January 1,  |             |
|-------------------------------------------------------|-------------|-------------|
|                                                       | 1985        | 1984        |
| Actuarial present value of accumulated plan benefits: |             |             |
| Vested                                                | \$1,461,000 | \$1,041,000 |
| Nonvested                                             | 252,000     | 219,000     |
|                                                       | \$1,713,000 | \$1,260,000 |
| Net assets available for plan benefits                | \$1,422,000 | \$1,112,000 |



The Company adopted a Supplemental Retirement Plan covering a key officer. Under provisions of the Plan, the participant, upon retirement, will receive monthly supplemental benefits for life with a spousal residual. Costs of these supplemental benefits are being charged to pension expense over the estimated service period to date of retirement.

Pension expense for the Company was \$332,000 in 1985, \$245,000 in 1984 and \$139,000 in 1983.

**Note G—Stock Options:**

At December 31, 1985, nonqualified stock options were outstanding to purchase an aggregate of 97,459 shares. The options were granted various dates from 1976, are all currently exercisable at prices ranging from \$1.59 per share to \$4.90 per share, and expire at various dates to 1995. During the year, 21,600 shares were granted and options were exercised for 1,800 shares.

**Note H—Income Taxes:**

Income taxes consist of the following—

|                                                     | Year ended December 31, |             |           |
|-----------------------------------------------------|-------------------------|-------------|-----------|
|                                                     | 1985                    | 1984        | 1983      |
| Income tax provision at statutory rates             | \$491,000               | \$1,124,000 | \$391,000 |
| Decrease resulting from tax credits                 | (101,000)               | (69,000)    | (44,000)  |
| Income tax provision                                | 390,000                 | 1,055,000   | 347,000   |
| Net reductions (additions) to deferred income taxes | (208,000)               | 114,000     | (175,000) |
| Currently payable                                   | \$182,000               | \$1,169,000 | \$172,000 |

Changes in deferred income taxes result from timing differences in recognition of depreciation and from utilizing the installment method on certain asset sales. Included in the current income taxes payable at December 31, 1985 and 1984 are \$50,000 and \$85,000, respectively, of state income taxes. At December 31, 1984 current income taxes also include \$414,000, reflecting the current portion of deferred income taxes relating to the Company's Voluntary Employee Benefits Association.

Tax credits are accounted for as a reduction of income tax expense in the year they are utilized.

**Note I—Dividends:**

20% stock dividends were declared on July 18, 1985 and July 26, 1984 and were distributed to shareholders on September 9, 1985 and September 20, 1984, respectively. The Company did not declare any dividends in 1983.

**Note J—Major Customers:**

Transactions with one customer accounted for approximately \$6,400,000 in net sales in 1984. In 1985, there was no single customer who accounted for 10% or more in net sales.

**Note K—Gain on Sale of Real Estate:**

In January 1985 the Company sold a distribution facility for \$910,000. The Company continues to lease a portion of the facility on a month-to-month basis. Terms included a \$180,000 cash down payment and a \$730,000 promissory note bearing simple interest at 10.5%, collateralized by real property, and is due December 31, 1991. The after tax impact on earnings per share was \$0.23. The sale has been treated as an installment sale for Federal income tax purposes.

**Note L—Quarterly Financial Information (Unaudited):****1985**

|                         | First                                                  | Second   | Third    | Fourth   |
|-------------------------|--------------------------------------------------------|----------|----------|----------|
|                         | <i>(Dollars in thousands except per share amounts)</i> |          |          |          |
| Net sales               | \$11,347                                               | \$12,862 | \$13,584 | \$13,858 |
| Gross margin            | \$ 2,437                                               | \$ 3,138 | \$ 3,339 | \$ 3,700 |
| Net earnings            | \$ 111 <sup>(1)</sup>                                  | \$ 241   | \$ 193   | \$ 307   |
| Net earnings per share* | \$ 0.08                                                | \$ 0.18  | \$ 0.14  | \$ 0.23  |

<sup>(1)</sup>Includes a \$321,000 after-tax gain from the sale of real estate.

**1984**

|                         | First                                                  | Second   | Third    | Fourth   |
|-------------------------|--------------------------------------------------------|----------|----------|----------|
|                         | <i>(Dollars in thousands except per share amounts)</i> |          |          |          |
| Net sales               | \$14,905                                               | \$17,380 | \$13,205 | \$12,420 |
| Gross margin            | \$ 3,223                                               | \$ 3,831 | \$ 3,095 | \$ 3,434 |
| Net earnings            | \$ 354                                                 | \$ 531   | \$ 194   | \$ 170   |
| Net earnings per share* | \$ 0.27                                                | \$ 0.40  | \$ 0.15  | \$ 0.12  |

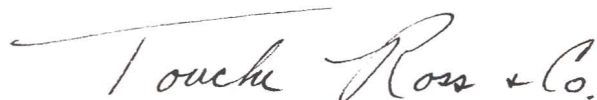
\*Restated for 20% stock dividends paid September 9, 1985 and September 20, 1984.

**Report of Independent Certified Public Accountants**

Board of Directors  
Timberland Industries, Inc.  
Bellevue, Washington

We have examined the consolidated balance sheets of Timberland Industries, Inc. and subsidiaries as of December 31, 1985 and 1984, and the related statements of operations, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Timberland Industries, Inc. and subsidiaries as of December 31, 1985 and 1984, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.



TOUCHE ROSS & CO.  
Certified Public Accountants

Seattle, Washington  
February 24, 1986



***Board of Directors***

**James F. Aylward**  
President  
Investors Mortgage Insurance Co.  
(Mortgage Insurance)

**Jack H. Canvin**  
Vice President  
Financial Analysis & Planning  
Bank of America (Banking)

**Robert J. DeArmond**  
Chairman, Idaho Forest Industries  
(Lumber manufacturer)

**Edward Easton**  
President  
Hopkins, Easton & Assoc., Inc.

**Donald S. Hansen**  
Personal investments

**Curtis P. Lindley**  
Chairman and Chief Executive  
Officer, Penwest Ltd  
(Agricultural processing)

**Ian MacDonald**  
President, Cal-Wood Door  
Senior Vice President,  
Timberland Industries, Inc.

**J. Allan MacDonald**  
President and Chief Executive Officer  
Timberland Industries, Inc.

**Delos W. McNutt**  
Personal Investments

**Carl N. Singer**  
Chairman of Canrad, Inc.  
Chairman of ECOA  
Chairman of Q-Cars Connection

**Milton D. Skutle**  
Senior Vice President,  
Timberland Industries, Inc.  
President  
WindowVisions, Inc.

***Officers***

**J. Allan MacDonald**  
President

**Ian MacDonald**  
Senior Vice President

**Milton D. Skutle**  
Senior Vice President

**Charles F. Lohman**  
Vice President

***Company Operations***

Timberland Industries, Inc.  
Corporate Offices  
P.O. Box 3546  
Bellevue, Washington 98009  
(206) 828-3565

Brennan Lighting  
2260-152nd N.E.  
Redmond, Washington 98052  
(206) 747-9300

Brennan Commercial  
11803 N.E. 116th  
Kirkland, Washington 98034  
(206) 823-1907

Cal-Wood Door  
P.O. Box 1656  
Santa Rosa, California 95402  
(707) 584-9663

Timberland International, Inc.  
2455 Bennett Valley Rd.  
Suite 214B  
Santa Rosa, California 95404  
Western Cabinet & Millwork  
P.O. Box 137  
Woodinville, Washington 98072  
(206) 823-4141

WindowVisions, Inc.  
11801 N.E. 116th  
Kirkland, Washington 98034  
(206) 823-5400

***Annual Meeting***

May 14, 1986  
The Rainier Club  
4th & Marion  
Seattle, Washington

***Form 10-K***

The Timberland Industries, Inc.  
Form 10-K report filed with the  
Securities and Exchange  
Commission is available to  
shareholders at no cost upon  
written request to:

Corporate Secretary  
Timberland Industries, Inc.  
P.O. Box 3546  
Bellevue, Washington 98009

***Registrar and Transfer Agent***

First Jersey Shareholder  
Services, Inc.  
1109 First Ave., Suite #306  
Seattle, Washington 98101

***Legal Counsel***

Foster, Pepper & Riviera  
1111 Third Avenue  
Seattle, Washington 98101

***Auditors***

Touche Ross & Co.  
One Bellevue Center  
Bellevue, Washington 98004  
This Company's stock is traded  
over-the-counter under  
NASDAQ symbol TIMB.



Timberland Industries, Inc.  
P.O. Box 3546  
Bellevue, WA 98009