

Brown Company 1978 Annual Report

A Gulf + Western Company

HOWARD ROSS LIBRARY
OF MANAGEMENT

NOV 14 1978

MCILL UNIVERSITY

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SUPPLEMENTAL INFORMATION

A copy of the Company's current annual report filed with the Securities and Exchange Commission on Form 10-K may be obtained free of charge by writing to the Treasurer, Brown Company, 251 South Lake Avenue, Pasadena, California 91101

Brown Company Highlights

	<u>1978</u>	<u>1977</u>
Year ended July 31:		
Net sales.....	\$491,906,000	\$453,828,000
Earnings before income taxes	9,279,000	8,447,000
Income tax provision	2,783,000	676,000
Net earnings	6,496,000	7,771,000
Net earnings per share91	1.12
Dividends per share30	.30
Capital expenditures.....	19,638,000	31,164,000
At July 31:		
Working capital.....	\$ 93,054,000	\$ 90,768,000
Total assets	358,896,000	331,743,000
Long-term debt.....	122,920,000	111,562,000
Shareholders' equity.....	150,353,000	145,967,000
Shareholders' equity per share.....	21.01	20.41
Number of shareholders	5,000	5,100
Number of employees	8,900	8,900

Report to Shareholders

Sales for the year ended July 31, 1978 were \$491.9 million compared with \$453.8 million in the year ended July 31, 1977 and net earnings were \$6.5 million in 1978 compared with \$7.8 million in 1977. Net earnings per share were \$.91 in 1978 and \$1.12 in 1977.

The decrease in net earnings in fiscal 1978 reflects an increase in the effective income tax rate from 8 percent in 1977 to 30 percent in 1978 caused mainly by a reduction in investment tax credits in 1978 compared with the prior year. However, pre-tax earnings of \$9.3 million were slightly above the \$8.4 million reported in 1977 and operating income (earnings before interest and income taxes) increased to \$17.7 million in 1978 from \$15.5 million in 1977, reflecting a significant increase in demand for building products.

Brown Company has two operating groups. The Paper Products Group accounts for about 80 percent of sales and the Building Products Group accounts for the remaining 20 percent. Over the past two years we have experienced a substantial decline in operating results of our paper operations and a substantial increase in operating results of our building

materials operations. We want to discuss briefly the major reasons for this significant change and the outlook for fiscal 1979.

Our Paper Products Group makes hardwood pulp, paperboard, and a variety of uncoated papers. These products make up the pulp, paper and paperboard segment of our paper operations. We also make converted paper products consisting of folding cartons, towels and tissues, matches and a variety of items used by the food service industry. Our Building Products Group makes products used in concrete construction (mostly non-residential construction) including rock, sand and gravel for the Southern California market and a variety of products used in the forming of concrete that are sold throughout the United States and overseas.

Operating income of our Paper Products Group dropped from \$26.7 million in fiscal 1976 to \$7.2 million in fiscal 1977 to \$5.9 million in fiscal 1978. These declines were due mainly to a cyclical drop in demand for major commodity-grade paper products such as hardwood pulp and uncoated printing and writing papers. During this two-year period the cost

of producing these products continued to escalate while market conditions would not permit price increases to recover these higher operating costs.

Operating income of our Building Products Group rose from \$5.3 million in fiscal 1976 to \$8.3 million in fiscal 1977 to \$11.8 million in fiscal 1978, reflecting a substantial increase in construction activity throughout the United States, the effect of the building boom in Southern California on the demand for rock, sand and gravel, and a rise in overseas demand for concrete forming equipment and accessories.

During the latter part of fiscal 1978 there was some improvement in demand for our commodity-grade paper products which have suffered a cyclical downturn over the past two years. The large world-wide inventory of pulp which depressed pulp prices has been reduced significantly in recent months and there has been some firming of prices for commodity-grade papers. We believe demand for our commodity paper products should continue to increase.

The Building Products Group had record operating results in fiscal 1978. Demand is continuing at a high

level going into the current fiscal year, and while there may be some reduction in residential construction, non-residential construction is projected to remain strong and overseas sales should continue to rise.

During 1978 we negotiated new union contracts with unions representing most of our employees. Also we completed the financing for construction of a \$12 million bark burning boiler that will reduce oil consumption by about 10 million gallons annually at our Berlin, New Hampshire pulp mill.

One of our major goals over the next several years will be to upgrade the mix of our paper products and reduce our reliance on commodity grades that are subject to wide profit fluctuations.

We are optimistic that our paper operations will improve significantly and that the Building Products Group will have another good year in fiscal 1979.



Merrill L. Nash
Chairman of the Board and President

September 15, 1978



Brown Company Paper Products Group

The Paper Products Group makes and directly sells primarily to paper manufacturers and converters, hardwood pulp, a variety of papers and recycled paperboard. Papers produced range from commodity-type printing and writing papers to specialty papers such as lightweight printing and communications papers and vegetable parchment used by the construction industry and used to make greeting cards, pressure-sensitive labels and other products. In addition the Paper Products Group makes flexible packaging papers used to wrap products such as candy, pet foods, meat, and dairy and poultry products.

The Group also makes and sells converted paper products including towels and tissues for the industrial and private label markets, folding cartons such as ice cream and cereal cartons, book matches used for advertising and food service disposables such as cups, pan liners, coffee filters and sandwich wraps. Converted paper products are sold mainly to distributors, users, retailers, and food processors by the Group's salesmen and by brokers.

Manufacturing facilities include pulp and paper mills in Berlin and Gorham, New Hampshire that are served by 800,000 acres of New England timberlands, paper and paperboard mills and folding carton operations in Kalamazoo and Parchment, Michigan, towel and tissue mills in Eau Claire and Ladysmith, Wisconsin, match plants in Chicago, Illinois and San Jose, California, and a paper mill in Holyoke, Massachusetts.

Results of operations of the Paper Products Group for the past five years are summarized below (see Note O and Note P to the consolidated financial statements for additional information):

	Years Ended July 31				
	1978	1977	1976(a)	1975(a)	1974(a)
Sales (millions):					
Pulp, paper and paperboard	\$201.7	\$193.4	\$193.8	\$173.8	\$179.4
Converted paper products	182.1	171.9	158.2	151.8	134.3
Total	\$383.8	\$365.3	\$352.0	\$325.6	\$313.7
Operating income (millions)	\$ 5.9	\$ 7.2	\$ 26.7	\$ 28.4	\$ 29.1
Production (1,000's of tons):					
Pulp	238.7	283.4	242.1	206.4	248.5
Paper	361.9	354.7	346.3	310.8	399.4
Paperboard	161.1	149.1	137.4	114.6	131.2

(a) Restated on an unaudited basis to reflect a change in fiscal year from a year ended November 30 to a year ended July 31 effective July 31, 1976.



Brown Company Building Products Group

Operations of the Building Products Group are all related to concrete construction and include the mining and processing of rock, sand and gravel, and the manufacture of reusable forms and accessories used in concrete construction.

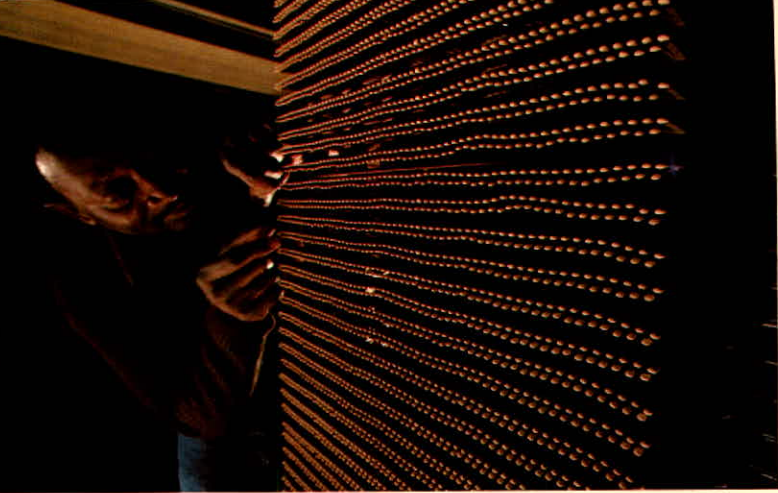
The Building Products Group is a principal supplier of rock, sand, gravel and ready-mixed concrete in Southern California where five aggregate producing plants and fourteen concrete batching plants service contractors engaged in the construction of highways, freeways, harbor improvements, skyscrapers, housing and other projects. The Group is a major manufacturer and distributor of reusable forms and accessories used by the construction industry for the on-site placement of concrete. Reusable forms consist generally of prefabricated steel frames with plastic coated plywood inserts which are joined and held together by ties during the pouring and hardening of concrete. Accessories include bolts, screw anchors, hanging devices, scaffolding and chemicals. The forms and accessories are used to build water and sewage treatment plants, electric power plants, industrial and commercial buildings, bridges and other structures.

Major manufacturing plants are located in Chicago, Illinois, New Braunfels, Texas, and Tremont, Pennsylvania. Most of the forms and accessories produced at these facilities are sold through the Group's distribution centers located throughout the United States.

Results of operations of the Building Products Group for the past five years are summarized below (see Note O and Note P to the consolidated financial statements for additional information):

	Years Ended July 31				
	1978	1977	1976(a)	1975(a)	1974(a)
Sales (millions)	\$108.1	\$88.5	\$78.2	\$85.0	\$90.9
Operating income (millions)	\$ 11.8	\$ 8.3	\$ 5.3	\$ 6.3	\$ 3.8
Rock, sand and gravel produced (1,000's of tons)	6,316	6,110	5,720	5,856	6,574

(a) Restated on an unaudited basis to reflect a change in fiscal year from a year ended November 30 to a year ended July 31 effective July 31, 1976.



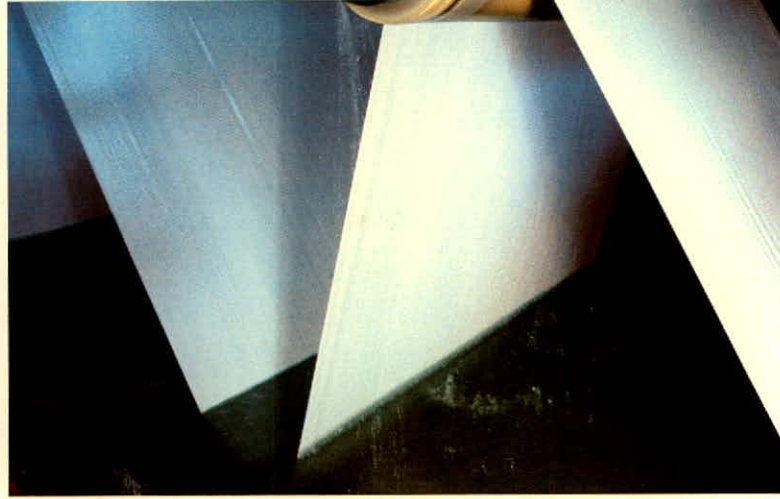
(1)



(2)



(3)



(4)



(5)



(6)



(7)

These photos depict some of Brown's products which include (1) book matches, (2) facial tissues, (3) plastic cups, (4) parchment paper, (5) accessories used in concrete construction, (6) folding cartons and (7) rock, sand and gravel.

Brown Company and Subsidiaries
Five Year Comparison
Years Ended and at July 31

	1978	1977	1976(a)	1975(a)	1974(a)
For the year (000):					
Sales and other revenues(b)	\$492,009	\$453,955	\$430,302	\$410,745	\$404,597
Operating costs.....	474,279	438,465	398,278	375,976	371,718
Operating income.....	17,730	15,490	32,024	34,769	32,879
Interest expense.....	9,672	7,948	5,428	5,771	7,768
Interest income.....	1,221	905	631	1,489	1,919
Earnings before income taxes	9,279	8,447	27,227	30,487	27,030
Income tax provision	2,783	676	9,614	12,361	9,842
Net earnings.....	6,496	7,771	17,613	18,126	17,188
Net earnings per share(c).....	.91	1.12	2.51	2.61	2.50
Depreciation and depletion.....	14,901	13,203	11,471	10,351	9,165
Capital expenditures.....	19,638	31,164	27,279	40,486	19,989
End of year (000):					
Working capital	\$ 93,054	\$ 90,768	\$ 74,844	\$ 63,443	\$ 63,271
Net properties	179,105	171,826	151,673	137,490	108,345
Total assets	358,896	331,743	298,125	280,414	247,692
Long-term debt.....	122,920	111,562	93,889	91,651	91,747
Shareholders' equity.....	150,353	145,967	136,063	119,823	86,552
Shareholders' equity per share.....	21.01	20.41	20.20	17.85	15.65
Ratio of long-term debt to equity82	.76	.69	.76	1.06

- (a) Unaudited except July 31, 1976 end of year amounts. The Company changed its fiscal year from a year ending November 30 to a year ending July 31 effective July 31, 1976. Years prior to 1977 have been restated on an unaudited basis to reflect operating results for years ended July 31.
- (b) Includes other revenues of \$103,000 in 1978, \$127,000 in 1977, \$92,000 in 1976, \$114,000 in 1975 and \$35,000 in 1974.
- (c) Net earnings per share have been retroactively adjusted to reflect a five-for-four split effected in February 1976 as though it had occurred at the beginning of the years presented.

Brown Company and Subsidiaries

Management Discussion and Analysis of Change in Earnings

Net Sales (Including Other Revenues) and Operating Income

Sales of the Paper Products Group changed from \$193.8 million in 1976 to \$193.4 million in 1977 to \$201.7 million in 1978 and operating income dropped from \$26.7 million in 1976 to \$7.2 million in 1977 to \$5.9 million in 1978. These declines in operating income were due mainly to a cyclical drop in demand for major commodity-grade paper products such as hardwood pulp and uncoated printing and writing papers. In 1977 moderate selling price increases for most paper products were offset by a decline in pulp selling prices plus an increase in the proportion of lower margin products sold while costs continued to rise (labor rates rose 10 percent, wastepaper costs were up 20 percent and the cost of energy increased 19 percent). Although weak market conditions continued into 1978 paper products sales rose by 4 percent and operating results remained at about the 1977 level reflecting higher productivity and sales volume, a 10 percent increase in labor rates, a 10 percent decline in purchased pulp costs, stable wastepaper and energy costs, and a firming of pulp and commodity-grade paper markets in the last part of 1978.

Sales of the Building Products Group rose from \$78.2 million in 1976 to \$88.5 million in 1977 to \$108.1 million in 1978 and operating income increased from \$5.3 million in 1976 to \$8.3 million in 1977 to \$11.8 million in 1978 reflecting a substantial increase in construction activity throughout the United States, the effect of the building boom in Southern California on the demand for concrete, rock, sand and gravel, and a rise in demand for concrete forming equipment and accessories. The improvement in 1977 in both sales and operating income from building products reflects improved market conditions and selling price and sales volume increases which more than offset cost increases, especially in the latter months of the year ended July 31, 1977. Cost increases in 1978 were more than offset by higher prices, especially for concrete, and increased sales volume, particularly for concrete forming equipment and concrete.

Interest Expense and Interest Income

The increase in interest expense in 1977 and 1978 was due mainly to increases in long-term debt and interest on debt that was capitalized in prior years as part of the cost of construction of pollution control facilities. The increase in interest income in 1977 and 1978 reflects an increase in the amount of funds available for temporary investment and an increase in the rate of interest earned on such investments.

Income Taxes

The effective income tax rate varies because of changes in the amount of earnings before income taxes in relation to investment tax credits, capital gains from timber cutting, depletion allowances and differences in the tax and financial reporting basis of certain assets (see Note I to the consolidated financial statements). The change in the effective tax rate from 35 percent in 1976 to 8 percent in 1977 to 30 percent in 1978 was due primarily to changes in the amount of available investment tax credits in relation to earnings before income taxes.

Addendum - The numbers appearing in the first line of the first paragraph on page 13 should be \$352.0 million in 1976, \$365.3 million in 1977 and \$383.8 million in 1978 instead of \$193.8 million, \$193.4 million and \$201.7 million and the percentage on line eight of the first paragraph should be 5 percent instead of 4 percent.

Brown Company and Subsidiaries
Consolidated Statements of Earnings
Years Ended July 31

	1978	1977
Revenues:		
Net sales	\$491,906,000	\$453,828,000
Other	103,000	127,000
	<u>492,009,000</u>	<u>453,955,000</u>
Operating costs:		
Cost of sales	421,104,000	389,287,000
Selling, administrative and general expenses.....	53,175,000	49,178,000
	<u>474,279,000</u>	<u>438,465,000</u>
Operating income	17,730,000	15,490,000
Interest cost:		
Interest expense — Note D	10,015,000	9,372,000
Interest income	(1,221,000)	(905,000)
Net interest cost capitalized — Notes A and H.....	(343,000)	(1,424,000)
	<u>8,451,000</u>	<u>7,043,000</u>
Earnings before income taxes	9,279,000	8,447,000
Income tax provision — Notes A and I	2,783,000	676,000
Net earnings	<u>\$ 6,496,000</u>	<u>\$ 7,771,000</u>
Net earnings per common and common equivalent share —		
Note J	<u>\$.91</u>	<u>\$ 1.12</u>
Cash dividends declared per common share	<u>\$.30</u>	<u>\$.30</u>

See notes to consolidated financial statements.

Brown Company and Subsidiaries
Consolidated Statements of Changes in Financial Position
Years Ended July 31

	1978	1977
Funds provided from operations:		
Net earnings	\$ 6,496,000	\$ 7,771,000
Items recognized in net earnings which did not affect working capital:		
Depreciation and depletion	14,901,000	13,203,000
Deferred income taxes	1,289,000	3,770,000
Provision for loss on disposal of assets	1,800,000	—
	<u>24,486,000</u>	<u>24,744,000</u>
Other funds provided:		
Asset dispositions	1,341,000	308,000
Debt issued	18,068,000	23,177,000
Stock issued	35,000	4,219,000
Other	158,000	1,074,000
	<u>19,602,000</u>	<u>28,778,000</u>
Total funds provided	44,088,000	53,522,000
Funds used:		
Plant additions	19,638,000	31,164,000
Pre-1977 leases capitalized	3,883,000	—
Business purchased less working capital acquired	—	2,500,000
Reduction in long-term debt and other liabilities	6,728,000	5,614,000
Funds reserved (expended) to pay for pollution control facilities	9,408,000	(3,766,000)
Cash dividends declared	2,145,000	2,086,000
	<u>41,802,000</u>	<u>37,598,000</u>
Total funds used	41,802,000	37,598,000
Increase in working capital	\$ 2,286,000	\$15,924,000
Elements of change in working capital		
Increase (decrease):		
Cash including short-term investments	\$ 5,216,000	\$ 9,693,000
Accounts receivable	4,011,000	2,313,000
Inventories	2,359,000	5,813,000
Prepaid expenses	(962,000)	486,000
Notes payable	—	2,000,000
Current long-term debt maturities	(918,000)	(377,000)
Accounts payable	(1,377,000)	(1,300,000)
Accrued expenses	(3,430,000)	(4,349,000)
Income taxes payable	(2,613,000)	1,645,000
Increase in working capital	\$ 2,286,000	\$15,924,000

See notes to consolidated financial statements.

Brown Company and Subsidiaries
Consolidated Balance Sheets
At July 31

	1978	1977
ASSETS		
Current assets:		
Cash including short-term investments — Notes A and N	\$ 19,677,000	\$ 14,461,000
Accounts receivable (less allowance of \$899,000 in 1978 and \$1,059,000 in 1977)	61,640,000	57,629,000
Inventories — Notes A and B	75,669,000	73,310,000
Prepaid expenses.....	726,000	1,688,000
	157,712,000	147,088,000
Properties — Notes A, D and K:		
Land and improvements	9,722,000	9,801,000
Timberlands and quarries.....	9,967,000	9,940,000
Buildings, machinery and equipment.....	345,137,000	322,091,000
Accumulated depreciation and depletion.....	(185,721,000)	(170,006,000)
	179,105,000	171,826,000
Other assets:		
Funds restricted for pollution control facilities.....	15,607,000	6,199,000
Investments and non-current receivables — Note N.....	2,241,000	2,541,000
Other	4,231,000	4,089,000
	22,079,000	12,829,000
	\$ 358,896,000	\$331,743,000

See notes to consolidated financial statements.

	1978	1977
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current long-term debt maturities	\$ 6,430,000	\$ 5,512,000
Accounts payable.....	16,204,000	14,827,000
Accrued expenses — Note N.....	38,296,000	34,866,000
Income taxes payable	3,728,000	1,115,000
	64,658,000	56,320,000
Other liabilities:		
Long-term debt — Note D.....	122,920,000	111,562,000
Deferred income taxes	18,982,000	17,693,000
Other	1,983,000	201,000
	143,885,000	129,456,000
Shareholders' equity — Notes A, D and E:		
Common stock.....	7,168,000	7,164,000
Treasury stock	(156,000)	(156,000)
Other capital	56,744,000	56,713,000
Retained earnings	86,597,000	82,246,000
	150,353,000	145,967,000
Commitments and contingencies — Notes D, F, K and L.....		
	<u>\$358,896,000</u>	<u>\$331,743,000</u>

Brown Company and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
Years Ended July 31

	1978	1977
Common stock:		
Beginning balance	\$ 7,164,000	\$ 6,750,000
Warrants exercised — Note E.....	—	369,000
Stock options exercised — Note E.....	<u>4,000</u>	<u>45,000</u>
Ending balance.....	<u>\$ 7,168,000</u>	<u>\$ 7,164,000</u>
Other capital:		
Beginning balance	\$56,713,000	\$ 52,908,000
Warrants exercised — Note E.....	—	3,475,000
Stock options exercised — Note E.....	<u>31,000</u>	<u>330,000</u>
Ending balance.....	<u>\$56,744,000</u>	<u>\$ 56,713,000</u>
Retained earnings:		
Beginning balance	\$82,246,000	\$ 76,561,000
Net earnings	6,496,000	7,771,000
Dividends.....	<u>(2,145,000)</u>	<u>(2,086,000)</u>
Ending balance.....	<u>\$86,597,000</u>	<u>\$ 82,246,000</u>

See notes to consolidated financial statements.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements
Years Ended July 31, 1978 and 1977

Note A — Summary of Accounting Policies

The accompanying consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. Significant inter-company accounts, transactions, and profits have been eliminated. At July 31, 1978, Gulf + Western Industries, Inc. owned 80.7 percent of the Company's common stock.

Short-term investments are stated at cost which approximates market value.

Inventories are generally valued at the lower of average cost or market.

Properties are stated at cost. Expenditures for maintenance and repairs are charged to income. Betterments and renewals are charged to the appropriate property account. The cost of assets and the related accumulated depreciation are eliminated from the accounts when assets are retired or otherwise disposed of. Gains on disposition of assets are reflected in income in the year of disposal and losses are reflected when a decision is made to dispose of assets.

Depreciation is, in general, computed using the straight-line method over the estimated useful lives of the various classes of properties. The estimated useful lives fall largely within the following ranges:

Buildings and other structures	10-50 years
Automotive equipment	3-10 years
Machinery (including capitalized leases), furniture and other equipment.....	2-25 years

The Company capitalized the net interest cost during construction on bonds issued to finance pollution control facilities since interest during construction was included in the proceeds from the sale of the bonds and such interest is considered part of the cost of the facilities. Net interest cost capitalized consists of bond interest expense less interest income received on the investment of bond proceeds until such proceeds are used to pay for the facilities.

Provisions for income taxes reflect the recognition of investment tax credits in the year realized (flow-through method). The Company and its subsidiaries are included in the consolidated Federal income tax return of Gulf + Western Industries, Inc. The Company's provision for Federal income taxes is computed (and payment made to Gulf + Western) as if the Company filed a separate consolidated return.

Contributions are made to pension trusts to fund accrued pension expense, including amounts needed to amortize the unfunded cost of past service over 30 years.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note B — Inventories

Inventories at July 31, 1978 and 1977 were classified as follows:

	<u>1978</u>	<u>1977</u>
Raw materials, work in process and supplies	\$37,088,000	\$ 34,889,000
Paper and other manufactured products	38,581,000	38,421,000
Total	<u>\$75,669,000</u>	<u>\$ 73,310,000</u>

The following inventories were used in computing the cost of sales:

July 31, 1978	\$ 75,669,000
July 31, 1977	73,310,000
July 31, 1976	67,497,000

Note C — Notes Payable

At July 31, 1978 and 1977, there were no short-term notes payable. Additional information concerning short-term notes for years ended July 31 is shown below:

	<u>1978</u>	<u>1977</u>
Maximum outstanding at any month-end	\$ —	\$ 9,500,000
Average amount outstanding (total of months-end outstanding principal balances divided by 12).....	—	1,500,000
Average interest rate (total interest expense for the year divided by the weighted total outstanding borrowings).....	—	6.9%

The Company has line of credit arrangements with banks totaling \$21,000,000 which do not have termination dates, but are reviewed annually for renewal. The Company is not required to maintain material compensating balances in connection with these arrangements and at July 31, 1978 none of the credit lines were being used.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note D — Long-Term Debt

	July 31	July 31
	1978	1977
Senior long-term debt:		
7% to 9 ⁷ / ₈ % notes payable to institutional investors 1979 to 1986	\$ 28,852,000	\$ 33,152,000
11% notes payable to institutional investors 1980 to 1991	30,000,000	30,000,000
Capitalized leases	6,835,000	2,019,000
6% to 9% pollution control revenue bonds payable 1981 to 2006	49,800,000	36,800,000
Other notes (5% to 9%) payable 1979 to 1987	3,899,000	5,139,000
	119,386,000	107,110,000
Current maturities	(6,430,000)	(5,512,000)
Total senior long-term debt.....	112,956,000	101,598,000
9% subordinated debentures due 1995.....	9,964,000	9,964,000
Total long-term debt.....	\$ 122,920,000	\$111,562,000

The following payments are required on the above long-term debt during the five years ending July 31, 1983:

1979	\$ 6,430,000
1980	9,101,000
1981	9,511,000
1982	9,598,000
1983	8,711,000

Note agreements with institutional investors provide for the possible future mortgage (if certain conditions are not met) of the Company's New England timberlands and properties in Berlin and Gorham, New Hampshire and Kalamazoo and Parchment, Michigan. Certain pollution control revenue bonds are secured by the related pollution control facilities and a mortgage on approximately 79,000 acres of New England timberlands.

Certain long-term loan agreements restrict the payment of dividends. Under the most restrictive of the agreements, retained earnings at July 31, 1978 of \$16,179,000 were not restricted.

Interest expense is primarily attributable to long-term debt.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note E — Capital Stock

There are 10,000,000 shares of \$1 par value common stock and 2,500,000 shares of preferred stock authorized. At July 31, 1978 and 1977 there were outstanding 7,155,411 and 7,151,411 shares of common stock, respectively, excluding 12,280 treasury shares. Each share is entitled to one vote. No preferred stock is outstanding.

In January 1977, Gulf + Western Industries, Inc. exercised warrants to purchase 368,529 shares of Brown Company common stock at a price of \$10.43 per share. At July 31, 1978, unissued shares of common stock were reserved as follows for the exercise of warrants and options:

Warrants exercisable to May 15, 1980 at \$13.20 per share.....	1,356,682
Employee stock options outstanding	78,875
Employee stock options available for grant	<u>130,875</u>
Total	<u><u>1,566,432</u></u>

The Company's stock option incentive plans provide for the grant of qualified stock options to key employees to buy common stock of the Company at a price not less than fair market value on date of grant. Subject to termination of employment, the options expire five years from the date of grant or on May 20, 1981 with respect to any options granted after May 20, 1976.

The following table summarizes information relating to common stock options outstanding at July 31, 1978 and 1977:

Year of Grant	1978			1977		
	Number of Shares	Option Price		Number of Shares	Option Price	
		Per Share(c)	Total		Per Share(c)	Total
1972(a)	—	\$ —	\$ —	2,500	\$ 8.45	\$ 21,120
1973(a)	4,750	8.35	39,672	15,375	8.35-8.90	133,327
1974(a)	6,625	8.25	54,643	7,125	8.25	58,767
1975(a)	2,500	8.80	22,000	2,500	8.80	22,000
1976(b)	<u>65,000</u>	10.45	<u>679,120</u>	<u>65,000</u>	10.45	<u>679,120</u>
Total.....	<u>78,875</u>		<u>\$795,435</u>	<u>92,500</u>		<u>\$914,334</u>

(a) Year ended November 30.

(b) Eight months ended July 31.

(c) Market price on date option was granted.

Brown Company and Subsidiaries

Notes to Consolidated Financial Statements (continued)

Note E — Capital Stock (continued)

During the year ended July 31, 1978 options for 4,000 shares were exercised at a total price of \$34,832 at prices ranging from \$8.25 to \$8.90 per share, and options for 16,875 shares became exercisable at a total price of \$175,280 at prices ranging from \$8.80 to \$10.45 per share. The market value of the 4,000 shares at time of exercise was \$34,313 (ranging from \$8.25 to \$8.75 per share) and the market value of the 16,875 shares at the time the related options became exercisable was \$149,688 (ranging from \$8.75 to \$8.88 per share).

During the year ended July 31, 1977 options for 45,625 shares were exercised at a total price of \$374,981 at prices ranging from \$5.70 to \$8.35 per share, and options for 57,344 shares became exercisable at a total price of \$558,619 at prices ranging from \$8.25 to \$10.45 per share. The market value of the 45,625 shares at time of exercise was \$445,859 (ranging from \$9.25 to \$13.13 per share) and the market value of the 57,344 shares at the time the related options became exercisable was \$515,297 (ranging from \$8.88 to \$11.13 per share).

At July 31, 1978 options for 62,625 shares were exercisable. At July 31, 1977 options for 59,375 shares were exercisable. Options for 130,875 shares were available for future grants at July 31, 1978, and options for 121,250 shares were available for future grants at July 31, 1977. No charges were made to income for option transactions in 1978 or 1977. The excess of proceeds from the exercise of stock options over par value of shares of common stock issued is credited to other capital.

Note F — Pension Plans

Substantially all employees are covered by pension plans. Pension expense aggregated \$12,888,000 for the year ended July 31, 1978 and \$10,622,000 for the year ended July 31, 1977. On January 1, 1978 (the last actuarial valuation date), the actuarially computed value of vested benefits under the pension plans exceeded the actuarial value of pension trust assets and balance sheet accruals by approximately \$46,000,000 and the estimated unfunded past service liability under the plans approximated \$85,000,000.

Note G — Incentive Compensation Plans

The Company has incentive compensation plans for key management personnel under which at July 31, 1978 the amount payable to individual participants is limited to 25 percent of the participants' base salaries. The Company also has a deferred incentive compensation plan based on meeting certain return on shareholders' equity requirements. The charge to income for incentive compensation plans was \$1,468,000 for the year ended July 31, 1978 and \$1,076,000 for the year ended July 31, 1977.

Note H — Capitalized Interest

Net interest cost capitalized increased net earnings \$257,000 (four cents per share) for the year ended July 31, 1978 and \$712,000 (ten cents per share) for the year ended July 31, 1977.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note I — Income Taxes

An analysis of the income tax provision for the years ended July 31, 1978 and 1977 is shown below:

	<u>1978</u>	<u>1977</u>
Current provision:		
Federal	\$ 398,000	\$ (4,019,000)
State	1,096,000	925,000
Deferred provision	<u>1,289,000</u>	<u>3,770,000</u>
Total income tax provision.....	<u>\$2,783,000</u>	<u>\$ 676,000</u>

The income tax provision was reduced by investment tax credits of \$1,506,000 in the year ended July 31, 1978 and \$3,029,000 in the year ended July 31, 1977. The income tax provision in 1977 reflects investment tax credits in excess of income taxes before credits, such credits being assured for tax payable purposes as a reduction of taxes currently payable or as a carryback to recover taxes paid in prior years.

The provision for taxes on income is low in relation to earnings before taxes primarily because of investment tax credits, capital gain from timber cutting, depletion allowances and differences in the tax and financial reporting basis of certain assets. The income tax provision as a percent of earnings before income taxes for the years ended July 31, 1978 and 1977 is less than the Federal statutory rate of 48 percent as explained below:

	<u>1978</u>	<u>1977</u>
Statutory rate.....	48 %	48 %
Decrease arising from investment tax credits	(16)	(36)
State income taxes	6	6
Other items.....	<u>(8)</u>	<u>(10)</u>
Effective tax rate.....	<u>30 %</u>	<u>8 %</u>

The deferred portion of the income tax provision for years ended July 31, 1978 and 1977 results from reporting income and deductions at different times for financial reporting and income tax purposes as follows:

	<u>1978</u>	<u>1977</u>
Tax effect of:		
Excess depreciation for Federal income tax purposes	\$2,760,000	\$2,959,000
Investment tax credits.....	(948,000)	—
Aggregate timing differences due to expense accruals deductible for income tax purposes when paid but deducted for financial reporting purposes when incurred	<u>(523,000)</u>	<u>811,000</u>
Deferred portion of income tax provision	<u>\$1,289,000</u>	<u>\$3,770,000</u>

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note J — Earnings Per Share

Net earnings per common and common equivalent share are based on weighted average common shares and dilutive common share equivalents (warrants and options) outstanding during the years assuming that the warrants and options were exercised and the proceeds therefrom used first to buy 20 percent of the outstanding common shares for the treasury and the remainder to retire debt at market values. For the years ended July 31, 1978 and 1977 common share equivalents were not dilutive.

Average common shares outstanding were 7,153,000 in 1978 and 6,947,000 in 1977.

Note K — Leases

The Company leases various buildings, machinery and equipment under both operating leases and capital leases. All capital leases have been capitalized to comply with Statement of Financial Accounting Standards No. 13 including leases entered into prior to January 1, 1977. Machinery and equipment at July 31, 1978 include \$6,743,000 (\$12,151,000 less accumulated depreciation of \$5,408,000) of property acquired pursuant to such leases. At July 31, 1978, lease commitments and the present value of capitalized lease commitments were:

<u>Year Payable</u>	<u>Capitalized Leases</u>	<u>Non- Cancellable Operating Leases</u>
1979	\$1,754,000	\$1,485,000
1980	1,754,000	808,000
1981	1,566,000	485,000
1982	1,132,000	255,000
1983	786,000	189,000
After 1983	<u>2,088,000</u>	<u>674,000</u>
Total	9,080,000	<u>\$3,896,000</u>
Amount representing interest	<u>2,245,000</u>	
Present value of capital lease payments of which \$1,186,000 is payable currently	<u>\$6,835,000</u>	

Rental expense totaled \$5,191,000 for the year ended July 31, 1978 and \$4,941,000 for the year ended July 31, 1977.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note L — Contingencies

In February 1976, a Federal Grand Jury returned an indictment in the Federal District Court in Chicago, Illinois naming the Company and 22 other companies in the folding carton business as defendants in an action under the Sherman Act, alleging a conspiracy to fix, raise, maintain and stabilize prices of folding cartons from 1960 to 1974. In July 1976, the Company pleaded *nolo contendere* to this charge and in September 1976 was fined \$45,000. In relation to this matter, 78 private treble damage actions seeking unspecified amounts of damages have been filed against the Company and the other defendants. Some of the defendants have recently entered into settlement agreements with the plaintiffs in the class actions which are subject to approval of the Court. The Company, however, is continuing to vigorously contest all of these actions. While the amount of liability which the Company may ultimately incur in connection with these actions is presently not determinable, management is of the opinion that their ultimate resolution will have no material effect on the consolidated financial position of the Company and its subsidiaries.

Brown and its subsidiaries are defendants in various other lawsuits arising in the ordinary course of business. Damages requested in such lawsuits are covered by liability insurance or involve immaterial amounts.

Note M — Supplementary Earnings Statement Information

	<u>1978</u>	<u>1977</u>
Maintenance and repairs	<u>\$37,020,000</u>	<u>\$33,298,000</u>
Taxes other than income taxes:		
Local property taxes	\$ 5,154,000	\$ 4,395,000
Payroll taxes	8,904,000	7,979,000
Other taxes	<u>851,000</u>	<u>885,000</u>
Total	<u>\$14,909,000</u>	<u>\$13,259,000</u>

Royalties, advertising and amortization of intangible assets, preoperating costs and similar costs did not exceed one percent of net revenues.

Note N — Supplementary Balance Sheet Information

	<u>1978</u>	<u>1977</u>
Cash including short-term investments:		
Cash	\$12,824,000	\$ 8,080,000
Short-term investments	<u>6,853,000</u>	<u>6,381,000</u>
Total	<u>\$19,677,000</u>	<u>\$14,461,000</u>

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note N — Supplementary Balance Sheet Information (continued)

	<u>1978</u>	<u>1977</u>
Investments and non-current receivables:		
Amounts receivable from officers, directors and employees	\$ 474,000	\$ 462,000
Other	1,767,000	2,079,000
Total	<u>\$ 2,241,000</u>	<u>\$ 2,541,000</u>
Accrued expenses:		
Compensation and taxes thereon	\$10,341,000	\$ 7,073,000
Pensions	15,636,000	13,523,000
Other	12,319,000	14,270,000
Total	<u>\$38,296,000</u>	<u>\$34,866,000</u>

Note O — Analysis of Operations by Business Segments

The Company is engaged in the production and sale of pulp, paper and paperboard; converted paper products; and building products. Operating results and other financial data are presented below for these three business segments as of and for the year ended July 31, 1978:

	(000)				
	Pulp, Paper and Paperboard	Converted Paper Products	Building Products	Corporate Items and Eliminations	Consoli- dated
Sales	\$201,710	\$182,073	\$108,123	\$ —	\$491,906
Intersegment sales	53,401	—	—	(53,401)	—
Operating income	598	5,373	11,820	(61)	17,730
Identifiable assets	186,764	78,655	63,646	29,831	358,896
Depreciation and depletion	10,070	3,230	1,601	—	14,901
Capital expenditures	14,730	3,874	1,034	—	19,638

Operating income is total revenue less all costs other than interest cost (net of interest income) and income taxes. In computing operating income corporate administration expenses of \$4,560,000 have been allocated to each business segment based on the ratio of sales of the segment to total sales for all segments. Identifiable assets are those assets used in the Company's operations in each business segment. Corporate assets are principally cash and short-term investments. Export sales to foreign customers and total sales to a single customer are each less than 10 percent of consolidated sales. Intersegment sales consist principally of sales at prevailing market prices of paper to the converted paper products segment to make towels, tissues and food service disposables and of paperboard to the converted paper products segment to make folding cartons.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note P — Sales by Classes of Products (unaudited)

Sales by classes of products within each of the Company's three business segments for the five years ended July 31, 1978 were as follows:

	(000)				
	1978	1977	1976(a)	1975(a)	1974(a)
Pulp.....	\$ 26,679	\$ 31,810	\$ 30,506	\$ 25,877	\$ 18,272
Paper.....	156,138	144,752	146,804	134,393	145,716
Paperboard.....	18,893	16,841	16,442	13,489	15,475
Total pulp, paper and paperboard.....	201,710	193,403	193,752	173,759	179,463
Towels and tissues.....	76,346	75,064	63,037	61,213	53,369
Food service disposables.....	35,568	32,152	32,581	30,344	27,498
Folding cartons.....	61,035	55,370	53,167	51,324	44,671
Matches.....	9,124	9,321	9,515	8,991	8,697
Total converted paper products.....	182,073	171,907	158,300	151,872	134,235
Rock, sand, gravel and transit-mixed concrete.....	50,441	41,745	34,088	30,051	30,758
Concrete forming equipment and related services.....	57,682	46,773	44,070	54,949	60,106
Total building products.....	108,123	88,518	78,158	85,000	90,864
Total sales.....	\$491,906	\$453,828	\$430,210	\$410,631	\$404,562

(a) Restated on an unaudited basis to reflect a change in fiscal year from a year ended November 30 to a year ended July 31 effective July 31, 1976.

Note Q — Replacement Cost Information (unaudited)

In compliance with regulations of the Securities and Exchange Commission (SEC), the Company has estimated replacement cost of inventories and certain property, plant and equipment at July 31, 1978 and 1977 and the related estimated effects (before income tax benefits) on cost of sales and depreciation expense for the years then ended. This information is included in the Company's annual report on Form 10-K filed with the SEC. The replacement cost information was prepared based on guidelines provided by the SEC which required the use of many hypothetical assumptions and subjective judgments and does not represent actual costs which will be incurred in future periods, nor the manner in which replacement of assets will occur.

Cost of sales and depreciation expense computed on a replacement cost basis (which does not reflect operating cost savings which would result from the replacement of existing assets) exceed comparable amounts computed on an historical cost basis as a result of the continuing impact of inflation on the prices of goods and services. Over the past several years, the Company's operating results have been subjected to these pressures of inflation; however, the Company has been able to offset certain of the effects of inflation through increased productivity, emphasis on cost and expense controls, and selective price increases.

Brown Company and Subsidiaries
Notes to Consolidated Financial Statements (continued)

Note R — Summary of Quarterly Results of Operations (unaudited)

Unaudited quarterly financial results for the years ended July 31, 1978 and 1977 are summarized below:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter (a)
1978:				
Sales	\$ 120,312,000	\$ 108,858,000	\$ 125,459,000	\$ 137,277,000
Gross profit	16,005,000	11,120,000	18,534,000	25,143,000
Net earnings (loss)	846,000	(2,824,000)	2,614,000	5,860,000
Per common share:				
Net earnings (loss).....	\$.12	\$ (.40)	\$.37	\$.82
Dividends075	.075	.075	.075
Market price:				
High	9	10¼	9¼	9½
Low	8	8	8¼	8¼
1977:				
Sales	\$ 112,783,000	\$ 104,152,000	\$ 114,831,000	\$ 122,062,000
Gross profit	16,202,000	12,126,000	15,073,000	21,140,000
Net earnings (loss)	1,364,000	(1,186,000)	2,511,000	5,082,000
Per common share:				
Net earnings (loss).....	\$.20	\$ (.17)	\$.36	\$.73
Dividends075	.075	.075	.075
Market price:				
High	13½	10⅝	9¾	9½
Low	10¼	9⅝	8⅝	8½

(a) The fourth quarter of 1978 includes a provision for loss on disposal of assets that reduced net earnings by \$1,300,000 (eighteen cents per share).

**Report of Ernst & Ernst,
Independent Auditors**

To the Board of Directors and
Shareholders of Brown Company

We have examined the consolidated balance sheets of Brown Company and subsidiaries as of July 31, 1978 and 1977, and the consolidated statements of earnings, changes in shareholders' equity and changes in financial position for the years then ended. 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 financial statements referred to above present fairly the consolidated financial position of Brown Company and subsidiaries at July 31, 1978 and 1977, and the consolidated results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Ernst

New York, New York
September 15, 1978

Brown Company
Directors and Officers

Directors

- John E. Cherrix — Vice President – Finance and Treasurer
- † Sherwood C. Chillingworth — President, Chillingworth Corporation
(a real estate development company)
- * David D. Davis — Senior Vice President
- * Don F. Gaston — Executive Vice President, Gulf + Western Industries, Inc.
(a multi-industry company)
- Leonard E. Hickey — Vice President and Controller
- * David N. Judelson — President, Gulf + Western Industries, Inc.
- James R. Maurer — Vice President, Secretary and General Counsel
- * Merrill L. Nash — Chairman of the Board and President
- † William T. Pascoe, III — Chairman of the Board, Amcord, Inc.
(a cement manufacturer)
- † Herbert J. Seakwood — Management Consultant and Attorney
- * Member of Executive Committee
- † Member of Audit Committee

Officers

- Merrill L. Nash — Chairman of the Board and President
- David D. Davis — Senior Vice President
- R. James Alexy — Vice President
- John E. Cherrix — Vice President – Finance and Treasurer
- Edgar T. Dean — Vice President
- Leonard E. Hickey — Vice President and Controller
- Richard S. Longnecker — Vice President
- James R. Maurer — Vice President, Secretary and General Counsel
- Robert J. Sherry — Vice President – Administration
- Francis A. Somers — Vice President
- Charles M. Williams — Vice President

**Brown Company
Miscellaneous Data****Common Stock Transfer Agents and Registrars**

Manufacturers Hanover Trust Company, 40 Wall Street, New York,
New York 10015
Bank of America, 555 South Flower Street, Los Angeles, California 90071

Debenture Trustee and Warrant Agent

Manufacturers Hanover Trust Company, 40 Wall Street, New York,
New York 10015

Stock Exchange Listings

Common Stock — New York Stock Exchange and Pacific Stock Exchange
\$13.20 Warrants — American Stock Exchange and Pacific Stock Exchange
Debentures Payable in 1995 — Pacific Stock Exchange

Auditors

Ernst & Ernst, Citicorp Center, 153 East 53rd Street, New York, New York 10022

Executive Offices

251 South Lake Avenue, Pasadena, California 91101

Annual Meeting

The Annual Meeting of Stockholders will be held on Wednesday,
December 6, 1978 at 10:00 A.M. in the Yosemite Room of the Hilton Hotel,
150 South Los Robles, Pasadena, California.

