

GAMBLE-SKOGMO, INC., "This report depicts a changing Gamble-Skogmo, a major diversified corporation with substantial growth potential in two of the most dynamic areas of consumer activity: merchandising and financial services." **1978 ANNUAL REPORT**





GAMBLE-SKOGMO, INC.

"People helping people to buy and pay for the things they want."

MERCHANDISING GROUP

ALDEN'S

Chicago, IL

Nation's fifth largest mail order merchandising catalog company emphasizing fashion and specialty products.

GAMBLE DEPARTMENT STORES

Chicago, IL

19 conventional department stores operating under a variety of names in medium-size cities from coast to coast.

Gambles

Minneapolis, MN

40 company and 903 dealer-owned stores, located in smaller towns in the Midwest and Rocky Mountain states, selling "do-it-yourself" products.

HOWARD'S BRANDdiscount

Monroe, LA

84 stores merchandising top quality, national brand products at discount prices in 10 "Sunbelt" states.

jm mcdonald's

Hastings, NB

68 stores selling medium to higher-priced men's, women's, and children's apparel, accessories and shoes, plus 74 fabric stores, principally in Western and Plains states.

Blazer HOME FURNISHINGS

Chicago, IL

49 full-service furniture stores located in the Midwest combined with 81 Maxwell Home Furnishings outlets, primarily in the Carolinas and Florida.

Woman's World Shops

La Mesa, CA

56 stores featuring higher-priced, branded women's fashion apparel in large and half sizes, in shopping centers in major metropolitan markets.

MACLEODS

Winnipeg, Manitoba, Canada

75 company and 197 dealer-owned stores selling hard lines in smaller towns, in Canada's Western provinces.

MODE O'DAY

Burbank, CA

28 company and 685 dealer-owned stores merchandising lower-priced women's fashions nationally; 21 Double Up stores retail medium priced junior fashions.

RASCO

Burbank, CA

90 large discount variety stores in California, Arizona and New Mexico; 41 Toy World stores in Southern California; 29 Rasco-*Tempo* department stores in Northern California and Midwest states.

RED OWL

Hopkins, MN

88 company and 279 dealer-owned retail food outlets located in the Midwest, principally in Minnesota and Wisconsin.

Snyder

Hopkins, MN

45 company and 69 dealer-owned drug stores, primarily in Minnesota and Wisconsin.

STEDMANS

Toronto, Ontario, Canada

53 company and 210 dealer-owned stores selling soft lines and variety goods in all Canadian provinces.

FINANCIAL SERVICES GROUP

ARISTAR

Blazer

Coral Gables, FL

295 Blazer Financial Services offices in 24 states offer installment loans to individuals and purchase installments sales contracts from local retail stores.



Gambles
C&M Leasing
Company

Minneapolis, MN

An 80 per cent-owned subsidiary which is among the 10 largest in the industry; providing vehicle leasing and management services to corporate fleet clients.

GAMBLES INTERNATIONAL LEASING

Minneapolis, MN

A wholly-owned subsidiary offering a full range of equipment leasing services, principally to Gamble dealers and Gamble-Skogmo subsidiaries.

John Alden INSURANCE COMPANY

Coral Gables, FL

A new entity with over \$2 billion of insurance in force, licensed in every state and Canadian province, with a primary marketing focus on life insurance for consumer credit purchases, small business groups, and supplemental coverage by direct mail.

Highlights of the Year

All dollars in thousands
except amounts per share

PERFORMANCE	1978	1977	% Change
	Fifty-two weeks ended January 27, 1979	Fifty-two weeks ended January 28, 1978	
Net Earnings	\$ 23,224	\$ 9,764	137.9
Net Earnings Per Common Share*			
Primary	\$ 5.47	\$ 2.04	168.1
Fully Diluted	\$ 5.15	\$ 2.02	155.0
Dividends Per Share of Common Stock	\$ 1.40	\$ 1.40	—
SALES AND REVENUES BY MAJOR AREAS OF OPERATION	1978	1977	% Change
MERCHANDISING GROUP			
Net Sales by Business Segment			
General Merchandising — Retail	\$ 306,687	\$ 209,399	46.5
General Merchandising — Wholesale	198,140	203,369	(2.6)
Mass Merchandising	263,524	118,552	122.3
Food & Drug	730,351	669,919	9.0
Catalog	256,009	228,331	12.1
Canadian Merchandising	199,933	204,552	(2.3)
Total Net Sales	\$ 1,954,644	\$ 1,634,122	19.6
FINANCIAL SERVICES GROUP			
Revenues by Business Segment			
Consumer Finance	\$ 63,083	\$ 9,761	546.3
Insurance	52,785	41,951	25.8
Leasing	17,587	10,838	62.3
Total Revenues	\$ 133,455	\$ 62,550	113.4
OTHER SIGNIFICANT COMPARISONS	1978	1977	% Change
Stockholders' Equity	\$ 232,912	\$ 233,305	(.2)
Common Shares Outstanding	4,036,034	4,298,628	(6.1)
Number of Stockholders	11,471	12,076	(5.0)
Number of Subordinated Income Noteholders	39,414	39,110	.8

*Foreign exchange losses adversely affected primary earnings per share by \$.98 and \$1.26 in 1978 and 1977, respectively.

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To Our Stockholders:

Improvement of continuing operations and two major acquisitions combined to produce record net sales and earnings per common share for Gamble-Skogmo in the fiscal year ended January 27, 1979:

- Net sales rose almost 20 percent to \$1.95 billion
- Net earnings were up 138 percent to \$23.2 million
- Earnings per share rose 168 percent to \$5.47

This performance was achieved in spite of foreign exchange losses from the company's Canadian operations and a special item charge relating to the liquidation of the firm's Tempo-Buckeye division which together reduced 1978 earnings by \$6,974,000.

Operations, exclusive of acquisitions made during 1977 and 1978, contributed 25 percent of our sales increase and 31 percent of the net earnings gain.

Because of our strong performance in 1978 and our optimism about the current year, the Board of Directors in March approved an increase in the company's quarterly cash dividend to 37.5 cents per common share. This marks the first dividend increase by Gambles since 1974.

Early in 1978, Gambles acquired Leath and Company, a home furnishings chain located primarily in the Midwest. In mid-year, we acquired the Howard Bros. Discount Store group, which has compiled an enviable record of growth in the Sunbelt states.

At the end of the fiscal year, Aristar, Inc., a major financial services company, was merged into Gambles. Aristar will operate as a wholly-owned subsidiary and will retain its own identity under which we will operate our financial services division. As discussed later in this report, Gambles' financial services subsidiaries have been transferred to Aristar, Inc., and Aristar's furniture retailing operation has been transferred to Gambles' merchandising group. We believe that these changes will contribute to management efficiency and facilitate future growth.

In addition to these acquisitions, we purchased slightly more than 20 percent of Garfinckel, Brooks Brothers, Miller & Rhoads, Inc., a department and specialty store chain. Garfinckel owns several "prestige" store groups, primarily located in 30 eastern and southeastern states.

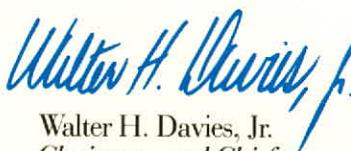
We believe that our earnings improvement in 1978 confirms the validity of business strategies which we adopted nearly two years ago. Furthermore, we believe that our progress has just begun. The "Year In Review" section of this report highlights some of the steps taken to produce this year's record results and to encourage future years' profitability. We believe that you will find an impressive record of positive change. Problems have been identified and, in many cases, successful solutions achieved. For example, we closed our New York Buying Office and transferred its functions to other existing divisions. We dissolved a layer of management in our Canadian group, and liquidated Wood Alexander, Ltd., a small unprofitable Canadian division. We reduced personnel levels on the corporate staff and at the same time improved the levels of support which our corporate group provides to our profit centers.

Through the years, Gambles has enjoyed a broad base of support from its customers, suppliers and employees. It is particularly noteworthy that our employees own over 40 percent of our common stock.

Too, there are approximately 40,000 holders of Gambles' income bonds, a unique financial instrument which provides over one quarter billion dollars of growth capital to the company. The proceeds from the sale of income bonds contributed to our ability to make the important acquisitions and the investment indicated above.

We see clear prospects of another excellent year in 1979. A significant portion of our business and growth potential rests in the midwestern United States, where the improving farm economy provides an outstanding growth opportunity for Gambles. Similarly, Gambles' broad range of specialty retail stores, its merchandising thrust in the Sunbelt and the expanded capability of the consumer financial services group present major opportunities for growth.

This report depicts a changing Gamble-Skogmo, a major diversified corporation with substantial growth potential in two of the most dynamic areas of consumer activity: merchandising and financial services. Because of the importance and compatible nature of these businesses, the theme of this year's annual report, "People Helping People To Buy and Pay For The Things They Want," is especially significant.



Walter H. Davies, Jr.
*Chairman and Chief
Financial Officer*



Wayne E. Matschullat
*President and Chief
Executive Officer*



Gamble-Skogmo was significantly restructured and reoriented in 1978 to better focus on long-term growth and profitability in its merchandising and financial services business. The results achieved in 1978 reflect these actions.

The improvement throughout Gambles' continuing operations resulted primarily from the efforts of the thousands of people who work for us. Employees of our merchandising companies helped people in their communities to select and purchase nearly \$2 billion of quality merchandise. And personnel in our financial services companies offered the financial assistance to help bridge the gap between what customers wanted and what they could afford.

Merchandising Group

Diversified retail and wholesale activities in this group span a broad range of consumer products, including durable goods, fashion apparel, food and pharmaceuticals sold through company-owned stores, mail order catalogs, and through independent dealers.

Specialty and Department Stores

In recent years, some of the most significant growth in the retailing industry has been in specialty stores. Gamble-Skogmo is well represented in a wide variety of specialized retail store categories, including women's fashions, family apparel, furniture, toys and fabrics.

Our largest specialty store operation, Mode O'Day, a chain of 713 company and dealer-owned stores, merchandises lower-priced women's fashion apparel and accessories; it produced excellent profits in 1978 on a substantial gain in net sales. The company expects to add approximately 70 new outlets in 1979.

During the year, Mode O'Day expanded its efforts in several new areas of fashion merchandising. Substantial growth in the retailing of junior fashions has been achieved through 21 "Double Up" stores which are located in regional shopping centers. Similarly, to take advantage of the high traffic and store visibility in such shopping centers, 14 "Fashion Crossroads" stores specialize in misses and half-size fashions. Nine large Sarco stores, which offer attractive savings on domestic and imported "dated" merchandise, are operated in downtown locations, the largest of which is in San Antonio, Texas.

Mode O'Day continued in 1978 to refine its merchandising strategy to respond more quickly to changing fashion trends. Capital investments were made to improve efficiency in production facilities and in warehouse materials handling systems.

*A shopper in Roshek's
Department Store, Dubuque, IA,
is shown the latest fashions from
the Panache shop.*



Merchandising Group

Sales and profits were up sharply for Woman's World Shops, which experienced the greatest growth in its history. At fiscal year-end, 56 stores were operating in shopping centers in major metropolitan markets, specializing in higher priced, branded women's fashion apparel in large and half sizes.

Woman's World opened 16 new stores in 1978, expanded its California distribution facility, and opened a second distribution center in Columbus, Ohio. Important investments were made to computerize warehouse inventory control systems and to add point-of-sale transaction equipment. These investments will continue in 1979 as Woman's World opens at least a dozen new stores.

The Rasco division of Gamble-Skogmo operates 90 large variety stores located in California, Arizona and New Mexico; 41 Toy World stores located in Southern California, and 29 Rasco-Tempo department stores concentrated in Northern California and 11 Midwest states.

The Rasco division produced a fine increase in sales and profitability, with the majority of the growth coming from the Toy World stores, a division which plans to open 15 new outlets in 1979.

The Gambles House of Fabrics division showed improvement in 1978, despite the continuing decline in the home sewing market. Seventeen of the division's 91 stores were closed; a management reorganization was instituted; upgraded merchandise was introduced, and a test program was started to add domestics to the product mix. This division was consolidated with J. M. McDonald's in February 1979 to improve the profitability of the combined operations.

J. M. McDonald's operates 68 stores, primarily in the Midwest, and features fashions for all members of the family and the home. The division performed well during the year, benefitting from significantly higher levels of farm income in the Rocky Mountain and Plains states. Further growth is expected in 1979, as expansion continues into additional metropolitan shopping centers and more store clusters are developed to maximize advertising impact. Improved sales should result from a promotional campaign to develop a better image of J. M. McDonald's as an innovative retailer of brand name fashion merchandise compatible with the tastes of middle income customers.

The home furnishing segment of specialty store retailing holds extremely bright growth prospects for Gamble-Skogmo. Leath and Company, a Midwest chain of 49 retail furniture stores, was acquired in February 1978. Maxwell Home Furnishings, which was acquired in the merger with Aristar, Inc., operates 81 stores in the Carolinas and Georgia. These two furniture companies were merged at the beginning of the year which should result in improved efficiencies in both management and distribution, and will produce marketing advantages resulting from their combined purchasing power.

Red Owl's warehouse-style food markets, called Country Stores, promote savings with bag-it-yourself and quantity purchase themes. Shown here is the fresh produce section in one of the large Minneapolis outlets.



The Gamble Stores division operates 40 company-owned stores and supplies merchandise to 903 dealer-owned stores, most of which are located in rural towns in 25 central states. These general merchandise stores primarily sell hard lines, including appliances, electronics, home improvement products, automotive supplies, hardware and furniture. Generally, these customer service-oriented stores assert a strong merchandising leadership in their communities by offering competitive prices on nationally advertised brands, as well as selected private label products.

During 1978, an analysis to determine those stores with the best longer-term profit potential and those which were least likely to produce future growth resulted in the closing of 62 stores. Both sales and profits for the division were under pressure during a transition to a merchandising strategy with more emphasis on "do-it-yourself" products and sporting goods.

The Gamble Department Stores division is comprised of 19 conventional department stores which operate in 13 states under a variety of regional and local names and are generally situated in smaller cities of under 100,000 population.

Many of the department stores are the key retail establishments in their respective areas and are merchandised to suit local needs and tastes. The stores sell primarily nationally branded goods of moderate to better quality, and in recent years heavier emphasis has been placed on fashion soft lines.

The Gamble Department Stores division is meeting the challenge of increased competition from national chain stores through careful analysis of the individual markets, and by continuing the long-standing tradition of providing full service and quality merchandise.

Mass Merchandising

An increasing number of consumers are enjoying the convenience and economies offered by mass merchandise, large volume discount store chains as inflation continues to erode the disposable income of the American consumer. In 1978, Gamble-Skogmo acquired one of the most successful regional discount chains, Howard Bros. Discount Stores, an 84-store chain selling top quality, nationally-known brand name merchandise at discount prices.

Located in ten fast-growing Sunbelt states, Howard Bros. has an excellent reputation with consumers and high visibility in its market area. Because of its size and geographic concentration, the company enjoys major purchasing economies and marketing efficiencies. Sophisticated management controls have enabled the chain to maintain both its low price image and its profitability. Plans exist for the addition of at least 12 new stores in 1979.

*At Howard's in Monroe, LA,
a customer checks out her
purchases, many of which are
well-known national brands.
All of these stores are located in
the fast-growing Sunbelt states.*



A corporate marketing strategy ("BRANDdiscount") is underway at Howard Bros. to unify every aspect of its visual presentation, including signage, store packaging and layouts, to focus consumer attention on its primary competitive advantage in local markets — low priced brand name products. Where this strategy has been implemented, stores are experiencing sales increases as a result of improved traffic flow and consumer recognition.

After a long period of unsatisfactory performance and a lengthy study of alternative courses of action, the decision was made to liquidate the 45-store Tempo-Buckeye chain in 1978. Twenty-six of the stores have been reassigned to the Rasco division and other Gamble-Skogmo retailing profit centers. The remaining stores were closed or sold to other retailers. This action freed over \$38 million of assets for deployment in potentially more profitable activities.

Catalog Sales

Aldens, the nation's fifth largest mail order catalog merchandising company, produced excellent profits in 1978, as an increased number of people recognized the benefits of "shopping at home". Catalog sales are being aided by several factors such as higher personal income, a greater number of working wives and increasing loyalty to brand names, rather than particular stores. Because catalog prices are fixed for the "life" of the catalog and do not reflect month-to-month price increases, accelerating inflation spurred brisk sales in 1978.

Strong growth occurred in fashion apparel and specialty products. Aldens has added talented personnel to direct the fashion marketing effort and to keep pace with rapidly changing consumer preferences. Daily monitoring of consumer purchasing patterns will become possible this year through the use of a new on-line computer system.

Food and Drug Stores

In the six-state region where it operates, Red Owl Stores is the largest food retailer with 279 dealer-owned and 88 company-owned stores.

Red Owl management placed greater emphasis on cost control, employee scheduling, inventory control and more effective product marketing techniques to produce substantial sales and profit increases. A profitability analysis of outdated stores resulted in either the refurbishing or closing of units which were no longer suited to changed consumer traffic patterns. This ongoing effort has produced substantial profit improvement in the refurbished units when measured against the performance of existing older units.

Red Owl's Country Stores, which focus on a "warehouse market" strategy, made dramatic profit contributions in 1978, as more stores were converted to this successful food retailing format.



Thousands of Aldens' catalog shoppers will identify with this pleased young lady who has received just what she ordered by mail.

Food shoppers appreciate the range of products, efficiency of store layout, and lower prices offered in Country Stores. Conversions of older, less profitable Red Owl stores to the Country Store concept will be continued in 1979. The Red Owl division should experience even better gross profit margins as a result of generally excellent store locations, creative marketing techniques, and competitive pricing strategies.

Snyder drug stores, which operates 69 dealer-owned and 45 company-owned units, increased its efforts to make each of its stores the price leader in its community. The integration of several company-owned Snyder stores with remodeled Red Owl stores is planned in 1979 as is the establishment of a number of dealer-owned stores in communities near existing concentrations of Snyder outlets.

Canadian Merchandising

The Macleods division supplies merchandise to 197 dealer-owned hard line stores in Central and Western Canada. These stores are among the leading general merchandising outlets in their respective rural communities, like the Gamble stores in the U.S.A.

The company also operates 75 company-owned stores, some of which are located in urban areas. Profit margins in these stores have improved dramatically in the last two years. Much of this improvement has resulted from a new merchandising emphasis on "do-it-yourself" products and sporting goods. The division plans to encourage its dealer-owned stores to adopt this changed merchandising emphasis in 1979, so as to improve their profitability as well.

Macleods is also developing an increased emphasis on mass merchandising of name brand products, particularly in its larger urban stores. In locations where the conversion from general to mass merchandising is complete, Macleods stores have recorded substantial increases in customer transactions and revenues. The conversion to mass merchandising is expected to account for a major share of the increased profits anticipated by Macleods in 1979.

Gambles' other Canadian subsidiary, the Stedmans division, is comprised of 210 dealer-owned and 55 company-owned variety and soft line stores, which merchandise such items as linens, towels, bedding, necessity clothing, basic footwear, accessories, and health and beauty aids, all across Canada. The company added 14 dealer-owned stores in 1978, and converted five company stores to dealer units.

To build customer traffic, Stedmans introduced a merchandising concept called "category dominance" in which it develops the best selection within certain product categories. Early indications are that this merchandising technique is building customer traffic and higher revenue.

Financial Services Group-Aristar, Inc.

Gamble-Skogmo's stake in the financial services business grew dramatically in 1978 with the merger of Aristar, Inc. Early in 1979, four of Gambles' financial services subsidiaries — Gamble Alden Life Insurance Company, Gamble Alden Agency, Gambles C&M Leasing Company, and Gambles International Leasing Corporation — were merged into Aristar which will now serve as the corporate entity encompassing all financial services activities.

A corporate administrative office has been established at Aristar's headquarters in Coral Gables, Florida. The centralization of the company's financial services businesses will improve communications, consolidate banking relations and is a major step planned to broaden Gambles' participation in financial services.

While Gambles' merchandising companies help people by providing quality merchandise at reasonable prices, the financial services group has an improved capability to supply people with financial security and the financial resources they need to make the purchases they want.

Consumer Finance

Aristar, Inc.'s Blazer Financial Services division operates 295 consumer finance offices in 24 states. These offices make installment loans to individuals and purchase retail installment sales contracts from local retail establishments.



In this Blazer finance office a counselor assists a couple with their loan request.

Blazer's substantially improved performance last year resulted from better expense control, fewer loan delinquencies, and sharply increased loan volume. Rising residential home values have allowed greater use of second mortgages for securing installment loans.

Blazer directed considerable management attention in 1978 to training and the motivation of qualified office managers. A dynamic marketing and promotion effort was developed to introduce a new logo to all offices and company literature.

Insurance

Gambles' insurance subsidiaries were reorganized in the early months of 1979. Gamble Alden Life merged with Diamond State Life Insurance Company, Aristar's insurance subsidiary, to form a new entity named John Alden Life Insurance Company, with over \$2 billion of insurance in force. Both Gamble Alden Life and Diamond State Life had their origins writing credit life insurance on installment credit accounts. The combined larger entity has the ability to market all forms of life insurance throughout the 50 states and in all Canadian provinces and territories. The new company ranks in the top 10 percent of all life companies in terms of insurance in force.

This merger culminated changes within Gamble Alden Life which began early in fiscal 1978, when it undertook a major re-evaluation of its operations. A decision was made to discontinue writing straight group life insurance and certain other specialized forms of coverage and to focus on three high growth segments of insurance: consumer credit insurance, group insurance for small businesses, and mass marketing of supplemental life insurance coverage.

While the growth of consumer credit insurance is tied primarily to the amount of retail credit sales generated throughout Gambles' various merchandising divisions, the growth potential for small group insurance and the mass marketing of supplemental coverage is unlimited. For example, Gamble Alden increased the number of its offices selling small group insurance by 50 percent in fiscal 1978 and expects a similar increase in fiscal 1979.

The mass marketing of supplemental life insurance coverage only began in January 1977, but marketing agreements have already been reached to solicit the credit card customers of Standard Oil Company of Indiana and Sunoco. A third major marketing arrangement was concluded in January of this year, which will allow the solicitation of certain bank customers holding VISA and Master Charge credit cards.

Estate planning is made easy and understandable for John Alden Life Insurance Co. policyholders. Here, an agent performs a computer analysis to aid in projecting this young couple's financial needs.



Leasing

Gambles C&M Leasing Company, an 80 percent-owned subsidiary, provides vehicle leasing and management services to corporate fleet clients throughout the United States. It is among the 10 largest companies in the fleet vehicle management industry. Gambles International Leasing Corporation offers a full range of equipment leasing services, principally to Gamble dealers and Gamble-Skogmo subsidiaries.

Gambles C&M reported sharp earnings gains in 1978, its ninth consecutive year of sustained growth. Aggressive sales and marketing efforts resulted in the addition of 48 new corporate clients during the year. Substantial gains in automobile orders from new and existing clients, and more than double the number of truck orders resulted in a 30 percent increase in unit additions in 1978.

A new maintenance management system for expense identification and control was developed and implemented to provide computer reports which classify various expense categories. The system also summarizes expenses which differ from normal operating standards, and forecasts mileage and replacement dates.

Financial Review

Gamble-Skogmo, Inc. and consolidated subsidiaries continue in a strong financial position. Cash and temporary investments totaling \$84,000,000 exceeded short-term debt by more than \$31,000,000. Capital funds in the amount of \$484,700,000 included \$251,800,000 in subordinated income notes and \$232,900,000 of stockholders' equity. This capital base represented more than 50 percent of tangible assets. At year end, over \$188,000,000 of the outstanding subordinated income notes had a maturity beyond the year 2001 and had no sinking fund requirement. Our acquisition and investment programs used some of our excess cash and added approximately \$100,000,000 of borrowings to our balance sheet during 1978. Of our total debt in the parent company, 90 percent is long-term, of which 68 percent is subordinated. The subordinated portion includes \$251,800,000 with a contingent interest feature and approximately \$48,000,000 of the long-term portion of the senior subordinated debentures and notes issued for Aristar, Inc.

During 1978, Gamble's Credit Corporation, a wholly-owned subsidiary that purchases receivables from various Gamble retail companies, sold \$26,760,000 of 20-year subordinated notes at a rate of 10 percent. Placement of this debt increased the capital base of Gamble's Credit Corporation to almost \$153,000,000, representing 36 percent of total assets. The company additionally placed \$22,500,000 of 9 percent, 5-year notes with a number of banks. As a result of these financings, the ratio of short-term debt to total debt dropped to 35 percent compared to a ratio of 46 percent the previous year. Thus, Gamble's Credit Corporation's reliance on the short-term money market was significantly reduced during a period when short-term rates rose more than 300 basis points. Commercial paper continued to provide most of the short-term funds, both in this country and Canada.

Our need for borrowed funds arises primarily from the financing of inventories and consumer receivables. At year end, inventories totaled \$352,600,000 compared to \$286,500,000 a year ago. Included in this year's inventory figure is \$77,800,000 attributable to Leath and Company and Howard Bros. Discount Stores, Inc., two companies which were acquired during 1978. Consumer receivables sold to merchandising-related finance subsidiaries of \$405,790,000 were up \$29,560,000, of which \$17,500,000 was due to the acquisition of Leath. In addition, the receivables of Maxwell Home Furnishings were sold to their finance subsidiary for over 11 months of the year. Approximately \$38,000,000 of Maxwell receivables were sold to banks in January 1979. At year end Gamble's was collecting balances from 1,962,000 customers with average balances of \$226, up from 1,816,000 customer accounts with an average balance of \$207 the previous year.

Chargeoffs, as a percentage of liquidations, were up somewhat to 3.6 percent from 3.3 percent last year. Tighter controls on the granting of credit were imposed during the year, particularly in mail order. This is an area to which we devote a considerable amount of time and effort. Not only do we want to keep chargeoffs within acceptable limits, we also wish to moderate the growth in receivables, our single biggest need for borrowed funds.

Capital expenditures, excluding capitalized leases, for 1978 totaled approximately \$24,000,000 compared to \$19,000,000 the previous year. Our budget for the coming year calls for the spending level to increase to \$37,000,000, the highest in company history. Included in the plan are 58 new stores, 7 replacement stores and 34 remodelings. The company believes that funds derived from operations and capital released by the Tempo-Buckeye dissolution will more than cover the capital requirements. Thus, while most of our growth has come through acquisitions, we also have a vigorous program to expand in the profit centers which are giving us the rate of return on investment we require.

Included in "The Year in Review" section is a description of the companies acquired during 1978. These acquisitions were made for cash and long-term debt.

Leath and Company was acquired in February for \$21,191,000 cash. The purchase price included more than \$14,000,000 of retail receivables which were sold to Gamble's Credit Corporation.

Howard Bros. Discount Stores, Inc. was acquired in July for \$41,185,000 of which \$21,738,000 was cash and \$19,447,000 was in 8½ percent notes amortized equally over five years.

On January 26, 1979, Gamble's acquired the remaining 49 percent of the outstanding common shares and all the preferred shares of Aristar, Inc. A total of \$43,800,000 principle amount of 10 percent subordinated debentures due to January 1, 1989 were issued for the outstanding common shares, \$9,989,000 principle amount of 5 percent subordinated notes due to April 1, 1992 were issued for the Series A preferred shares and \$2,000,000 principle amount of 5½ percent notes due to April 1, 1996 were issued for the Series B preferred shares.

In addition to these acquisitions, Gamble's made an investment in Garfinckel, Brooks Brothers, Miller & Rhoads, Inc. and, as of the January 27, 1979 fiscal year end, held approximately 20 percent of the outstanding common shares. The purchase price was comprised of approximately \$16,248,000 cash and \$9,607,000 of 7½ percent notes amortized over 3 years.

Consolidated Statements of Earnings

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(All dollars in thousands except earnings per share)

	1978	1977
	Fifty-two weeks ended January 27, 1979	Fifty-two weeks ended January 28, 1978 (restated)
Net sales	\$1,954,644	\$1,634,122
Costs and expenses:		
Cost of sales, including certain occupancy and buying costs	1,480,415	1,257,708
Operating and administrative (Notes 8 and 11)	375,216	306,115
Depreciation and amortization	19,800	15,917
Interest (Notes 12 and 13)	60,208	42,496
Total costs and expenses	1,935,639	1,622,236
Other income — net	2,881	807
Earnings before income taxes and equity in		
net earnings of unconsolidated subsidiaries and investee company	21,886	12,693
Income taxes (Notes 12 and 14)	9,296	6,875
Equity in net earnings of Aristar Holdings, Inc. and subsidiaries (Note 2)	8,924	4,084
Equity in net earnings (loss) of other unconsolidated subsidiaries and investee company (Note 2)	1,710	(138)
Net earnings (Note 5)	\$ 23,224	\$ 9,764
Earnings per common share:		
Primary	\$ 5.47	\$ 2.04
Fully diluted	\$ 5.15	\$ 2.02
Average number of common and common equivalent shares outstanding:		
Primary	4,114,000	4,403,000
Fully diluted	4,511,000	4,833,000

Consolidated Statements of Retained Earnings

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(All dollars in thousands)

Beginning balance, as previously reported	\$ 211,883	\$ 208,965
Cumulative effect of recording capital leases pursuant to the provisions of Financial Accounting Standards Board Statement No. 13 (Note 5)	(4,383)	(4,326)
Beginning balance, as restated	207,500	204,639
Net earnings	23,224	9,764
Cash dividends:		
Preferred stock	(726)	(779)
Common stock	(5,706)	(6,124)
Ending balance (Note 10)	\$ 224,292	\$ 207,500

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(All dollars in thousands)

	1978	1977
	Fifty-two weeks ended January 27, 1979	Fifty-two weeks ended January 28, 1978 (restated)
ASSETS		
Current assets:		
Cash including temporary cash investments of \$73,591,000 and \$101,521,000	\$ 84,066	\$117,396
Receivables — net (Note 3)	56,292	80,463
Inventories	352,611	286,534
Prepaid expenses	18,799	18,656
Total current assets	511,768	503,049
Investments, principally unconsolidated subsidiaries and investee company (Notes 2, 5 and 12)	250,021	165,457
Property and equipment — net (Notes 4, 5, and 6)	168,868	132,375
Excess of purchase price over equity of companies acquired	42,866	25,786
Deferred charges and other assets (Note 8)	27,514	24,642
TOTAL ASSETS	\$1,001,037	\$851,309
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Commercial paper and notes payable	\$ 31,498	\$ 23,843
Current instalments of long-term debt and lease obligations	21,359	8,281
Accounts payable and accrued liabilities	190,232	175,110
Current income taxes	3,982	1,177
Deferred income taxes applicable to instalment sales	62,797	54,463
Total current liabilities	309,868	262,874
Deferred credits, including deferred income taxes	5,815	4,153
Excess of equity over purchase price of company acquired (Note 2)	17,362	22,728
Long-term debt (Notes 2, 6 and 8) and lease obligations (Note 5) excluding subordinated income notes shown below as capital accounts	183,237	74,170
Capital accounts:		
Subordinated income notes (Note 7)	251,843	254,079
Stockholders' equity (Note 9):		
Preferred stock, \$40 par value	10,418	12,195
Preferred stock, \$5 par value, including allocated paid-in capital	10,123	10,590
Common stock, \$5 par value, including additional paid-in capital; authorized 10,000,000 shares; issued 5,694,839 and 5,626,297	59,497	58,586
Retained earnings (Notes 5 and 10)	224,292	207,500
Receivable for stock sold under restricted stock plan	(5,029)	—
Net unrealized loss on marketable equity securities of unconsolidated insurance subsidiaries	(823)	(67)
Cost of common stock and preferred stock reacquired and held in treasury	(65,566)	(55,499)
Total stockholders' equity	232,912	233,305
Contingent liabilities and commitments (Notes 5 and 15)		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,001,037	\$851,309

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(All dollars in thousands)

	1978		1977 (restated)	
	SHARES	AMOUNT	SHARES	AMOUNT
Preferred stock, \$40 par value:			Fifty-two weeks ended January 27, 1979	Fifty-two weeks ended January 28, 1978
Beginning of year	304,868	\$12,195	314,128	\$12,565
Conversion to common stock	(44,429)	(1,777)	(9,260)	(370)
End of year	260,439	10,418	304,868	12,195
Preferred stock, \$5 par value including allocated paid-in capital:				
Beginning of year	481,700	10,590	498,019	11,161
Conversion to common stock	(13,322)	(467)	(16,319)	(571)
End of year	468,378	10,123	481,700	10,590
Common stock, \$5 par value, including additional paid-in capital:				
Beginning of year	5,626,297	58,586	5,597,142	57,486
Allocation of paid-in capital due to conversion of \$5 par value preferred stock to common stock	—	400	—	489
Conversion of preferred stock	52,742	1,844	23,255	452
Exercise of stock options	15,800	352	5,900	159
Loss on sale of treasury stock (Note 9)	—	(1,685)	—	—
End of year	5,694,839	59,497	5,626,297	58,586
Retained earnings at end of year		224,292		207,500
Receivable for stock sold under restricted stock plan (Note 9)	(225,020)	(5,029)	—	—
Net unrealized loss on marketable equity securities of unconsolidated insurance subsidiaries:				
Beginning of year		(67)		(67)
Net unrealized loss during year		(756)		—
End of year		(823)		(67)
Treasury stock at cost:				
Common stock, \$5 par value:				
Beginning of year	(1,327,669)	(44,277)	(1,150,827)	(38,570)
Purchased, at cost	(557,256)	(17,467)	(176,842)	(5,707)
Sold, at average cost	226,120	7,400	—	—
End of year	(1,658,805)	(54,344)	(1,327,669)	(44,277)
Preferred stock, \$40 par value	(117,817)	(4,045)	(117,817)	(4,045)
Preferred stock, \$5 par value	(208,971)	(7,177)	(208,971)	(7,177)
Total common stock and preferred stock reacquired and held in treasury, at cost		(65,566)		(55,499)
Total stockholders' equity		\$232,912		\$233,305

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(All dollars in thousands)

	1978	1977 (restated)
	Fifty-two weeks ended January 27, 1979	Fifty-two weeks ended January 28, 1978
SOURCE OF FUNDS		
Net earnings	\$ 23,224	\$ 9,764
Add (deduct) items not requiring working capital		
Net earnings of unconsolidated subsidiaries and investee company included above	(17,530)	(9,110)
Depreciation and amortization	19,800	15,917
Cash dividends from unconsolidated subsidiaries and investee company	660	190
Non-current deferred income taxes	1,514	(625)
Other — net	958	1,764
Funds derived from operations	28,626	17,900
Issuance of subordinated income notes	—	21,212
Issuance of long-term debt and lease obligations	93,522	2,734
Carrying value of property, equipment and investments disposed of	14,702	6,932
Issuance of common stock	352	159
Conversion of Aristar notes to equity	—	15,000
Increase in deferred credits	—	1,251
Decrease in working capital	38,275	6,379
	\$175,477	\$ 71,567
USE OF FUNDS		
Cash dividends	\$ 6,432	\$ 6,903
Reduction of subordinated income notes	2,236	4,518
Reduction of long-term debt and lease obligations	17,183	3,256
Additions to property and equipment, including capital leases	34,059	25,427
Investment in Aristar	53,727	22,408
Investment in Garfinckel	25,855	—
Acquisition of treasury stock	17,467	5,707
Increase in other investments	628	2,469
Acquisition of Leath and Howard Bros.		
less working capital of \$48,464,000 (Note 2)	35,579	—
Property and equipment	11,428	—
Intangibles	(32,728)	—
Long-term debt	(367)	—
Other — net	3,978	879
	\$175,477	\$ 71,567
CHANGE IN WORKING CAPITAL BY COMPONENT		
Cash including temporary cash investments	\$ (33,330)	\$ (70,886)
Receivables	(24,171)	37,132
Inventories	66,077	31,376
Prepaid expenses	143	6,890
Commercial paper, notes payable and current instalments		
of long-term debt and lease obligations	(20,733)	4,830
Accounts payable and accrued liabilities	(15,122)	(19,926)
Current and deferred income taxes	(11,139)	4,205
Decrease in working capital	\$ (38,275)	\$ (6,379)

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

GAMBLE-SKOGMO, INC. AND CONSOLIDATED SUBSIDIARIES

(1) Summary of Significant Accounting Policies

The company's accounting policies, which conform with generally accepted accounting principles, were revised in 1978 to implement Statement No. 13 of the Financial Accounting Standards Board as described in Note 5. Significant policies are outlined below.

DEFINITION OF FISCAL YEAR. The company's fiscal year ends on the last Saturday in January. Fiscal 1978 ended on January 27, 1979 and fiscal 1977 on January 28, 1978. Each year is comprised of 52 weeks.

PRINCIPLES OF CONSOLIDATION. The consolidated financial statements include all accounts of the merchandising operations and real estate subsidiaries whose properties are utilized in merchandising operations. Finance, insurance, and leasing subsidiaries and several other small non-merchandising subsidiaries are not consolidated. Investments in unconsolidated subsidiaries and investee company are carried at underlying equity values. Condensed, combined financial information for the unconsolidated merchandise-related finance companies is presented in Note 12. Financial statements for the other unconsolidated financial service subsidiaries (Aristar Holdings, Inc. and subsidiaries) are presented elsewhere in this annual report.

In addition to the restatement for the change in method of accounting, certain 1977 balances have been reclassified to conform to the 1978 presentation.

TRANSLATION OF CANADIAN FINANCIAL STATEMENTS. Inventory, properties, and intangible assets of the company's Canadian subsidiaries are translated at exchange rates applicable at the time of acquisition. Other assets and liabilities are translated at period-end exchange rates and income and expense items at average exchange rates in effect during the year, except for depreciation and cost of sales which are translated at exchange rates applicable at time of acquisition. Gains and losses arising as a result of these translation procedures are recognized currently and reduced net income \$4,049,000 in 1978 and \$5,528,000 in 1977.

INVENTORIES. Merchandise inventories are comprised principally of general merchandise and food and are stated at lower of cost (first-in, first-out) or realizable value.

DEPRECIATION. Property and equipment is depreciated over the estimated service lives or, in the case of leasehold improvements, over the period of leases if shorter. Depreciation and amortization is provided generally on the straight-line method for financial reporting and on accelerated methods for income taxes.

EXCESS COST. Excess cost of companies acquired since 1970 is being amortized on the straight-line basis over its estimated life. Prior to January 29, 1978 acquisition costs in excess of fair value for companies acquired prior to 1970 was not being amortized unless in the opinion of management it had diminished in value.

Based upon management's continuing evaluation, beginning January 29, 1978, the excess of cost over equity relating to companies acquired prior to 1970 is being amortized on a straight-line basis over periods ranging from ten to forty years. The effect of this change on net income for the fifty-two weeks ended January 27, 1979 has been to reduce net income by approximately \$775,000.

The excess of equity over purchase price is being taken into income over 12 years.

INCOME TAXES. For financial reporting, deferred income taxes are provided for expenses and income recognized in different periods for income tax purposes.

Deferred income taxes from timing differences on instalment sales are included in the financial statements as current liabilities. All other deferred income taxes are included in deferred credits.

It is the policy of the company to accrue taxes on such earnings of the Canadian subsidiary companies which are intended to be remitted to the parent company in the near future.

ACCOUNTS RECEIVABLE. The entire merchandising profit from instalment sales is taken into income at date of sale. The majority of the receivables are revolving charge accounts on which finance charges are taken into income monthly based on a percentage of outstanding balances.

Certain customer and dealer accounts are sold to merchandise-related finance subsidiaries. For additional information see Note 12 on page 26.

EARNINGS PER SHARE. Primary earnings per common share have been computed by dividing net earnings after provision for preferred dividends by the weighted average number of common shares and common equivalent shares (dilutive stock options and warrants) outstanding during the year.

Fully diluted earnings per share is computed assuming conversion of all convertible preferred stock (with appropriate elimination of preferred dividend requirements) and issuance of all shares reserved for stock options and warrants deemed to be common stock equivalents.

(2) Acquisitions

On November 30, 1977, Gamble converted its \$15,000,000 of 10 3/4 % convertible subordinated notes of Aristar, Inc. into 4,411,764 shares of Aristar, Inc. common stock, thereby increasing its ownership in Aristar, Inc. to approximately 51% of the outstanding common shares. The remainder of the outstanding common shares, and all of the outstanding preferred shares of Aristar, Inc. were acquired on January 26, 1979 through the issuance of debentures and notes totaling \$49,429,000. Both transactions were accounted for as a purchase, and the combined purchase price totalled \$64,972,000. The combined purchase price was less than the fair value of Aristar, Inc.'s net assets and such difference is being

taken into income over twelve years. Aristar, Inc. is a holding company whose subsidiaries are engaged in the businesses of consumer finance and related insurance activities and in home furnishing merchandising. The consumer finance and insurance companies are being accounted for by the equity method and, accordingly, the results of their operations are included in the consolidated statements of earnings since the date of acquisition. The assets and liabilities and the results of operations since the date of acquisition of the home furnishings division are included in the consolidated financial statements of Gambles. On January 26, 1979, Aristar, Inc. transferred to Gambles the net assets of the home furnishings subsidiaries. As of January 27, 1979, Gambles contributed the capital stock of Aristar, Inc. to a newly-formed subsidiary, Aristar Holdings, Inc. (Aistar). Additionally, Gambles contributed its investment in the net assets of Gamble Alden Life Insurance Company, Inc., Gamble Alden Agency, Inc., and Gambles International Leasing Company, Inc., wholly-owned unconsolidated subsidiaries of Gamble, and of Gambles C & M Leasing Company, Inc., an 80%-owned unconsolidated subsidiary to Aristar. The accounts of these subsidiaries have been combined with Aristar's financial statements presented elsewhere in this annual report.

On February 28, 1978, Gamble acquired all of the outstanding shares of Leath and Company (Leath) for cash totaling \$21,191,000. Leath is primarily engaged in the retail household furnishing business. The transaction was accounted for as a purchase. The purchase cost was less than the fair value of Leath's net assets at date of acquisition, and such difference has been allocated to fixed assets in accordance with the purchase method of accounting. Since the acquisition was accounted for as a purchase, the results of operations of Leath have been included in the consolidated statement of earnings since the date of acquisition.

On June 3, 1978, Gamble acquired approximately 70% of the outstanding shares of Howard Bros. Discount Stores, Inc. (Howard Bros.). The remainder of the outstanding shares of Howard Bros. were acquired on July 20, 1978. The purchase price consisted of cash and notes totaling \$41,185,000. Notes were issued for \$19,447,000 of the total purchase price. The purchase price was in excess of the fair value of Howard Bros. net assets, and such excess is being amortized over forty years. Howard Bros. is primarily engaged in the operation of discount department stores. Since the acquisition was accounted for as a purchase, the results of operations of Howard Bros. have been included in the consolidated statement of earnings since the date of acquisition.

The following unaudited data represents the results of operations of Gamble on a pro forma basis as if Aristar, Leath and Howard Bros. had been combined with the company for its full fiscal years ended January 27, 1979 and January 28, 1978.

	(unaudited)	
	1978	1977
	(in thousands, except per share)	
Net sales	\$2,018,087	\$1,914,736
Net earnings	27,523	22,928
Net earnings per share	\$6.69	\$5.21

In August and September 1978, Gamble purchased approximately 20% of the outstanding common stock of Garfinckel, Brooks Brothers, Miller & Rhoads, Inc. (Garfinckel), at a price of approximately \$25,855,000. Notes were issued for \$9,607,000 of the purchase price and the remainder was in cash. The purchase price was in excess of the book value of Garfinckel's net assets, and such excess is being amortized over forty years. Included in the 1978 results of operations of Gamble is approximately \$1,600,000 representing the company's equity in the net earnings of Garfinckel from the date Gamble acquired 20% ownership.

(3) Receivables

	(thousands)	
	1978	1977
Equity in instalment accounts sold	\$40,579	\$37,623
Other trade receivables	22,543	8,689
Dealer accounts	6,752	9,584
Miscellaneous, principally affiliates	12,198	48,906
Total accounts receivable	82,072	104,802
Less: Allowance for		
doubtful accounts	20,762	19,480
Deferred finance charges	5,018	4,859
Net receivables	<u>\$56,292</u>	<u>\$80,463</u>

Customer instalment accounts, less a portion withheld, were sold to finance subsidiaries and a bank at January 27, 1979 and January 28, 1978 (see Note 12). The allowance for doubtful accounts provides for the exposure on all receivables listed above and those sold to finance subsidiaries. Dealer accounts sold to finance subsidiaries were \$32,912,000 at January 27, 1979 and \$26,486,000 at January 28, 1978.

(4) Property and Equipment (at cost)

	(thousands)	
	1978	1977
Land	\$ 11,062	\$ 10,067
Buildings and equipment	177,488	156,225
	188,550	166,292
Less allowance for depreciation	87,445	84,249
	101,105	82,043
Leasehold improvements		
less amortization	21,240	16,924
	122,345	98,967
Capitalized leases		
less amortization (Note 5)	46,523	33,408
	<u>\$168,868</u>	<u>\$132,375</u>

(5) Leases

The company conducts a major part of its operations from leased premises. In 1978, the company and its consolidated subsidiaries retroactively changed their method of accounting for lease transactions entered into prior to January 1, 1977, as prescribed by Statement No. 13 of the Financial Accounting Standards Board. The new accounting rules require capitalization of any lease that transfers substantially all the benefits and risks of ownership to the lessee. This change resulted in a decrease in net earnings of \$280,000, for the year ended January 27, 1979. The financial statements for the year ended January 28, 1978 and prior years have been restated for this change as follows:

	(thousands)	
	Net Income —	Retained Earnings —
	1977	Years Through 1976
As previously reported	\$9,821	\$208,965
Effect of capitalizing leases	<u>(57)</u>	<u>(4,326)</u>
As restated	<u>\$9,764</u>	<u>\$204,639</u>

Capital leases are amortized in accordance with the guidelines established in Statement No. 13. Lease amortization expense is included in depreciation expense.

The company has leases for warehousing, manufacturing and administrative facilities and equipment. These leases have terms ranging from one to 40 years. The majority of these leases contain provisions to renew the leases for varying periods. In some limited instances the company may, after the initial lease term, purchase the property. In addition, retail store properties are leased for the majority of the company-owned stores. The initial terms usually are between five and twenty years with one or more five-year renewal options. The majority of the store leases provide for a minimum rental plus a percentage of the stores' sales in excess of stipulated amounts. Certain of the store leases are in turn sublet to franchise dealers. The majority of these subleases are for the same term as the company's primary lease.

In most cases, management expects that in the normal course of business, leases will be renewed or replaced by other leases.

Commitments as lessee

The following schedule analyzes assets under leases which have been accounted for as capital leases under Statement No. 13 and are reported in the accompanying consolidated balance sheets:

	(thousands)	
	1978	1977
Land and buildings	\$70,917	\$52,680
Furniture, fixtures and equipment	12,078	10,074
	<u>82,995</u>	<u>62,754</u>
Less accumulated amortization	<u>36,472</u>	<u>29,346</u>
Net leased assets under capital leases	<u>\$46,523</u>	<u>\$33,408</u>

At January 27, 1979 minimum rental payments are as follows:

	Capital leases	Operating leases
Year ended January		(thousands)
1980	\$ 11,922	\$ 26,188
1981	11,339	22,964
1982	10,006	20,405
1983	8,778	17,875
1984	8,232	15,353
Later years	<u>68,938</u>	<u>92,108</u>
Total minimum lease payments (a)	<u>119,215</u>	<u>\$194,893</u>
Less executory costs	<u>2,646</u>	
Net minimum lease payments	<u>116,569</u>	
Less amount representing interest	<u>52,031</u>	
Present value of net minimum lease payments (b)	<u>\$ 64,538</u>	

(a) Minimum payments for capital and operating leases have not been reduced by sublease rentals of \$13,703,000 and \$41,904,000, respectively, due in the future under noncancelable subleases. In addition to minimum future lease payments, contingent rentals may be paid under certain store leases. Contingent rentals amounted to \$5,001,000 and \$3,416,000 in 1978 and 1977, respectively.

(b) Presented in the January 27, 1979 and January 28, 1978 consolidated balance sheets as current installments of long-term debt of \$5,454,000 and \$3,926,000 and long-term debt of \$59,084,000 and \$43,138,000, respectively, related to capital lease obligations.

The following schedule shows the composition of total rental expense for all operating leases:

	1978	1977
Minimum rentals	\$31,732	\$27,927
Contingent rentals	4,300	3,391
Less — sublease rentals	<u>(9,680)</u>	<u>(9,019)</u>
	<u>\$26,352</u>	<u>\$22,299</u>

Investments as lessor

The Company has subleased some store buildings and equipment to independent dealers. In compliance with the requirements of Statement No. 13, those leases which meet the requirements for capitalization have been accounted for as direct financing leases. The following lists the net investment in direct financing leases at January 27, 1979 and January 28, 1978:

	1978	1977
Total minimum lease payments receivable	\$13,443	\$10,083
Estimated unguaranteed residual value	629	302
Less unearned income	<u>6,016</u>	<u>5,083</u>
Net investment	<u>8,056</u>	<u>5,302</u>
Less current portion included in miscellaneous receivables	<u>1,649</u>	<u>825</u>
Net investment in direct financing leases	<u>\$ 6,407</u>	<u>\$ 4,477</u>

The net investment in direct financing leases is included in "investments" in the accompanying consolidated balance sheets.

Mid-South Development Company, Inc., 50% of the stock of which is owned by officers and directors of Howard Bros. Discount Stores, Inc. (Howard Bros.), a subsidiary of Gamble owns 43 store buildings and a warehouse which it leases to Howard Bros. for an annual rental of \$2,441,000. These leases are made on terms and conditions which compare favorably, with leases between Howard Bros. and unrelated parties and provide for fixed monthly rentals.

(6) Long-term Debt

The long-term debt of the operating companies (\$99,466,000) is principally unsecured and matures through 1999, paying interest at a weighted average rate of 10.2% (range 5%-12%). The long-term debt of the real estate companies (\$24,687,000) is mortgage notes maturing through 1999, paying interest at a weighted average rate of 8.2% (range 4 3/4 %-10 1/4 %).

Annual sinking fund and principal payments on long-term debt (excluding obligations under capital leases — Note 5) and subordinated income notes (Note 7) during the next five years are as follows:

1979 — \$15,905,000; 1980 — \$36,951,000; 1981 — \$16,877,000; 1982 — \$13,520,000; 1983 — \$12,719,000.

(7) Subordinated Income Notes

Subordinated income notes mature from 1979 to 2006 and pay interest at a weighted average rate of 9.8% (range 7% to 10%). Principal payments aggregating \$188,575,000 mature subsequent to the year 2001.

The provisions of the note indentures require that interest be paid currently if earned. If not earned, interest must be paid upon maturity of the notes to the extent not previously paid. In financial statements filed with the Securities and Exchange Commission, the company includes subordinated income notes under the caption "long-term debt" and does not include the caption "capital accounts."

(8) Pension and Profit Sharing Plans

The company and its subsidiaries have various retirement plans covering substantially all regular full-time employees not covered under union agreements.

It is the company's policy to fund normal costs accrued and interest on unfunded prior service costs. The actuarially computed value of vested benefits exceeds the market value of the plans' assets plus balance sheet accruals by approximately \$5,900,000.

The contributory profit sharing plans of the company and its subsidiaries provide that the company make minimum annual contributions to the plans based upon contributions made by participating employees plus additional amounts based on earnings of the company.

Employer contributions to the above plans are irrevocable and upon termination of the plans the amounts thereof are not available to the company. Costs of these plans, excluding pension costs under union agreements, but including costs of unconsolidated subsidiaries, were \$6,864,000 and \$5,313,000 in 1978 and 1977 respectively.

Costs of the plans for the consolidated companies are included in operating and administrative expense in the accompanying consolidated statements of earnings.

The Gambles Thrift/Sharing and Employee Stock Ownership Plan (Plan) has outstanding borrowings of \$9,445,000 at January 27, 1979 (\$5,690,000 at January 28, 1978) the proceeds of which were used to purchase common stock of the company on the open market. In 1978 the Plan converted its demand notes to a term loan due in 1985. The repayment of this obligation is guaranteed by the company. Since the current obligation is a term loan, and because the company has ultimate responsibility to discharge the obligation through future contributions or, in the event of default by the Plan, the obligation has been included in "long-term debt" in the accompanying consolidated balance sheet at January 27, 1979. The 1977 obligation was a demand note and was included in "notes payable" in the accompanying consolidated balance sheet at January 28, 1978. Corresponding amounts have been included in "deferred charges and other assets."

(9) Capital Stock

Preferred stock, \$40 par value; \$1.75 per share dividend — authorized 600,000 shares. Each share is voting, cumulative and convertible into 927/1,000ths of a share of common stock until October 31, 1978, and 824/1000ths of a share to October 31, 1983, on which date conversion rights expire. The stock is redeemable at the option of the company and in the event of involuntary liquidation at \$40.00 per share plus accrued and unpaid dividends. Sinking fund requirements, equal to 5% per year of shares issued, commence in 1983. The aggregate preference upon involuntary liquidation at January 27, 1979 is \$5,705,000.

Preferred stock, \$5 par value; \$1.60 per share dividend — authorized 1,400,000 shares. Each share is voting, cumulative and convertible into 9/10ths of a common share to November 30, 1979, and 8/10ths of a share to November 30, 1984, on which date conversion rights expire. The stock is redeemable at the option of the company and in the event of involuntary liquidation at \$35.00 per share plus accrued and unpaid dividends. Sinking fund requirements, equal to 5% of shares issued, commence in 1984. The aggregate preference upon involuntary liquidation at January 27, 1979 is \$9,079,000. Paid-in capital allocated to \$5 par value preferred stock is equivalent to the mandatory redemption price in excess of par value.

Common stock, \$5 par value — authorized 10,000,000 shares. Common shares were reserved at fiscal year-end as follows:

	1978	1977
Conversion of preferred stock	350,987	418,852
Employee stock options	1,200	383,831
Common stock purchase warrants	224,000	224,000
	<u>576,187</u>	<u>1,026,683</u>

Under the company's option plans for executives and key employees, options are granted at market value and are exercisable from one to five years after date of grant. Shares under option were as follows:

	1978	1977
Outstanding beginning of year	29,300	82,000
Exercised	(15,800)	(5,900)
Expired	(12,300)	(46,800)
Outstanding end of year	<u>1,200</u>	<u>29,300</u>
Aggregate option price for shares outstanding	<u>\$ 32,400</u>	<u>\$724,000</u>
Shares exercisable	<u>1,200</u>	<u>15,900</u>

Warrants to purchase common stock issued in connection with the sale of subordinated income notes are exercisable at \$40.00 per share and expire in January 1984.

In June 1978 stockholders approved the 1978 Restricted Stock Plan under which a maximum of 300,000 shares of Gamble's common stock held in treasury were reserved for issuance.

Under the Plan, participants are awarded shares of common stock by a committee of the Board of Directors. The purchase price of the stock is payable at the end of the restricted period, June 1983 through November 1983, and is the fair value of a share of common stock on the date the award was granted. The purchase price may be reduced by a performance factor which is based on the cumulative compound growth of Gamble's earnings per share during the restricted period on a performance base established by such committee.

Following are the changes in the restricted stock plan for the current year.

	Shares	(thousands)	Amount
Shares sold during 1978	226,120	\$ 5,715	
Shares terminated	(1,100)	(28)	
Amount charged against earnings as compensation	—	(658)	
Balance January 27, 1979	<u>225,020</u>	<u>\$ 5,029</u>	

(10) Retained Earnings

Retained earnings of certain unconsolidated subsidiaries are restricted as to payment of dividends in the amount of \$65,300,000.

(11) Consumer Credit Operations

The results of the consumer credit operations are as follows:

	(thousands)	1978	1977
Finance charge income	\$71,869	\$60,669	
Operating expense (including credit sales expense, collection expense, and provision for doubtful accounts)	48,918	37,954	
Interest expense	29,267	23,642	
Income taxes	(3,158)	(464)	
Total expenses	75,027	61,132	
Net income (loss) from consumer credit operations	<u>(\$3,158)</u>	<u>(\$463)</u>	

Finance-charge income and operating expense are included in operating and administrative expense in the accompanying consolidated statements of earnings. Interest expense is calculated based upon the average cost of borrowings of the finance subsidiaries of 8.95% in 1978 and 7.66% in 1977 applied to the average balance of customer receivables reduced by deferred income taxes. An effective rate of 50% is assumed in calculating income taxes.

(12) Condensed Combined Finance Companies

Gambles Credit Corporation and Gambles Canada Acceptance, Ltd., unconsolidated wholly owned finance subsidiaries of the company, purchase accounts receivable from the merchandise companies, withholding ten percent of the receivable balances pending collection. The finance companies charge Gambles a service fee which is calculated to produce earnings sufficient to cover fixed charges, principally interest on borrowings at one and one half times. Such service fee is included in the consolidated statements of earnings as interest expense.

The condensed combined balance sheets of Gambles Credit Corporation and Gambles Canada Acceptance, Ltd. are as follows:

	(thousands)	1978	1977
Assets:			
Customer and dealer accounts receivable	\$438,702	\$408,785	
Other assets	29,991	20,200	
	<u>\$468,693</u>	<u>\$428,985</u>	
Liabilities and Stockholders' Equity:			
Notes payable and current installments of long-term debt	\$106,777	\$153,948	
Contract reserve account, applicable to customer and dealer accounts receivable	43,870	40,878	
Other liabilities	9,176	3,801	
Long-term debt	223,909	152,293	
	<u>383,732</u>	<u>350,920</u>	
Stockholders' equity	84,961	78,065	
	<u>\$468,693</u>	<u>\$428,985</u>	

The net earnings of these finance companies were \$6,896,000 in 1978 and \$5,164,000 in 1977. The pre-tax earnings of these finance companies are deducted from interest expense in the accompanying consolidated statements of earnings (see Note 13).

(13) Interest Expense

The principal components of interest expense are shown in the following table:

	(thousands)	
	1978	1977
Service fee on receivables sold to finance companies	\$42,088	\$32,093
Interest on long-term debt	36,255	32,495
Interest on short-term borrowings	7,360	1,519
	<u>85,703</u>	<u>66,107</u>
Less pre-tax earnings of finance companies	13,765	10,424
Less interest income*	11,730	13,187
Net interest expense	<u>\$60,208</u>	<u>\$42,496</u>

*Includes \$5,393,000 and \$6,357,000 in 1978 and 1977, respectively, from the combined finance subsidiaries, and \$567,000 and \$749,000 in 1978 and 1977, respectively, from other unconsolidated subsidiaries.

In 1977 pre-tax earnings of the combined finance subsidiaries were reflected as a reduction of operating and administrative expense. They have been reclassified to conform to the 1978 presentation.

(14) Income Taxes

Income tax expense is made up of the following components:

	(thousands)	
	1978	1977
Current tax expense:		
Federal	(\$3,073)	(\$3,447)
Canadian	4,020	4,445
State and local	1,983	679
Deferred tax expense:		
Federal and state	6,193	5,499
Canadian	173	(301)
	<u>\$ 9,296</u>	<u>\$ 6,875</u>

Deferred taxes arose from timing differences related to the following:

	(thousands)	
	1978	1977
Store closing costs	\$1,004	(\$1,014)
Instalment receivables	4,852	5,509
Interest accrual	(70)	720
Undistributed foreign earnings	—	436
Retirement benefits	183	430
Data processing costs	(226)	(330)
Other — net	623	(553)
	<u>\$6,366</u>	<u>\$ 5,198</u>

A reconciliation of the 1978 and 1977 U.S. Federal statutory tax rates of 47.9% and 48.0%, respectively, to the actual effective rates is as follows:

	1978	1977
U.S. Federal Statutory tax rate	47.9%	48.0%
State income tax net of:		
Federal tax benefit	4.7	4.5
Investment tax credit	(5.8)	(9.6)
Translation adjustment on -		
Canadian earnings	9.5	16.9
Capital gain transactions taxed at lower tax rate	(3.0)	—
Canadian inventory tax credit	(2.9)	(4.8)
Permanent differences arising from income recognition of purchase accounting adjustments	(2.9)	(1.0)
Other — net (not individually significant)	(5.0)	.2
	<u>42.5%</u>	<u>54.2%</u>

No provision for income taxes has been made on approximately \$46,400,000 of undistributed earnings of the Canadian companies that have been indefinitely reinvested in the subsidiaries' business.

Investment tax credits are used to reduce income taxes in the year the property is acquired (\$1,270,000 in 1978 and \$1,427,000 in 1977).

Internal Revenue Service examinations of Federal income tax returns for Gambles have been completed through January 25, 1975. An examination for the years ended January 31, 1976 and January 29, 1977 is in progress. Gambles believes that all taxes due have been fully paid or provided for.

(15) Commitments and Litigation

The company has guaranteed indebtedness of unconsolidated subsidiaries of approximately \$48,604,000. In addition the company, as a result of a corporate reorganization in 1964, may be liable for the payment of \$15,928,000 of long-term debt of an unconsolidated finance subsidiary. The company has also guaranteed loans and other debt with banks of \$7,920,000 at January 27, 1979.

A number of lawsuits and inquiries and complaints from state regulatory agencies, are pending against Aldens, Inc., a subsidiary of the company. These proceedings relate to the legality of certain credit and finance charge practices.

Notwithstanding the above, management is of the opinion that Aldens is presently in compliance with applicable state laws. If such lawsuits are tried and decided adversely, it is impossible to predict what amounts, if any, might be awarded, although a theoretical liability in the millions of dollars could be involved. Aldens has been unsuccessful in substantially all cases that have

been finally adjudicated, but is vigorously defending each pending case. Management is of the opinion that ultimate resolution of the pending matters or possible litigation involving finance charges, taken in the aggregate, will not materially affect the company's financial position or results of operations.

In August and September 1978 Gamble purchased approximately 20% of the outstanding common stock of Garfinckel, Brooks Brothers, Miller & Rhoads, Inc. (Garfinckel). Garfinckel has commenced an action in the United States District Court for the District of Delaware to require divestiture of the common stock purchased to date and to obtain monetary damages of not less than \$10,000,000 and certain other remedies. Gamble intends to defend its position vigorously and management of Gamble does not believe that the outcome of such proceedings would materially affect Gamble's financial position or results of operation.

(16) Business Segment Information

Business segment information for the fiscal years ended January 27, 1979 and January 28, 1978 set forth on page 29 is an integral part of these financial statements.

(17) Quarterly Financial Information (Unaudited)

Set forth below are financial data showing results of operations for the four fiscal quarters of 1978 and 1977 (restated). In the opinion of management all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation have been included.

Accountants' Report

PEAT, MARWICK, MITCHELL & CO.
Certified Public Accountants
1700 IDS Center
Minneapolis, Minnesota 55402

The Board of Directors and Stockholders
Gamble-Skogmo, Inc.:

We have examined the consolidated balance sheets of Gamble-Skogmo, Inc. and consolidated subsidiaries as of January 27, 1979 and January 28, 1978 and the consolidated balance sheets of Aristar Holdings, Inc. (wholly-owned by Gamble-Skogmo, Inc.) and subsidiaries as of January 31, 1979 and 1978 and the related consolidated statements of earnings, retained earnings, stockholders' 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 aforementioned consolidated financial statements present fairly the financial position of Gamble-Skogmo, Inc. and consolidated subsidiaries at January 27, 1979 and January 28, 1978 and of Aristar Holdings, Inc. and subsidiaries at January 31, 1979 and 1978 and the results of their operations and the changes in their financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis after restatement by Gamble-Skogmo, Inc. for the change, with which we concur, in the method of accounting for leases as described in Note 5 to the financial statements of Gamble-Skogmo, Inc. and consolidated subsidiaries.

Peat, Marwick, Mitchell & Co.

March 28, 1979

	In Thousands, except per share, For the Thirteen Weeks Ended			
	April 29, 1978	July 29, 1978	Oct. 28, 1978	Jan. 27, 1979
Net sales	\$415,135	\$457,233	\$501,420	\$580,856
Cost of sales	317,298	348,217	378,716	436,184
Net earnings	1,007	5,294	2,980	13,943
Earnings per share:				
Primary	.19	1.24	.70	3.42
Fully diluted	.19*	1.16	.68	3.18
	April 30, 1977	July 30, 1977	Oct. 29, 1977	Jan. 28, 1978
Net sales	\$376,650	\$384,718	\$409,314	\$463,440
Cost of sales	294,964	300,510	319,267	342,967
Net earnings	(2,407)	1,879	2,064	8,228
Earnings per share:				
Primary	(.59)	.38	.43	1.87
Fully diluted	(.59)*	.38*	.43*	1.74

*antidilutive

(18) Replacement Cost Information (Unaudited)

In compliance with rules of the Securities and Exchange Commission the company is required to estimate certain replacement cost information. This information is contained in the company's Form 10-K report filed with the Securities and Exchange Commission, a copy of which is available upon request.

Business Segment Information

Gambles' merchandising businesses operate in six primary business segments: general merchandising — retail, general merchandising — wholesale, mass merchandising, food and drug, catalog, and Canadian merchandising. General merchandising — retail includes operations that are primarily oriented toward retailing a wide variety of consumer goods. General merchandising — wholesale comprises the operations primarily making sales to dealers. Mass merchandising includes retail general merchandise stores operating on high volume and low margin, including certain operations now discontinued. Food and drug includes groceries and drugs and other drug store merchandise. Catalog includes catalog and direct mail merchandising operations. Canadian merchandising comprises all Canadian merchandising operations. Set forth below is certain information about these business segments.

Net Sales and Operating Earnings

Year Ended January	Net Sales (thousands)					Operating Earnings (thousands)				
	1979	1978	1977	1976	1975	1979	1978	1977	1976	1975
Business Segments:										
General Merchandising — Retail	\$ 306,687	\$ 209,399	\$ 187,659	\$ 180,500	\$ 166,966	\$ 20,412	\$ 9,470	\$ 10,195	\$ 7,848	\$ 8,807
General Merchandising — Wholesale	210,680	220,826	218,722	207,920	197,098	11,518	7,820	10,214	13,026	11,978
Mass Merchandising	263,524	118,552	131,742	145,653	141,433	2,706	(952)	1,036	2,710	5,158
Food and Drug	730,351	670,490	627,186	616,639	575,620	12,434	11,728	11,587	10,951	10,897
Catalog	256,009	228,331	226,622	220,205	226,226	28,701	27,163	24,626	24,462	25,764
Canadian Merchandising	199,933	204,552	218,274	204,810	192,284	8,856	7,058	15,090	19,039	20,846
Eliminations	(12,540)	(18,028)	(19,833)	(16,684)	(12,172)	—	—	—	—	—
Net Sales	<u>\$1,954,644</u>	<u>\$1,634,122</u>	<u>\$1,590,372</u>	<u>\$1,559,043</u>	<u>\$1,487,455</u>					
Operating Earnings						84,627	62,287	72,748	78,036	83,450
General corporate expenses						(2,533)	(7,098)	(4,886)	(5,571)	(3,677)
Interest expense, net of interest income						(60,208)	(42,496)	(39,846)	(35,920)	(37,638)
Earnings before taxes and equity in net earnings of unconsolidated subsidiaries and investee company						<u>\$21,886</u>	<u>\$12,693</u>	<u>\$28,016</u>	<u>\$36,545</u>	<u>\$42,135</u>

Identifiable Assets, Depreciation and Capital Expenditures	Identifiable Assets		Depreciation		Capital Expenditures	
	1979	1978	1979	1978	1979	1978
Business Segments:						
General Merchandising — Retail	\$ 160,847	\$ 122,744	\$ 4,116	\$ 3,151	\$ 7,352	\$ 5,968
General Merchandising — Wholesale	131,714	135,870	1,225	1,123	2,387	2,371
Mass Merchandising	150,880	65,545	3,911	2,073	4,902	886
Food and Drug	124,452	115,282	5,193	4,874	12,356	12,011
Catalog	364,061	365,462	2,236	1,626	5,141	1,407
Canadian Merchandising	141,378	151,284	3,077	3,002	1,398	2,200
Eliminations	(394,832)	(367,907)	—	—	—	—
	678,500	588,280	19,758	15,849	33,536	24,843
Corporate	86,530	110,958	42	68	523	584
Investment in unconsolidated subsidiaries and investee company	236,007	152,071	—	—	—	—
	<u>\$1,001,037</u>	<u>\$851,309</u>	<u>\$19,800</u>	<u>\$15,917</u>	<u>\$34,059</u>	<u>\$25,427</u>

5 Year Summary of Operations

The following summary of operations presents in condensed form the consolidated results of operations of the company for the five years ended January 27, 1979, and should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this annual report.

	1978	1977	1976	1975	1974
(All dollars in thousands except amounts per share)					
Net sales	\$1,954,644	\$1,634,122	\$1,590,372	\$1,559,043	\$1,487,455
Costs and expenses:					
Cost of sales	1,480,415	1,257,708	1,224,082	1,202,937	1,142,569
Operating and administrative	375,216	306,115	284,078	269,725	252,955
Interest:					
Long-term debt	52,126	42,488	33,787	24,379	21,757
Other	14,419	6,838	11,581	13,810	18,266
Income	(6,337)	(6,830)	(5,522)	(2,269)	(2,385)
Other costs and expenses	16,919	15,110	14,350	13,916	12,158
Earnings before income taxes and equity in net earnings of unconsolidated subsidiaries and investee company	21,886	12,693	28,016	36,545	42,135
Income taxes	9,296	6,875	13,417	18,445	20,919
Equity in net earnings of unconsolidated subsidiaries and investee company	10,634	3,946	3,611	4,274	3,540
Net earnings	23,224	9,764	18,210	22,374	24,756
Dividend requirements on preferred stock	(726)	(779)	(1,079)	(1,376)	(1,810)
Net earnings applicable to common stock	\$ 22,498	\$ 8,985	\$ 17,131	\$ 20,998	\$ 22,946

Other Significant Comparisons

Average number of common and common-equivalent shares outstanding:

Primary	4,114,000	4,403,000	4,439,000	4,404,000	4,201,000
Fully diluted	4,511,000	4,833,000	5,083,000	5,162,000	5,300,000

Earnings per common share:

Primary	\$ 5.47	\$ 2.04	\$ 3.86	\$ 4.77	\$ 5.46
Fully diluted	\$ 5.15	\$ 2.02	\$ 3.58	\$ 4.33	\$ 4.67

Cash dividends paid per share of common stock	\$ 1.40	\$ 1.40	\$ 1.40	\$ 1.40	\$ 1.40
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Inventories	352,611	286,534	255,158	255,479	253,550
Net working capital	201,900	240,175	246,554	235,846	197,226
Current ratio	1.7 to 1	1.9 to 1	2.0 to 1	2.0 to 1	1.9 to 1
Subordinated income notes	251,843	254,079	237,385	188,379	163,095
Stockholders' equity	232,912	233,305	235,999	234,756	220,590

Number of:

Full-time employees	21,100	20,700	18,100	19,000	18,800
Company-owned stores — Merchandising	861	668	676	680	678
Dealer-owned stores — Merchandising	2,402	2,476	2,647	2,752	2,843
Common shares outstanding at year-end*	4,036,034	4,298,628	4,446,315	4,416,580	4,385,468
Shareholders	11,471	12,076	12,661	14,525	14,540
Subordinated income note holders	39,414	39,110	37,396	27,762	23,285

*Excludes shares of treasury stock

Analysis of Summary of Operations

1978 Compared with 1977

Net sales increased \$320.5 million (19.6%) to almost two billion dollars in 1978. The increase reflected improved sales of both continuing and newly acquired businesses.

Cost of sales as a percent of sales decreased from 77.0% in 1977 to 75.7% in 1978. This decrease was due in part to the acquisition of Leath and Company and the inclusion of Aristar Home Furnishings for an entire year. These furniture retailers earn a higher gross profit than most other retailers included in the company's consolidated financial statements. In addition, the strengthening of our economy in our operating areas allowed the company to obtain better markups than the prior year, further lowering the cost of sales as a percent of sales.

Operating and administrative expenses increased from 18.7% in 1977 to 19.2% in 1978. Inflationary pressures and the addition of the furniture businesses increased operating expenses. Both years had higher than normal closing costs; approximately \$5.7 million pre-tax for Tempo-Buckeye stores in 1978 and approximately \$4.6 million for various stores closed in 1977.

Interest expense increased significantly during 1978 for various reasons. Short-term rates averaged 277 basis points higher than a year ago and, in recent months, were more than 300 basis points higher. Long-term interest was up due to the placement of higher cost long-term debt and the assumption of long-term debt of acquired companies. Notes were issued for a portion of the shares purchased in the Howard Bros. and Garfinckel acquisitions. The remainder of these shares were purchased for cash. This, plus the purchase of Leath and the purchase of common stock for the Treasury contributed to the increase in short-term interest. The financing of higher receivable balances due primarily to our catalog business, also contributed to the higher interest expense. Interest income is down because of a decrease in average short-term investments.

Tax expense as a percentage of earnings before income taxes and equity in net earnings of unconsolidated subsidiaries was 42.5% in 1978 compared to 54.2% in 1977. Tax benefits from capital gains transactions, a lesser tax impact from the translation of the company's Canadian operation into U.S. dollars and investment tax credits were the principle causes of this lower tax rate.

The company combined and streamlined existing warehouse facilities utilized by the Gamble Division which enabled the company to sell a warehouse for a pre-tax gain of approximately \$2.5 million. The liquidation and the redeployment of the Tempo-Buckeye assets together with the foreign exchange loss from the translation of our Canadian operations into U.S. dollars reduced net earnings by approximately \$7.0 million or \$1.70 per share.

1977 Compared with 1976

Net sales increased \$43.8 million in fiscal 1977. The increase was achieved despite weak sales demand resulting from the soft agricultural economy in the company's rural trading areas. Cost of sales as a percentage of sales was the same for both years.

Operating and administrative expenses increased slightly from 17.9% of sales to 18.7%. The increase was attributable to more aggressive sales promotion efforts in 1977 compared to 1976, and increased operating and administrative costs due to inflation.

In addition, the company established a provision for store closing costs in the amount of \$4,589,000.

Interest expense for 1977 was about \$2.6 million higher than the previous year. The higher interest was due principally to an increase in long-term borrowings at higher rates. The proceeds of these borrowings were employed primarily as advances to the company's domestic finance subsidiary to repay short-term debts.

Tax expense as a percentage of earnings before income taxes and equity in net earnings of unconsolidated subsidiaries was 54.2% in 1977 compared to 47.9% in 1976. The increase was primarily attributable to the impact of translation of the company's Canadian operations into U.S. dollars.

The provision for store closing costs and unrealized loss on translation of the company's Canadian operations into U.S. dollars reduced net earnings approximately \$7.8 million or \$1.77 per share.

Stock Information

The company's common stock, \$5 par value preferred stock, and \$40 par value preferred stock are listed on the New York Stock Exchange. The common stock is also listed on the Midwest Stock Exchange. The symbol on both exchanges for the company's common stock is GSK.

Quarterly dividend payments per share and market prices per share for the various classes of stock over the past two fiscal years are shown below.

		1978			1977		
	Quarter	New York Stock Exchange Market Price		Dividends Paid	New York Stock Exchange Market Price		Dividends Paid
		High	Low		High	Low	
COMMON STOCK	1st	30 1/8	26 1/4	\$0.35	33	22 1/2	\$0.35
	2nd	28 7/8	24 1/8	0.35	39 1/4	30 1/8	0.35
	3rd	38 1/8	27	0.35	34 1/2	22	0.35
	4th	28 7/8	23 3/8	0.35	28 3/8	22 7/8	0.35
				\$1.40			\$1.40
\$5 PAR VALUE PREFERRED STOCK	1st	25	23	\$0.40	29 1/8	22 1/2	\$0.40
	2nd	25	22	0.40	35	27	0.40
	3rd	32 1/2	24 3/4	0.40	29 1/2	20 1/2	0.40
	4th	24 1/2	21 3/4	0.40	25	21	0.40
				\$1.60			\$1.60
\$40 PAR VALUE PREFERRED STOCK	1st	26 1/4	24	\$0.43 3/4	30 1/2	24	\$0.43 3/4
	2nd	24 5/8	22 1/8	0.43 3/4	36	28	0.43 3/4
	3rd	34	24 1/4	0.43 3/4	29 7/8	21 3/4	0.43 3/4
	4th	23 1/2	22 1/4	0.43 3/4	25	21 3/4	0.43 3/4
				\$1.75			\$1.75

Consolidated Statements of Earnings and Retained Earnings (Note 2)

ARISTAR HOLDINGS, INC. AND SUBSIDIARIES

(All dollars in thousands)

	1978	1977
	Year Ended January 31, 1979	Year Ended January 31, 1978
Revenue:		
Interest and fees applicable to finance and related receivables	\$ 61,257	\$ 9,217
Leasing rentals and fees	17,399	10,637
Insurance premiums	44,093	36,022
Investment and other income	10,706	6,674
Total revenue	133,455	62,550
Expenses:		
Interest and debt expense (Notes 7 and 9)	26,757	7,844
Personnel costs (Note 11)	21,660	6,101
Insurance claims and benefit provisions	27,308	24,583
Provision for credit losses	6,960	1,765
Other operating expenses	28,785	14,128
Total expenses	111,470	54,421
Earnings before income taxes, preferred stock requirements and minority interest	21,985	8,129
Income taxes (Note 8)	7,360	3,480
Earnings before preferred stock requirements and minority interest	14,625	4,649
Preferred stock requirements (Note 10)	(1,075)	—
Earnings before minority interest	13,550	4,649
Minority interest in earnings of Aristar, Inc. and Gambles C&M Leasing (Note 2)	(4,626)	(565)
Earnings applicable to Gamble-Skogmo common stock	8,924	4,084
Retained earnings beginning of year (Notes 2 and 10)	24,250	21,266
Cash dividends on common stock	(110)	(1,100)
Retained earnings end of year (Notes 2 and 10)	\$33,064	\$24,250

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheets

ARISTAR HOLDINGS, INC. AND SUBSIDIARIES

(All dollars in thousands)

	1978	1977
	January 31, 1979	January 31, 1978
ASSETS		
Cash (Note 7)	\$ 25,792	\$ 20,516
Notes and contracts receivable (Note 3)	354,220	298,950
Less:		
Unearned finance charges	59,365	45,996
Allowance for doubtful accounts	9,681	10,087
Notes and contracts receivable — net	285,174	242,867
Net investment in direct financing leases (Note 4)	39,812	52,163
Marketable securities (Note 5)	64,817	61,480
Equipment on operating leases	44,909	19,419
Investment in and advances to subsidiaries (Note 2)	—	34,894
Property and equipment — net	1,732	16
Assets held in separate account (Note 1)	29,739	29,846
Mortgage and other notes receivable	14,490	8,175
Deferred charges (Note 6)	7,689	6,471
Other assets	15,174	18,887
TOTAL ASSETS	\$529,328	\$494,734
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable to banks (Note 7)	\$ 82,900	\$ 85,061
Equipment financing obligations (Note 7)	56,127	47,774
Accounts payable and accrued expenses	16,200	18,426
Due to affiliates	4,062	300
Deposits and other liabilities	4,810	3,937
Federal and state income taxes (Note 8)	17,218	15,778
Insurance claims and benefit reserves	38,307	35,396
Unearned insurance premiums and commissions	21,748	18,327
Liabilities and participants' equity in separate account (Note 1)	29,739	29,846
Long-term debt (Note 9)	126,279	128,295
Total liabilities	397,390	383,140
Minority interests	1,099	36,831
Stockholders' equity (Notes 2 and 10):		
Preferred stock	—	9,984
Common stock	1	4,726
Paid-in surplus	98,597	40,168
Retained earnings	33,064	24,250
Less:		
Cost of common stock reacquired and held in treasury	—	(4,175)
Net unrealized loss on marketable equity securities (Note 5)	(823)	(190)
Total stockholders' equity	130,839	74,763
Contingent liabilities and commitments (Notes 12 and 13)		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$529,328	\$494,734

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

ARISTAR HOLDINGS, INC. AND SUBSIDIARIES

(All dollars in thousands)

	1978	1977
	Year Ended January 31, 1979	Year Ended January 31, 1978
SOURCES OF FUNDS		
Operations:		
Net earnings	\$ 8,924	\$ 4,084
Add (deduct) items not requiring funds for the current period:		
Provision for credit losses	6,960	1,765
Depreciation of equipment on operating leases	7,658	2,552
Deferred income taxes (Note 8)	(2,148)	1,376
Amortization of deferred policy acquisition costs	8,721	2,373
Provision for unpaid insurance claims and future benefits	2,160	(1,657)
Increase in unearned insurance premiums and commissions	3,421	656
Decrease in accrued expenses and accounts payable	(2,226)	(1,975)
Other — net	—	2,033
Total funds provided by operations	33,470	11,207
Decrease in net investment in direct financing leases	12,351	15,828
Increase (decrease) in due to affiliates	3,762	(1,329)
Decrease in investments in and advances to subsidiaries	34,894	388
Decrease in other assets	3,713	2,227
Increase in notes payable to banks	29,939	8,400
Increase in equipment financing obligation — net	8,353	5,784
Increase in Federal and state income taxes	3,588	610
Tax benefit from utilization of a purchased subsidiary's loss carryforward (reflected as a reduction of goodwill) (Note 8)	56	1,333
Increase (decrease) in insurance claims and benefit reserves	1,726	(3,181)
Increase in minority interests	6,974	565
Newly-issued common stock to Gamble (Note 10)	1	—
Stock options exercised (Note 10)	64	—
Cancellation of treasury stock upon merger (Note 10)	4,175	—
Increase in paid-in surplus (Note 10)	58,429	—
Increase in net unrealized loss on marketable equity securities	633	—
Decrease in carrying value of marketable equity securities	(633)	—
Total Sources	\$201,495	\$41,832
USES OF FUNDS		
Increase in cash	\$ 5,276	\$ 166
Increase in notes and contracts receivables — net	49,267	8,384
Increase in marketable securities	3,970	1,248
Additions to equipment on operating leases — net	33,148	21,972
Increase in property and equipment — net	1,716	16
Increase in mortgages and other receivables	6,315	2,897
Increase in deferred charges	9,939	3,260
Decrease in notes payable to banks	32,100	1,645
Decrease in long-term debt	2,016	541
Acquisition of minority interest (Note 10)	42,706	—
Preferred stock requirements (Note 10)	(1,075)	—
Dividends paid — common stock	110	1,100
Dividends paid — preferred stock (Note 10)	2,439	—
Cancellation of preferred and common stock (Note 10)	13,410	—
Other — net	158	603
Total Uses	\$201,495	\$41,832

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

ARISTAR HOLDINGS, INC. AND SUBSIDIARIES

(1) Summary of Significant Accounting Policies

PRINCIPLES OF CONSOLIDATION. The consolidated financial statements include the accounts of Aristar Holdings, Inc. ("Aristar") and its finance, leasing, insurance and related management subsidiaries after elimination of all material intercompany balances and transactions (see Note 2). The insurance subsidiaries are included in the accompanying financial statements as of their fiscal years ended December 31.

ALLOWANCE FOR DOUBTFUL ACCOUNTS. At the end of each month, the unpaid balance of all loans where there has been no payment of at least one half of one contractual instalment in the preceding six months are charged against the allowance for doubtful accounts. The allowance is then adjusted to an amount which, in management's judgment, is sufficient to cover estimated losses in the portfolio. In evaluating the adequacy of the allowance, consideration is given to recent loan loss experience and such other factors which in management's judgment deserve current recognition in estimating losses.

INVESTMENTS IN SECURITIES. Bonds are stated at amortized cost. Preferred stock which must be redeemed are carried at cost, not in excess of redemption price. The marketable equity securities owned by the insurance subsidiaries of Aristar are reported at market value and any resulting unrealized gains or losses are credited or charged to stockholders' equity (See Note 5). Gain or loss on the sale of securities included in operating income for the period is computed principally on the specific identification method.

PROPERTY AND EQUIPMENT. Property is stated at cost, less accumulated depreciation and amortization computed on the straight-line method over the estimated useful life of the asset. Expenditures for new property and equipment, and for renewals and betterments, are generally capitalized; expenditures for maintenance and repairs are charged to income as incurred. Fully-depreciated furniture and equipment and fully-amortized leasehold improvements are removed from assets and related accumulated depreciation accounts. Gains and losses on retirement and disposals are included in income.

DEFERRED CHARGES. Expenditures that are deferred are amortized over the periods in which the benefit is expected to be realized. Amortization is computed principally on the straight-line method (except for insurance acquisition costs) over the following periods:

	Years
Long-term Debt Expense	10-25
Premiums on Purchased Accounts	3-6
Insurance Acquisition Costs	1-18
Excess Cost of Subsidiary Over Equity	15
Unamortized Initial Direct Costs of Operating Leases	1

INTEREST AND FEES ON LOANS. Finance charges included in notes and contracts receivable (precomputed charges) are deferred and proportionate amounts are included in income over the term of the loan using the "sum of the digits" method (Rule of 78), principally on the collection basis. Finance charges on simple interest loans are recorded as collected.

Delinquency fees on precomputed accounts are recorded as the cash is received. Deferment charges are credited to deferred income when collected and proportionate amounts are included in income over the term of the loan.

INSURANCE PREMIUMS AND ACQUISITION EXPENSES.

Premium income applicable to life insurance and annuities is reported as earned when due. Policy and contract benefits and expenses are associated with premium income in a manner that results in recognition of profits over the lives of the policies. This association is accomplished by means of the provisions for future policy benefits and the deferral and subsequent amortization of policy acquisition costs.

Insurance premiums on credit life and accident and health policies are deferred and proportionate amounts are included in income over the term of the related policy using the "Rule of 78" method for credit life and principally the average of "pro rata" and "Rule of 78" for accident and health.

Casualty insurance premiums are earned over the term of the related policies principally on the "pro rata" method.

The costs of acquiring new life insurance and annuity policies, principally commissions, certain policy issuance and other underwriting and sales expenses, have been deferred. Such costs are being amortized over the premium-paying periods of the related policies in proportion to the ratio of the expected annual premium revenue to the expected total premium revenue. Such expected premium revenue is estimated using the same assumptions as are used for calculating the liabilities for future policy benefits.

Acquisition expenses relating to unearned casualty, credit life and accident and health insurance premiums, which expenses are comprised of commissions, premium taxes and certain other acquisition expenses, are deferred and amortized to income over the terms of the related policies. The method of computing such deferred acquisition expenses limits the deferral to the lower of (a) the amount of unearned premiums remaining after deducting expected losses, loss adjustment expenses, and run-off expenses that will be incurred as the premiums are earned, or (b) the acquisition expenses applicable to the unearned premiums.

INSURANCE CLAIMS AND BENEFIT RESERVES. Liabilities for future policy benefits are generally computed based upon assumptions as to future investment yield, mortality and

withdrawals. The liability for policy and contract claims represents management's estimate of the ultimate liability associated with unpaid policy claims. This liability is based primarily upon past experience and may be more or less than the amount ultimately paid when the claims are settled. Changes in the estimated cost to settle unpaid claims are charged or credited to operations as the estimates are revised.

LEASING INCOME. Aristar's leasing subsidiaries are primarily engaged in leasing automotive equipment to corporate fleet users under operating and direct financing lease arrangements. For financial accounting purposes, the cost of the equipment on operating leases is recorded at the inception of the lease as an asset and is depreciated over the lease term to the expected residual value. The initial lease term typically covers a period of twelve months and thereafter may be extended at the option of the lessee on a month-to-month basis. Initial direct costs associated with such leases are deferred and amortized over the lease term on a straight-line basis. Rental income is recognized as it becomes due. For direct financing leases the aggregate rental payments due during the lease term are recorded at inception of the lease. The excess of such rental payments over the cost of the related equipment, after establishing residual values, represents the unearned finance charge, which is taken into income over the term of the lease using the interest method. Initial direct costs are charged to income as incurred and an equivalent amount of unearned finance charge is recognized as revenue in the same period.

INCOME TAXES. Prior to the merger of Aristar, Inc. with a wholly-owned subsidiary of Gamble, Aristar, Inc. and its subsidiaries, other than its life insurance subsidiary, filed consolidated Federal income tax returns. Subsequent to the merger, Aristar Holdings, Inc. and its subsidiaries, other than the life insurance subsidiaries, will file a consolidated Federal income tax return with its parent, Gamble-Skogmo, Inc. Income taxes are allocated between Aristar and its non-insurance subsidiaries in proportion to the respective contribution to consolidated income or loss. Dividends paid by the subsidiaries are generally not taxable; however, under certain conditions dividends paid by the life insurance subsidiaries would be taxable. Management does not intend to declare any such taxable dividends. Deferred income taxes are provided on elements of income that are recognized for financial reporting purposes either earlier or later than such items are recognized for income tax purposes. For financial reporting purposes, Aristar defers the investment tax credit on leased equipment that it anticipates will be recaptured in future periods. The remaining investment tax credit is treated as a reduction of income tax expense in the year the equipment is placed in service.

SEPARATE ACCOUNT. Assets held and liabilities related to the separate account represent funds held applicable to the Gamble Pension Plan, which is administered by an insurance subsidiary of Aristar. Income and expenses attributable to the separate account funds are not included in the accompanying consolidated financial statements. Such insurance subsidiary receives administrative fees and annuity considerations from the Separate Account.

(2) Acquisition of Aristar and Corporate Reorganization

Aristar, Inc. became a 51%-owned subsidiary of Gamble on November 30, 1977 as a result of the conversion by Gamble of \$15 million of subordinated convertible notes issued by Aristar, Inc. On January 26, 1979 Aristar, Inc. became a wholly-owned subsidiary as a result of the acquisition described in Note 2 of Notes to Consolidated Financial Statements of Gamble-Skogmo, Inc. and consolidated subsidiaries. This acquisition of Aristar, Inc. has been accounted for as a purchase. Accordingly, the accounts of Aristar, Inc. acquired through the purchase have been adjusted to fair value as of the dates of acquisition, November 30, 1977 and January 26, 1979 and the results of their operations have been included in the financial statements since the respective dates of acquisition with appropriate adjustment for minority interests prior to January 26, 1979. This adjustment to reflect the acquisition resulted in a decrease in paid-in surplus of \$5,351,000 at January 26, 1979 and an increase to paid-in surplus of \$44,493,000 (including the capitalization of retained earnings of approximately \$41,700,000) at November 30, 1977. On January 18, 1979, Aristar, Inc. sold, at book value, substantially all of the net receivables relating to its home furnishings subsidiaries to several banks. On January 26, 1979, Aristar, Inc. transferred substantially all of the remaining assets, net of certain liabilities, of these subsidiaries to Gamble at Aristar, Inc.'s historical book value. Aristar, Inc.'s investment in these subsidiaries was reflected as "Investment in and advances to subsidiaries" in the January 31, 1978 financial statements. However, substantially all of the results of operations of these subsidiaries were reflected in the consolidated financial statements of Gamble for the years ended January 27, 1979 and January 28, 1978 and, therefore, are not included in the accompanying financial statements.

As of January 27, 1979, Gamble contributed the capital stock of Aristar, Inc. to a newly-formed subsidiary, Aristar Holdings, Inc. Additionally, Gamble contributed the capital stock of Gamble C & M Leasing Company, Inc., an 80%-owned subsidiary, and Gamble International Leasing Company, Inc., a wholly-owned subsidiary, to Aristar Holdings, Inc. and the

capital stock of Gamble Alden Life Insurance Company and Gamble Alden Agency, Inc., wholly-owned insurance subsidiaries, to Aristar, Inc. References made to "Aristar" throughout the financial statements, refer to Aristar Holdings, Inc. For financial statement purposes, these transactions have been reflected as of January 31, 1979 and the accounts of these subsidiaries have been combined for all periods presented.

(3) Notes and Contracts Receivable

Notes and contracts receivable and maximum terms of loans made as of January 31 were:

	(thousands)		Maximum Term	
	Notes and Contracts Receivable		(Months)	
	1979	1978	1979	1978
Direct Cash Loans:				
Precomputed Interest	\$244,362	\$199,929	96	96
Interest Bearing	69,207	70,982	84	84
Retail Contracts	40,651	28,039	36	36
Total	<u>\$354,220</u>	<u>\$298,950</u>		

The weighted average contractual term of all loans made during the year ended January 31, 1979 was approximately 34 months. Experience of Aristar, however, has shown that a majority of direct cash loans and many, although not a majority, of the retail contracts will be renewed prior to contractual maturity dates. During the year ended January 31, 1979 cash collections (excluding collection of deferred income) on notes and contracts receivable was \$162,420,000 and the ratio of cash collections to average balances (net of unearned income) was 55%.

(4) Net Investment in Direct Financing Leases

The net investment in direct financing leases consists of amounts due from lessees on such leases over the lease periods as follows:

	January 31, 1979	January 31, 1978
Aggregate Future Rentals —		
Due in Instalments	\$17,322	\$26,599
Equipment Residual Values	26,233	30,577
	43,555	57,176
Allowance for Uncollectibles	(500)	(622)
Unearned Finance Charges	(3,243)	(4,391)
Total	<u>\$39,812</u>	<u>\$52,163</u>

Although substantially all lease periods used in deriving the January 31, 1979 and January 31, 1978 net investment in direct financing leases expire within one year, the actual amounts received from leases may vary considerably due to extensions, early terminations and other changes to the equipment on lease.

The net investment in direct financing leases at January 31, 1979 and January 31, 1978 included approximately \$7,869,000 and \$12,342,000, respectively, due from affiliated companies. Equipment under lease agreements with affiliated companies signed after January 1, 1977 is reflected on the January 31, 1979 and January 31, 1978 balance sheets as equipment on operating leases and amounted to approximately \$3,600,000 and \$2,400,000 net of accumulated depreciation of approximately \$900,000 and \$230,000, respectively. Lease income, net of related depreciation of equipment on operating leases, from affiliated companies for the years ended January 31, 1979 and 1978 aggregated approximately \$650,000 and \$500,000, respectively.

(5) Marketable Securities

At December 31, the life insurance subsidiaries' investments in securities were:

	1978			1977		
	Cost	Carrying Value	Quoted Market Value	Cost	Carrying Value	Quoted Market Value
Common Stock	\$13,615	\$12,993	\$12,993	\$ 6,114	\$ 5,902	\$ 5,902
Preferred Stock	2,118	1,917	1,917	3,289	3,195	3,195
Government Obligations	12,584	12,584	11,374	8,230	8,230	8,125
Certificates of Deposit and Other	35,342	35,342	34,635	37,927	37,927	37,527
Bonds of Affiliate	1,981	1,981	1,981	6,226	6,226	6,293
Total	<u>\$65,640</u>	<u>\$64,817</u>	<u>\$62,900</u>	<u>\$61,786</u>	<u>\$61,480</u>	<u>\$61,042</u>

At December 31, 1978 the marketable equity securities portfolio included gross unrealized gains of \$11,000 and gross unrealized losses of \$834,000. Management does not foresee or anticipate any circumstances which would require the sale of any marketable equity securities at a significant loss. These investments are in companies that appear to be financially

sound with no indication of any difficulties that would permanently impair the value of their stock. Net realized gains included in the determination of net earnings for the years ended December 31, 1978 and 1977 are \$1,713,000 and \$1,197,000, respectively.

(6) Deferred Charges

Deferred Charges net of amortization, as of January 31 were:

	(thousands)	
	1979	1978
Long-term Debt Expense	\$ 136	\$ -
Premiums on Purchased Accounts	26	-
Insurance Acquisition Costs (December 31)	6,637	5,637
Unamortized Initial Direct Costs of Operating Leases	192	115
Excess Cost of Subsidiary Over Equity	698	719
Total	<u>\$7,689</u>	<u>\$6,471</u>

(7) Notes Payable to Banks and Equipment

Financing Obligations

Aristar, Inc. entered into a new Revolving Credit Agreement dated October 2, 1978 with 49 lending banks for aggregate contractual commitments of \$190,000,000. The previous credit agreement dated September 30, 1977, which was due to expire April 30, 1979 had provided for aggregate commitments of \$101,600,000.

The new Agreement provides for an initial maturity date of April 30, 1980 with annual renewals thereafter. The outstanding amount of any obligations not extended pursuant to the Agreement on an annual renewal date would be converted to a term loan to be paid out over a two-year period. The new Agreement also provides restrictions with respect to the maintenance of defined senior debt leverage ratios, minimum equity levels, maximum investments and advances to unconsolidated subsidiaries and limitation on the payment of dividends to a stated proportion of certain prescribed earnings levels.

The new Agreement provides for an interest rate of 116% of the agent bank's prime lending rate with compensating balances up to 10% of each bank's commitment. If compensating balances are not sufficiently maintained, the Agreement provides for the effective rate to increase to a maximum of approximately 124% of the agent's prime rate. Since the option of maintaining compensating balances remains with Aristar, Inc., the cash balances are not considered restricted. These provisions with respect to rates and compensating balances are similar in all material respects to the Aristar, Inc.'s previous credit agreement dated September 30, 1977. Aggregate compensating balances were approximately \$19,000,000 and \$11,260,000 at January 31, 1979 and 1978, respectively.

Borrowings under the credit agreement totaled \$82,900,000 at January 31, 1979. Additionally, at January 31, 1979 the leasing subsidiaries have certain other notes which are payable to affiliates, including Gamble-Skogmo, Inc., totaling \$2,600,000 and provide for interest rates of from 10% to 11 1/4%. Total interest expense with respect to affiliated notes was \$381,000 and \$662,000 for the years ended January 31, 1979 and 1978, respectively.

The maximum aggregate short-term borrowings of Aristar, Inc. and consolidated subsidiaries during the years ended January 31, 1979 and 1978 were approximately \$109,800,000 and \$78,000,000, respectively. Other information with respect to such borrowings is as follows:

	Years Ended January 31,	
	1979	1978
Average Borrowings (thousands)	\$85,985	\$74,253
Weighted-Average Interest Rate During the Period	11.1%	9.7%
Weighted-Average Interest Rate at End of Period	14.4%	9.8%

Gambles C & M Leasing Company has separate borrowings of \$56,127,000 at January 31, 1979 under equipment financing obligations with financial subsidiaries of vehicle manufacturers, principally at 1/2% to 1 1/2% above prime lending rates. Such obligations are payable in instalments correlated with rental receipts for collateralized lease equipment and further provide that such subsidiary may not declare or pay any cash dividends.

(8) Income Taxes

The components of income tax expense shown in the accompanying statement of consolidated earnings are as follows:

	Years Ended January 31,	
	1979	1978
Currently Payable:		
Federal	\$9,212	\$ 462
State	35	139
Canadian	205	170
Charge Equivalent to Tax Benefit from Utilization of Purchased Subsidiary's Loss Carryforward	56	1,333
Deferred	(2,148)	1,376
Total	<u>\$7,360</u>	<u>\$3,480</u>

Deferred taxes are provided on elements of income that are recognized for financial reporting purposes either earlier or later than such items are recognized for income tax purposes. The elements of income on which deferred taxes are provided, and the related tax effects, are as follows:

	Years Ended January 31,	
	1979	1978
Depreciation	\$(2,439)	\$1,080
Insurance Premiums, Reserves and Acquisition Costs	919	282
Finance Charges	43	94
Other	(671)	(80)
Total	<u>\$(2,148)</u>	<u>\$1,376</u>

Income taxes applicable to income before incomes taxes ("pretax income") differ from the amounts determined by multiplying pretax income by the statutory Federal income tax rate of approximately 48%. A reconciliation between these amounts is as follows:

	Years Ended January 31, (thousands)	
	1979	1978
Income Taxes at Statutory Rate	\$10,510	\$3,902
Increase (Reduction) in Taxes Resulting From:		
Insurance Subsidiaries:		
Dividends Subject to 85% Exclusion	(13)	(293)
Investment Income Taxed at Capital Gains Rate	(30)	
Income Exclusion Available Under Internal Revenue Code (See Below)	(1,478)	(757)
State Taxes (Net of Federal Income Tax Benefit)	83	122
Permanent Differences Arising from Income Recognition of Purchase Accounting Adjustments	(494)	(164)
Benefit Arising from Utilization of Capital Loss Carryforward	(426)	
Other - Net	(792)	670
Income Tax as Shown in Accompanying Consolidated Statement of Earnings	\$ 7,360	\$3,480

Under provisions of the Internal Revenue Code, the life insurance subsidiaries are permitted to exclude from taxable income amounts determined under a formula; at December 31, 1978 the accumulated amount of this untaxed income was approximately \$23,300,000. Although such amounts are taxable under certain circumstances, the life insurance subsidiaries do not intend to take, or fail to take, any action that would cause all or part of these amounts to be included in taxable income; accordingly, deferred income taxes have not been provided on these amounts.

The life insurance subsidiaries' income tax returns for the calendar years 1973 and 1974 are currently being examined. Although a Revenue Agent's Report has not been issued, preliminary discussions with the Internal Revenue Service indicate their intention to propose a tax deficiency. The Company submitted a request for "technical advice" to the National Office of the Internal Revenue Service in connection with one substantial issue. A favorable ruling has been received and in management's opinion ultimate liability for any assessment on the remaining issues would not be material.

(9) Long-term Debt

Long-term debt at January 31 was comprised of:
(all dollars in thousands)

	1979	1978
Senior Debentures:		
5%, due October 15, 1981 — discounted \$1,190 and \$2,028, respectively	\$ 12,086	\$ 11,783
9½%, due October 15, 1989 — discounted \$785 and \$486, respectively	20,102	22,051
4¾%, due May 15, 1990 — discounted \$11,540 and \$14,671, respectively	15,160	20,329
Senior Notes:		
5%, due April 1, 1979 — discounted \$93 in 1978	666	1,240
9¾%, due October 1, 1983 (issued by leasing subsidiary and guaranteed by Gamble-Skogmo, Inc.)	9,500	—
8¼%, due April 30, 1982 (issued by leasing subsidiary and guaranteed by Gamble-Skogmo, Inc.)	5,000	5,000
6¾%, due December 1, 1987 — discounted \$1,310 and \$1,551, respectively	7,986	8,779
8½%, due October 1, 1993 — discounted \$4,296 and \$4,162, respectively	28,054	28,188
Total Senior Debt — discounted \$19,121 and \$22,991, respectively	98,554	97,370
Senior Subordinated Notes:		
5½%, due April 1, 1979 — discounted \$24 in 1978	184	343
4¾%, due May 1, 1983 — discounted \$466 and \$727, respectively	2,866	3,272
7½%, due December 1, 1988 — discounted \$1,067 and \$1,233, respectively	5,598	6,099
8¾%, due December 15, 1992 — discounted \$2,309 and \$2,431, respectively	11,691	12,569
Total Senior Subordinated Debt — discounted \$3,842 and \$4,415, respectively	20,339	22,283
Junior Subordinated Notes:		
5½%, due June 1, 1981 — discounted \$167 and \$367, respectively	1,832	2,298
10¾%, Convertible due January 15, 1986 — discounted \$396 and \$456, respectively	5,554	6,344
Total Junior Subordinated Debt — discounted \$563 and \$823, respectively	7,386	8,642
Total — discounted \$23,526 and \$28,229, respectively	\$126,279	\$128,295

The long-term debt of Aristar was discounted to fair value at dates of acquisition. Such discount is being amortized over the remaining term of the debt. Aggregate maturities and net sinking fund requirements in the five years ending subsequent to January 31, 1979 are:

	(thousands)			
	Senior Subordinated	Junior Subordinated	Notes	Total
Senior Debt				
1980	\$ 7,615	\$2,518	\$1,517	\$11,650
1981	7,911	2,334	1,516	11,761
1982	19,311	2,334	1,516	23,161
1983	12,061	2,334	850	15,245
1984	6,561	2,331	850	9,742

Under the provisions of the 9 1/2% Senior Debentures due October 15, 1989, the holders of the debentures can request advancement of their maturity up to a maximum of \$12,500,000 on October 15, 1979.

Aristar, Inc. has offered \$25,000,000 of 10 1/2% Subordinated Capital Notes due January 1, 1991 to the public on a "best efforts" underwriting basis. The securities have been registered with the Securities and Exchange Commission in a Registration Statement which became effective on January 17, 1979. The notes provide for the monthly payment of interest, are subordinated in right of payment to all present and future indebtedness of Aristar, Inc., and do not provide for a sinking fund for the retirement of principal. Total proceeds, estimated at \$22,600,000 assuming all securities offered are sold and net of commission and other expenses, will be used to reduce notes payable to banks. As of March 28, 1979 a total of approximately \$14,000,000 of such notes had been sold.

(10) Capital Stock and Surplus

As described in Note 2 of the Notes to Consolidated Financial Statements of Aristar Holdings, Inc. and subsidiaries, on January 26, 1979 the stockholders of Aristar, Inc., other than Gamble, approved the merger of Aristar, Inc. with a wholly-owned subsidiary of Gamble. Under the terms of the merger, holders of Aristar, Inc.'s common stock (other than Gamble) received 10% Gamble Senior Subordinated Sinking Fund Debentures due to 1989 and holders of Aristar, Inc.'s Preferred Stock, Series A and B, received new Gamble senior subordinated instalment 5% and 5 1/2% notes due to 1992 and 1996, respectively. Coincident with the merger, the outstanding common and preferred stock was canceled and contributed to Aristar, Inc.'s paid-in surplus, and 1,000 newly issued common shares were issued to Gamble.

During the year ended January 31, 1979 options for Aristar, Inc.'s common stock totaling 63,400 shares were exercised and no options expired during the period. Prior to the merger, Aristar, Inc. reached agreement with each holder of the stock options for the disposition of such persons' options. Accordingly, at January 31, 1979, there are no stock options outstanding.

The holders of Aristar, Inc.'s 10 3/4% Convertible Subordinated Notes continue to have the right to conversion to Gamble senior subordinated debentures.

Pursuant to the reorganization referred to in Note 2, Gamble transferred its equity in the net assets of certain insurance subsidiaries to Aristar, Inc. and its equity of certain leasing subsidiaries to Aristar Holdings, Inc. These transfers have been accounted for in a manner similar to that of a "pooling of interests", and, accordingly, paid-in surplus and retained earnings have been retroactively adjusted to reflect these transfers.

The following is a summary of the changes in preferred and common stock and paid-in surplus for the years ended January 31, 1979 and 1978:

	(thousands)					
	Preferred Stock	Common Stock	Paid-in Surplus			
	1979	1978	1979	1978	1979	1978
Beginning Balance — Aristar, Inc.			\$7,676		\$9,199	
Adjustments to Reflect Acquisition — November 30, 1977			2,308			44,493
Elimination of Aristar, Inc. Minority Interests				(4,473)		(35,217)
Contribution of Subsidiaries by Gamble						2,952
Beginning Balance — Combined, as Adjusted	\$9,984	9,984	\$4,726	4,726	\$40,168	40,168
Preferred Stock Requirements	1,075					
Preferred Stock Dividends Paid	(2,439)					
Employee Stock Options Exercised			64		114	
Adjustments to Reflect Fair Value at Date of Acquisition — January 26, 1979					(5,351)	
Purchase of Minority Interests					42,706	
Transfers of Subsidiaries					11,725	
Cancellation of Stock Outstanding	(8,620)		(4,790)		13,410	
Cancellation of Stock in Treasury					(4,175)	
Newly-issued Stock			1			
Ending Balance — Aristar Holdings, Inc.	\$ —	\$9,984	\$1 \$4,726	\$98,597	\$40,168	

On September 13, 1978 the Board of Directors of Aristar, Inc. declared dividends in the full amount of the arrearages on preferred stock totaling \$2,133,075, together with the dividends for the three months ended September 30, 1978. One-half of such amount was paid on October 15, 1978 with the remainder paid on January 5, 1979. On December 5, 1978 preferred stock dividends of \$152,463 for the current three months were also declared and subsequently paid on January 5, 1979.

Provisions of Aristar, Inc.'s credit agreement restricts the payment of dividends or redemptions of stock up to a maximum prescribed proportion of earnings. With respect to the life insurance subsidiaries, retained earnings available for distribution as dividends issued to the parent company are limited to the statutory unassigned surplus (approximately \$22,400,000 at December 31, 1978) as determined in accordance with accounting practices prescribed by state insurance regulatory authorities. The excess of generally accepted accounting principles' retained earnings of \$14,700,000 over statutory unassigned surplus, is unavailable for payment of dividends. With respect to Gamble C&M Leasing Company, dividend payments are precluded under provisions of its equipment obligations with finance subsidiaries of automobile manufacturers. Retained earnings of Gamble C & M Leasing at January 31, 1979 and 1978 were \$4,233,000 and \$3,279,000, respectively.

(11) Retirement Plan

Aristar and its subsidiaries existing prior to the contribution of certain subsidiaries described in Note 2, of Notes to Consolidated Financial Statements of Aristar Holdings, Inc. and subsidiaries, have a non-contributory retirement plan covering substantially all of their employees. The policy of Aristar is to fund pension cost accrued. The contributed insurance and leasing subsidiaries participate in the Gamble Pension Plan. The pension plan agreement provides for annual contributions of at least an amount equal to the actuarially computed normal cost as defined in the pension plan plus interest on prior service costs. Pension expense for Aristar and subsidiaries for the years ended January 31, 1979 and 1978 was \$239,000 and \$59,000, respectively. On July 1, 1978, Aristar amended its retirement plan to increase plan benefits. Unfunded costs attributable to the amendment at January 31, 1979 were \$634,000.

Aristar and all subsidiaries participate in the Gamble Thrift/Sharing and Employee Stock Ownership Plan which provides for annual contributions equal to 25% of contributions made by participating employees plus additional amounts based on earnings of the participating companies. Total expense for Aristar and subsidiaries for

pension contribution was \$62,000 and \$6,000 for the years ended January 31, 1979 and 1978, respectively.

Employer contributions to both plans are irrevocable and upon termination of the plans the amounts thereof are not available to the participating companies.

(12) Leases

At January 31, 1979 Aristar and subsidiaries were lessees of office space, principally for loan offices, with terms of three years or less, except for the lease for the offices of the management subsidiary of Aristar which has a term of ten years.

Under operating leases that have initial or remaining noncancelable lease terms in excess of one year, approximate aggregate annual minimum rentals are:

Years Ending January 31	Gross Rentals	Sublease Income	Net Rentals
1980	\$2,319	\$ 204	\$2,115
1981	1,799	188	1,611
1982	1,407	180	1,227
1983	1,158	174	984
1984	827	174	653
Later Years	1,188	333	855
Total Minimum Future Rentals	\$8,698	\$1,253	\$7,445

Aristar has no material amount of capital leases and there would be an immaterial effect on the financial statements had such leases been capitalized.

Rental expense for the years ended January 31, 1979 and 1978 is summarized as follows:

	(thousands)	1979	1978
Office Space		\$2,308	\$479
Computer Equipment		682	166
Other (principally office equipment)		31	11
Sublease Income		(190)	(24)
Total		\$2,831	\$632

(13) Contingencies

Because of the highly regulated nature of Aristar's business, various subsidiaries are routinely parties or subject to pending or threatened litigation and unasserted possible claims, particularly alleged failures to comply with statutory and regulatory requirements. Within the normal conduct of business Aristar's subsidiaries are further involved in numerous actions for collection, the enforcement of liens, loss claims and other matters. Management does not, however, foresee or anticipate that the amount of any loss which may result, individually or collectively, will be material.

The maximum amount of risk retained by the life insurance subsidiaries on any one life is \$75,000, depending on age and classification of the risk. The excesses are reinsured with other life insurance companies on a yearly renewable term basis. At December 31, 1978, life insurance in force aggregated approximately \$1,724,000,000 (\$1,942,000,000 at December 31, 1977) after reduction by approximately \$141,000,000 (\$98,000,000 at December 31, 1977) for reinsurance. Accident and health premiums ceded aggregated approximately \$463,000 in 1978 and \$681,000 in 1977. Reinsurance ceded could become a liability in the event that the reinsurers should be unable to meet the obligations assumed under the reinsurance agreements.

(14) Business Segments

The following table provides information regarding the operations of Aristar and subsidiaries by industry segment for the year ended January 31, 1979:

	(thousands)		
	Consumer Finance	Insurance	Leasing
Revenues	\$63,083	\$52,785	\$17,587
Earnings Before Income Taxes	\$8,640	\$11,348	\$1,997
Identifiable Assets at January 31, 1979	\$299,187	\$135,592	\$94,549

The determination of income before income taxes by business segment includes certain parent company (Aistar) management fees and interest charged to the various operating subsidiaries, representing their share of management and finance costs utilized and absorbed by these operations. Such allocation of management and interest expense is based on the proportionate assets employed by each subsidiary.

Officers

Wayne E. Matschullat	<i>President and Chief Executive Officer</i>
Walter H. Davies, Jr.	<i>Chairman of the Board and Chief Financial Officer</i>
Lawrence W. Rixe	<i>Senior Vice President</i>
Robert E. Craighead	<i>Vice President</i>
Donald G. Dreblow	<i>Vice President for Public Relations</i>
Stanley J. Edwards	<i>Vice President for Distribution</i>
Herbert D. Froemming	<i>Vice President and Controller</i>
Charles H. Gauck	<i>Vice President, Secretary and General Counsel</i>
David A. Heider	<i>Vice President and Assistant to the President</i>
William A. Hickey	<i>Vice President for Personnel</i>
Frank T. Matthews	<i>Vice President for Real Estate, Store Design and Construction</i>
Richard L. Parry	<i>Vice President and Economist</i>
Paul P. Senio	<i>Vice President for Taxation</i>
Norman M. Steck	<i>Vice President and Treasurer</i>
Lee G. Swygman	<i>Vice President for Credit</i>
Carle R. Wunderlich	<i>Vice President</i>
Donald J. Hirsch	<i>Assistant Vice President</i>
Richard B. Miller	<i>Assistant Vice President</i>
John H. Stubstad	<i>Assistant Vice President</i>
Dennis C. Anderson	<i>Assistant Controller</i>
Richard W. Nelson	<i>Assistant Treasurer</i>
William E. Oppenheimer	<i>Assistant Secretary</i>

Directors

Walter H. Davies, Jr.	<i>Chairman of the Board and Chief Financial Officer</i>
Wayne E. Matschullat	<i>President and Chief Executive Officer</i>
Robert E. Craighead	<i>Vice President; President, Gambles Import Corporation</i>
Arthur G. Johnson	<i>Retired; former Executive Vice President</i>
Ellsworth L. Johnson	<i>Chairman, First American Care Facilities, Inc.</i>
Wenda Weekes Moore	<i>Chairman, Board of Regents, University of Minnesota</i>
George S. Moore	<i>Retired; former Chairman, Citicorp and Citibank, N.A.</i>
Burr L. Robbins	<i>Retired; former President, General Outdoor Advertising Company, Inc.</i>

Melvin Roth	<i>President, Red Owl Stores, Inc.</i>
Wheelock Whitney	<i>President, Minnesota Council on Health</i>
Carle R. Wunderlich	<i>Vice President; President, Aldens, Inc.</i>

Committees of the Board

Executive Committee	
Wayne E. Matschullat, Chairman	
Walter H. Davies, Jr.	
Arthur G. Johnson	
Audit Committee	
Burr L. Robbins, Chairman	
Ellsworth L. Johnson	
George S. Moore	
Wenda Weekes Moore	
Finance Committee	
Walter H. Davies, Jr., Chairman	
Wayne E. Matschullat	
George S. Moore	
Wheelock Whitney	
Compensation Committee	
George S. Moore, Chairman	
Arthur G. Johnson	
Wheelock Whitney	

**FOUNDER –
HONORARY CHAIRMAN**
Bertin C. Gamble, Retired

Transfer Agents

Citibank, N.A.
15th Floor, Suite 20
111 Wall Street
New York, New York 10043

The First National Bank of Chicago
One First National Plaza
Chicago, Illinois 60670

Registrars

The Chase Manhattan Bank, N.A.
One Chase Manhattan Plaza
New York, New York 10015

Continental Illinois National Bank and
Trust Company of Chicago
231 South La Salle Street
Chicago, Illinois 60693

Note Trustees

Senior Subordinated Sinking
Fund Debentures:

Irving Trust Company
One Wall Street
New York, New York 10015

Subordinated Income Capital Notes:
Northwestern National Bank
of St. Paul
55 East Fifth Street
St. Paul, Minnesota 55101

Aristar, Inc. 4 3/4% Senior Debentures,
5% Senior Debentures and
9 1/2% Senior Debentures:

Irving Trust Company
One Wall Street
New York, New York 10015

Gambles Credit Corporation
Senior Notes:

The First National Bank of Chicago
One First National Plaza
Chicago, Illinois 60670

Gambles Credit Corporation
Subordinated Notes:
National City Bank of Minneapolis
75 South Fifth Street
Minneapolis, Minnesota 55402

Annual Meeting

The annual meeting of stockholders
will be held at the home office of the
company on Friday, June 22, 1979. A
proxy statement, including a request
for proxies, will be mailed to
stockholders approximately three
weeks prior to the meeting.

Form 10-K

A copy of the company's annual report
to the Securities and Exchange
Commission on Form 10-K for its
most recent fiscal year may be
obtained by stockholders without
charge by writing to:

Charles H. Gauck, Vice President,
Secretary and General Counsel
Gamble-Skogmo, Inc.
5100 Gamble Drive
Minneapolis, Minnesota 55481

Corporate Headquarters

Gamble-Skogmo, Inc.
5100 Gamble Drive
Minneapolis, Minnesota 55481
(612) 374-6123



GAMBLE-SKOGMO, INC.

5100 Gamble Drive
Minneapolis, Minnesota 55481