ARIZONA PUBLIC SERVICE COMPANY

Sale and Leaseback Transactions
with respect to
Palo Verde Nuclear Generating Station Unit 2
(Docket No. STN-529)

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Financial Information
with respect to
Prospective Equity Investors

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August 6, 1986



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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 1985 — Commission File Number 1-7393

# SECURITY PACIFIC CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State or Other Jurisdiction of Incorporation or Organization) | 95-2741988<br>(I.R.S. Employer Identification Number) |
| 333 South Hope Street<br>Los Angeles, California<br>(Address of Principal Executive Offices) | 90071<br>(Zip Code) |

(213) 613-4540
(Registrant's Telephone Number, including Area Code)

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

| (Title of Each Class) | (Name of Each Exchange on which Registered) |
|---|---|
| Common Stock, $10 par value | New York Stock Exchange and Pacific Stock Exchange |
| Floating Rate Subordinated Capital Notes Due August 15, 1996 | New York Stock Exchange |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ✓ No ___

Aggregate market value of Common Stock held by non-affiliates of Security Pacific Corporation at February 28, 1986: $2,499,198,400

Number of shares of Common Stock outstanding at February 28, 1986: 76,770,718

Documents Incorporated by Reference and Parts of Form 10-K into Which Incorporated:

| | |
|---|---|
| 1985 Annual Report to Stockholders | Parts I, II and IV |
| Definitive Proxy Statement dated March 7, 1986 | Part III |

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## PART I

TABLE OF CONTENTS (Continued)

## PART I

### ITEM 1. BUSINESS.

Security Pacific Corporation ("SPC") is a Delaware corporation organized in 1971 and registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. SPC's principal asset is the capital stock of Security Pacific National Bank ("Bank"), which became its subsidiary on June 30, 1972. The Bank was founded in 1871 and provides a full line of commercial banking and fiduciary services. It has the second largest branch banking system in both the United States and in California as measured by number of offices.

SPC and its subsidiaries engage in a full range of financial services activities. The administration of these activities was reorganized in 1985 as set forth below. Unless otherwise indicated, information herein is as of December 31, 1985. For additional discussion of the business of SPC and its subsidiaries, see "Financial Review" at Pages 15 through 36, and "Financial Reports" at Pages 37 through 59, of SPC's 1985 Annual Report to Stockholders ("Annual Report"), which are incorporated in this Item 1 by reference.

**California Banking and Real Estate Industries System**

The California Banking and Real Estate Industries System administers the Bank's network of approximately 640 banking offices and business banking centers in California, offering customers both retail and commercial banking facilities and providing access to the full range of SPC's services. The System also administers Security Pacific State Bank which was established as a subsidiary of SPC in 1984. Security Pacific State Bank is organized under the laws of California, and engages in a broad range of retail and wholesale banking activities.

The California Banking and Real Estate Industries System is administered through the following organizations:

*California Branch Banking Group*

The California Branch Banking Group provides services which include personal and commercial checking accounts, interest/checking accounts, savings and time deposit accounts, personal and business loans, money transfer services, and safe deposit facilities. This Group has approximately 1.3 million personal checking accounts, 0.3 million interest/checking accounts and 1.6 million personal time and savings deposit accounts.

*California Business Banking Division*

The California Business Banking Division serves the needs of middle-market business customers and prospects through strategically located business banking centers. This Division supports a total banking relationship with its customers by offering cash management services, extensions of credit and wire transfer and international banking services, including letters of credit.

*Bank-Related Business Division*

The Bank-Related Business Division provides broad customer services, including financial management, trust, estate, tax planning and income tax preparation, and investment advisory services, and administers the Bank's precious metals business.

*Real Estate Industries Group*

The Real Estate Industries Group was formed in 1985 to administer both SPC's and the Bank's real estate activities throughout California and the United States. These activities include commercial real estate lending, mortgage banking, and real estate advisory services.

## Capital Markets System

The worldwide activities of SPC and the Bank in the areas of wholesale banking, capital markets, investments and securities are administered through the Capital Markets System. The Capital Markets System is comprised of the following three major groups:

### *Merchant Banking Group*

The Merchant Banking Group provides loan, debt and equity securities and foreign exchange origination, trading, brokerage and distribution services in domestic and international financial markets. The Group engages in a broad range of corporate and investment banking activities, including lending, corporate finance, interest rate and currency swaps, foreign exchange, public finance, funds management, and investment advisory and merger and acquisition services. In addition, through limited investments this Group engages in international securities brokerage, research and portfolio management services. These activities are conducted through the Bank and other SPC and Bank subsidiaries. The Group also services the financial requirements of correspondent banks throughout the United States and administers the Bank's dealer-related activities in foreign exchange, government securities, money market instruments, and tax-exempt state and municipal securities.

### *International Banking and Investments Group*

The majority of the Bank's international subsidiaries and investments in wholesale financially-oriented companies abroad are supervised by the International Banking and Investments Group. The Group administers full service commercial and merchant banks outside the United States and also provides private banking and trust services to individuals worldwide. In addition, the Group operates SPC subsidiaries which engage in *a forfait* and countertrade, arrange international trades and countertrades, and provide other related services, including the arranging of international trade financing.

The International Banking and Investments Group also provides financial products and services, primarily wholesale in nature, to foreign governments, international banking and financial organizations, and corporate entities, including United States and foreign multinational corporations and foreign corporations in selected markets. The Group provides complete commercial banking services, funding, refinancing, letters of credit, documentary business and clearing, and cash management services. International customers also have access to a full range of other SPC services through this Group.

### *Domestic Securities Group.*

The Domestic Securities Group offers a variety of services to banks, securities firms and financial institutions, including custody, clearing and credit, as well as money market, fixed income and equity security brokerage and other investment-related services. In addition, the Domestic Securities Group offers corporate trust services, including stock transfer, bond indenture and employee benefit trust services, and engages in investment management activities for individual as well as institutional customers. The Group also develops, licenses and sells trading, securities clearing, money transfer and other securities-oriented recordkeeping and operations systems. These services are provided through the Bank and other SPC and Bank subsidiaries.

## Financial Services System

The Financial Services System provides worldwide distribution of financial products and services primarily through subsidiaries of SPC, although the Bank and its subsidiaries also provide some of these services. This System operates through the following three major groups:

### *Commercial Finance and Leasing Group*

The Commercial Finance and Leasing Group is responsible for domestic and international asset-based financing. This Group offers a broad range of financing activities, including accounts receivable and inventory financing, industrial term loans, factoring, major equipment leasing, real estate financing, manufactured housing and automobile financing for manufacturers, dealers and consumers, and consumer automobile leasing.

*Consumer Services Group*

The Consumer Services Group offers domestic consumer finance products and services, including personal loans, sales financing, residential mortgage loans, credit-related insurance products and private brand financing. In addition, this Group offers personal loans, first and second mortgages and leasing services in England, West Germany, Hong Kong, Spain and Japan, and is awaiting approval from England's Department of Trade and Industry to engage in general life insurance underwriting and related reinsurance activities in England.

*Venture Capital Group*

The Venture Capital Group engages in all aspects of venture capital financing throughout the United States under the Small Business Investment Act of 1958 and other laws.

**Security Pacific Automation Company**

Security Pacific Automation Company ("SPAC"), formerly the Automated Data Processing Department of the Bank, was created as a division of the Bank in 1984 to pursue new business opportunities in the information processing and services industry. SPAC's activities, which are conducted through the Bank, SPC subsidiaries and subsidiaries of Security Pacific State Bank, include transaction processing, telecommunications, advisory services, software development and turnkey systems, and software and training for personal computers. SPAC is also responsible for the development of advanced technology systems for SPC's worldwide activities and the administration of data processing functions for SPC and its subsidiaries.

**Other Activities**

In August 1985, SPC announced that the Boards of Directors of SPC and Arizona Bancwest Corporation ("ABC") had unanimously approved an agreement providing for the acquisition of Arizona Bancwest by SPC. On November 6, 1985, the agreement was approved by the shareholders of ABC. This acquisition is expected to be consummated in the fourth quarter of 1986, after state and federal regulatory approvals have been obtained.

In 1984, SPC filed applications with the Comptroller of the Currency for charters with respect to 20 new national banks in 19 states other than California. These national banks would provide a full range of commercial and consumer banking services, exclusive of accepting deposits that the depositor has a legal right to withdraw on demand. Because demand deposits will not be accepted, these entities will not be "banks" as defined by the Bank Holding Company Act of 1956, and, accordingly, will not be subject to the Act's geographic limitations applicable to the ownership of "banks" by bank holding companies. SPC has received preliminary approval from the Comptroller with respect to some of these new national banks. See "Supervision and Regulation" below.

**Foreign Risk Management and International Operations**

Foreign risk management includes several risk considerations not found in domestic operations. One of these involves the handling of foreign exchange trading activities. A well defined system of trading limits and controls has been established for each trading unit to balance income opportunities against loss exposure. A second risk characteristic of international operations exists when SPC acquires assets or liabilities denominated in a foreign currency. If the asset and liability positions in a currency are not in balance, they are frequently hedged through offsetting foreign exchange contracts. Investments in capital positions of foreign branches and in equity ownership of overseas affiliates represent a special category of this type of risk and are frequently hedged based on Management's assessment of the cost of hedging contracts as contrasted with the outlook for changes in the value of the currency.

For a discussion of SPC's international operations, including political and economic risks associated with international lending and certain data concerning the distribution of international loans, acceptances and other earning assets, see "International Net Interest Income" at Page 21, "Credit Risk Management" at Pages 31 through 34, Note 8 of "Notes to Financial Statements" at Pages 49 and 50, and "Analysis of Domestic and International Net Interest Income" at Pages 56 and 57, of the Annual Report.

**Consolidated Average Balance Sheet and Analysis of Domestic and International Net Interest Income**

For information concerning consolidated daily average balances along with related average yields for earning assets and average interest rates for interest bearing liabilities, see "Consolidated Average Balance Sheet and Related Yields and Rates" at Pages 54 and 55 of the Annual Report. These data show SPC's growth over the last five years as well as changes in the composition of the asset and liability structure. Additional details on various asset and liability categories are included in the following sections and in the "Balance Sheet Analysis" at Pages 26 through 34 of the Annual Report.

The table on the following pages provides information on net interest income for the past three years, showing net interest income for domestic and international operations separately. The table also attributes changes between 1985 and 1984 and between 1984 and 1983 in interest income and expense for various categories of earning assets and sources of funds to changes in balances outstanding and to changes in average rates earned and paid on these respective balances. Because of numerous and simultaneous changes in both balances outstanding and rates earned and paid during any year, it is impossible to allocate precisely the changes in net interest income between changes in balances and changes in rates. For purposes of this table, the change due to change in average balance is initially calculated as the change in average balance times the average rate in the preceding year, while the change due to change in average rate is initially calculated as the change in average rate times the average balance in the preceding year. Any change remaining unallocated after these two steps is allocated to these two categories based on their relative absolute magnitudes. Because the changes in income and expense due to balance changes and rate changes are calculated independently for each line in the table, the totals are not necessarily the sum of the individual lines.

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## Analysis of Domestic and International Net Interest Income

(Dollars in Millions)

| | 1985 | | | 1984 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Interest Income/ Expense | Average Rate % |
| **DOMESTIC OPERATIONS(1)** | | | | | | |
| Earning assets: | | | | | | |
| Loans | $26,357 | $3,068.0 | 11.64 | $22 773 | $2,922.8 | 12.83 |
| Lease financing | 1,794 | 247.3 | 13.78 | 1,474 | 212.5 | 14.41 |
| Investment securities | 1,764 | 170.9 | 9.69 | 1,819 | 179.9 | 9.89 |
| Federal funds sold | 1,114 | 86.2 | 8.03 | 949 | 98.9 | 10.42 |
| Trading account assets | 367 | 33.6 | 9.15 | 192 | 22.3 | 11.61 |
| Due from banks—interest bearing | 326 | 25.3 | 7.76 | 398 | 41.9 | 10.52 |
| Total earning assets | 31,722 | 3,631.3 | 11.44 | 27,605 | 3,478.3 | 12.60 |
| Net sources of funds(2): | | | | | | |
| Demand deposits | 3,849 | — | — | 3,473 | — | — |
| Interest/checking deposits | 1,711 | 108.6 | 6.35 | 1,490 | 100.3 | 6.73 |
| Insured money market accounts | 4,126 | 277.6 | 6.73 | 3,796 | 331.1 | 8.72 |
| Other savings deposits | 1,789 | 96.3 | 5.38 | 1,782 | 96.5 | 5.42 |
| Time deposits—under $100,000 | 3,455 | 332.5 | 9.62 | 3,191 | 339.0 | 10.62 |
| Total core deposits | 14,931 | 815.0 | 5.46 | 13,732 | 866.9 | 6.31 |
| Time deposits—$100,000 and over | 5,927 | 543.9 | 9.18 | 4,941 | 525.2 | 10.69 |
| Borrowed funds | 9,180 | 783.2 | 8.53 | 7,052 | 721.6 | 10.22 |
| Funds supplied by or (to) international operations | 43 | 28.9 | — | 435 | 51.7 | — |
| Total net deposits and borrowed funds | 30,081 | 2,171.0 | 7.22 | 26,170 | 2,168.4 | 8.29 |
| All other sources of funds | 1,641 | — | — | 1,435 | — | — |
| Total sources of funds | $31,722 | 2,171.0 | 6.84 | $27,605 | 2,168.4 | 7.85 |
| Domestic net interest income and margin | — | $1,460.3 | 4.60 | — | $1,309.9 | 4.75 |
| **INTERNATIONAL OPERATIONS(1)** | | | | | | |
| Earning assets: | | | | | | |
| Loans | $ 5,291 | $ 600.3 | 11.35 | 4,898 | $ 612.1 | 12.50 |
| Lease financing | 537 | 79.9 | 14.89 | 377 | 62.2 | 16.50 |
| Investment securities | 152 | 15.4 | 16.15 | 96 | 7.0 | 7.32 |
| Trading account assets | 180 | 20.1 | 11.15 | 115 | 13.0 | 11.30 |
| Due from banks—interest bearing | 2,655 | 248.8 | 9.37 | 2,045 | 232.7 | 11.38 |
| Total earning assets | 8,815 | 964.5 | 10.94 | 7,531 | 927.0 | 12.31 |
| Net sources of funds(2): | | | | | | |
| Non-interest bearing deposits | 188 | — | — | 172 | — | — |
| Interest bearing deposits | 6,462 | 569.7 | 8.82 | 6,310 | 678.7 | 10.76 |
| [illegible]owed funds | 1,660 | 193.2 | 11.64 | 1,118 | 130.2 | 11.65 |
| [illegible]s supplied by or (to) domestic operations | (43) | (28.9) | — | (435) | (51.7) | — |
| Total net deposits and borrowed funds | 8,267 | 734.0 | 8.87 | 7,165 | 757.2 | 10.57 |
| [illegible]er sources of funds | 548 | — | — | 366 | — | — |
| Total sources of funds | $ 8,815 | 734.0 | 8.33 | $ 7,531 | 757.2 | 10.06 |
| International net interest income and margin | — | $ 230.5 | 2.61 | — | $ 169.8 | 2.25 |
| **TOTAL DOMESTIC AND INTERNATIONAL OPERATIONS(1)** | | | | | | |
| Earning assets | $40,537 | $4,595.8 | 11.34 | $35,136 | $4,405.3 | 12.54 |
| Sources of funds | $40,537 | 2,905.0 | 7.17 | $35,136 | 2,925.6 | 8.33 |
| Total net interest income and margin | — | $1,690.8 | 4.17 | — | $1,479.7 | 4.21 |

| | 1985 | 1984 |
|---|---|---|
| (1) Includes adjustments as follows: | | |
| To convert non-taxable income to fully taxable equivalent | $ 32.5 | $ 30.3 |
| Pretax equivalent of investment tax credits on leasing activities | 50.2 | 34.8 |
| Total | $ 82.7 | $ 65.1 |

(2) After deducting float and legal reserves.

## An f Domestic and International
## et Interest Income

(Dollars in Millions)

| | 1985 | | | 1984 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Interest Income/ Expense | Average Rate % |
| TIC OPERATIONS(1) | | | | | | |
| ssets: | | | | | | |
| | $26,357 | $3,068.0 | 11.64 | $22,773 | $2,922.8 | 12.83 |
| inancing | 1,794 | 247.3 | 13.78 | 1,474 | 212.5 | 14.41 |
| ent securities | 1,764 | 170.9 | 9.69 | 1,819 | 179.9 | 9.89 |
| l funds sold | 1,114 | 86.2 | 8.03 | 949 | 98.9 | 10.42 |
| g account assets | 367 | 33.6 | 9.15 | 192 | 22.3 | 11.61 |
| om banks—interest bearing | 326 | 25.3 | 7.76 | 398 | 41.9 | 10.52 |
| Total earning assets | 31,722 | 3,631.3 | 11.44 | 27,605 | 3,478.3 | 12.60 |
| es of funds(2): | | | | | | |
| d deposits | 3,849 | — | — | 3,473 | — | — |
| /checking deposits | 1,711 | 108.6 | 6.35 | 1,490 | 100.3 | 6.73 |
| money market accounts | 4,126 | 277.6 | 6.73 | 3,796 | 331.1 | 8.72 |
| avings deposits | 1,789 | 96.3 | 5.38 | 1,782 | 96.5 | 5.42 |
| eposits—under $100,000 | 3,455 | 332.5 | 9.62 | 3,191 | 339.0 | 10.62 |
| l core deposits | 14,931 | 815.0 | 5.46 | 13,732 | 866.9 | 6.31 |
| eposits—$100,000 and over | 5,927 | 543.9 | 9.18 | 4,941 | 528.2 | 10.69 |
| ed funds | 9,180 | 783.2 | 8.53 | 7,052 | 721.6 | 10.22 |
| supplied by or (to) international operations | 43 | 28.9 | — | 435 | 51.7 | — |
| Total net deposits and borrowed funds | 30,081 | 2,171.0 | 7.22 | 26,170 | 2,168.4 | 8.29 |
| sources of funds | 1,641 | — | — | 1,435 | — | — |
| Total sources of funds | $31,722 | 2,171.0 | 6.84 | $27,605 | 2,168.4 | 7.85 |
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| ssets: | | | | | | |
| | $ 5,291 | $ 600.3 | 11.35 | 4,898 | $ 612.1 | 12.50 |
| inancing | 537 | 79.9 | 14.89 | 377 | 62.2 | 16.50 |
| ent securities | 152 | 15.4 | 10.15 | 96 | 7.0 | 7.32 |
| g account assets | 180 | 20.1 | 11.15 | 115 | 13.0 | 11.30 |
| om banks—interest bearing | 2,655 | 248.8 | 9.37 | 2,045 | 232.7 | 11.38 |
| Total earning assets | 8,815 | 964.5 | 10.94 | 7,531 | 927.0 | 12.31 |
| es of funds(2): | | | | | | |
| terest bearing deposits | 188 | — | — | 172 | — | — |
| bearing deposits | 6,462 | 569.7 | 8.82 | 6,310 | 678.7 | 10.76 |
| ed fu | 1,660 | 193.2 | 11.64 | 1,118 | 130.2 | 11.65 |
| suppl to) domestic operations | (43) | (28.9) | — | (435) | (51.7) | — |
| Total ts and borrowed funds | 8,267 | 734.0 | 8.87 | 7,165 | 757.2 | 10.57 |
| sources ds | 548 | — | — | 366 | — | — |
| Total sources of funds | $ 8,815 | 734.0 | 8.33 | $ 7,531 | 757.2 | 10.06 |
| nal net interest income and margin | — | $ 230.5 | 2.61 | — | $ 169.8 | 2.25 |
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| ssets | $40,537 | $4,595.8 | 11.34 | $35,136 | $4,405.3 | 12.54 |
| funds | $40,537 | 2,905.0 | 7.17 | $35,136 | 2,925.6 | 8.33 |
| nterest income and margin | — | $1,690.8 | 4.17 | — | $1,479.7 | 4.21 |

des adjustments as follows:

| | 1985 | 1984 |
|---|---|---|
| convert non-taxable income to fully taxable equivalent | $ 32.5 | $ 30.3 |
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## Analysis of Domestic and International Net Interest Income

(Dollars in Millions)

| | 1985 | | | 1984 | | |
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| All other sources of funds | 548 | — | — | 366 | — | — |
| Total sources of funds | $ 8,815 | 734.0 | 8.33 | $ 7,531 | 757.2 | 10.06 |
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| Total net interest income and margin | — | $1,690.8 | 4.17 | — | $1,479.7 | 4.21 |

| | 1985 | 1984 |
|---|---|---|
| (1) Includes adjustments as follows: | | |
| To convert non-taxable income to fully taxable equivalent | $ 32.5 | $ 30.3 |
| Pretax equivalent of investment tax credits on leasing activities | 50.2 | 34.8 |
| Total | $ 82.7 | $ 65.1 |

(2) After deducting float and legal reserves.

| 1983 | | | Analysis of Changes in Interest Income and Expense | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 1985/1984 | | | 1984/1983 | | |
| | | | Amount of Increase (Decrease) Due to Change in: | | | Amount of Increase (Decrease) Due to Change in: | | |
| Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Average Rate | Total | Average Balance | Average Rate | Total |
| $20,548 | $2,518.4 | 12.26 | $ 432.3 | $(287.1) | $ 145.2 | $283.0 | $ 121.4 | $ 404.4 |
| 1,249 | 175.7 | 14.07 | 44.4 | (9.6) | 34.8 | 32.5 | 4.3 | 36.8 |
| 1,831 | 177.8 | 9.71 | (5.4) | (3.6) | (9.0) | (1.2) | 3.3 | 2.1 |
| 451 | 40.1 | 9.36 | 14.1 | (26.8) | (12.7) | 53.5 | 5.3 | 58.8 |
| 180 | 17.3 | 9.67 | 16.8 | (5.5) | 11.3 | 1.3 | 3.7 | 5.0 |
| 226 | 49.5 | 9.28 | (6.8) | (9.8) | (16.6) | (10.3) | 3.2 | (7.6) |
| 24,485 | 2,978.8 | 12.16 | 49[illegible].5 | (337.5) | 153.0 | 389.1 | 110.4 | 499.5 |
| 3,229 | — | — | — | — | — | — | — | — |
| 1,329 | 38.0 | 6.62 | 14.3 | (6.0) | 8.3 | 10.8 | 1.5 | 12.3 |
| 3,724 | 321.3 | 8.63 | 26.9 | (80.4) | (53.5) | 6.4 | 3.4 | 9.8 |
| 1,915 | 99.5 | 5.20 | 0.4 | (0.6) | (0.2) | (7.1) | 4.1 | (3.0) |
| 2,562 | 272.6 | 10.64 | 26.8 | (33.3) | (6.5) | 66.9 | (0.5) | 66.4 |
| 12,759 | 781.4 | 6.12 | 71.4 | (123.3) | (51.9) | 60.8 | 24.7 | 85.5 |
| 5,095 | 499.7 | 9.81 | [illegible] | (80.8) | 15.7 | (15.4) | 43.9 | 28.5 |
| 5,592 | 542.1 | 9.69 | 193.7 | (132.1) | 61.6 | 148.5 | 31.0 | 19.5 |
| (195) | (5.6) | — | (81.3) | 58.5 | (22.[illegible]) | 47.1 | 10.2 | 57.3 |
| 23,251 | 1,817.6 | 7.83 | 301.7 | (299.1) | 2.6 | 238.9 | 111.9 | 350.8 |
| 1,234 | — | — | — | — | — | — | — | — |
| $24,485 | 1,817.6 | 7.42 | 300.6 | (298.0) | 2.[illegible] | 241.2 | 109.6 | 350.8 |
| — | $1,161.2 | 4.74 | $ 192.4 | $ (47.[illegible]) | $ 150.4 | $146.4 | $ 2.3 | $ 148.7 |
| $ 4,621 | $ 533.7 | 11.55 | $ 46.9 | $ (58.7) | $ (11.8) | $ 33.0 | $ 45.4 | $ 78.4 |
| 295 | 45.6 | 15.45 | 24.3 | (6.6) | 17.7 | 13.3 | 3.3 | 16.6 |
| 75 | 6.3 | 8.43 | 5.1 | 3.3 | 8.4 | 1.6 | (0.9) | 0.7 |
| 55 | 6.2 | 12.03 | 7.3 | (0.2) | 7.[illegible] | 6.7 | (0.4) | 6.3 |
| 1,866 | 189.8 | 10.17 | 61.7 | (45.6) | 16.1 | 19.1 | 23.8 | 42.9 |
| 6,912 | 782.1 | 11.32 | 147.5 | (1[illegible]) | 37.5 | 73.4 | 71.5 | 144.9 |
| 163 | — | — | — | — | — | — | — | — |
| 5,286 | 509.4 | 9.64 | 16.0 | (125.0) | (109.0) | 105.9 | 63.4 | 169.3 |
| 845 | 91.7 | 9.49 | 63.1 | (0.[illegible]) | 63.0 | 22.5 | 16.0 | 38.5 |
| 195 | 5.6 | — | 81.3 | (58.5) | 22.8 | (47.1) | (10.2) | (57.3) |
| 6,489 | 606.7 | 9.36 | 107.7 | (130.9) | (23.2) | 67.2 | 83.3 | 150.5 |
| 423 | — | — | — | — | — | — | — | — |
| $ 6,912 | 606.7 | 8.78 | 118.2 | (141.4) | (23.2) | 57.2 | 93.3 | 150.5 |
| — | $ 175.4 | 2.54 | $ 31.3 | $ 29.4 | $ 60.7 | $ 15.1 | $ (2[illegible].7) | $ (5.6) |
| $31,397 | $3,760.9 | 11.98 | $ 636.9 | $(446.4) | $ 190.5 | $462.8 | $ 181.6 | $ 644.4 |
| 31,397 | 2,424.3 | 7.72 | 417.2 | (437.8) | (20.6) | 301.4 | 199.9 | 501.3 |
| — | $1,336.6 | 4.26 | $ 225.3 | $ (14.2) | $ 211.1 | $1[illegible]8.8 | $ (15.7) | $ 143.1 |
| | $ 31.4 | | | | | | | |
| | 29.6 | | | | | | | |
| | $ 61.0 | | | | | | | |

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

**Loans and Lease Financing**

*Credit Risk Management*

For a discussion of credit risk management and composition of the loan and lease financing portfolios, see "Credit Risk Management" at Pages 31 through 34 of the Annual Report. For data concerning loan maturities and interest rate sensitivity of loans, see "Liquidity and Interest Rate Sensitivity Management" at Pages 27 through 29 of the Annual Report and the table below.

| | (In Millions) | | |
|---|---|---|---|
| | December 31, 1985 | | |
| | Loan Maturity(1) | | |
| | Within 1 Year | After 1 Year | Total |
| Domestic loans: | | | |
| Loans with predetermined interest rates | $ 5,540 | $10,145 | $15,685 |
| Loans with floating or adjustable interest rates | 9,966 | 3,048 | 13,014 |
| International loans: | | | |
| Loans with predetermined interest rates | 835 | 749 | 1,584 |
| Loans with floating or adjustable interest rates | 3,434 | 765 | 4,199 |
| Total | $19,775 | $14,707 | $34,482 |

(1) Based on scheduled principal repayments.

*Non-Performing Loans and Leases*

SPC's policy regarding non-performing loans and leases is discussed in "Non-Performing Loans and Leases; Other Problem Assets" at Page 33, and Note 1 of "Notes to Financial Statements" at Page 46, of the Annual Report.

**Loans and Lease Financing**

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|---|---|---|---|
| | December 31, 1985 | | |
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| | Within 1 Year | After 1 Year | Total |
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SPC's policy regarding non-performing loans and leases is discussed in "Non-Performing Loans and Leases; Other Problem Assets" at Page 33, and Note 1 of "Notes to Financial Statements" at Page 46, of the Annual Report.

The following table provides an analysis of non-performing loans and leases as of December 31 for each of the last five years. In addition to non-performing loans and leases, the table also presents other loans and leases more than 90 days past due as of December 31, 1985, 1984 and 1983, and more than 60 days past due as of December 31, 1982 and 1981. During the fourth quarter of 1983, SPC changed the time at which business loans are normally placed on non-accrual status from 60 days past due to 90 days past due. For further information concerning non-performing loans and leases, and for information on loans to Mexico and Brazil, see "Non-Performing Loans and Leases; Other Problem Assets" at Page 33, and "International Lending" at Pages 33 and 34, of the Annual Report.

| | (In Millions) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Domestic Loans | | | | | | | |
| | Business | | | | | | | |
| December 31, 1985 | Real Estate Related | Other | Total | Consumer | Real Estate (1) | International Loans | Lease Financing | Total |
| Non-performing: | | | | | | | | |
| Non-accrual | $108 | $560 | $668 | $ 39 | $ 19 | $217 | $ 24 | $ 967 |
| Restructured | 153 | 14 | 167 | — | — | — | — | 167 |
| Total | $261 | $574 | $835 | $ 39 | $ 19 | $217 | $ 24 | $1,134 |
| Other, 90 days or more past due | $ 47 | $ 98 | $145 | $ 34 | $ 51 | $ 20 | $ 6 | $ 256 |
| **December 31, 1984** | | | | | | | | |
| Non-performing: | | | | | | | | |
| Non-accrual | $137 | $520 | $657 | $ 25 | $ 7 | $278 | $ 1 | $ 968 |
| Restructured | 151 | 4 | 155 | — | — | — | — | 155 |
| Total | $288 | $524 | $812 | $ 25 | $ 7 | $278 | $ 1 | $1,123 |
| Other, 90 days or more past due | $ 21 | $ 59 | $ 80 | $ 28 | $ 44 | $ 13 | $ 2 | $ 167 |
| **December 31, 1983** | | | | | | | | |
| Non-performing: | | | | | | | | |
| Non-accrual | $146 | $453 | $599 | $ 41 | $ 7 | $215 | $ 1 | $ 863 |
| Restructured | — | 2 | 2 | — | — | — | — | 2 |
| Total | $146 | $455 | $601 | $ 41 | $ 7 | $215 | $ 1 | $ 865 |
| Other, 90 days or more past due | $ 7 | $ 32 | $ 39 | $ 27 | $ 52 | $ 79 | $ 2 | $ 199 |
| **December 31, 1982** | | | | | | | | |
| Non-performing: | | | | | | | | |
| Non-accrual | $128 | $272 | $400 | $ 30 | $ — | $177 | $ 2 | $ 609 |
| Restructured | 5 | 52 | 57 | — | — | 10 | — | 67 |
| Total | $133 | $324 | $457 | $ 30 | $ — | $187 | $ 2 | $ 676 |
| Other, 60 days or more past due | $ 43 | $ 88 | $131 | $ 82 | $103 | $129 | $ 5 | $ 450 |
| **December 31, 1981** | | | | | | | | |
| Non-performing: | | | | | | | | |
| Non-accrual | $ 60 | $146 | $206 | $ 15 | $ — | $ 53 | $ 3 | $ 277 |
| Restructured | 2 | 48 | 50 | — | — | 6 | — | 56 |
| Total | $ 62 | $194 | $256 | $ 15 | $ — | $ 59 | $ 3 | $ 333 |
| Other, 60 days or more past due | $ 13 | $ 76 | $ 89 | $ 42 | $ 67 | $ 3 | $ 2 | $ 203 |

(1) Permanent loans secured by first mortgages or the equivalent. Construction loans are included under "Business Loans".

The following table shows the amount of pretax interest income reduction experienced as a result of non-performing loans.

| | (In Millions) | | |
|---|---|---|---|
| | 1985 | | |
| | Domestic Loans | International Loans | Total |
| Interest income that should have been recognized at original rates | $138.2 | $28.5 | $166.7 |
| Amount of interest income recognized | 37.0 | 20.6 | 57.6 |
| Net reduction of interest income | $101.2 | $ 7.9 | $109.1 |

*Reserve for Credit Losses*

The provision for credit losses is basically a function of the current level of net credit losses plus Management's assessment of the appropriate level of the reserve for credit losses. In making that assessment, consideration is given to the condition of individual credits and the risks and uncertainties inherent in the loan and lease portfolios, as well as to the economic outlook.

For a discussion of the reserve for credit losses and related statistics for the five years ended December 31, 1985, see "Reserve for Credit Losses" at Pages 31 and 32, "Credit Losses" at Pages 32 and 33, and Note 6 of "Notes to Financial Statements" at Page 48, of the Annual Report.

The nature of the reserve for credit losses is such that it is not possible to break it down with a high degree of precision. However, the reserve has been allocated to broad categories of loans and lease financing to indicate Management's assessment of the relative risk characteristics of these types of assets. This allocation is based on an evaluation of known problem credits, consideration of historical credit losses, an assessment of economic conditions worldwide and other factors which may influence risk in the future. The following table shows such an allocation at December 31 for the last five years. A portion of the reserve allocated to international loans has not been reflected in international net income, and therefore is not included in the table at Page 12 of this Form 10-K.

| | Allocation of Reserve for Credit Losses (%) | | | | | Loans and Leases Outstanding as % of Total Loans and Leases | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1985 | 1984 | 1983 | 1982 | 1981 | 1985 | 1984 | 1983 | 1982 | 1981 |
| Domestic loans: | | | | | | | | | | |
| Business loans | 38 | 40 | 40 | 43 | 39 | 42 | 44 | 43 | 43 | 42 |
| Ready ReserveAccount/charge card loans | 4 | 4 | 6 | 7 | 8 | 2 | 3 | 2 | 2 | 3 |
| Other consumer loans | 18 | 16 | 22 | 20 | 20 | 19 | 17 | 16 | 14 | 14 |
| Real estate loans(1) | — | — | — | — | — | 14 | 15 | 16 | 18 | 19 |
| International loans | 34 | 35 | 26 | 25 | 27 | 16 | 15 | 17 | 17 | 17 |
| Lease financing | 6 | 5 | 6 | 5 | 6 | 7 | 6 | 6 | 6 | 5 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

(1) Permanent loans secured by first mortgages or the equivalent. Construction loans are included under "Business Loans".

The following table shows an analysis of net losses by type of credit for the last five years.

| | (Dollars In Millions) | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic Loans | | | | | | |
| | Business | Ready Reserve Account/ Charge Card | Other Consumer | Real Estate(1) | International Loans | Lease Financing | Total |
| **1985** | | | | | | | |
| Charge-offs | $ 239.7 | $ 33.2 | $ 106.7 | $ 0.5 | $ 25.3 | $ 28.2 | $ 433.6 |
| Recoveries | (22.7) | (5.6) | (41.0) | — | (8.2) | (3.0) | (80.5) |
| Net credit losses | $ 217.0 | $ 27.6 | $ 65.7 | $ 0.5 | $ 17.1 | $ 25.2 | $ 353.1 |
| Average amount outstanding | $14,146 | $ 877 | $ 6,157 | $ 5,177 | $ 5,29[illegible] | $ 2,331 | $33,979 |
| Net credit losses as a % of average amount outstanding | 1.53 | 3.15 | 1.07 | 0.01 | 0.32 | 1.08 | 1.04 |
| **1984** | | | | | | | |
| Charge-offs | $ 120.4 | $ 20.6 | $ 96.5 | $ 0.7 | $ 19.4 | $ 5.0 | $ 262.6 |
| Recoveries | (8.9) | (5.2) | (35.0) | — | (2.4) | (1.1) | (52.6) |
| Net credit losses | $ 111.5 | $ 15.4 | $ 61.5 | $ 0.7 | $ 17.0 | $ 3.9 | $ 210.0 |
| Average amount outstanding | $12,309 | $ 751 | $ 4,974 | $ 4,739 | $ 4,898 | $ 1,851 | $29,522 |
| Net credit losses as a % of average amount outstanding | 0.91 | 2.05 | 1.24 | 0.01 | 0.35 | 0.21 | 0.71 |
| **1983** | | | | | | | |
| Charge-offs | $ 85.4 | $ 17.1 | $ 54.8 | $ 0.2 | $ 12.2 | $ 6.2 | $ 175.9 |
| Recoveries | (25.3) | (4.9) | (20.2) | — | (9.1) | (1.1) | (60.6) |
| Net credit losses | $ 60.1 | $ 12.2 | $ 34.6 | $ 0.2 | $ 3.1 | $ 5.1 | $ 115.3 |
| Average amount outstanding | $11,106 | $ 603 | $ 4,168 | $ 4,671 | $ 4,621 | $ 1,544 | $26,713 |
| Net credit losses as a % of average amount outstanding | 0.54 | 2.02 | 0.83 | — | 0.07 | 0.33 | 0.43 |
| **1982** | | | | | | | |
| Charge-offs | $ 58.5 | $ 19.1 | $ 40.7 | $ 0.3 | $ 4.0 | $ 7.0 | $ 129.6 |
| Recoveries | (11.5) | (4.1) | (13.3) | — | (3.2) | (0.5) | (32.6) |
| Net credit losses | $ 47.0 | $ 15.0 | $ 27.4 | $ 0.3 | $ 0.8 | $ 6.5 | $ 97.0 |
| Average amount outstanding | $10,135 | $ 585 | $ 3,323 | $ 4,526 | $ 4,166 | $ 1,271 | $24,006 |
| Net credit losses as a % of average amount outstanding | 0.46 | 2.57 | 0.82 | 0.01 | 0.02 | 0.51 | 0.40 |
| **1981** | | | | | | | |
| Charge-offs | $ 31.0 | $ 17.7 | $ 38.0 | $ — | $ 5.5 | $ 2.8 | $ 95.0 |
| Recoveries | (21.3) | (4.1) | (12.1) | — | (12.7) | (0.6) | (50.8) |
| Net credit losses | $ 9.7 | $ 13.5 | $ 25.9 | $ — | $ (7.2) | $ 2.2 | $ 44.2 |
| Average amount outstanding | $ 8,332 | $ 568 | $ 3,030 | $ 4,355 | $ 3,514 | $ 1,062 | $20,861 |
| Net credit losses as a % of average amount outstanding | 0.12 | 2.38 | 0.85 | — | (0.20) | 0.21 | 0.21 |

(1) Permanent loans secured by first mortgages or the equivalent. Construction loans are included under "Business Loans".

The following table provides an analysis of the reserve for international credit losses for the past five years. The data included in the table contain only the reserve derived from expense provisions charged to international operations. As a result, the ending reserve does not represent the total reserve available for international credits. For further information on the reserve allocated to international credits, see the table at Page 10 of this Form 10-K.

| | (In Millions) | | | | |
|---|---|---|---|---|---|
| | 1985 | 1984 | 1983 | 1982 | 1981 |
| Balance, beginning of period | $106.5 | $ 92.6 | $76.0 | $61.9 | $43.3 |
| Provision for credit losses charged to expense | 29.1 | 28.6 | 20.4 | 18.8 | 6.8 |
| Other(1) | 4.8 | 2.3 | (0.3) | (1.1) | 4.9 |
| Sub-total | 140.4 | 123.5 | 96.1 | 79.6 | 55.0 |
| Amount charged off | (33.1) | (19.4) | (12.5) | (6.8) | (5.7) |
| Recoveries | 8.2 | 2.4 | 9.0 | 3.2 | 12.6 |
| Net credit (losses) recoveries | (24.9) | (17.0) | (3.5) | (3.6) | 6.9 |
| Balance, end of period(2) | $115.5 | $106.5 | $92.6 | $76.0 | $61.9 |

(1) Includes additions from acquisitions and foreign currency translation adjustments.

(2) Includes $21.3 million in 1985, $7.2 million in 1984 and $2.0 million in 1983 of Allocated Transfer Risk Reserve.

**Deposits**

For a discussion concerning deposits, see "Consolidated Average Balance Sheet and Analysis of Domestic and International Net Interest Income" above, and "Sources and Uses of Funds Trends" at Pages 26 and 27, and "Liquidity and Interest Rate Sensitivity Management" at Pages 27 through 29, of the Annual Report. Most international deposits are in amounts of $100,000 or more.

The following table shows the maturity distribution of domestic time deposits—$100,000 and over.

| | (In Millions) | | | | | |
|---|---|---|---|---|---|---|
| | December 31, 1985 | | | December 31, 1984 | | |
| | Certificates of Deposit | Other | Total | Certificates of Deposit | Other | Total |
| Maturing in: | | | | | | |
| 1 month or less | $1,454 | $ 549 | $2,003 | $1,533 | $ 451 | $1,984 |
| 1-3 months | 1,455 | 400 | 1,855 | 1,021 | 336 | 1,357 |
| 3-6 months | 556 | 229 | 785 | 686 | 222 | 908 |
| 6-12 months | 416 | 107 | 523 | 388 | 156 | 544 |
| Over 12 months | 849 | 96 | 945 | 1,145 | 58 | 1,204 |
| Total | $4,730 | $1,381 | $6,111 | $4,774 | $1,223 | $5,997 |

### Short-Term Borrowings

The following table shows additional information for the last three years for short-term borrowings.

| | (Dollars in Millions) | | | | |
|---|---|---|---|---|---|
| | End of Period | | Maximum Month-end Outstanding During Period | Average of Period | |
| | Outstanding | Average Rate | | Outstanding | Average Rate |
| **1985** | | | | | |
| Federal funds purchased and securities under repurchase agreements | $4,689 | 9.6% | $4,689 | $3,596 | 7.9% |
| Commercial paper | 2,687 | 8.0 | 3,082 | 2,558 | 8.8 |
| **1984** | | | | | |
| Federal funds purchased and securities under repurchase agreements | $2,831 | 8.4% | $5,005 | $3,121 | 10.1% |
| Commercial paper | 2,270 | 9.0 | 2,288 | 1,784 | 10.6 |
| **1983** | | | | | |
| Federal funds purchased and securities under repurchase agreements | $2,770 | 10.1% | $3,465 | $2,582 | 9.0% |
| Commercial paper | 1,846 | 9.4 | 1,846 | 1,467 | 9.2 |

### Competition

The businesses in which SPC and its subsidiaries are engaged are highly competitive. The Bank competes for core deposits, and SPC, the Bank and other SPC subsidiaries compete for other sources of funds, in a variety of domestic and international markets with both financial and non-financial institutions. In local, national and international markets, there is intense competition with all types of financial firms, and with many other types of companies, for the diverse financial products and services offered by SPC and its subsidiaries.

### Supervision and Regulation

SPC, as a bank holding company, is subject to regulation under the Bank Holding Company Act of 1956 ("Act"). Under the Act, every bank holding company must obtain the prior approval of the Federal Reserve Board before acquiring substantially all the assets of any bank or acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank. Approval by the Federal Reserve Board of an acquisition of voting shares or substantially all the assets of any "bank" located in any state other than the state in which the operations of such bank holding company's banking subsidiaries are principally located, is contingent upon the laws of such state specifically authorizing the acquisition. For this purpose, a "bank" is defined by the Act as an institution that both makes commercial loans and accepts demand deposits. Legal proceedings are pending in which it is contended that the Comptroller of the Currency does not have the legal authority to grant a charter for a national bank that will engage in only one, but not both banking functions. Federal legislation and regulatory actions have been proposed that would extend the geographic limits of the Act to all banks, and a number of states have enacted or are considering legislation that prohibits ownership of banks within the state unless the bank both makes commercial loans and accepts demand deposits. See "Other Activities" above.

As contemplated by the Act, many states have enacted laws, and many other states are considering proposals, specifically authorizing the acquisition of banks located within the state by bank holding companies located in other states. The State of Arizona has enacted legislation permitting bank holding companies located in all other states to acquire banks located in Arizona on or after October 1, 1986. See "Other Activities" above. The Assembly of the State of California has passed a bill that authorizes the

acquisition of California banks by bank holding companies located in other states that extend reciprocal rights to bank holding companies located in California. The Senate of the State of California has passed a substantially similar bill except that the Senate bill provides that until federal legislation permits bank holding companies located in California to acquire banks located in all other states, the authorization is restricted to those bank holding companies located in the Twelfth Federal Reserve District. It is uncertain whether the Assembly bill, the Senate bill, or a modification of either will be enacted by the California Legislature.

Under the Act, SPC may not engage in any business other than managing or controlling banks or furnishing services to its subsidiaries, except that it may engage in certain domestic activities which, in the opinion and with the approval of the Federal Reserve Board, are so closely related to banking or to managing or controlling banks as to be incidental thereto. Additionally, SPC may acquire direct or indirect ownership of not more than 5% of the voting shares of any company engaged in domestic activities and, with prior approval of the Federal Reserve Board, may acquire more than 5% of the voting shares of any company engaged in banking related activities. With the approval of the Federal Reserve Board, SPC may engage in those foreign activities which the Federal Reserve Board considers routine when conducting banking or other financial transactions abroad. For some time, the Federal Reserve Board has followed a restrictive policy in permitting the entry or expansion of bank holding companies and other bank affiliates into domestic and foreign banking and banking-related activities. The Act does not place territorial restrictions on the activities of non-bank subsidiaries of bank holding companies. Arizona Bancwest Corporation ("ABC"), as a bank holding company, is presently, and subsequent to its acquisition by SPC will continue to be, subject to the same regulation as SPC; see "Other Activities" above.

Federal law significantly limits the extent to which the Bank and Security Pacific State Bank ("SPSB") may supply funds to SPC and its non-bank subsidiaries, whether through direct extensions of credit or through purchases of securities, issuances of guarantees or the like. Generally, SPC and its non-bank subsidiaries may not borrow from the Bank or SPSB unless such loans are secured by specified kinds of collateral, such as obligations of or guarantees by the U.S. Government or its agencies, or by certain bank deposits. Unless in each case fully secured, any loan made by the Bank or by SPSB to SPC or any other single non-bank subsidiary is limited to 10% of such bank's capital and surplus (as defined), and all such loans in the aggregate are limited to 20% of such bank's capital and surplus. Similar limitations would also apply to loans made by any other bank subsidiaries of SPC to SPC or any of its non-bank subsidiaries; see "Other Activities" above. Additionally, a national bank may not declare a dividend that exceeds its undivided profits. Further, the approval of the Comptroller of the Currency is required if the total of all dividends declared in any calendar year exceeds the bank's net profits (as defined) for that year combined with its retained net profits for the preceding two calendar years. Under these restrictions, the Bank expects that it can declare dividends at any time in 1986 without approval from the Comptroller of the Currency of approximately $300,000,000 plus an additional amount equal to the difference between (i) the Bank's net profits for 1986 up to the date of any such dividend declaration and (ii) dividends declared prior to that date. The Comptroller also has the authority to further limit a national bank's payment of dividends under certain circumstances.

The Bank and its domestic subsidiaries and foreign branches are under the supervision of, and subject to examination by, the Comptroller of the Currency. SPSB is generally subject under California law to restrictions similar to those imposed on national banks and is subject to supervision and examination by the California Superintendent of Banks. The Arizona Bank, the principal subsidiary of ABC, is, and will continue to be subsequent to the acquisition of ABC by SPC, generally subject under Arizona law to restrictions similar to those imposed on national banks and subject to supervision and examination by the Arizona Superintendent of Banks. In addition, all banking subsidiaries are subject to the rules and regulations of the Federal Deposit Insurance Corporation, and the Bank's foreign branches and international subsidiaries are also subject to the rules and regulations of the Federal Reserve Board. As to operations in other countries, the Bank and its foreign branches and international subsidiaries are also subject to various restrictions imposed by the laws and banking authorities of such countries. Any new national bank subsidiaries of SPC would be subject to the same supervision and regulation as the Bank.

As to many of SPC's non-bank subsidiaries, the laws of many of the jurisdictions in which they operate impose restrictions on their activities and the amounts of, and interest rates on, the credit they provide.

The Glass-Steagall Act limits the domestic securities activities of SPC and its subsidiaries by restricting their ability to engage in securities underwriting, other than the underwriting of obligations of the United States, or general obligations of any State or of any political subdivision thereof, and limiting affiliations with organizations that underwrite, distribute or sell securities. Additionally, the Securities Exchange Act of 1934 imposes regulatory and reporting requirements on various securities activities conducted by banks, including beneficial ownership of certain securities, dealing in municipal securities, acting as a transfer agent, and providing certain types of investment management services. Certain SPC and Bank subsidiaries are also subject to the rules and regulations of the self regulatory organizations of which they are members.

**Effect of Governmental Policies**

The earnings and business of SPC are affected by the policies of various regulatory authorities of the United States, foreign governments and international agencies, including, in the United States, the Federal Reserve Board. The Federal Reserve Board utilizes instruments of monetary policy to regulate the supply of money and to deal with general economic conditions in the United States. These instruments influence the overall levels of investments, loans, and other extensions of credit and of deposits, as well as the interest rates paid on liabilities and earned on assets.

For a discussion of core deposits and certain factors affecting them, see "Sources and Uses of Funds Trends" at Pages 26 and 27, and "Liquidity and Interest Rate Sensitivity Management" at Pages 27 through 29, of the Annual Report.

Various legislative and regulatory proposals are being considered at the federal and state level which, if adopted, would affect the earnings and business of SPC and its subsidiaries. They include wide ranging proposals affecting deregulation of the banking industry, interstate banking, consumer protection and comprehensive tax reform. It cannot be predicted whether or in what form any of these proposals will be adopted or the extent to which the business of SPC and its subsidiaries may be affected.

## ITEM 2. PROPERTIES.

No single property of SPC and its subsidiaries is of material importance to SPC. For information concerning investments in premises, see Note 7 of "Notes to Financial Statements" at Page 49 of the Annual Report, which is incorporated herein by reference.

## ITEM 3. LEGAL PROCEEDINGS.

For information concerning legal proceedings, see the third paragraph of Note 15 of "Notes to Financial Statements" at Page 52 of the Annual Report, which is incorporated herein by reference.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

ITEM 4(A). EXECUTIVE OFFICERS OF THE REGISTRANT.

As of March 18, 1986, the principal executive officers of SPC are:

| Name | Current Office | Age |
|---|---|---|
| Richard J. Flamson III* | Chairman of the Board and Chief Executive Officer | 57 |
| George F. Moody* | President and Chief Operating Officer | 55 |
| Robert H. Smith* | Vice Chairman of the Board | 50 |
| William F. Ford* | Vice Chairman | 61 |
| Roy D. Hartmann* | Vice Chairman | 58 |
| George H. Benter, Jr. | Executive Vice President | 44 |
| Nicholas B. Binkley | Executive Vice President | 40 |
| Walter S. Fisher, Jr. | Executive Vice President and Auditor | 53 |
| Russell A. Freeman | Executive Vice President and General Counsel | 53 |
| John W. Hancock | Executive Vice President | 49 |
| Sidney Ipaktchian | Executive Vice President | 52 |
| John F. Kooken | Executive Vice President and Chief Financial Officer | 54 |
| David R. Lovejoy | Executive Vice President | 37 |
| Irving Margol | Executive Vice President and Personnel Director | 55 |
| DuWayne J. Pet son | Executive Vice President | 53 |
| Richard A. Warner | Executive Vice President | 50 |
| Kraig A. Westra | Executive Vice President and Treasurer | 42 |

* Member of the Office of the Chairman.

Section 4 of Article VII of SPC's By-Laws provides that the Chairman of the Board holds office for the term for which he was elected a Director, unless he sooner resigns, becomes disqualified or is removed. All other officers hold office at the pleasure of the Board of Directors. Directors are elected annually.

There is no family relationship between any of the above named officers or any of SPC's directors. Set forth below is a brief description of the business experience of each of the above named officers during the past five years:

Mr. Flamson has served as Chairman of the Board and Chief Executive Officer of SPC since January 1981; he has also served as Chairman of the Board of the Bank since June 1985 and Chairman of the Board and Chief Executive Officer of the Bank prior to that.

Mr. Moody has served as President and Chief Operating Officer and a director of SPC since January 1981; he has also served as President and Chief Executive Officer and a director of the Bank since June 1985 and President and Chief Operating Officer and a director of the Bank prior to that.

Mr. Smith has served as Vice Chairman of the Board of SPC and Vice Chairman of the Board and Chief Operating Officer of the Bank since June 1985, a Vice Chairman of SPC and the Bank from March 1984 to June 1985, and an Executive Vice President of the Bank prior to that.

Mr. Ford has served as a Vice Chairman of SPC and the Bank since March 1984, an Executive Vice President of SPC and the Bank from June 1981 to March 1984, and as Chairman of the Board, President and Chief Executive Officer of Security Pacific Finance Corp., an SPC non-bank subsidiary, prior to that.

M[illegible]mann has served as a Vice Chairman of SPC and the Bank since October 1981, and an Executive Vice President of the Bank prior to that.

Mr. Benter has served as an Executive Vice President of SPC and the Bank since January 1986, an Executive Vice President of the Bank from July 1983 to January 1986, a Senior Vice President of the Bank from February 1981 to July 1983 and of SPC from May 1978 to October 1981, and a Vice President of the Bank prior to that.

Mr. Binkley has served as an Executive Vice President of SPC and the Bank since June 1985, a Senior Vice President of SPC and the Bank from June 1984 to June 1985, a First Vice President of SPC and the Bank from June 1983 to June 1984, and a Vice President of the Bank prior to that.

Mr. Fisher has served as Executive Vice President and Auditor of SPC and Executive Vice President and General Auditor of the Bank since October 1985, and Auditor of SPC and Senior Vice President and General Auditor of the Bank prior to that.

Mr. Freeman has served as Executive Vice President and General Counsel of SPC and the Bank since October 1981, and General Counsel and Assistant Secretary of SPC and Senior Vice President and Counsel of the Bank prior to that.

Mr. Hancock has served as an Executive Vice President of SPC since July 1985 and of the Bank since September 1984, and a Senior Vice President of the Bank prior to that.

Mr. [illegible]an has served as an Executive Vice President of SPC since July 1985 and of the Bank since Oct[illegible]2, and a Senior Vice President of the Bank prior to that.

Mr. Kooken has served as Executive Vice President and Chief Financial Officer of SPC and the Bank since March 1984, an Executive Vice President of SPC from October 1981 to March 1984 and of the Bank from June 1981 to March 1984, Executive Vice President and Treasurer of SPC from June 1981 to October 1981, and Corporate Controller of SPC and Senior Vice President and Controller of the Bank prior to that.

Mr. Lovejoy has served as an Executive Vice President of SPC since April 1985 and of the Bank since March 1984, Executive Vice President and Treasurer of SPC from March 1984 to April 1985, Senior Vice President and Treasurer of SPC and a Senior Vice President of the Bank from October 1981 to March 1984, [illegible] a Vice President and Assistant Treasurer of SPC and a Vice President of the Bank prior to that.

[illegible]rgol has served as Executive Vice President and Personnel Director of SPC and an Executive Vice [illegible]ent of the Bank since October 1981; and a Senior Vice President of the Bank prior to that.

Mr. Peterson has served as an Executive Vice President of SPC since September 1984 and an Executive Vice President of the Bank prior to that.

Mr. Warner has served as an Executive Vice President of SPC and the Bank since February 1985, and a Senior Vice President of the Bank prior to that.

Mr. Westra has served as Executive Vice President and Treasurer of SPC since April 1985, an Executive Vice President of the Bank since October 1981, and a Senior Vice President of the Bank prior to that.

Mr. Hartmann has served as a Vice Chairman of SPC and the Bank since October 1981, and an Executive Vice President of the Bank prior to that.

Mr. Benter has served as an Executive Vice President of SPC and the Bank since January 1986, an Executive Vice President of the Bank from July 1983 to January 1986, a Senior Vice President of the Bank from February 1981 to July 1983 and of SPC from May 1978 to October 1981, and a Vice President of the Bank prior to that.

Mr. Binkley has served as an Executive Vice President of SPC and the Bank since June 1985, a Senior Vice President of SPC and the Bank from June 1984 to June 1985, a First Vice President of SPC and the Bank from June 1983 to June 1984, and a Vice President of the Bank prior to that.

Mr. Fisher has served as Executive Vice President and Auditor of SPC and Executive Vice President and General Auditor of the Bank since October 1985, and Auditor of SPC and Senior Vice President and General Auditor of the Bank prior to that.

Mr. Freeman has served as Executive Vice President and General Counsel of SPC and the Bank since October 1981, and General Counsel and Assistant Secretary of SPC and Senior Vice President and Counsel of the Bank prior to that.

Mr. Hancock has served as an Executive Vice President of SPC since July 1985 and of the Bank since September 1984, and a Senior Vice President of the Bank prior to that.

Mr. [illegible]an has served as an Executive Vice President of SPC since July 1985 and of the Bank since Oct[illegible]2, and a Senior Vice President of the Bank prior to that.

Mr. Kooken has served as Executive Vice President and Chief Financial Officer of SPC and the Bank since March 1984, an Executive Vice President of SPC from October 1981 to March 1984 and of the Bank from June 1981 to March 1984, Executive Vice President and Treasurer of SPC from June 1981 to October 1981, and Corporate Controller of SPC and Senior Vice President and Controller of the Bank prior to that.

Mr. Lovejoy has served as an Executive Vice President of SPC since April 1985 and of the Bank since March 1984, Executive Vice President and Treasurer of SPC from March 1984 to April 1985, Senior Vice President and Treasurer of SPC and a Senior Vice President of the Bank from October 1981 to March 1984, and a Vice President and Assistant Treasurer of SPC and a Vice President of the Bank prior to that.

Mr. Margol has served as Executive Vice President and Personnel Director of SPC and an Executive Vice President of the Bank since October 1981, and a Senior Vice President of the Bank prior to that.

Mr. Peterson has served as an Executive Vice President of SPC since September 1984 and an Executive Vice President of the Bank prior to that.

Mr. Warner has served as an Executive Vice President of SPC and the Bank since February 1985, and a Senior Vice President of the Bank prior to that.

Mr. Westra has served as Executive Vice President and Treasurer of SPC since April 1985, an Executive Vice President of the Bank since October 1981, and a Senior Vice President of the Bank prior to that.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

For information concerning SPC's Common Stock and related stockholder matters, see "Capital and Dividends" at Pages 29 and 30, "Selected Quarterly Data" at Page 36, and Note 14 of "Notes to Financial Statements" at Page 52, of the Annual Report, which are incorporated herein by reference, and "Supervision and Regulation" under the heading "Item 1. Business" above. At February 18, 1986, there were 28,357 holders of record of SPC Common Stock.

### ITEM 6. SELECTED FINANCIAL DATA.

For selected financial data concerning SPC, see "Highlights" at Pages 16 through 19 of the Annual Report, which is incorporated herein by reference.

### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

For Management's discussion and analysis of financial condition and results of operation, see "Financial Review" at Pages 15 through 36, and the six year financial summaries appearing at Pages 54 through 59, of the Annual Report, which are incorporated herein by reference.

The principal restrictions on the ability of its subsidiaries to transfer funds to SPC are included in Note 14 of "Notes to Financial Statements" at Page 52 of the Annual Report, which is incorporated herein by reference. These restrictions have not had, and are not expected to have, any impact on the ability of SPC to meet its cash obligations. For additional discussion concerning these restrictions, see "Supervision and Regulation" under the heading "Item 1. Business" above.

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

For financial statements of SPC and subsidiaries and SPC (Parent Company), together with the related notes, see "Financial Reports" at Pages 37 through 41 and 43 through 52 of the Annual Report, which is incorporated herein by reference. See Page 21 of this Form 10-K for the related report of Peat, Marwick, Mitchell & Co., independent certified public accountants. See "Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K" below for the exhibits filed as part of this Form 10-K. For certain supplementary data, see "Selected Quarterly Data" at Page 36, and "Supplementary Inflation Adjusted Data" at Pages 35 and [illegible], of the Annual Report, which are incorporated herein by reference.

The following table provides ratios of earnings to fixed charges for the last five years:

| | 1985 | 1984 | 1983 | 1982 | 1981 |
|---|---|---|---|---|---|
| Consolidated(1): | | | | | |
| Excluding interest on deposits | 1.46 | 1.52 | 1.68 | 1.48 | 1.44 |
| Including interest on deposits | 1.17 | 1.15 | 1.18 | 1.12 | 1.11 |
| Parent company only(1) | 1.13 | 1.23 | 1.20 | 1.17 | 1.19 |

(1) For purposes of computing the consolidated ratios, earnings represent income before income taxes plus fixed charges. For purposes of computing the parent company ratios, earnings represent income before income tax benefits and equity in undistributed income of subsidiaries, plus fixed charges. For all ratios, fixed charges include interest expense, the estimated interest component of net rental payments and the pre-tax equivalent of preferred stock dividends.

### ITEM 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

For information concerning directors and executive officers of SPC, see "Election of Directors" at Pages 2 through 8 of SPC's definitive proxy statement dated March 7, 1986 ("Proxy Statement"), which is incorporated herein by reference, and "Item 4(A). Executive Officers of the Registrant" above.

ITEM 11. EXECUTIVE COMPENSATION.

For information concerning executive compensation, see "The Board of Directors and its Committees", "Executive Compensation", and "Other Compensation" at Pages 8 through 17 of the Proxy Statement, which are incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

For information concerning security ownership of certain beneficial owners and Management, see "Voting Securities and Principal Stockholders" and "Election of Directors" at Pages 2 through 8 of the Proxy Statement, which are incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

For information concerning certain relationships and related transactions, see "Transactions with Directors, Executive Officers and Associates" at Pages 18 and 19 of the Proxy Statement, which is incorporated herein by reference.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

For information concerning directors and executive officers of SPC, see "Election of Directors" at Pages 2 through 8 of SPC's definitive proxy statement dated March 7, 1986 ("Proxy Statement"), which is incorporated herein by reference, and "Item 4(A). Executive Officers of the Registrant" above.

ITEM 11. EXECUTIVE COMPENSATION.

For information concerning executive compensation, see "The Board of Directors and its Committees", "Executive Compensation", and "Other Compensation" at Pages 8 through 17 of the Proxy Statement, which are incorporated herein by reference.

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For information concerning security ownership of certain beneficial owners and Management, see "Voting Securities and Principal Stockholders" and "Election of Directors" at Pages 2 through 8 of the Proxy Statement, which are incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

For information concerning certain relationships and related transactions, see "Transactions with Directors, Executive Officers and Associates" at Pages 18 and 19 of the Proxy Statement, which is incorporated herein by reference.

## PART IV

### ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K:

(a) Exhibits and financial statement schedules:

(1) The following financial statements of SPC and subsidiaries and SPC (Parent Company) and the related notes to financial statements, included in the Annual Report, are incorporated herein by reference. Page number references are to the Annual Report.



The related Accountants' Report is submitted herewith at Page 21 of this Form 10-K.

(2) All schedules are omitted because they are not applicable, not material or because the information is included in the financial statements or the notes thereto.

(3) Exhibits:

See Index to Exhibits at Page 24 of this Form 10-K.

(b) Reports on Form 8-K:

During the last quarter of 1985, the following reports on Form 8-K were filed with the Securities and Exchange Commission:

(1) Form 8-K dated October 4, 1985, which reported that on September 30, 1985, SPC agreed to sell 150 shares of its Money Market Cumulative Preferred Stock, Series A and 150 shares of its Money Market Cumulative Preferred Stock, Series B;

(2) Form 8-K dated November 22, 1985, which reported that (i) on October 25, 1985, certain legal proceedings were commenced against SPC and one of its subsidiaries, and, in the opinion of SPC's management, the disposition of these proceedings will not have a material effect on the consolidated financial position of SPC, and (ii) on November 19, 1985, SPC agreed to sell $3,500,000 aggregate principal amount of 8.80% Fixed Rate Notes due December 2, 1987;

(3) Form 8-K dated December 11, 1985, which reported that on November 20, 1985, SPC agreed to sell $30,000,000 aggregate principal amount of 8.77% Fixed Rate Notes Due December 15, 1987, and on December 9, 1985, SPC agreed to sell $25,000,000 aggregate principal amount of 9.0% Fixed Rate Notes Due December 15, 1988;

(4) Form 8-K dated December 24, 1985, which reported that on December 17, 1985, SPC agreed to sell $50,000,000 aggregate principal amount of 8.75% Intermediate-Term Notes Due 1989.

## ACCOUNTANTS' REPORT

To the Stockholders and the Board of Directors
Security Pacific Corporation:

We have examined the financial statements of Security Pacific Corporation and subsidiaries and Security Pacific Corporation (Parent Company) as listed in the accompanying index. These financial statements are contained in the 1985 annual report to stockholders and are incorporated by reference in the annual report on Form 10-K for the year 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Security Pacific Corporation (both consolidated and Parent Company) at December 31, 1985 and 1984 and the results of their operations and changes in their financial position for each of the years in the three year period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT, MARWICK, MITCHELL & CO.

Los Angeles, California
January 23, 1986

## POWER OF ATTORNEY

Each person whose signature appears below hereby authorizes each of Richard J. Flamson III, George F. Moody, Robert H. Smith, John F. Kooken, Linda Judd Foss, Russell A. Freeman, Edward J. McAniff, Frederick B. McLane, Michael T. Masin and Michael J. Fairclough, as attorney-in-fact, to sign in his or her behalf, individually and in each capacity stated below, and to file, all amendments and/or supplements to this Annual Report on Form 10-K.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 18th day of March, 1986.

SECURITY PACIFIC CORPORATION
(Registrant)

By JOHN F. KOOKEN
John F. Kooken
Executive Vice President and
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities indicated on March 18, 1986.

| Signature | Title |
|---|---|
| RICHARD J. FLAMSON III<br>Richard J. Flamson III | Chairman of the Board and Chief Executive Officer (Principal Executive Officer) |
| JOHN F. KOOKEN<br>John F. Kooken | Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) |
| JOSEPH F. ALIBRANDI<br>Joseph F. Alibrandi | Director |
| R. Anderson | Director |
| J. G. BOSWELL II<br>J. G. Boswell II | Director |

| Signature | Title |
|---|---|
| WALDO H. BURNSIDE<br>Waldo H. Burnside | Director |
| EARL CLARK<br>Earl Clark | Director |
| TIMM F. CRULL<br>Timm F. Crull | Director |
| CAMILLA C. FROST<br>Camilla C. Frost | Director |
| DONALD E. GUINN<br>Donald E. Guinn | Director |
| CARL E. HARTNACK<br>Carl E. Hartnack | Director |
| FRANK L. HOPE, JR.<br>Frank L. Hope, Jr. | Director |
| LAWRENCE O. KITCHEN<br>Lawrence O. Kitchen | Director |
| HOWARD W. KOCH<br>Howard W. Koch | Director |
| GEORGE F. MOODY<br>George F. Moody | Director |
| FRED W. O'GREEN<br>Fred W. O'Green | Director |
| HENRY T. SEGERSTROM<br>Henry T. Segerstrom | Director |
| H. RUSSELL SMITH<br>H. Russell Smith | Director |
| ROBERT H. SMITH<br>Robert H. Smith | Director |
| JACQUES S. YEAGER<br>Jacques S. Yeager | Director |
| JAMES H. ZUMBERGE<br>James H. Zumberge | Director |

## INDEX TO EXHIBITS

| Exhibit No. | |
|---|---|
| (2)(a) | Agreement dated August 20, 1985, between SPC and Arizona Bancwest Corporation ("ABC") providing for the acquisition of ABC by SPC through the merger of ABC with and into SPC Acquisition, Inc., a wholly owned subsidiary of SPC, for a total cash purchase price of approximately $480,000,000.[1] |
| (2)(b) | Agreement dated September 6, 1985, between SPC Securities Services Corp., a wholly-owned subsidiary of SPC, and The Bank of New York Company, Inc., providing for the sale by SPC Securities Services Corp. of all of the issued and outstanding shares of the common stock of RMJ Securities Corp. for a cash purchase price of $52,500,000, subject to certain adjustments.[2] |
| (3)(a) | Certificate of Incorporation of SPC as amended to date. |
| (3)(b) | By-Laws of SPC as amended to date. |
| (3)(c) | Articles of Association of the Bank as amended to date. |
| (3)(d) | By-Laws of the Bank as amended to date. |
| (4) | SPC has outstanding certain long-term debt. See Note 10 of "Notes to Financial Statements" at Pages 50 and 51 of the Annual Report. Such long-term debt does not exceed 10% of the total assets of SPC and its consolidated subsidiaries; therefore, copies of constituent instruments defining the rights of holders of such long-term debt are not included as exhibits. SPC agrees to furnish copies of such instruments to the Securities and Exchange Commission upon request. |
| (10)(a) | Agreement dated as of May 1, 1981, by and between Security Pacific National Bank and Carl E. Hartnack as amended to date. |
| (10)(b) | Security Pacific Corporation Performance Incentive Plan as amended to date. |
| (10)(c) | Security Pacific Corporation Stock Option Plan as amended to date. |
| (11) | Computation of consolidated earnings per common share. |
| (12) | Computation of ratio of earnings to fixed charges. |
| (13) | SPC's annual report to stockholders for the fiscal year ended December 31, 1985. |
| (22) | Subsidiaries of SPC. |
| (24) | Consent of Peat, Marwick, Mitchell & Co. |
| (25) | Power of attorney of certain officers and directors (included on Page 22). |

[1] Previously filed as Exhibit 28 to Report on Form 8-K dated August 29, 1985, and incorporated herein by reference.

[2] Previously filed as Exhibit 28 to Report on Form 8-K dated September 18, 1985, and incorporated herein by reference.

# CERTIFICATE OF INCORPORATION

## ARTICLE I

The name of this Corporation is Security Pacific Corporation.

## ARTICLE II

The address of its registered office in the State of Delaware is located at Number 100 West Tenth Street, in the City of Wilmington, County of New Castle. The name of its registered agent at such address is The Corporation Trust Company.

## ARTICLE III

The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.

## ARTICLE IV

(A) The total number of shares of all classes of capital stock which the Corporation shall have the authority to issue is two hundred five million (205,000,000) shares, of which five million (5,000,000) shares shall be shares of Preferred Stock of no par value (hereinafter called "Preferred Stock") and two hundred million (200,000,000) shares shall be shares of Common Stock of the par value of $10.00 per share (hereinafter called "Common Stock").

(B) The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment if the amendment would increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely. If any proposed amendment would alter or change the powers, preferences, or special rights of one or more series of any class so as to affect them adversely, but shall not so affect



Rev. 4/85

EXHIBIT 3(a)

the entire class, then only the shares of the series so affected by the amendment shall be considered a separate class for the purposes of this paragraph. The number of authorized shares of any such class or classes of stock may be increased or decreased by the affirmative vote of the holders of a majority of the stock of the Corporation entitled to vote.

(C) The designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of the Preferred Stock shall be as follows:

(1) The Board of Directors is expressly authorized at any time, and from time to time, to provide for the issuance of shares of Preferred Stock in one or more series, with such voting powers, full or limited but not to exceed one vote per share, or without voting powers, and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions providing for the issue thereof adopted by the Board of Directors, and as are not stated and expressed in this Certificate of Incorporation, or any amendment thereto, including (but without limiting the generality of the foregoing) the following:

(a) the designation of and number of shares constituting such series;

(b) the dividend rate of such series, the conditions and dates upon which such dividends shall be payable, the preference or relation which such dividends shall bear to the dividends payable on any other class or classes or of any other series of capital stock, and whether such dividends shall be cumulative or noncumulative;

(c) whether the shares of such series shall be subject to redemption by the Corporation, and, if made subject to such redemption, the times, prices and other terms and conditions of such redemption;

(d) the terms and amount of any sinking fund provided for the purchase or redemption of the shares of such series;

(e) whether or not the shares of such series shall be convertible into or exchangeable for shares of any other class or classes or of any other series of any class or classes of capital stock of the Corporation, and, if provision be made for conversion or exchange, the times, prices, rates, adjustments, and other terms and conditions of such conversion or exchange;

(f) the extent, if any, to which the holders of the shares of such series shall be entitled to vote as a class or otherwise with respect to the election of the Directors or otherwise; *provided, however,* that in no event shall any holder of any series of Preferred Stock be entitled to more than one vote for each share of such Preferred Stock held by him;

(g) The restrictions, if any, on the issue or reissue of any additional Preferred Stock;

(h) the rights of the holders of the shares of such series upon the dissolution of, or upon the distribution of assets of, the Corporation.

(2) Except as otherwise required by law and except for such voting powers with respect to the election of Directors or other matters as may be stated in the resolutions of the Board of Directors creating any series of Preferred Stock, the holders of any such series shall have no voting power whatsoever.

(D) No stockholder of this Corporation shall have any pre-emptive or preferential right of subscription to any shares of any stock of this Corporation, or to any obligations convertible into stock of this Corporation, issued or sold, nor any right of subscription to any thereof other than such, if any, as the Board of Directors of this Corporation in its discretion from time to time may determine, and the Board of Directors may issue stock of this Corporation, or obligations convertible into stock, without offering such issue of stock, either in whole or in part, to the stockholders of this Corporation. The acceptance of stock in thi Corporation shall be a waiver of any such pre-emptive or preferential rights which in the absence of this provision might otherwise be asserted by stockholders of this Corporation or any of them.

This Corporation shall be entitled to treat the person in whose name any share is registered as the owner thereof, for all purposes, and shall not be bound to recognize any equitable or other claim to, or interest in, such share on the part of any other person, whether or not this Corporation shall have notice thereof, save as expressly provided by the laws of the State of Delaware.

## ARTICLE V

The names and places of residence of the incorporators are as follows:

| Name | Address |
|---|---|
| Edwin H. Corbin | 106 North Grand Avenue<br>Pasadena, California 91103 |
| Frederick G. Larkin, Jr. | 771 South Windsor Boulevard<br>Los Angeles, California 90005 |
| William E. Siegel | 1520 San Remo Drive<br>Pacific Palisades, California 90272 |

## ARTICLE VI

The Corporation shall, to the full extent permitted under the provisions of Section 145 of Title 8 of the Delaware Code, as amended from time to time, and in the manner permitted by the Corporation's By-Laws, indemnify all persons whom it may indemnify under that Section and pursuant to said By-Laws.

## ARTICLE VII

The number of Directors of this Corporation shall be fixed and may be altered from time to time as may be provided in the By-Laws. In case of any increase in the number of Directors, the additional Directors may be elected by a majority of the Directors then in office, to hold office until the next annual meeting of the stockholders and until their successors are elected and qualified. In case of vacancies in the Board of Directors,

a majority of the remaining members of the Board may elect Directors to fill such vacancies. Any Director may be removed by a majority vote of the stockholders entitled to vote at any annual or special meeting thereof, for any cause deemed sufficient by the stockholders present or represented at such meeting. The Directors of this Corporation need not be stockholders therein.

## ARTICLE VIII

The stockholders and Board of Directors shall have power, if the By-Laws so provide, to hold their meetings and to keep the books of this Corporation (except such as are required by the law of the State of Delaware to be kept in Delaware) and documents and papers of this Corporation outside the State of Delaware.

## ARTICLE IX

All of the powers of this Corporation, insofar as the same may be lawfully vested by this Certificate of Incorporation in the Board of Directors, are hereby conferred upon the Board of Directors of this Corporation. In furtherance and not in limitation of that power, the Board of Directors shall have power to make, adopt, alter, amend and repeal from time to time By-Laws of this Corporation, subject to the right of the stockholders entitled to vote with respect thereto to alter and repeal By-Laws made by the Board of Directors.

## ARTICLE X

Whenever a compromise or arrangement is proposed between this Corporation and its creditors or any class of them and/or between this Corporation and its stockholders or any class of them, any court of equitable jurisdiction within the State of Delaware may, on the application in a summary way of this Corporation or of any creditor or stockholder thereof, or on the application of any receiver or receivers appointed for this Corporation under the provisions of Section 291 of Title 8 of the Delaware Code or on the application of trustees in dissolution or of any receiver or receivers appointed for this Corporation under the provisions of Section 279 of Title 8 of the Delaware Code,

order a meeting of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this Corporation as the case may be, to be summoned in such manner as the said court directs. If a majority in number representing three-fourths in value of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this Corporation, as the case may be, agree to any compromise or arrangement and to any reorganization of this Corporation as a consequence of such compromise or arrangement, the said compromise or arrangement and the said reorganization shall, if sanctioned by the court to which the said application has been made, be binding on all the creditors or class of creditors, and/or on all the stockholders or class of stockholders, of this Corporation, as the case may be, and also on this Corporation.

## ARTICLE XI

This Corporation reserves the right to amend, alter, change, add to or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights and powers conferred by this Certificate of Incorporation on stockholders, Directors and officers are granted subject to this reservation.

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549



FORM 10-Q

Quarterly Report Under Section 13 or 15(d)
of the Securities Exchange Act of 1934

For Quarter Ended March 31, 1986 Commission File No. 1-7393

SECURITY PACIFIC CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE<br>(State or other jurisdiction of incorporation or organization). | 95-2741988<br>(I.R.S. Employer Identification No.) |
| 333 SOUTH HOPE STREET<br>LOS ANGELES, CALIFORNIA<br>(Address of principal executive offices) | 90071<br>(Zip Code) |

Registrant's telephone number, including area code: (213) 613-4540

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X . No___.

Approximate number of shares outstanding of the registrant's common stock, as of May 2, 1986.

| | |
|---|---|
| COMMON STOCK $10.00 PAR VALUE<br>(TITLE OF CLASS) | 76,874,140<br>(SHARES OUTSTANDING) |

## PART I. - FINANCIAL INFORMATION

Item 1. Financial Statements.

Certain of the unaudited consolidated financial statements for the Registrant and its subsidiaries required by this Item are set forth at Pages 8, 9, 10 and 14 of the Security Pacific Corporation Quarterly Report for the quarter ended March 31, 1986 (the "Quarterly Report"), and are incorporated herein by reference. The Consolidated Statement of Changes in Financial Position for the three months ended March 31, 1986 and March 31, 1985, and an additional Note to the Consolidated Financial Statements, are set forth at Pages 2 and 3 of this Form 10-Q.

SECURITY PACIFIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
(Unaudited) (In Millions)

| | 3 Months Ended March 31, 1986 | 3 Months Ended March 31, 1985 |
|---|---|---|
| inancial Resources Were Provided by (applied to): | | |
| perations: | | |
| Net Income | $ 87.9 | $ 73.5 |
| Cash dividends | (27.7) | (22.3) |
| | 60.2 | 51.2 |
| eposits and other financing activities: | | |
| Deposits | 89.9 | (268.2) |
| Short-term funds borrowed (1) | (2,979.4) | (456.5) |
| Intermediate-term debt and long-term debt (2) | 588.0 | 194.8 |
| Common stock issued (net) | 1.3 | 0.4 |
| Net treasury stock transactions | 7.0 | 2.4 |
| | (2,293.2) | (527.1) |
| ther activities: | | |
| Cash and due from banks | 855.5 | 295.6 |
| Translation adjustments | 0.5 | (0.1) |
| Other, net | (307.8) | (265.8) |
| | 548.2 | 29.7 |
| Total | $(1,684.8) | $(446.2) |
| ncrease (Decrease) in Earning Assets: | | |
| Du[illegible]m banks-interest bearing | $ (595.4) | $ (43.2) |
| In[illegible]ent securities and trading account a[illegible]ts | (220.6) | (406.2) |
| Federal funds sold | 41.1 | (86.6) |
| Net loans and lease financing | (909.9) | 89.8 |
| Total | $(1,684.8) | $(446.2) |

) Includes federal funds purchased and securities under repurchase agreements, commercial paper and other short-term funds borrowed.

) Includes subordinated capital notes.

ee Accompanying Note to Financial Statements

SECURITY PACIFIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
(Unaudited) (In Millions)

| | 3 Months Ended March 31, 1986 | 3 Months Ended March 31, 1985 |
|---|---|---|
| Financial Resources Were Provided by (applied to): | | |
| Operations: | | |
| Net Income | $ 87.9 | $ 73.5 |
| Cash dividends | (27.7) | (22.3) |
| | 60.2 | 51.2 |
| Deposits and other financing activities: | | |
| Deposits | 89.9 | (268.2) |
| Short-term funds borrowed (1) | (2,979.4) | (456.5) |
| Intermediate-term debt and long-term debt (2) | 588.0 | 194.8 |
| Common stock issued (net) | 1.3 | 0.4 |
| Net treasury stock transactions | 7.0 | 2.4 |
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| Cash and due from banks | 855.5 | 295.6 |
| Translation adjustments | 0.5 | (0.1) |
| Other, net | (307.8) | (265.8) |
| | 548.2 | 29.7 |
| Total | $(1,684.8) | $(446.2) |
| Increase (Decrease) in Earning Assets: | | |
| Due from banks-interest bearing | $ (595.4) | $ (43.2) |
| Investment securities and trading account assets | (220.6) | (406.2) |
| Federal funds sold | 41.1 | (86.6) |
| Net loans and lease financing | (909.9) | 89.8 |
| Total | $(1,684.8) | $(446.2) |

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1) Includes federal funds purchased and securities under repurchase agreements, commercial paper and other short-term funds borrowed.

2) Includes subordinated capital notes.

See Accompanying Note to Financial Statements

NOTE TO CONSOLIDATED FINANCIAL STATEMENTS

In the opinion of management, the unaudited consolidated financial statements of Security Pacific Corporation and its subsidiaries as of March 31, 1986 and 1985, and the three months then ended, reflect all adjustments (which consist only of normal recurring adjustments) necessary for a fair presentation.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation.

The information for the Registrant and its subsidiaries required by this Item is set forth at Pages 4 through 7 of the Quarterly Report and is incorporated herein by reference.

PART II. OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders.

(a) The annual meeting of stockholders of the Registrant was held April 15, 1986.

(b) In addition to the election of directors and the ratification of the selection of auditors, the following action was taken at the annual meeting of stockholders held April 15, 1986: Stockholders approved an amendment to the Registrant's Stock Option Plan by an affirmative vote of 60,674,974 votes, with 1,869,063 votes against the proposal.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits.

(11) Computation of Consolidated Earnings Per Share.

(12) Computation of Ratio of Earnings to Fixed Charges.

(20) Security Pacific Corporation Quarterly Report for the quarter ended March 31, 1986.

(b) Reports on Form 8-K.

During the quarter ended March 31, 1986, the Registrant filed the following Current Reports on Form 8-K:

1. Report dated January 21, 1986, stating under Item 5 that, in connection with Registration Statement No. 2-82946 and other presently effective registration statements under the Securities Act of 1933 filed with the Securities and Exchange Commission by the Registrant, certain information for and financial statements of the Registrant and its subsidiaries were to be incorporated by reference therein, and reporting the filing of such information and unaudited financial statements which had not been previously filed with the Securities and Exchange Commission. The financial statements are described below:

a. Earnings Summary of Security Pacific Corporation and subsidiaries for the three months and twelve months ended December 31, 1985 and 1984; and

b. Balance Sheet Summary of Security Pacific Corporation and subsidiaries for the twelve months ended December 31, 1985 and 1984;

2. Report dated January 31, 1986, which indicates under Item 5 that (a) on January 22, 1986, Registrant and Salomon Brothers Inc. entered into an Underwriting Agreement relating to the issue and sale of certain debt securities registered under Registration statement No. 2-82946; and (b) on January 22, 1986, Registrant agreed to sell A$175,000,000 aggregate principal amount of Floating Rate Australian Dollar Notes Due 1991;

3. Report dated February 26, 1986, stating under Item 5 that, in connection with Registration Statement No. 2-82946 and other presently effective registration statements under the Securities Act of 1933 filed with the Securities and Exchange Commission by the Registrant, certain information for and financial statements of the Registrant and its subsidiaries were to be incorporated by reference therein, and reporting the filing of such information and unaudited financial statements which had not been previously filed with the Securities and Exchange Commission. The financial statements are described below:

a. Consolidated balance sheet of Security Pacific Corporation and subsidiaries as of December 31, 1985 and 1984 and the related consolidated statement of earnings for the three months and twelve months then ended; and

b. Consolidated statement of changes in stockholders' equity of Security Pacific Corporation and subsidiaries for the twelve months ended December 31, 1985 and 1984; and

4. Report dated March 3, 1986, which indicates under Item 5 that on February 26, 1986, the Registrant agreed to sell $150,000,000 aggregate principal amount of 8 7/8% Notes due March 1, 1996.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, on the 8th day of May, 1986.

SECURITY PACIFIC CORPORATION
(Registrant)

By John F. Kooken
JOHN F. KOOKEN
Executive Vice President and
Chief Financial Officer
(Principal Financial and
Accounting Officer)

By Rebecca H. Fischer
REBECCA H. FISCHER
Assistant Secretary
(Authorized Officer)

INDEX TO EXHIBITS

| Exhibit No. | Description | Sequentially Numbered Page |
|---|---|---|
| 11 | Computation of Consolidated Earnings Per Share. | |
| 12 | Computation of Ratio of Earnings to Fixed Charges. | |
| 20 | Security Pacific Corporation Quarterly Report for the Quarter ended March 31, 1986. | |

SECURITY PACIFIC CORPORATION AND SUBSIDIARIES
COMPUTATION OF CONSOLIDATED EARNINGS PER SHARE
(In Millions, Except Per Common Share Amounts)

| | 3 Months Ended March 31, 1986 | 3 Months Ended March 31, 1985 |
|---|---|---|
| Computation of Net Income Applicable to Common Stock: | | |
| Consolidated net income (1) | $87.9 | $73.5 |
| Less preferred dividends | 2.0 | -- |
| Total | $85.9 | $73.5 |
| Computation of Common Shares and Share Equivalents: | | |
| Weighted average number of shares outstanding | 76.7 | 73.1 |
| Weighted average number of share units awarded under incentive plans | 0.2 | 0.2 |
| Dilutive effect of outstanding stock options | 0.2 | 0.2 |
| Weighted average number of shares and share equivalents for primary earnings per common share | 77.1 | 73.5 |
| Earnings Per Common Share: | | |
| Primary(1) | $1.11 | $1.00 |

1) Amounts agree with C... ...lidated Statement of Earnings.

Exhibit 11

SECURITY PACIFIC CORPORATION AND SUBSIDIARIES (CONSOLIDATED)
SECURITY PACIFIC CORPORATION (PARENT COMPANY)
COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES
(Dollars in Millions)

| | Three Months Ended March 31, 1986 |
|---|---|
| A. Security Pacific Corporation and Subsidiares (Consolidated): | |
| Earnings: | |
| 1. Income before income taxes | $128.6 |
| 2. Plus interest expense (a) | 737.4 |
| 3. Earnings including interest on deposits | 866.0 |
| 4. Less interest on deposits | 454.8 |
| 5. Earnings excluding interest on deposits | $411.2 |
| Fixed Charges: | |
| 6. Including interest on deposits (Line 2) | $737.4 |
| 7. Plus preferred dividends (b) | 4.2 |
| 8. Fixed charges | 741.6 |
| 9. Less interest on deposits (Line 4) | 454.8 |
| 10. Excluding interest on deposits | $286.8 |
| Ratio of Earnings to Fixed Charges: | |
| Including interest on deposits (Line 3 ÷ Line 8) | 1.17 |
| Excluding interest on deposits (Line 5 ÷ Line 10) | 1.43 |
| B. Security Pacific Corporation (Parent Company): | |
| Earnings: | |
| 11. Income before income taxes and equity in undistributed income of subsidiaries | $ 37.8 |
| 12. Plus interest expense | 119.8 |
| 13. Earnings including interest expense | $157.6 |
| Fixed Charges: | |
| 14. Interest Expense (Line 12) | $119.8 |
| 15. Plus preferred dividends (b) | 4.2 |
| 16. Fixed charges | $124.0 |
| Ratio of Earnings to Fixed Charges (Line 13 ÷ Line 16) | 1.27 |

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(a) Includes amounts representing the estimated interest component of net rental payments.

(b) Pre-tax equivalent.

Exhibit 12

EXHIBIT 2C

## Highlights

*Security Pacific Corporation and Subsidiaries*

| *3 Months Ended March 31* | 1986 | 1985 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| $ in millions, except per share amounts | | | | |
| Net income | $ 87.9 | $ 73.5 | $ 14.4 | 20 |
| Common dividends | 25.7 | 22.3 | 3.4 | 15 |
| Per common share. | | | | |
| Net income | $ 1.11 | $ 1.00 | $ 0.11 | 11 |
| Dividends | 0.335 | 0.305 | 0.03 | 10 |
| Book value (period end) | 30.69 | 27.57 | 3.12 | 11 |
| ***At March 31*** | | | | |
| $ in millions | | | | |
| Assets | $50,104 | $45,222 | $4,882 | 11 |
| Deposits | 32,963 | 30,738 | 2,225 | 7 |
| Loans and lease financing | 36,191 | 33,102 | 3,089 | 9 |
| Investment securities | 2,329 | 1,925 | 404 | 21 |
| Stockholders' equity | 2,508 | 2,017 | 491 | 24 |

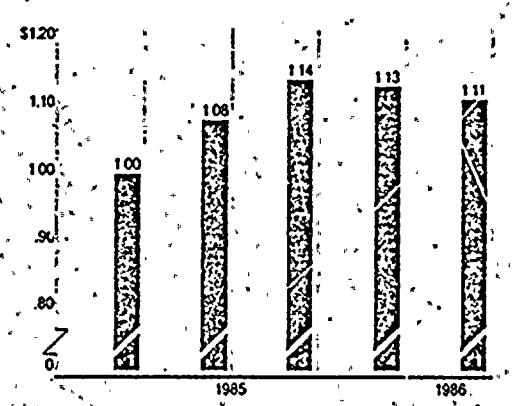
Earnings were up 20 percent and totaled $87.9 million. On a per common share basis, net income increased 11 percent. The California Banking and Real Estate Industries System and the Capital Markets System contributed to the earnings gains.

A strong increase in non-interest income and solid growth in net interest income were responsible for the earnings improvement. These favorable factors were partially offset by an increase in non-interest expense and a larger provision for credit losses.

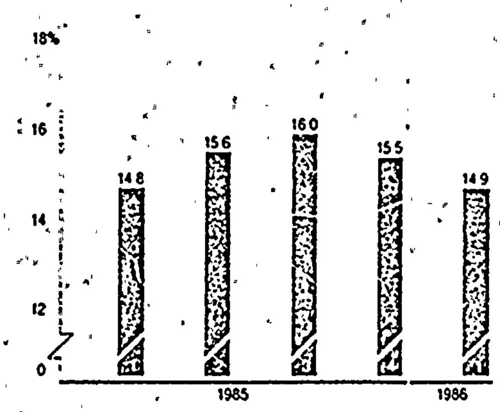
At March 31, 1986, stockholder's equity was $2,508 million, up $491 million, or 24 percent, from a year ago. Approximately one-half of the increase resulted from the issuance of preferred and common stock during the 1985 fourth quarter.

On April 15, 1986, the Board of Directors increased the quarterly dividend 10 percent to $0.37 from $0.335 per share, payable on May 20, 1986, to stockholders of record on April 29, 1986. This represents the tenth consecutive year of dividend growth.

***Net Income Per Common Share***




***Return on Average Common Equity***



On April 15, 1986, approximately 400 persons attended the annual meeting of stockholders at Security Pacific Plaza in Los Angeles, representing over 85 percent of shares outstanding. Opening the proceedings, Chairman of the Board and Chief Executive Officer Richard J. Flamson III announced that the Board of Directors had earlier that morning approved an increase in the quarterly dividend from $0.335 to $0.37 per share, a 10.4 percent increase. This represents the tenth consecutive annual increase in the amount of dividends paid to Security Pacific stockholders.

Each of the three items on the meeting agenda was approved: the re-election of the 20 incumbent members to the Board of Directors; an amendment to the Stock Option Plan increasing the number of shares of SPC Common Stock available under the Plan to a total of 4,500,000 shares; and ratification of the selection of Peat, Marwick, Mitchell and Co. as auditors for 1986.

### *Unprecedented Challenge in 1985*

Flamson highlighted the Corporation's progress during 1985, a period of challenge and opportunity for the financial services industry. "Because the nature of our business is subject to fluctuations in national and international economies, we have carefully planned and built diversity and balance into our operations in terms of products and geography." Flamson further stated, "that balance, we believe, has been pivotal in our ability to capitalize on new opportunities to expand our business."

Flamson noted that 1985 was the eleventh consecutive year of strong profit growth for Security Pacific. After-tax earnings increased 11 percent, to $323 million, which placed Security Pacific seventh among the country's largest bank holding companies. Earnings per share were $4.35, a ten percent increase from the previous year.

"During the past twelve months," Flamson continued, "we have taken some decisive steps to ensure the strength and stability of this Corporation which will have historic significance to the future of Security Pacific." These include the agreement to acquire Arizona Bancwest Corporation, holding company for The Arizona Bank, the third largest bank in that state. The agreement, to take effect in October 1986 following state and federal regulatory approval, will give Security Pacific "a very high quality presence in a very high quality market," said Flamson.

The April completion of the acquisition of an 83 percent share in Hoare Govett Limited, one of the most prestigious and competent securities firms based in London, is another significant step for Security Pacific. Flamson additionally remarked, "we have substantially increased our level of market presence in Canada, in Australia and in other mature and important financial markets.

"Building from our strong and growing base here in California," Flamson said, "we see our growing global presence as very consistent with meeting the needs of our customers in the rapidly evolving financial services environment."

### *Continued Change*

"To put the last ten years in perspective," Flamson continued, "we have had, to say the least, a rapidly changing financial environment. The next ten years promise continuing and rapidly accelerating changes in markets, changes in rules, and changes in customer requirements. These changes are going to give rise to a different competitive landscape, including new products and services, new market geographics and demographics, higher levels of technology and a need for new and vastly different skills and abilities.

"The financial services business is changing at an accelerating pace on both the wholesale and retail levels. In every facet of our business, we have important new products and services, important new markets *and*, we have important new competitors," Flamson said. "Many of those new competitors do not operate under the same legal and regulatory restraints that banks have to live with and that disadvantage is the single most important issue facing the industry today."

### *Benefits of Deregulation*

"It is abundantly clear that deregulation is the solution, not the cause, for many of the problems of the banking industry," Flamson remarked.

The benefits of deregulation "include diversification of earnings streams, substantial synergy utilizing established customer bases, maximization of existing delivery systems and economies of scale that drop unit costs to remarkably low levels. Security Pacific has demonstrated the validity of those benefits of deregulation.

"To further demonstrate that point, last year 43 percent of our total corporate earnings came from non-bank subsidiaries that mostly didn't exist ten years ago," Flamson noted. "That includes leasing, consumer and commercial finance, venture capital and so on. That's what product and geographical diversification has meant to us so far.

"In building the basic business of banking, one of the most onerous industry restraints is the interstate issue," Flamson noted. "The McFadden Act and the Douglas Amendment, both of which prevent growth across state lines, are uniquely American concepts which don't exist elsewhere. The maintenance of those laws is short-sighted, inefficient, and anti-consumer.

"The original rationale for those interstate restraints is just not valid today, and I'm not sure that it ever was," Flamson continued. "With those limitations, American banks cannot reasonably be expected to compete on an equal footing with their international counterparts. In Japan, Germany, France, England and Canada, a small number of relatively large banks compete effectively in both domestic and international markets.

"Looking forward," Flamson observed, "we feel very optimistic about the future. California continues to be a strong and dynamic market and in addition, we've been able to move effectively into other key business and financial markets in the U.S. and overseas, blending traditional banking expertise and new, leading edge financial services. That diversity of service and geography places Security Pacific squarely and solidly on the frontline of the financial services industry as we move forward."

At the conclusion of his remarks, Flamson introduced George F. Moody, President and Chief Operating Officer, who discussed the principal operating systems of the Corporation in 1985.

*Organizational Balance*

"A large part of our success can be attributed to the balance of our organization," Moody commented. "Over the past decade we have successfully constructed and managed a balanced financial services institution.

"The California Banking and Real Estate Industries System focuses on the California retail and commercial markets through the California Branch Banking Group, which has approximately 600 banking offices statewide, serving over 2.5 million customers," Moody said. "The focus in the California bank continues to be the development of low-cost, high-quality delivery systems. We are capitalizing on opportunities to provide a full line of financial services, coupled with high quality customer service.

"Overall, the California Banking & Real Estate Industries System contributed roughly 44 percent of Security Pacific's 1985 profits, earning $140.6 million. This was an 11 percent increase over 1984 earnings. Furthermore, the return on assets of 80 basis points reflects a consistently improving trend over the past several years. The California banking units have always been our top priority and largest contributor to earnings. They have provided the foundation for our profitable diversification during the past decade.

"The restructured Capital Markets System administers the worldwide activities of the Corporation and the Bank in the areas of wholesale banking, capital markets, investments and securities," Moody explained. "Security Pacific has developed a strong foundation of corporate and international banking skills, foreign exchange and securities trading operations, and investment banking capabilities. During the past year we have made significant investments in staff and technology. We also continue to monitor and evaluate global markets, developing new financial instruments and strategies to satisfy the needs of our clients around the world.

"For the full year 1985, the Capital Markets System earned about $49 million, or 15 percent of total Security Pacific profits. That compares with $67 million, or 23 percent of total SPC profits in 1984." This income measure was significantly affected by loan losses and non-accruals. For example, the Capital Markets System absorbed $175 million, or 49 percent of loan losses, as well as a majority share of the $109 million cost of carrying non-accruals in 1985. "We expect the Capital Markets System to improve its profit contribution in 1986 for two reasons," Moody stated. "First, we expect profit growth from our merchant banking activity. Second, we anticipate fewer loan losses and lower costs associated with the level of non-performing loans.

"The Financial Services System, a group of non-bank domestic and international subsidiaries, offers a variety of innovative products and services such as consumer and commercial finance, leasing, venture capital, insurance, mortgage banking, discount brokerage, auto dealer financing and manufactured housing financing," Moody said. "These companies and subsidiaries operate from approximately 500 offices in 46 states and a dozen foreign countries. An entrepreneurial spirit drives the Financial Services System and although each business functions as an independent profit center, their interrelationships create profit and growth opportunities for the group as a whole.

"After deducting corporate expense, the Financial Services System earned $139 million in 1985. This represented 43 percent of the Corporation's net income. Furthermore, this group of companies produced about 180 basis points return on assets last year. In 1984, we reported the Financial Services System as producing 30 percent of the total corporate earnings. The jump to 43 percent of total earnings in 1985 is the result of very solid growth, combined with a restructuring which added about 4 percent or 5 percent to the 43 percent contribution.

"Security Pacific Automation Company ('SPAC'), the fourth major component of Security Pacific Corporation, is a division of the Bank. In 1985 SPAC moved beyond providing data processing and telecommunications services to Security Pacific and into the external marketplace. The company has become an important supplier of a broad range of technology-based services to other companies in the financial services industry.

"As part of its still embryonic external marketing activities, SPAC sold $14 million of services to other financial service companies. The company currently has plans to further develop its expertise in specialized fields. In 1986, SPAC is expected to nearly double its outside revenues and become a new source of profits for Security Pacific."

*Security Pacific Employees*

Balance, diversity and adaptability have played key roles in the success of Security Pacific. However, "one very important element must not be forgotten," remarked Moody. "The 30,000 people of Security Pacific deserve much of the credit for the success of the Corporation. Their teamwork, flexibility and perseverance are responsible for the progress achieved at Security Pacific.

"Our employees' contributions go beyond what they do at work," he continued. "In addition to managing their professional responsibilities, many of our employees contribute actively to their communities. SecuriTeam, our corporate volunteer program, is a good example of the commitment that Security Pacific and its employees have to their communities. During 1985, SecuriTeam's 3,000 members worked on 167 projects, volunteering nearly 30,000 hours of their own time."

Moody added that at a special White House ceremony last June, he was proud to accept a private sector initiative award from President Reagan, on behalf of Security Pacific. The award recognizes the Corporation for its outstanding community involvement in supporting private solutions to public, social and economic problems.

In closing, Moody remarked to stockholders, "it is important that you realize your active support of Security Pacific and your confidence in this organization are important elements in our success. Thank you for that support and confidence."

Net income for the first quarter of 1986 totaled $87.9 million, 20 percent above the $73.5 million reported for the first quarter of 1985. On a per common share basis, net income was $1.11, up 11 percent from a year ago. The lower earnings per share growth rate was influenced by the fourth quarter 1985 issuances of preferred and common stock.

A strong increase in non-interest income and solid growth in net interest income were responsible for the earnings improvement between first quarters. The growth in non-interest income was affected by the Corporation's gain from the previously announced sale of RMJ Securities Corp. and by increases in gains on sales of investment securities, loan fees and foreign exchange gains. Net interest income increased due to earning asset growth, as the net interest margin remained virtually unchanged from the year-ago quarter. These favorable factors were partially offset by an increase in non-interest expense and a larger provision for credit losses.

Organizationally, the net income of the California Banking and Real Estate Industries System and the Capital Markets System increased 44 and 40 percent, respectively, between first quarters. The California Banking and Real Estate Industries System experienced growth in both net interest income and non-interest income. The Capital Markets System benefited from increased non-interest income, which included the gain from the sale of RMJ Securities Corp. These favorable items were partially offset in both organizations by a larger provision for credit losses and higher non-interest expense. Net income of the Financial Services System declined 9 percent. This decline was primarily in the Venture Capital Group as a result of higher capital gains in the first quarter of 1985.

The return on average assets was 0.70 percent in the 1986 first quarter compared to 0.69 percent reported for all of 1985. The decline in the return on average common stockholders' equity from 15.5 percent for all of 1985 to 14.9 percent in the 1986 first quarter reflects the issuance of $83 million of common stock in the 1985 fourth quarter.

Stockholders' equity totaled $2,538 million at March 31, 1986, up 24 percent from a year ago. The increase includes both the proceeds from the issuance of common stock and the 1985 fourth quarter issuance of $150 million of preferred stock. The stock was issued in anticipation of acquisitions, principally Arizona Bancwest Corporation. The primary capital ratio was 7.03 percent at March 31, 1986, based on period-end capital and quarterly average assets, compared to 6.75 percent a year ago and 7.00 percent at December 31, 1985. The total capital ratio was 8.46 percent compared to 7.55 percent a year ago and 7.95 percent at year-end 1985.

### *Net Interest Income*

Taxable equivalent net interest income totaled $441.3 million in the first quarter of 1986, an increase of 12 percent from the year-ago quarter. The increase was attributable to earning asset growth of 12 percent, as the net interest margin at 4.09 percent was virtually unchanged from 4.08 percent in 1985.

The negative impact of non-performing loans and leases on consolidated net interest income amounted to $25.5 million ($0.17 per share, after taxes) in the 1986 first quarter, down from $27.8 million ($0.19 per share, after taxes) a year ago. Substantially all of the negative impact

| *Earnings Summary* | 3 Months Ended March 31, | | Increase (Decrease) | |
|---|---|---|---|---|
| $ in millions | 1986 | 1985 | Amount | Percent |
| Net interest income(1) | $441.3 | $392.3 | $49.0 | 12 |
| Non-interest income | 294.0 | 226.7 | 67.3 | 30 |
| Less provision for credit losses | 116.2 | 78.8 | 37.4 | 47 |
| Less other non-interest expense: | | | | |
| Staff expense | 239.0 | 216.2 | 22.8 | 11 |
| Other expense | 228.1 | 189.5 | 38.6 | 20 |
| Total | 467.1 | 405.7 | 61.4 | 15 |
| Income before income taxes | 152.0 | 134.5 | 17.5 | 13 |
| Less adjustment(1) | 23.4 | 19.0 | 4.4 | 23 |
| Less income taxes | 40.7 | 42.0 | (1.3) | (3) |
| Net income | $ 87.9 | $ 73.5 | $14.4 | 20 |

(1) Includes amounts to convert nontaxable income, primarily securities income, to a fully taxable equivalent basis and to add the pre-tax equivalent of investment tax credit on leasing activities to interest income.

was the result of domestic non-performing credits. Total non-performing loans and leases were $1,071 million, or 3.0 percent of total loans and leases, at March 31, 1986, down $63 million from December 31, 1985, and $118 million from March 31, 1985. Both domestic and international non-performing loans and leases declined from December 31, 1985. The domestic decrease was in restructured loans, primarily as a result of a loan that was renegotiated to a market rate of interest. Partially offsetting this decrease was an increase in non-accrual credits, primarily in the energy and "other" categories. The decline in international credits was mainly related to Argentine loans. Detail of non-performing loans and leases for the past five quarters is shown in the table on page six.

Domestic net interest income at $381.5 million was 14 percent above the prior-year first quarter. The increase between quarters was due to an 11 percent increase in average earning assets and a higher net interest margin of 4.54 percent compared to 4.40 percent in the 1985 first quarter.

All major domestic earning asset categories were above year-ago levels. Although consumer loans experienced strong growth between first quarters and averaged 20 percent higher, the rate of growth has slowed since mid-1985. Domestic business loans increased 6 percent, while real estate loans increased 3 percent between quarters. Average net core deposits grew 9 percent between first quarters, with the largest increases in demand deposits, up 14 percent, and interest/checking deposits, up 19 percent.

The domestic net interest margin improved from a year ago as interest rates paid on funding sources declined more rapidly than earning asset yields. This relationship is not expected to continue as the decline in consumer deposit rates moderates.

| *Sources and Uses of Funds Growth* ($ in billions) | [illegible] March 1986 | [illegible] December [illegible] | Increase (Decrease) |
|---|---|---|---|
| Total assets | $49,763 | [illegible] | [illegible] |
| Total earning assets | 43,104 | [illegible] | [illegible] |
| Net core deposits | 15,863 | [illegible] | [illegible] |
| Long-term debt | 1,319 | [illegible] | [illegible] |
| Stockholders' equity | 2,487 | [illegible] | 105 |

International net interest income totaled $59.8 million in the first quarter of 1986, up 3 percent from a year ago. The increase resulted from earning asset growth of 19 percent, as the net interest margin declined. Average international loans increased 18 percent between first quarters primarily reflecting continued growth and acquisitions in indigenous banking activities in Australia and Canada as well as in the Corporation's finance subsidiaries.

The decline in the international net interest margin from 2.91 percent to 2.49 percent in the 1986 first quarter resulted in part from significant growth in investment securities and trading account assets which have lower spreads than do other earning assets. The net interest margin was also negatively affected by a decline in non-interest-bearing deposits.

### *Non-Interest Income*

Non-interest income totaled $294.0 million in the first quarter of 1986, an increase of $67.3 million, or 30 percent, over the same period last year. In addition to a $34.7

| *Analysis of Net Interest Income*[1] ($ in millions) | 3 Months Ended March 31, 1986 | 1985 | Increase (Decrease) Amount | Percent |
|---|---|---|---|---|
| ***Domestic Operations*** | | | | |
| Net interest income | $ 381.5 | $ 334.3 | $ 47.2 | 14 |
| Average earning assets | $33,747 | $30,510 | $3,237 | 11 |
| Net interest margin | 4.54% | 4.40% | 0.14% | — |
| ***International Operations*** | | | | |
| Net interest income | $ 59.8 | $ 58.0 | $ 1.8 | 3 |
| Average earning assets | $ 9,618 | $ 8,056 | $1,562 | 19 |
| Net interest margin | 2.49% | 2.91% | (0.42)% | — |
| ***Total*** | | | | |
| Net interest income | $ 441.3 | $ 392.3 | $ 49.0 | 12 |
| Average earning assets | $43,365 | $38,566 | $4,799 | 12 |
| Net interest margin | 4.09% | 4.08% | 0.01% | — |

(1) Fully taxable equivalent basis

million pre-tax gain on the sale of RMJ Securities Corp., this category included $15.9 million of gains on sales of investment securities, up from $0.3 million in the year-ago quarter. Other increases included loan fees, up $7.8 million, and foreign exchange gains, up $5.4 million. Securities-related transaction fees declined $5.4 million quarter-over-quarter, reflecting the sale of RMJ Securities Corp., although remaining activities in the Corporation generating these fees experienced growth. Gains on sales of equity securities, primarily in the Venture Capital Group, totaled $8.5 million in the 1986 first quarter, down from the first quarter 1985 level of $19.5 million.

### *Provision for Credit Losses*

The provision for credit losses increased $37.4 million from the comparable 1985 period to $116.2 million in the first quarter of 1986. The provision exceeded net credit losses by $29.5 million and further strengthened the reserve for credit losses. Net credit losses in the 1986 first quarter totaled $86.7 million compared to $78.6 million in the 1985 first quarter. The increase was concentrated in the consumer loan and lease categories. The largest increase was in Ready Reserve Account/charge card loans which reflects business development efforts in the latter part of 1984. It is expected that these losses will drop off later in the year.

At March 31, 1986, the reserve for credit losses was $591.3 million, an increase of $71.1 million from a year ago. The ratio of the reserve for credit losses to loans and leases outstanding was 1.63 percent at March 31, 1986, compared to 1.57 percent a year earlier and 1.50 percent at December 31, 1985.

### *Other Non-Interest Expense*

Total non-interest expense for the quarter was $467.1 million, up $61.4 million, or 15 percent, from the 1985 first quarter.

Total staff expense at $239.0 million increased 11 percent from the prior-year first quarter. Average full-time equivalent staff increased 2 percent from the prior-year quarter to 30,595 persons.

Other expense was $228.1 million, up 20 percent from the comparable 1985 quarter. Most major categories of other expense were above first quarter 1985 levels.

### *Income Tax*

The provision for income taxes declined between first quarters, reflecting a decline in the effective tax rate to 31.6 percent from 36.4 percent in the year-ago quarter. The

### *Analysis of Non-Performing Loans and Leases*

| $ in millions | 1986 First Quarter | 1985 Fourth Quarter | 1985 Third Quarter | 1985 Second Quarter | 1985 First Quarter |
|---|---|---|---|---|---|
| End of period: | | | | | |
| Non-accrual loans and leases: | | | | | |
| Domestic: | | | | | |
| Real estate related business | $ 100 | $ 108 | $ 147 | $ 128 | $ 136 |
| Energy | 255 | 194 | 280 | 316 | 291 |
| Agriculture | 149 | 128 | 116 | 124 | 116 |
| Other (primarily business) | 356 | 319 | 357 | 346 | 256 |
| International | 194 | 218 | 244 | 248 | 233 |
| Total non-accrual loans and leases | 1,054 | 967 | 1,144 | 1,162 | 1,032 |
| Restructured loans and leases: | | | | | |
| Domestic: | | | | | |
| Real estate related business | 9 | 153 | 152 | 153 | 153 |
| Other (primarily business) | 8 | 14 | 19 | 4 | 4 |
| Total restructured loans and leases | 17 | 167 | 171 | 157 | 157 |
| Total non-performing loans and leases | $1,071 | $1,134 | $1,315 | $1,319 | $1,189 |
| As a percent of total loans and lease financing[1] | 2.96% | 3.06% | 3.79% | 3.92% | 3.59% |
| Net reduction in interest income | $ 25.5 | $ 12.3 | $ 34.8 | $ 34.2 | $ 27.8 |

(1) Based on period-end balances.

decline resulted primarily from a higher proportion of income being taxed at the lower capital gains rate.

*Status of Significant International Credits*

Total outstandings to Mexico at March 31, 1986, were approximately $515 million, of which approximately $315 million and $200 million were to the public sector, which includes banks, and the private sector, respectively. Interest payments on public-sector debt were generally current. Non-performing Mexican private-sector loans totaled $22 million at March 31, 1986, compared to $23 million at December 31, 1985.

The Mexican government, the International Monetary Fund (IMF), and the World Bank are currently holding discussions concerning the Mexican government's financial requirements. Mexico's financial request for 1986 may approximate $6 billion due to the impact of declining world oil prices. In addition, the Mexican government may seek interest rate concessions on its foreign debt. Once an agreement is reached with the IMF and the World Bank, negotiations will begin with the commercial banks comprising the lending group.

During the first quarter of 1986, the Corporation recognized approximately $7 million in interest income on Mexican public-sector outstandings. The Corporation received cash payments of about $8 million on Mexican public-sector outstandings, of which $7 million represented interest and $1 million represented principal.

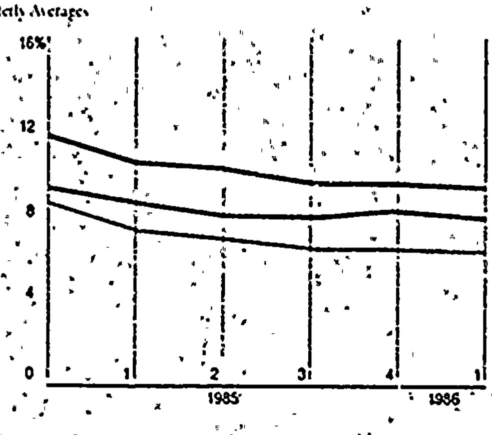
Total outstandings to Brazil at March 31, 1986, were approximately $570 million, substantially all of which were to governmental and financial institutions. Non-performing Brazilian loans were $13 million at March 31, 1986, unchanged from December 31, 1985.

During the quarter, Brazil and its Bank Advisory Group reached agreement on a 1985-86 financial plan which provides for a new $31 billion debt refinancing package. This proposal would restructure 1985 debt maturities for a seven year period, provide a one year postponement of 1986 principal maturities and a one year extension of trade and interbank credit lines. Under this new financial package, contractual spreads on those debt maturities would average 1½ percentage points above the London Interbank Offered Rate (LIBOR). The agreement is subject to the approval of the individual banks which comprise the lending group.

During the first quarter of 1986, the Corporation recognized approximately $15 million in interest income on Brazilian outstandings. The Corporation received cash payments of about $15 million on Brazilian outstandings, all of which represented interest payments.

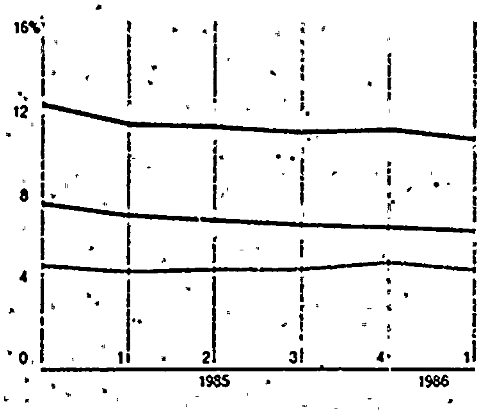
*Prime, Federal Funds, and Insured Money Market Account Rates*

Quarterly Averages




- Prime Rate
- Federal Funds Rate
- Insured Money Market Account Rate.

*Domestic Net Interest Margin*




- Yield on Earning Assets
- Interest Cost of Funds for Earning Assets
- Net Interest Margin

## Consolidated Balance Sheet

*Security Pacific Corporation and Subsidiaries*

| $ in millions | March 31 1986 | March 31 1985 | Increase (Decrease) |
|---|---|---|---|
| ***Assets*** | | | |
| Cash and due from banks | $ 4,423 | $ [illegible] | $ 887 |
| Due from banks—interest bearing | 2,135 | 2,681 | (546) |
| Investment securities | 2,329 | 1,925 | 404 |
| Trading account assets | 911 | 240 | 671 |
| Federal funds sold and securities under resale agreements | 962 | 920 | 42 |
| Loans | 33,481 | 30,873 | 2,608 |
| Lease financing | 2,710 | 2,229 | 481 |
| Total loans and lease financing | 36,191 | 33,102 | 3,089 |
| Less reserve for credit losses | 591 | 520 | 71 |
| Net loans and lease financing | 35,600 | 32,582 | 3,018 |
| Premises and equipment | 684 | 616 | 68 |
| Customers' acceptance liability | 991 | 1,275 | (284) |
| Earned interest receivable | 410 | 417 | (7) |
| Real estate owned | 158 | 127 | 31 |
| Other assets | 1,501 | 903 | 598 |
| Total assets | $50,104 | $45,222 | $4,882 |
| ***Liabilities*** | | | |
| Demand deposits in domestic offices | $ 7,704 | $ 6,209 | $1,495 |
| Interest/checking deposits in domestic offices | 2,408 | 2,019 | 389 |
| Insured money market accounts in domestic offices | 4,394 | 4,265 | 129 |
| Other savings accounts in domestic offices | 1,906 | 1,737 | 169 |
| Time deposits in domestic offices—under $100,000 | 3,565 | 3,411 | 154 |
| Time deposits in domestic offices—$100,000 and over | 6,205 | 6,110 | 95 |
| Total deposits in domestic offices | 26,182 | 23,751 | 2,431 |
| Deposits in foreign branches and international subsidiaries | 6,781 | 6,987 | (206) |
| Total deposits | 32,963 | 30,738 | 2,225 |
| Federal funds purchased and securities under repurchase agreements | 2,424 | 2,485 | (61) |
| Commercial paper | 2,528 | 2,306 | 222 |
| Other short-term funds borrowed | 2,300 | 1,775 | 525 |
| Intermediate-term debt | 2,752 | 1,707 | 1,045 |
| Long-term debt | 844 | 443 | 401 |
| Subordinated capital notes | 500 | 500 | — |
| Acceptances outstanding | 991 | 1,275 | (284) |
| Accrued interest, taxes and other expense | 1,283 | 1,164 | 119 |
| Other liabilities | 1,011 | 812 | 199 |
| Total liabilities | 47,596 | 43,205 | 4,391 |
| ***Stockholders' Equity*** | | | |
| Preferred stock—without par value<br>Shares authorized 1986 and 1985—5,000,000<br>Shares issued 1986—[illegible] | 150 | — | 150 |
| Common stock—$10 par value<br>Shares authorized 1986—200,000,000 1985—100,000,000<br>Shares issued 1986—76,850,091 1985—73,749,999 | 769 | 737 | 32 |
| Surplus | 519 | 466 | 53 |
| Undivided profits | 1,070 | 825 | 245 |
| | 2,508 | 2,028 | 480 |
| Less common stock in treasury, at cost<br>1986—[illegible] shares 1985—584,116 shares | — | 11 | (11) |
| Total stockholders' equity | 2,508 | 2,017 | 491 |
| Total liabilities and stockholders' equity | $50,104 | $45,222 | $4,882 |

**Consolidated Statement of Earnings**

*Security Pacific Corporation and Subsidiaries*

| $ in millions, except per share amounts | Three Months Ended March 31 1986 | 1985 | Increase (Decrease) |
|---|---|---|---|
| ***Interest Income*** | | | |
| Loans | $ 951.8 | $ [illegible] | $ 39.7 |
| Balances due from banks | 47.6 | 69.9 | (22.3) |
| State and municipal investment securities | 4.4 | 4.8 | (0.4) |
| Other investment securities | 45.5 | 37.6 | 7.9 |
| Trading account assets | 23.3 | 6.1 | 17.2 |
| Lease financing | 71.3 | 63.7 | 7.6 |
| Total interest income | 1,143.9 | 1,094.2 | 49.7 |
| ***Interest Expense*** | | | |
| Deposits | 454.8 | 493.2 | (38.4) |
| Federal funds purchased and securities under repurchase agreements | 69.1 | 76.9 | (7.8) |
| Commercial paper | 53.3 | 49.5 | 3.8 |
| Other short-term funds borrowed | 43.4 | 29.8 | 13.6 |
| Intermediate-term debt | 77.0 | 50.9 | 26.1 |
| Long-term debt | 28.4 | 20.6 | 7.8 |
| Total interest expense | 726.0 | 720.9 | 5.1 |
| ***Net Interest Income*** | 417.9 | 373.3 | 44.6 |
| ***Provision for Credit Losses*** | 116.2 | 78.8 | 37.4 |
| Net interest income less provision for credit losses | 301.7 | 294.5 | 7.2 |
| ***Non-Interest Income*** | | | |
| Loan fees | 43.8 | 36.0 | 7.8 |
| Service charges on deposit accounts | 43.0 | 39.7 | 3.3 |
| Securities-related transaction fees | 35.5 | 40.9 | (5.4) |
| Fiduciary and investment management fees | 22.9 | 18.0 | 4.9 |
| International fees and other income | 19.3 | 16.8 | 2.5 |
| Investment securities gains | 15.9 | 0.3 | 15.6 |
| Charge card merchant fees | 14.0 | 11.8 | 2.2 |
| Gain on sale of equity securities | 8.5 | 19.5 | (11.0) |
| Trading account profits | 4.6 | 6.6 | (2.0) |
| Other income | 86.5 | 37.1 | 49.4 |
| Total non-interest income | 294.0 | 226.7 | 67.3 |
| ***Other Non-Interest Expense*** | | | |
| Staff expense | 239.0 | 216.2 | 22.8 |
| Net occupancy—premises | 46.5 | 42.3 | 4.2 |
| Furniture and equipment expense | 37.2 | 28.4 | 8.8 |
| Telecommunications expense | 16.0 | 13.3 | 2.7 |
| Other operating expense | 128.4 | 105.5 | 22.9 |
| Total other non-interest expense | 467.1 | 405.7 | 61.4 |
| ***Income Before Income Taxes*** | 128.6 | 115.5 | 13.1 |
| Income taxes | 40.7 | 42.0 | (1.3) |
| ***Net Income*** | $ 87.9 | $ 73.5 | $ 14.4 |
| Net income applicable to common stock | $ 85.9 | $ 73.5 | $ 12.4 |
| ***Net Income Per Common Share*** | $ 1.11 | $ 1.00 | $ 0.11 |
| Average common shares and share equivalents (millions) | 77.1 | 73.5 | 3.6 |

## Consolidated Statement of Changes in Stockholders' Equity

*Security Pacific Corporation and Subsidiaries*

| $ in millions | Three Months Ended March 31 1986 | 1985 |
|---|---|---|
| Balance, beginning of period | $2,439.0 | [illegible] |
| Net income | 87.9 | [illegible] |
| Common dividends | (25.7) | [illegible] |
| Preferred dividends | (2.0) | – |
| Issuance of common stock (net) | 1.3 | [illegible] |
| Net treasury stock transactions | 7.0 | 2.4 |
| Translation adjustments | 0.5 | (0.1) |
| Balance, end of period | $2,508.0 | [illegible] |

## Common Stock Data—Per Share

| | 1986 First Quarter | 1985 Fourth Quarter | 1985 Third Quarter | 1985 Second Quarter | 1985 First Quarter |
|---|---|---|---|---|---|
| Stock price[1]: | | | | | |
| High | $ 38[illegible] | $ 31[illegible] | $ 31[illegible] | $ 31[illegible] | $ 30[illegible] |
| Low | 27[illegible] | 25[illegible] | 25[illegible] | 26[illegible] | 25[illegible] |
| End of period | 38[illegible] | 31[illegible] | 25[illegible] | 30[illegible] | 28[illegible] |
| Book value | $30.69 | $29.90 | $29.12 | $28.30 | $27.57 |
| Dividend paid | $0.335 | $0.335 | $0.335 | $0.335 | $0.305 |
| Dividend yield[2] | 3.47% | 4.11% | 5.33% | 4.39% | 4.30% |
| Net income | $ 1.11 | $ 1.13 | $ 1.14 | $ 1.08 | $ 1.00 |
| Price-to-earnings ratio[3] | 8.66x | 7.33x | 5.83x | 7.28x | 7.02x |

(1) Based on closing prices as reported on the Composite Tape and published in the Western Edition of The Wall Street Journal.
(2) Based on stock price and annualized dividend rate at end of period.
(3) Based on most recent twelve months reported net income and end of period stock price.

### *Notes to Consolidated Financial Statements*

*Net Income Per Common Share:*

The average number of shares used in the computation of net income per common share has been adjusted for the share equivalents from the assumed exercise of dilutive stock options and incentive plan awards. Also, for the purpose of this computation, net income is decreased by the amount of preferred stock dividends.

*Taxes on Investment Securities Gains:*

For the three months ended March 31, taxes related to securities gains in 1986 were $8.1 million and in 1985 were $0.1 million.

*Issuance of Intermediate and Long-Term Debt:*

In January 1986, the Corporation issued approximately (U.S.) $93 million of Dutch guilder floating rate notes due January 31, 1996. The notes were issued at par and may not be redeemed prior to maturity.

In February 1986, the Corporation issued approximately (U.S.) $125 million of Australian dollar floating rate notes due February 1, 1991. The notes were issued at par and may be redeemed in whole or in part on any interest payment date after February 1989.

In March 1986, the Corporation issued $150 million of [illegible]% notes due March 1, 1996. The notes were issued at 99.5% of par and may be redeemed in whole or in part on or after March 1, 1993.

*Sale of Subsidiary:*

In March 1986, the Corporation sold RMJ Securities Corp., a New York based U.S. government securities broker, for cash totaling approximately $54 million. The sale resulted in a pretax gain of approximately $34.7 million.

**Consolidated Statement of Condition**

*Security Pacific National Bank and Subsidiaries*

| In millions | March 31 1986 | 1985 | Increase (Decrease) |
|---|---|---|---|
| ***Assets*** | | | |
| Cash and due from banks | $ 4,386 | $ [illegible] | $ 877 |
| Due from banks—interest bearing | 1,791 | 2,356 | (565) |
| Investment securities | | | |
| U.S. Treasury securities | 1,282 | 1,165 | 117 |
| Other U.S. government securities | 9 | 63 | (54) |
| State and municipal securities | 306 | 340 | (34) |
| Other securities | 495 | 176 | 319 |
| Total investment securities | 2,092 | 1,744 | 348 |
| Trading account assets | 894 | 214 | 680 |
| Federal funds sold and securities under resale agreements | 1,157 | 1,002 | 155 |
| Loans | 27,521 | 26,191 | 1,330 |
| Lease financing | 2,121 | 1,935 | 186 |
| Total loans and lease financing | 29,642 | 28,126 | 1,516 |
| Less reserve for credit losses | 460 | 422 | 38 |
| Net loans and lease financing | 29,182 | 27,704 | 1,478 |
| Premises and equipment | 605 | 542 | 63 |
| Customers' acceptance liability | 991 | 1,275 | (284) |
| Earned interest receivable | 371 | 389 | (18) |
| Real estate owned | 119 | 111 | 8 |
| Other assets | 678 | 303 | 375 |
| Total assets | $42,268 | $39,151 | $3,117 |
| ***Liabilities*** | | | |
| Demand deposits in domestic offices | $ 7,672 | $ 6,201 | $1,471 |
| Interest/checking deposits in domestic offices | 2,406 | 2,018 | 388 |
| Insured money market accounts in domestic offices | 4,390 | 4,262 | 128 |
| Other savings deposits in domestic offices | 1,905 | 1,737 | 168 |
| Time deposits in domestic offices—under $100,000 | 3,563 | 3,408 | 155 |
| Time deposits in domestic offices—$100,000 and over | 6,226 | 6,115 | 111 |
| Total deposits in domestic offices | 26,162 | 23,741 | 2,421 |
| Deposits in foreign branches and international subsidiaries | 6,683 | 6,999 | (316) |
| Total deposits | 32,845 | 30,740 | 2,105 |
| Federal funds purchased and securities under repurchase agreements | 2,398 | 2,477 | (79) |
| Subordinated long-term notes payable to parent company | 197 | 196 | 1 |
| Subordinated capital notes payable to parent company | 398 | 398 | — |
| Other funds borrowed | 1,989 | 945 | 1,044 |
| Acceptances outstanding | 991 | 1,275 | (284) |
| Accrued interest, taxes and other expense | 1,098 | 1,019 | 79 |
| Other liabilities | 453 | 341 | 112 |
| Total liabilities | 40,369 | 37,391 | 2,978 |
| ***Stockholder's Equity*** | | | |
| Common stock—$10 par value<br>Shares authorized and outstanding 1986 and 1985—55,000,000 | 550 | 550 | — |
| Surplus | 553 | 550 | 3 |
| Undivided profits | 796 | 660 | 136 |
| Total stockholder's equity | 1,899 | 1,760 | 139 |
| Total liabilities and stockholder's equity | $42,268 | $39,151 | $3,117 |

## Analysis of Quarterly Earnings

*Security Pacific Corporation and Subsidiaries*

| $ in millions | 1986 First Quarter | 1985 Fourth Quarter | 1985 Third Quarter | 1985 Second Quarter | 1985 First Quarter |
|---|---|---|---|---|---|
| ***Earnings Summary*** | | | | | |
| Interest income[1] | $1,167.3 | $1,196.[illegible] | $1,[illegible] | $1,136.4 | $1,113.2 |
| Interest expense | 726.0 | 730.5 | 727.8 | 725.8 | 720.9 |
| Net interest income | 441.3 | [illegible] | [illegible] | [illegible] | [illegible] |
| Non-interest income | 294.0 | [illegible] | [illegible] | [illegible] | 226.7 |
| Less provision for credit losses | 116.2 | 149.7 | 83.0 | 67.9 | 78.8 |
| Less other non-interest expense: | | | | | |
| Staff expense | 239.0 | 233.3 | 231.2 | 226.5 | 216.2 |
| Other expense | 228.1 | 232.9 | 218.6 | 209.4 | 189.5 |
| Total | 467.1 | 466.2 | 449.8 | 435.9 | 405.7 |
| Income before income taxes | 152.0 | 145.8 | 146.1 | 151.2 | 134.5 |
| Less adjustment[1] | 23.4 | 24.1 | 20.0 | 19.6 | 19.0 |
| Less income taxes | 40.7 | 35.6 | 42.1 | 52.4 | 42.0 |
| Net income | $ 87.9 | $ 86.1 | $ 84.0 | $ 79.2 | $ 73.5 |
| ***Earnings Ratios[2]*** | | | | | |
| *Ratios to average assets:* | | | | | |
| Net interest income[1] | 3.52% | 3.60% | 3.53% | 3.55% | 3.54% |
| Non-interest income | 2.35 | 2.42 | 2.15 | 2.12 | 2.04 |
| Less provision for credit losses | 0.93 | 1.22 | 0.69 | 0.59 | 0.71 |
| Less other non-interest expense: | | | | | |
| Staff expense | 1.91 | 1.91 | 1.94 | 1.96 | 1.95 |
| Other expense | 1.82 | 1.90 | 1.83 | 1.81 | 1.71 |
| Total | 3.73 | 3.81 | 3.77 | 3.77 | 3.66 |
| Income before income taxes | 1.21 | 1.19 | 1.22 | 1.31 | 1.21 |
| Net income | 0.70 | 0.70 | 0.70 | 0.69 | 0.66 |
| *Ratio of net income to:* | | | | | |
| Average common equity | 14.9% | 15.5% | 16.0% | 15.6% | 14.8% |
| Average total equity | 14.3 | 14.9 | 16.0 | 15.6 | 14.8 |

### Capital Adequacy Measures

| | 1986 First Quarter | 1985 Fourth Quarter | 1985 Third Quarter | 1985 Second Quarter | 1985 First Quarter |
|---|---|---|---|---|---|
| End of period: | | | | | |
| Stockholders' equity | $2,508 | $2,43[illegible] | [illegible] | $2,075 | $2,017 |
| Primary capital[3] | 3,561 | 3,46[illegible] | [illegible] | 3,089 | 3,031 |
| Total capital[4] | 4,288 | 3,932 | 3,416 | 3,444 | 3,390 |
| Ratios to quarterly average assets:[5] | | | | | |
| Stockholders' equity | 4.95% | 4.93% | [illegible] | 4.44% | 4.49% |
| Primary capital | 7.03 | 7.00 | [illegible] | 6.61 | 6.75 |
| Total capital | 8.46 | 7.95 | 7.07 | 7.37 | 7.55 |
| Ratios to end of period assets:[5] | | | | | |
| Stockholders' equity | 4.95% | 4.51% | 4.27% | 4.29% | 4.41% |
| Primary capital | 7.03 | 6.41 | 6.32 | 6.38 | 6.63 |
| Total capital | 8.46 | 7.28 | 6.81 | 7.12 | 7.41 |

(1) Includes amounts to convert non-taxable income, primarily securities income, to a fully taxable equivalent basis and to add the pretax equivalent of investment tax credits on leasing activities to interest income.
(2) Ratios are based on annualized income and expense.
(3) Includes stockholders' equity, the reserve for credit losses, mandatory convertible debt and minority interest.
(4) Includes primary capital and qualifying long-term debt.
(5) Based on adjusted assets as defined by bank regulators.

## Analysis of Non-Interest Income and Expense

*Security Pacific Corporation and Subsidiaries*

| $ in millions | 1986 First Quarter | 1985 Fourth Quarter | 1985 Third Quarter | 1985 Second Quarter | 1985 First Quarter |
|---|---|---|---|---|---|
| ***Non-Interest Income*** | | | | | |
| Loan fees: | | | | | |
| Domestic: | | | | | |
| Business | $ 26.8 | $ 28.5 | $ [illegible] | $ [illegible] | $ [illegible] |
| Real estate | 4.7 | 4.6 | 4.9 | 4.1 | 3.4 |
| Consumer | 9.8 | 10.6 | 10.9 | 10.8 | 9.5 |
| International | 2.5 | 2.6 | 2.8 | 1.9 | 2.1 |
| Total | 43.8 | 46.3 | 45.3 | 41.4 | 36.0 |
| Service charges on deposit accounts | 43.0 | 45.4 | 43.0 | 45.1 | 39.7 |
| Securities-related transaction fees | 35.5 | 48.5 | 50.6 | 52.2 | 40.9 |
| Fiduciary and investment management fees | 22.9 | 21.6 | 23.1 | 21.8 | 18.0 |
| International fees and other income: | | | | | |
| Foreign exchange gains | 8.0 | 4.3 | 7.6 | 2.8 | 2.6 |
| All other | 11.3 | 13.6 | 14.6 | 12.9 | 14.2 |
| Charge card merchant fees | 14.0 | 13.2 | 13.2 | 12.0 | 11.8 |
| Trading account profits | 4.6 | 7.5 | 2.5 | 5.2 | 6.6 |
| Mortgage loan servicing fees | 3.3 | 3.2 | 5.2 | 4.6 | 4.1 |
| Commercial service fees | 2.8 | 2.8 | 2.9 | 2.6 | 2.8 |
| Escrow fees | 1.5 | 1.8 | 1.7 | 1.8 | 1.6 |
| Investment securities gains | 15.9 | 3.4 | 0.1 | 1.0 | 0.3 |
| Gains on sales of equity securities | 8.5 | 28.6 | 20.3 | 5.6 | 19.5 |
| All other | 78.9 | 55.4 | 26.5 | 35.4 | 28.6 |
| Total | $ 294.0 | $ 296.1 | $ 256.6 | $ 244.4 | $ 226.7 |
| ***S*** | | | | | |
| and other compensation | $ 201.2 | $ 202.5 | $ 198.6 | $ 190.7 | $ 182.8 |
| on and other benefits | 37.8 | 30.8 | 32.6 | 35.8 | 33.4 |
| Total | $ 239.0 | $ 233.3 | $ 231.2 | $ 226.5 | $ 216.2 |
| Average full time equivalent staff | 30,595 | 30,380 | 30,593 | 30,528 | 29,930 |
| Average annual staff expense per employee | $31,250 | $30,712 | $30,240 | $29,676 | $28,890 |
| ***Other Expense*** | | | | | |
| Net occupancy—premises | $ 46.5 | $ 44.9 | $ 43.9 | $ 46.6 | $ 42.3 |
| Furniture and equipment | 37.2 | 36.5 | 34.6 | 32.5 | 28.4 |
| Telecommunications | 16.0 | 17.9 | 16.6 | 13.0 | 13.3 |
| Postage and delivery | 10.5 | 10.4 | 10.4 | 9.7 | 10.0 |
| Advertising and promotion | 9.0 | 9.0 | 9.6 | 8.4 | 9.4 |
| Stationery and supplies | 10.0 | 9.9 | 9.7 | 9.8 | 8.1 |
| Travel | 7.8 | 9.2 | 8.9 | 9.1 | 7.1 |
| All other | 91.1 | 95.1 | 85.0 | 80.3 | 70.9 |
| Total | $ 228.1 | $ 232.9 | $ 218.6 | $ 209.4 | $ 189.5 |

**…erly Consolidated Balance Sheet**

*…ity Pa… …ration and Subsidiaries*

| $ in millions | 1986 March 31, | 1985 December 31, | September 30 | June 30 | March 31 |
|---|---|---|---|---|---|
| **…s** | | | | | |
| Cash and due from banks | $ 4,423 | $ 5,279 | $ 4,737 | $ 3,768 | $ 3,5[illegible] |
| Due from banks—interest bearing | 2,135 | 2,730 | 3,273 | 3,049 | 2,63[illegible] |
| Investment securities | 2,329 | 2,0[illegible]4 | 2,0[illegible] | 1,87[illegible] | 1,[illegible] |
| Trading account assets | 911 | 1,457 | 862 | 554 | 240 |
| Federal funds sold and securities under resale agreements | 962 | 921 | 971 | 1,376 | 920 |
| Loans | 33,481 | 34,482 | 32,307 | 31,301 | 30,873 |
| Lease financing | 2,710 | 2,582 | 2,388 | 2,361 | 2,229 |
| Total loans and lease financing | 36,191 | 37,064 | 34,695 | 33,662 | 32,102 |
| Less reserve for credit losses | 591 | 554 | 542 | 527 | 520 |
| Net loans and lease financing | 35,600 | 36,510 | 34,153 | 33,135 | 32,582 |
| Premises and equipment | 684 | 689 | 664 | 635 | 616 |
| Customers' acceptance liability | 991 | 1,218 | 1,102 | 1,145 | 1,275 |
| Earned interest receivable | 410 | 459 | 441 | 426 | 417 |
| Real estate owned | 158 | 144 | 132 | 132 | 127 |
| Other assets | 1,501 | 2,092 | 1,193 | 1,776 | 903 |
| Total assets | $50,104 | $53,503 | $49,594 | $47,874 | $45,222 |
| ***…lities*** | | | | | |
| Demand deposits in domestic offices | $ 7,704 | $ 7,849 | $ 6,865 | $ 6,327 | $ 6,209 |
| Interest-checking deposits in domestic offices | 2,408 | 2,293 | 2,116 | 2,073 | 2,019 |
| Insured money market accounts in domestic offices | 4,394 | 4,244 | 4,263 | 4,230 | 4,265 |
| Other savings accounts in domestic offices | 1,906 | 1,872 | 1,864 | 1,800 | 1,737 |
| Time deposits in domestic offices—under $100,000 | 3,565 | 3,465 | 3,544 | 3,528 | 3,411 |
| Time deposits in domestic offices—$100,000 and over | 6,205 | 6,111 | 6,383 | 6,236 | 6,110 |
| Total deposits in domestic offices | 26,182 | 25,640 | 25,055 | 24,194 | 23,751 |
| Deposits in foreign branches and …ational subsidiaries | 6,781 | 7,033 | 6,956 | 7,028 | 6,987 |
| …l deposits | 32,963 | 32,873 | 32,011 | 31,222 | 30,738 |
| …al funds purchased and securities under repurchase agreements | 2,424 | 4,689 | 3,669 | 3,181 | 2,485 |
| Commercial paper | 2,528 | 2,687 | 3,082 | 2,656 | 2,306 |
| Other short-term funds borrowed | 2,300 | 2,856 | 2,345 | 2,235 | 1,775 |
| Intermediate-term debt | 2,752 | 2,406 | 1,930 | 1,788 | 1,707 |
| Long-term debt | 844 | 603 | 334 | 440 | 443 |
| Subordinated capital notes | 500 | 500 | 500 | 500 | 500 |
| Acceptances outstanding | 991 | 1,341 | 1,102 | 1,145 | 1,275 |
| Accrued interest, taxes and other expense | 1,283 | 1,334 | 1,255 | 1,176 | 1,164 |
| Other liabilities | 1,011 | 1,775 | 1,225 | 1,456 | 812 |
| Total liabilities | 47,596 | 51,064 | 47,453 | 45,799 | 43,205 |
| ***…holders' Equity*** | | | | | |
| Preferred stock | 150 | 150 | — | — | — |
| Common stock | 769 | 768 | 739 | 738 | 737 |
| Surplus | 519 | 519 | 466 | 466 | 466 |
| Undivided profits | 1,070 | 1,007 | 943 | 880 | 825 |
| | 2,508 | 2,444 | 2,148 | 2,084 | 2,028 |
| Less common stock in treasury, at cost | — | 5 | 7 | 9 | 11 |
| Total stockholders' equity | 2,508 | 2,439 | 2,141 | 2,075 | 2,017 |
| Total liabilities and stockholders' equity | $50,104 | $53,503 | $49,594 | $47,874 | $45,222 |

**Quarterly Consolidated Balance Sheet**

*Security Pacific Corporation and Subsidiaries*

| $ in millions | 1986 March 31, | 1985 December 31 | September 30 | June 30 | March 31 |
|---|---|---|---|---|---|
| ***Assets*** | | | | | |
| Cash and due from banks | $ 4,423 | $ 5,273 | $ 4,737 | [illegible] | $ 3,636 |
| Due from banks—interest bearing | 2,135 | 2,730 | 3,273 | [illegible] | 2,651 |
| Investment securities | 2,329 | [illegible] | [illegible] | [illegible] | [illegible] |
| Trading account assets | 911 | 1,457 | [illegible] | 554 | 240 |
| Federal funds sold and securities under resale agreements | 962 | [illegible] | 971 | 1,376 | 920 |
| Loans | 33,481 | 34,482 | 32,307 | 31,301 | 30,873 |
| Lease financing | 2,710 | 2,582 | 2,388 | 2,361 | 2,229 |
| Total loans and lease financing | 36,191 | 37,064 | 34,695 | 33,662 | 32,102 |
| Less reserve for credit losses | 591 | 554 | 542 | 527 | 520 |
| Net loans and lease financing | 35,600 | 36,510 | 34,153 | 33,135 | 32,582 |
| Premises and equipment | 684 | 689 | 664 | 635 | 616 |
| Customers' acceptance liability | 991 | 1,218 | 1,102 | 1,145 | 1,275 |
| Earned interest receivable | 410 | 459 | [illegible] | 426 | 417 |
| Real estate owned | 158 | 144 | 132 | 132 | 127 |
| Other assets | 1,501 | 2,092 | 1,198 | 1,776 | 903 |
| Total assets | $50,104 | $53,503 | $49,594 | $47,674 | $45,222 |
| ***Liabilities*** | | | | | |
| Demand deposits in domestic offices | $ 7,704 | $ 7,849 | $ 6,855 | $ 6,327 | $ 6,209 |
| Interest/checking deposits in domestic offices | 2,408 | 2,293 | 2,116 | 2,073 | 2,019 |
| Insured money market accounts in domestic offices | 4,394 | 4,244 | 4,263 | 4,230 | 4,265 |
| Other savings accounts in domestic offices | 1,906 | 1,872 | 1,864 | 1,809 | 1,737 |
| Time deposits in domestic offices—under $100,000 | 3,565 | 3,465 | 3,544 | 3,523 | 3,411 |
| Time deposits in domestic offices—$100,000 and over | 6,205 | 6,111 | 6,383 | 6,236 | 6,110 |
| Total deposits in domestic offices | 26,182 | 25,640 | 25,055 | 24,194 | 23,751 |
| Deposits in foreign branches and international subsidiaries | 6,781 | 7,033 | 6,956 | 7,028 | 6,987 |
| Total deposits | 32,963 | 32,673 | 32,011 | 31,222 | 30,739 |
| Federal funds purchased and securities under repurchase agreements | 2,424 | 4,689 | 3,669 | 3,181 | 2,485 |
| Commercial paper | 2,528 | 2,687 | 3,082 | 2,656 | 2,306 |
| Other short-term funds borrowed | 2,300 | 2,856 | 2,345 | 2,235 | 1,775 |
| Intermediate-term debt | 2,752 | 2,406 | 1,930 | 1,788 | 1,707 |
| Long-term debt | 844 | 603 | 334 | 440 | 442 |
| Subordinated capital notes | 500 | 500 | 500 | 500 | 500 |
| Acceptances outstanding | 991 | 1,341 | 1,102 | 1,145 | 1,275 |
| Accrued interest, taxes and other expense | 1,283 | 1,334 | 1,255 | 1,176 | 1,104 |
| Other liabilities | 1,011 | 1,775 | 1,225 | 1,456 | 612 |
| Total liabilities | 47,596 | 51,064 | 47,453 | 45,799 | 43,205 |
| ***Stockholders' Equity*** | | | | | |
| Preferred stock | 150 | 150 | — | — | — |
| Common stock | 769 | 766 | 739 | 738 | 737 |
| Surplus | 519 | 519 | 466 | 466 | 466 |
| Undivided profits | 1,070 | 1,007 | 943 | 880 | 825 |
| | 2,508 | 2,444 | 2,148 | 2,084 | 2,028 |
| Less common stock in treasury, at cost | — | 5 | 7 | 9 | [illegible] |
| Total stockholders' equity | 2,508 | 2,439 | 2,141 | 2,075 | 2,017 |
| Total liabilities and stockholders' equity | $50,104 | $53,503 | $49,594 | $47,674 | $45,222 |

## Analysis of Loans and Reserve for Credit Losses

*Security Pacific Corporation and Subsidiaries*

| $ in millions | 1986 March 31 | 1985 December 31 | September 30 | June 30 | March 31 |
|---|---|---|---|---|---|
| ***Composition of Loan Portfolio*** | | | | | |
| Domestic loans: | | | | | |
| Business loans: | | | | | |
| Commercial and industrial loans | $ 9,543 | $ 9,837 | $ [illegible] | $ [illegible] | $ 9,507 |
| Construction loans | 1,703 | [illegible] | [illegible] | [illegible] | 1,345 |
| Loans for purchasing or carrying securities | 1,169 | 2,059 | 1,256 | [illegible] | 1,235 |
| Loans to financial institutions | 609 | 557 | 549 | [illegible] | 540 |
| Other business loans | 1,399 | 1,605 | 1,415 | 1,469 | 1,330 |
| Total business loans | 14,423 | 15,710 | 14,127 | 13,626 | 13,957 |
| Real estate loans:(1) | | | | | |
| 1–4 family residential properties | 3,875 | 3,915 | 3,989 | 4,025 | 4,004 |
| Other real estate loans | 1,334 | 1,306 | 1,226 | 1,135 | 1,087 |
| Total real estate loans | 5,209 | 5,221 | 5,215 | 5,160 | 5,091 |
| Consumer loans: | | | | | |
| Ready ReserveAccount/charge card loans | 869 | 914 | 890 | 873 | 869 |
| Other consumer loans | 6,953 | 6,853 | 6,562 | 6,258 | 5,826 |
| Total consumer loans | 7,822 | 7,767 | 7,452 | 7,131 | 6,695 |
| Total domestic loans | 27,454 | 28,698 | 26,794 | 26,117 | 25,743 |
| International loans | 6,027 | 5,784 | 5,513 | 5,184 | 5,130 |
| Total | $33,481 | $34,482 | $32,307 | $31,301 | $30,873 |

| ***Analysis of Reserve for Credit Losses*** | 1986 First Quarter | 1985 Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|---|---|---|---|---|
| Balance, beginning of period | $ 554.4 | $ 541.6 | $ 527.3 | $ 520.2 | $ 519.8 |
| Provision for losses charged to expense | 116.2 | 149.7 | 83.0 | 67.9 | 78.8 |
| Other(2) | 7.4 | 2.5 | 1.4 | 4.2 | 0.2 |
| Amount charged off | (101.9) | (157.8) | (69.3) | (87.3) | (99.2) |
| Recoveries | 15.2 | 18.4 | 19.2 | 22.3 | 20.6 |
| Net credit losses | (86.7) | (139.4) | (70.1) | (65.0) | (78.6) |
| Balance, end of period | $ 591.3 | $ 554.4 | $ 541.6 | $ 527.3 | $ 520.2 |
| End of period reserve for credit losses as percent of | | | | | |
| Total loans and lease financing | 1.63% | 1.50% | 1.56% | 1.57% | 1.57% |
| Adjusted total loans and lease financing(3) | 1.83 | 1.67 | 1.76 | 1.78 | 1.79 |

| ***Analysis of Net Credit Losses*** | 3 Months Ended March 31, 1986 | 1985 |
|---|---|---|
| Domestic loans: | | |
| Business loans | $ 48.7 | $ 50.9 |
| Ready ReserveAccount/charge card loans | 10.2 | 6.5 |
| Other consumer loans | 18.1 | 16.6 |
| Real estate loans(1) | 0.2 | 0.1 |
| International loans | 4.1 | 2.2 |
| Total net loan losses | 81.3 | 76.3 |
| Lease financing | 5.4 | 2.3 |
| Total net credit losses | $ 86.7 | $ 78.6 |

(1) Permanent loans secured by first mortgages or the equivalent.
(2) Includes additions from acquisitions and foreign currency translation adjustments.
(3) Excludes permanent real estate loans secured by 1–4 family residential properties.

## Consolidated Average Balance Sheet and Related Yields and Rates

*Security Pacific Corporation and Subsidiaries*

| $ in millions | Average Balances | | | | |
|---|---|---|---|---|---|
| | 1986 | 1985 | | | |
| | First Quarter | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| ***Assets*** | | | | | |
| Earning assets: | | | | | |
| Due from banks—interest bearing | $ 2,359 | $ [illegible] | $ [illegible] | $ [illegible] | $ [illegible] |
| State and municipal investment securities | 353 | 362 | 371 | 379 | 387 |
| Other investment securities | 1,885 | [illegible] | 1,600 | 1,528 | 1,487 |
| Total investment securities | 2,238 | [illegible] | 1,971 | 1,907 | 1,874 |
| Trading account assets | 1,137 | 895 | 632 | 398 | 263 |
| Federal funds sold | 1,399 | 132 | 1,000 | 1,149 | 1,074 |
| Domestic loans: | | | | | |
| Business loans | 14,665 | 14,391 | 14,376 | 14,006 | 13,810 |
| Real estate loans | 5,209 | 5,245 | 5,209 | 5,174 | 5,079 |
| Ready ReservAccount/charge card loans | 900 | 896 | 882 | 870 | 864 |
| Other consumer loans | 6,849 | 6,666 | 6,379 | 5,964 | 5,618 |
| Total domestic loans | 27,623 | 27,198 | 26,846 | 26,014 | 25,371 |
| International loans: | | | | | |
| Business loans | 5,313 | 5,140 | 4,832 | 4,727 | 4,652 |
| Consumer loans | 632 | 545 | 484 | 418 | 366 |
| Total international loans | 5,945 | 5,685 | 5,316 | 5,145 | 5,018 |
| Total loans | 33,568 | 32,883 | 32,162 | 31,159 | 30,389 |
| Lease financing | 2,664 | 2,488 | 2,375 | 2,309 | 2,150 |
| Less reserve for credit losses | 560 | 528 | 535 | 521 | 515 |
| Total net loans and lease financing | 35,672 | 34,843 | 34,002 | 32,947 | 32,024 |
| Total earning assets(2) | 43,365 | 42,281 | 41,330 | 39,967 | 38,566 |
| Cash and due from banks | 3,544 | [illegible] | 3,372 | 3,219 | 3,037 |
| Other non-earning assets | 3,789 | 3,876 | 3,638 | 3,561 | 3,302 |
| Total assets | $50,138 | $48,951 | $47,805 | $46,226 | $44,390 |
| ***Liabilities and Stockholders' Equity*** | | | | | |
| Non-interest bearing deposits: | | | | | |
| Domestic demand deposits | $ 6,487 | $ 6,463 | $ 6,147 | $ 5,936 | $ 5,715 |
| International deposits | 210 | 303 | 232 | 220 | 268 |
| Total non-interest bearing deposits | 6,697 | 6,766 | 6,379 | 6,156 | 5,983 |
| Interest bearing deposits: | | | | | |
| Interest checking deposits | 2,266 | 2,175 | 2,085 | 2,016 | 1,914 |
| Insured money market accounts | 4,376 | 4,329 | 4,292 | 4,175 | 4,167 |
| Other savings deposits | 1,876 | 1,863 | 1,828 | 1,746 | 1,717 |
| Other time deposits—under $100,000 | 3,490 | 3,470 | 3,511 | 3,478 | 3,359 |
| Time deposits—$100,000 and over | 6,121 | 6,273 | 6,072 | 5,850 | [illegible] |
| International deposits | 6,483 | 6,622 | 6,610 | 6,508 | 6,138 |
| Total interest bearing deposits | 24,612 | 24,737 | 24,398 | 23,773 | 23,200 |
| Total deposits | 31,309 | 31,503 | 30,777 | 29,929 | 29,183 |
| Federal funds purchased | 3,761 | 3,212 | 3,653 | 3,792 | 3,726 |
| Commercial paper | 2,571 | 2,781 | 2,826 | 2,400 | 2,226 |
| Other short-term funds borrowed | 2,363 | 2,009 | 2,091 | 2,002 | 1,527 |
| Intermediate-term debt | 2,701 | 2,169 | 1,857 | 1,754 | 1,714 |
| Long-term debt | 1,206 | 1,013 | 883 | 940 | 801 |
| Total interest bearing deposits and liabilities | 37,214 | 35,921 | 35,708 | 34,661 | 33,194 |
| Other liabilities | 3,765 | 3,950 | 3,612 | 3,373 | 3,231 |
| Preferred stock | 150 | 137 | — | — | — |
| Common equity | 2,312 | 2,177 | 2,106 | 2,036 | 1,982 |
| Stockholders' equity | 2,462 | 2,314 | 2,106 | 2,036 | 1,982 |
| Total liabilities and stockholders' equity | $50,138 | $48,951 | $47,805 | $46,226 | $44,390 |

(1) Fully taxable equivalent basis. (2) Before deduction of reserve for credit losses.

Yields and Rates (%)

| | 1986 | 1985 | | | |
|---|---|---|---|---|---|
| | First Quarter | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| | 8.19 | 8.46 | [illegible] | 9.30 | [illegible] |
| | 9.68 | 9.62 | 9.76 | 9.80 | 9.64 |
| | 9.72 | 9.32 | 9.55 | 9.86 | 10.22 |
| | 9.72 | 9.36 | 9.59 | 9.85 | 10.10 |
| | 9.59 | 9.25 | 10.66 | 10.41 | 10.18 |
| | 7.38 | 7.83 | 7.80 | 7.87 | 8.45 |
| | 9.29 | 9.99 | 9.50 | 10.00 | 10.11 |
| | 10.74 | 10.74 | 11.00 | 10.99 | 10.95 |
| | 18.98 | 19.23 | 18.77 | 18.73 | 19.29 |
| | 14.67 | 14.87 | 15.05 | 15.29 | 15.64 |
| | 11.21 | 11.64 | 11.42 | 11.70 | 11.82 |
| | 10.83 | 10.90 | 10.22 | 10.95 | 11.72 |
| | 14.09 | 14.87 | 15.41 | 16.23 | 16.65 |
| | 11.17 | 11.28 | 10.69 | 11.37 | 12.06 |
| | 11.21 | 11.57 | 11.30 | 11.65 | 11.86 |
| | 12.77 | 14.22 | 13.69 | 14.00 | 14.27 |
| | — | — | — | — | — |
| | 11.50 | 11.94 | 11.64 | 11.99 | 12.21 |
| | 10.88 | 11.24 | 11.06 | 11.40 | 11.66 |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | 5.18 | 5.22 | 5.23 | 5.30 | 5.46 |
| | 6.09 | 6.12 | 6.13 | 6.71 | 7.27 |
| | 5.38 | 5.38 | 5.37 | 5.39 | 5.36 |
| | 8.83 | 9.08 | 9.49 | 9.71 | 10.25 |
| | 8.43 | 8.54 | 8.69 | 9.30 | 9.63 |
| | 8.25 | 8.29 | 8.46 | 8.97 | 9.57 |
| | 7.49 | 7.60 | 7.75 | 8.19 | 8.62 |
| | 5.89 | 5.96 | 6.14 | 6.50 | 6.85 |
| | 7.45 | 7.73 | 7.63 | 7.79 | 8.36 |
| | 8.40 | 8.61 | 8.46 | 9.29 | 9.02 |
| | 9.68 | 10.20 | 10.43 | 9.66 | 9.28 |
| | 11.40 | 11.39 | 11.84 | 11.93 | 11.88 |
| | 9.42 | 9.85 | 9.78 | 9.98 | 10.30 |
| | 7.90 | 8.03 | 8.09 | 8.40 | 8.80 |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |
| | — | — | — | — | — |

## alysis [illegible] stic and International Net Interest Income

*urity [illegible] poration and Subsidiaries*

| $ in millions | | 1986 First Quarter | |
|---|---|---|---|
| | Average Balance | Interest Income/Expense | Average Rate % |
| ***mestic Operations*** (1) | | | |
| Earning assets | | | |
| Loans | $27,623 | $ 766.3 | 11.21 |
| Lease financing | 1,953 | 61.1 | 12.52 |
| Investment securities | 1,799 | 39.4 | 8.83 |
| Federal funds sold | 1,399 | 23.3 | 7.38 |
| Trading account assets | 766 | 17.8 | 9.30 |
| Due from banks—interest bearing | 207 | 3.9 | 7.53 |
| Total earning assets | 33,747 | 911.8 | 10.91 |
| Net sources of funds (2) | | | |
| Demand deposits | 4,071 | — | — |
| Interest/checking deposits | 1,895 | 29.0 | 6.20 |
| Insured money market accounts | 4,253 | 65.7 | 6.27 |
| Other savings deposits | 1,875 | 24.9 | 5.39 |
| Other time deposits—under $100,000 | 3,491 | 76.0 | 8.83 |
| Total core deposits | 15,585 | 195.6 | 5.09 |
| Time deposits—$100,000 and over | 6,031 | 127.3 | 8.56 |
| Borrowed funds | 10,121 | 199.5 | 7.99 |
| Funds supplied by or (to) international operations | (29) | 7.9 | — |
| Total | 31,708 | 530.3 | 6.78 |
| All other sources of funds | 2,039 | — | — |
| Total sources of funds | $33,747 | 530.3 | 6.37 |
| Domestic net interest income and margin | — | $ 381.5 | 4.54 |
| ***ernational Operations*** (1) | | | |
| Earning assets: | | | |
| ans | $ 5,945 | $ 163.8 | 11.17 |
| from banks—interest bearing | 2,152 | 43.8 | 8.25 |
| se financing | 711 | 23.9 | 13.47 |
| Trading account assets | 371 | 9.4 | 10.20 |
| Investment securities | 439 | 14.6 | 13.27 |
| Total earning assets | 9,618 | 255.5 | 10.74 |
| Net sources of funds (2) | | | |
| Non-interest bearing deposits | 132 | — | — |
| Interest bearing deposits | 6,473 | 131.9 | 8.27 |
| Borrowed funds | 2,481 | 71.7 | 11.73 |
| Funds supplied by or (to) domestic operations | 29 | (7.9) | — |
| Total | 9,115 | 195.7 | 8.71 |
| All other sources of funds | 503 | — | — |
| Total sources of funds | $ 9,618 | 195.7 | 8.25 |
| International net interest income and margin | — | $ 59.8 | 2.49 |
| ***al Domestic and International Operations*** (1) | | | |
| Earning assets | $43,365 | $1,167.3 | 10.88 |
| Sources of funds | $43,365 | 726.0 | 6.79 |
| Total net interest income and margin | — | $ 441.3 | 4.09 |

(1) Includes adjustments as follows

| | |
|---|---|
| To convert non-taxable income to fully taxable equivalent | $ 10.7 |
| Pretax equivalent of investment tax credits on leasing activities | 12.7 |
| Total | $ 23.4 |

(2) After deducting float and legal reserves

## Analysis of Domestic and International Net Interest Income

*Security Pacific Corporation and Subsidiaries*

| $ in millions | Average Balance | 1986 First Quarter Interest Income/Expense | Average Rate % |
|---|---|---|---|
| ***Domestic Operations***[1] | | | |
| Earning assets: | | | |
| Loans | $27,623 | $ 766.3 | 11.21 |
| Lease financing | 1,953 | 61.1 | 12.52 |
| Investment securities | 1,799 | 39.4 | 8.83 |
| Federal funds sold | 1,399 | 23.3 | 7.38 |
| Trading account assets | 766 | 17.8 | 9.30 |
| Due from banks—interest bearing | 207 | 3.9 | 7.53 |
| Total earning assets | 33,747 | 911.8 | 10.91 |
| Net sources of funds[2]: | | | |
| Demand deposits | 4,071 | — | — |
| Interest/checking deposits | 1,895 | 29.0 | 6.20 |
| Insured money market accounts | 4,253 | 65.7 | 6.27 |
| Other savings deposits | 1,875 | 24.9 | 5.39 |
| Other time deposits—under $100,000 | 3,491 | 76.0 | 8.83 |
| Total core deposits | 15,585 | 195.6 | 5.09 |
| Time deposits—$100,000 and over | 6,031 | 127.3 | 8.56 |
| Borrowed funds | 10,121 | 199.5 | 7.99 |
| Funds supplied by or (to) international operations | (29) | 7.9 | — |
| Total | 31,708 | 530.3 | 6.78 |
| All other sources of funds | 2,039 | — | — |
| Total sources of funds | $33,747 | 530.3 | 6.37 |
| Domestic net interest income and margin | — | $ 381.5 | 4.54 |
| ***International Operations***[1] | | | |
| Earning assets: | | | |
| Loans | $ 5,945 | $ 163.8 | 11.17 |
| Due from banks—interest bearing | 2,152 | 43.8 | 8.25 |
| Lease financing | 711 | 23.9 | 13.47 |
| Trading account assets | 371 | 9.4 | 10.20 |
| Investment securities | 439 | 14.6 | 13.27 |
| Total earning assets | 9,618 | 255.5 | 10.74 |
| Net sources of funds[2] | | | |
| Non-interest bearing deposits | 132 | — | — |
| Interest bearing deposits | 6,473 | 131.9 | 8.27 |
| Borrowed funds | 2,481 | 71.7 | 11.73 |
| Funds supplied by or (to) domestic operations | 29 | (7.9) | — |
| Total | 9,115 | 195.7 | 8.71 |
| All other sources of funds | 503 | — | — |
| Total sources of funds | $ 9,618 | 195.7 | 8.25 |
| International net interest income and margin | — | $ 59.8 | 2.49 |
| ***Total Domestic and International Operations***[1] | | | |
| Earning assets | $43,365 | $1,167.3 | 10.88 |
| Sources of funds | $43,365 | 726.0 | 6.79 |
| Total net interest income and margin | — | $ 441.3 | 4.09 |

(1) Includes adjustments as follows:

| | |
|---|---|
| To convert non-taxable income to fully taxable equivalent | $ 10.7 |
| Pretax equivalent of investment tax credits on leasing activities | 12.7 |
| Total | $ 23.4 |

(2) After deducting float and legal reserves

| | [illegible] | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Fourth Quarter | | | Third Quarter | | | Second Quarter | | | First Quarter | | |
| Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Interest Income/ Expense | Average Rate % | Average Balance | Interest Income/ Expense | Average Rate % |
| $27,198 | $ 796.1 | 11.64 | $26,846 | $ 770.9 | 11.42 | $26,014 | $ [illegible] | 11.70 | [illegible] | $ [illegible] | [illegible] |
| 1,866 | 66.2 | 14.18 | 1,833 | 60.7 | 13.25 | 1,798 | 61.7 | 13.73 | 1,676 | 58.7 | 13.99 |
| 1,685 | 38.3 | 9.05 | 1,798 | 43.7 | 9.64 | 1,792 | 44.4 | 9.95 | 1,780 | 44.5 | 10.08 |
| 1,132 | 20.7 | 7.83 | 1,099 | 21.1 | 7.80 | 1,149 | 22.6 | 7.87 | 1,074 | 21.8 | 8.45 |
| 575 | 13.3 | 9.23 | 389 | 8.5 | 8.77 | 303 | 6.8 | 9.01 | 202 | 5.0 | 9.85 |
| 278 | 5.4 | 7.67 | 299 | 5.5 | 7.37 | 321 | 6.1 | 7.57 | 405 | 8.3 | 8.36 |
| 32,734 | 940.0 | 11.42 | 32,264 | 910.4 | 11.22 | 31,377 | 900.9 | 11.51 | 30,510 | 880.0 | 11.65 |
| 4,106 | — | — | 3,928 | — | — | 3,604 | — | — | 3,556 | — | — |
| 1,818 | 28.6 | 6.24 | 1,743 | 27.5 | 6.26 | 1,685 | 26.6 | 6.34 | 1,539 | 25.9 | 6.56 |
| 4,208 | 66.8 | 6.29 | 4,175 | 66.2 | 6.30 | 4,063 | 69.9 | 6.90 | 4,057 | 74.7 | 7.47 |
| 1,867 | [illegible] | 5.38 | 1,827 | 24.8 | 5.38 | 1,746 | 23.4 | 5.39 | 1,716 | 22.7 | 5.36 |
| 3,471 | [illegible] | 9.08 | 3,513 | 84.0 | 9.49 | 3,481 | 84.3 | 9.71 | 3,360 | 84.6 | 10.24 |
| 15,470 | 200.2 | 5.13 | 15,186 | 202.5 | 5.29 | 14,779 | 204.2 | 5.54 | 14,268 | 208.1 | 5.91 |
| 6,172 | 135.0 | 8.68 | 5,976 | 133.1 | 8.83 | 5,755 | 135.6 | 9.45 | 5,807 | 140.2 | 9.79 |
| 9,040 | 196.9 | 8.64 | 9,623 | 199.9 | 8.24 | 9,383 | 196.5 | 8.40 | 8,672 | 189.9 | 8.88 |
| 78 | 7.3 | — | (34) | 6.2 | — | 31 | 7.9 | — | 93 | 7.5 | — |
| 30,760 | 539.4 | 6.96 | 30,751 | 541.7 | 6.99 | 29,948 | 544.2 | 7.29 | 28,860 | 545.7 | 7.67 |
| 1,974 | — | — | 1,513 | — | — | 1,429 | — | — | 1,650 | — | — |
| $32,734 | 539.4 | 6.54 | $32,264 | 541.7 | 6.66 | $31,377 | 544.2 | 6.96 | $30,510 | 545.7 | 7.25 |
| — | $ 400.6 | 4.88 | — | $ 368.7 | 4.56 | — | $ 356.7 | 4.55 | — | $ 334.3 | 4.40 |
| $ 5,685 | $ 161.7 | 11.28 | $ 5,316 | $ 143.2 | 10.69 | $ 5,145 | $ 145.9 | 11.37 | $ 5,018 | $ 149.5 | 12.08 |
| 2,692 | 58.0 | 8.54 | 2,792 | 64.7 | 9.20 | 2,724 | 64.5 | 9.50 | 2,411 | 61.6 | 10.35 |
| 622 | 22.2 | 14.32 | 542 | 20.6 | 15.19 | 511 | 19.1 | 14.94 | 472 | 18.0 | 15.26 |
| 321 | 7.5 | 9.28 | 243 | 7.4 | 12.13 | 95 | 3.5 | 14.87 | 61 | 1.7 | 11.25 |
| 227 | 6.7 | 11.89 | 173 | 3.9 | 8.94 | 115 | 2.4 | 8.24 | 94 | 2.4 | 10.39 |
| 9,547 | 256.1 | 10.65 | 9,066 | 239.8 | 10.50 | 8,590 | 235.4 | 10.99 | 8,056 | 233.2 | 11.73 |
| 221 | — | — | 167 | — | — | 160 | — | — | 205 | — | — |
| 6,613 | 138.4 | 8.31 | 6,603 | 140.9 | 8.46 | 6,502 | 145.5 | 8.98 | 6,128 | 144.9 | 9.59 |
| 2,144 | 60.0 | 11.11 | 1,688 | 51.5 | 12.09 | 1,505 | 43.9 | 11.72 | 1,323 | 37.8 | 11.57 |
| (78) | (7.3) | — | 34 | (6.2) | — | (31) | (7.9) | — | (93) | (7.5) | — |
| 8,900 | 191.1 | 8.52 | 8,492 | 186.2 | 8.70 | 8,136 | 181.5 | 8.95 | 7,563 | 175.2 | 9.28 |
| 647 | — | — | 574 | — | — | 454 | — | — | 493 | — | — |
| $ 9,547 | 191.1 | 7.94 | $ 9,066 | 186.2 | 8.14 | $ 8,590 | 181.5 | 8.48 | $ 8,056 | 175.2 | 8.82 |
| — | $ 65.0 | 2.71 | — | $ 53.6 | 2.36 | — | $ 53.9 | 2.51 | — | $ 58.0 | 2.91 |
| $42,281 | $1,196.1 | 11.24 | $41,330 | $1,150.2 | 11.06 | $39,967 | $1,136.3 | 11.40 | $38,566 | $1,113.2 | 11.66 |
| $42,281 | 730.5 | 6.85 | $41,330 | 727.9 | 6.98 | $39,967 | 725.7 | 7.28 | $38,566 | 720.9 | 7.58 |
| — | $ 465.6 | 4.39 | — | $ 422.3 | 4.08 | — | $ 410.6 | 4.12 | — | $ 392.3 | 4.08 |
| | $ 10.0 | | | $ 8.1 | | | $ 7.7 | | | $ 6.7 | |
| | 14.1 | | | 11.9 | | | 11.9 | | | 12.3 | |
| | $ 24.1 | | | $ 20.0 | | | $ 19.6 | | | $ 19.0 | |

## Analysis of Investment Securities Portfolio[1]

*Security Pacific Corporation and Subsidiaries*

| $ in millions | March 31, 1986 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Maturity | | | | | | | | Total Carrying Value | | Total Market Value | Average Maturity |
| | Within 1 Year | | 1-5 Years | | 6-10 Years | | After 10 Years | | | | | |
| | Amt. | Yield | Amt. | Yield | Amt. | Yield | Amt. | Yield | Amt. | Yield | Value | Yrs. Mos.[2] |
| U.S. Treasury | $643 | 8.38 | [illegible] | 7.86 | [illegible] | [illegible] | [illegible] | | [illegible] | [illegible] | [illegible] | [illegible] 10 |
| Other U.S. government | — | — | — | — | — | — | 10 | [illegible] | 10 | [illegible] | 10 | 21 10 |
| State and municipal | 34 | 8.60 | 95 | 6.65 | 79 | 10.63 | 139 | [illegible] | 350 | 9.71 | 308 | 9 7 |
| Other bonds, notes and debentures | 54 | 6.39 | 319 | 12.49 | 10 | 8.97 | 9 | [illegible] | 392 | [illegible] | 391 | 3 4 |
| Federal Reserve Bank and other stock | — | — | — | — | — | — | — | — | 285 | — | 305 | — |
| Total | $731 | 8.24 | $963 | 9.47 | $192 | 8.83 | $158 | 9.97 | $2,329 | 7.91 | $2,319 | 3 6 |

## Distribution of Net Income By Organization

| $ in millions | Net Income 3 Months Ended March 31, 1986 | 1985 | Percentage Contribution 1986 | 1985 | Return on Average Assets 1986 | 1985 |
|---|---|---|---|---|---|---|
| California Banking and Real Estate Industries System | $30.9 | $21.4 | 35% | 29% | 0.68% | 0.48% |
| Capital Markets System | 33.0 | 23.6 | 37 | 32 | 0.62 | 0.49 |
| Financial Services System | 27.8 | 30.6 | 32 | 42 | 1.27 | 1.78 |
| Other | (3.8) | (2.1) | (4) | (3) | — | — |
| Total | $87.9 | $73.5 | 100% | 100% | 0.70% | 0.66% |

## Financial Services System—Net Income

| $ in millions | Net Income 3 Months Ended March 31, 1986 | 1985 |
|---|---|---|
| Consumer services group | | |
| Consumer finance | $ 7.1 | $ 6.2 |
| Insurance services | 3.9 | 2.9 |
| Other | (1.0) | (0.1) |
| Total | 10.0 | 9.0 |
| Commercial finance & leasing group | | |
| Leasing | 10.2 | 9.2 |
| Business credit | 4.2 | 2.5 |
| Auto finance | 3.1 | 5.0 |
| Housing services | 1.1 | 0.1 |
| Total | 18.6 | 16.8 |
| Venture capital group | 4.9 | 8.6 |
| Undistributed corporate expense[3] | (5.7) | (3.8) |
| Total | $27.8 | $30.6 |

(1) Yields on fully taxable equivalent basis.
(2) Excludes Federal Reserve Bank and other stock.
(3) After tax basis.

*ecurity Pacific Corporation and Security Pacific National Bank*

| | |
|---|---|
| seph F. Alibrandi | Chairman of the Board and Chief Executive [illegible] (diversified [illegible] company) |
| bert Anderson | Chairman of the Board and Chief Executive [illegible] Corporation (multi-industry company) |
| G. Boswell II | Chairman of the Board and Chief Executive Officer [illegible] Company [illegible] |
| aloo H. Burnside | President and Chief Operating Officer, Carter Hawley Hale Stores, Inc. (department and specialty retail stores) |
| rt Clark | Vice Chairman of the Board, Retired, Transamerica Corporation, Chairman of the Board, The Clark Agency (insurance agency) |
| mm F. Crull | President and Chief Executive Officer, Carnation Company (food and related products processor) |
| chard J. Flamson III | Chairman of the Board and Chief Executive Officer of SPC<br>Chairman of the Board of the Bank |
| amilla C. Frost | Chairman of the Board of Trustees, Los Angeles County Museum of Art |
| onald E. Guinn | Chairman of the Board and Chief Executive Officer, Pacific Telesis Group (communications products and services) |
| arl E. Hartnack | Chairman of the Executive Committees of SPC and the Bank<br>Chairman of the Security Pacific International Board (an advisory committee to the Board of Directors of the Bank) |
| ank L. Hope, Jr. | Chairman, Hope Consulting Group (architectural and engineering firm) |
| wrence O. Kitchen | Chairman of the Board and Chief Executive Officer, Lockheed Corporation (aerospace, electronics, shipbuilding and information services) |
| ward W. Koch | Independent Motion Picture Director and Producer, affiliated with Paramount Pictures Corp. |
| eorge F. Moody | President and Chief Operating Officer of SPC<br>President and Chief Executive Officer of the Bank |
| ed W. O'Green | Chairman of the Board and Chief Executive Officer, Litton Industries, Inc. (multi-industry manufacturer) |
| enry T. S[illegible]rom | Managing Partner, C. J. Segerstrom & Sons (diversified real estate partnership) |
| Russ[illegible] | Chairman of the Executive Committee, Avery International Corporation (manufacturer of self-adhesive products) |
| bert H. Smith | Vice Chairman of the Board of SPC<br>Vice Chairman of the Board and Chief Operating Officer of the Bank |
| cques S. Yeager | President, E.L. Yeager [illegible] Company, Inc. (heavy engineering construction) |
| mes H. Zumberge | President, University of Southern California |

| | |
|---|---|
| vidend Reinvestment and ock Purchase Plan | Owners of Security Pacific Corporation common stock may reinvest their cash dividends in additional shares of SPC common stock at a five percent discount from the market price, as well as make optional cash payments for shares, without commissions or service charges. Stockholders who are not yet enrolled in the Dividend Reinvestment and Stock Purchase Plan, as well as brokers and custodians who hold common stock for clients, may obtain a prospectus and enrollment card by writing or calling Security Pacific National Bank, SPC Dividend Reinvestment and Stock Purchase Plan, P.O. Box 3546 Terminal Annex, Los Angeles, California 90051 (818) 507-2215. |

*rm 10-K and Additional Information*

r copies of Security Pacific Corporation's Form 10-K Annual Report for 1985, or additional information, contact Jay S. Gould, e President, H9-50, P.O. Box 2097, Terminal Annex, Los Angeles, California 90051, or telephone (213) 613-5568.

**Directors**

*Directors of Security Pacific Corporation and Security Pacific National Bank*

| | |
|---|---|
| Joseph F. Alibrandi | Chairman of the Board and Chief Executive [illegible] (diversified [illegible]) |
| Robert Anderson | Chairman of the Board and Chief Executive Officer, Rockwell International Corporation (multi-industry company) |
| J.G. Boswell II | Chairman of the Board and Chief Executive Officer, J.G. Boswell Company (agribusiness) |
| Waldo H. Burnside | President and Chief Operating Officer, Carter Hawley Hale Stores, Inc. (department and specialty retail stores) |
| Earl Clark | Vice Chairman of the Board, Retired, Transamerica Corporation; Chairman of the Board The Clark Agency (insurance agency) |
| Timm F. Crull | President and Chief Executive Officer, Carnation Company (food and related products processor) |
| Richard J. Flamson III | Chairman of the Board and Chief Executive Officer of SPC<br>Chairman of the Board of the Bank |
| Camilla C. Frost | Chairman of the Board of Trustees, Los Angeles County Museum of Art |
| Donald E. Guinn | Chairman of the Board and Chief Executive Officer, Pacific Telesis Group (communications products and services) |
| Carl E. Hartnack | Chairman of the Executive Committees of SPC and the Bank<br>Chairman of the Security Pacific International Board<br>(an advisory committee to the Board of Directors of the Bank) |
| Frank L. Hope, Jr. | Chairman, Hope Consulting Group (architectural and engineering firm) |
| Lawrence O. Kitchen | Chairman of the Board and Chief Executive Officer, Lockheed Corporation (aerospace, electronics, shipbuilding and information services) |
| Howard W. Koch | Independent Motion Picture Director and Producer affiliated with Paramount Pictures Corp. |
| George F. Moody | President and Chief Operating Officer of SPC<br>President and Chief Executive Officer of the Bank |
| Fred W. O'Green | Chairman of the Board and Chief Executive Officer, Litton Industries, Inc. (multi-industry manufacturer) |
| Henry T. Segerstrom | Managing Partner, C. J. Segerstrom & Sons (diversified real estate partnership) |
| H. Russell Smith | Chairman of the Executive Committee, Avery International Corporation (manufacturer of self-adhesive products) |
| Robert H. Smith | Vice Chairman of the Board of SPC<br>Vice Chairman of the Board and Chief Operating Officer of the Bank |
| Jacques S. Yeager | President, E.L. Yeager Construction Company, Inc. (heavy engineering construction) |
| James H. Zumberge | President, University of Southern California |

| | |
|---|---|
| Dividend Reinvestment and Stock Purchase Plan | Owners of Security Pacific Corporation common stock may reinvest their cash dividends in additional shares of SPC common stock at a five percent discount from the market price, as well as make optional cash payments for shares, without commissions or service charges. Stockholders who are not yet enrolled in the Dividend Reinvestment and Stock Purchase Plan, as well as brokers and custodians who hold common stock for clients, may obtain a prospectus and enrollment card by writing or calling Security Pacific National Bank, SPC Dividend Reinvestment and Stock Purchase Plan, P.O. Box 3546 Terminal Annex, Los Angeles, California 90051 (818) 507-2215. |

*Form 10-K and Additional Information*

For copies of Security Pacific Corporation's Form 10-K Annual Report for 1985, or additional information, contact Jay S. Gould, Vice President, H9-50, P.O. Box 2097, Terminal Annex, Los Angeles, California 90051; or telephone (213) 613-5568

END

# Safety-Kleen Corp. Annual Report 1985

## Company Profile

Seventeen years ago, Safety-Kleen was a small, regional parts cleaner service company located in Milwaukee. Profits were non-existent and the future was very uncertain. Then in October of 1968, Chicago Rawhide Manufacturing Company purchased this obscure firm and began developing the potential that had remained dormant since its inception.

Safety-Kleen Corp. was spun off from its parent in 1974, and today it is a fast-growing, continuously evolving company engaged in five separate, yet complementary services in the U.S. and abroad. Each of these provides a unique range of services to commercial and industrial customers. They are directed and controlled from corporate headquarters in Elgin, Illinois through a tightly structured system of branch operations and route sales representatives.

The first and largest Safety-Kleen service is concerned with the safe and efficient degreasing of small metal parts in vehicular and industrial markets. Safety-Kleen is the world's largest marketer of parts cleaner services, with operations in the United States, the United Kingdom, and Canada, and with licensed or joint venture operations in Australia, New Zealand, West Germany, France, Spain and Puerto Rico.

In performing the parts cleaner service, Company sales representatives supply parts cleaning equipment, solvent, and allied products to Safety-Kleen's customers, while also collecting used solvent for transport to Company-owned recycle centers.

In the four newer service areas which utilize common facilities or systems, Safety-Kleen provides grease filters, cleaning equipment and related supplies to restaurants; offers materials and services to the automotive body repair and paint refinishing market; provides a variety of cleaning solvents to larger industrial users, and reclaims those solvents for continued use; and collects filter cartridges and distillation residue from dry cleaners for recycling and solvent recovery.

More information about the Company's activities begins on page 7, with "Reclamation: The Best Alternative."

## Contents



[illegible] ment from contamination.

## Financial Highlights

| Fiscal Year Ended | December 28, 1985 | December 29, 1984[2] |
|---|---|---|
| Service revenues and sales | $221,080,000 | $185,630,000 |
| Net earnings | $ 27,185,000[1] | $ 19,428,000 |
| Working capital | $ 46,182,000 | $ 36,921,000 |
| Total assets | $176,885,000 | $140,537,000 |
| Shareholders' equity | $113,643,000 | $ 89,230,000 |
| Number of common shares outstanding at year-end | 21,441,528 | 14,114,011 |
| Financial Ratios | | |
| Net earnings to revenues and sales | 12.3%[1] | 10.5% |
| Net earnings to beginning shareholders' equity | 30.5%[1] | 27.6% |
| Current ratio | 2.5 to 1 | 2.4 to 1 |
| Number of Employees | 2,898 | 2,635 |
| Per Common Share[2] | | |
| Net earnings | $1.26[1] | $.93 |
| Cash dividends | $ .28 | $.20 |

[1]1985 net earnings include $3,706,000 ($.17 per share) for the cumulative effect of change in accounting for investment tax credits.

[2]All per share data has been restated for a three-for-two stock split on December 9, 1985. The December 29, 1984 Consolidated Balance Sheet has been restated for the acquisition of Custom Organics, Inc. as more fully described in Note 2 to the Consolidated Financial Statements, appearing on page 38.

## Market and Dividend Information

The Company's common stock is traded on the New York Stock Exchange. The approximate number of record holders of the Company's common stock at December 28, 1985, was 2,628.

The following table shows the range of common stock prices and cash dividends for the calendar quarters indicated. The quotations represent the high and low prices on the New York Stock Exchange as reported by The Wall Street Journal. All data has been restated for the three-for-two stock splits in December, 1984, and December, 1985.

| | 1985 | | | 1984 | | |
|---|---|---|---|---|---|---|
| Quarter Ended | Prices High | Prices Low | Cash Dividends Paid | Prices High | Prices Low | Cash Dividends Paid |
| March 31 | $22.33 | $16.17 | $.066 | $15.67 | $13.00 | $.044 |
| June 30 | 23.83 | 20.50 | .067 | 15.50 | 13.45 | .044 |
| September 30 | 25.58 | 21.42 | .067 | 18.55 | 14.44 | .045 |
| December 31 | 27.25 | 21.38 | .080 | 18.05 | 15.50 | .067 |
| | | | $.280 | | | $.200 |

The Company has continuously paid quarterly cash dividends since March, 1979. The Company expects to continue its policy of paying regular cash dividends, although there is no assurance as to future dividends, as they are dependent upon future earnings, capital requirements, financial condition of the Company and other factors. The payment of dividends is subject to the restrictions described in Note 6 to the Consolidated Financial Statements, appearing on page 39.

## History of Growth[1] (Amounts, except per share amounts, expressed in thousands)

| | Service Revenues and Sales | Net Earnings (Loss) | Net Earnings (Loss) Per Share | Shareholders' Equity (end of year) | Return on Equity (beginning of year) |
|---|---|---|---|---|---|
| 1985 | $221,080 | $27,185[2] | $1.26[2] | $113,643 | 30% |
| 1984 | 185,630 | 19,428 | .93 | 89,230[1] | 28 |
| 1983 | 162,771 | 15,759 | .76 | 70,302 | 28 |
| 1982 | 149,244 | 13,024 | .64 | 55,946 | 30 |
| 1981 | 134,887 | 10,977[3] | .55[3] | 44,120 | 32 |
| 1980 | 115,648 | 7,906 | .40 | 34,529 | 29 |
| 1979 | 89,471 | 6,180 | .32 | 27,428 | 36 |
| 1978 | 70,185 | 4,486[4] | .26[4] | 17,061 | 37 |
| 1977 | 56,066 | 3,430 | .20 | 12,228 | 39 |
| 1976 | 47,495 | 2,728 | .16 | 8,799 | 44 |
| 1975 | 36,998 | 2,165 | .13 | 6,143 | 55 |
| 1974 | 29,037 | 1,786 | .11 | 3,930 | 84 |
| 1973 | 21,137 | 1,476 | .09 | 2,136 | 210 |
| 1972 | 13,436 | 929 | .06 | 702 | —[5] |
| 1971 | 7,592 | 353 | .02 | (232) | —[5] |
| 1970 | 3,978 | (219) | (.01) | (536) | —[5] |
| 1969 | 1,199 | (400) | (.02) | (318) | —[5] |

[1] All data has been restated to reflect a two-for-one stock split on November 25, 1980, a three-for-two stock split on December 6, 1982, a three-for-two stock split on December 10, 1984, a three-for-two stock split on December 9, 1985, and the acquisition of American Impacts Corporation in 1980, accounted for on a pooling of interests basis. The December 29, 1984 Consolidated Balance Sheet has been restated for the acquisition of Custom Organics, Inc. as more fully described in Note 2 to the Consolidated Financial Statements, appearing on page 38.

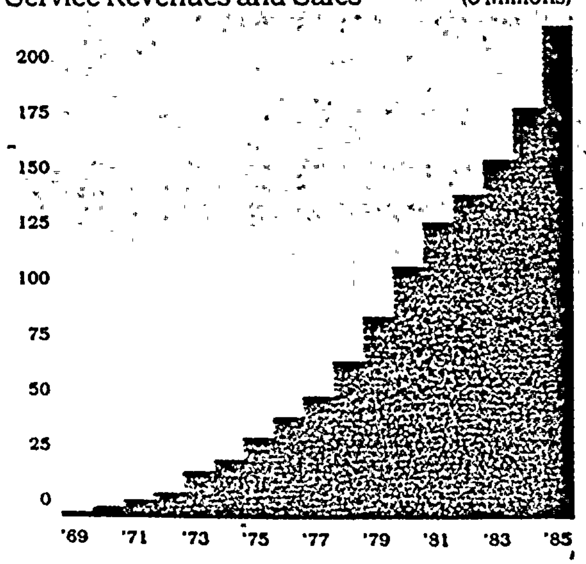
[2] 1985 net earnings include $3,706,000 ($.17 per share) for the cumulative effect of change in accounting for investment tax credits.

[3] 1981 net earnings include $975,000 ($.05 per share) for U.S. income tax benefits resulting from the sale of the Company's West German subsidiary.

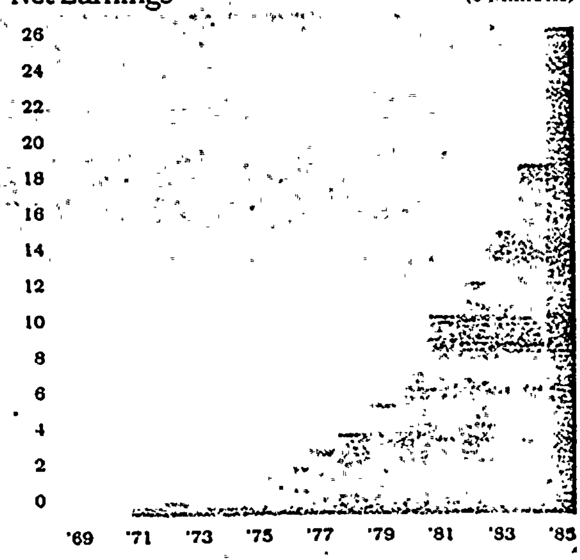
[4] A special bonus in the aggregate amount of $700,000 was approved by the Company's shareholders and paid to three executive officers in 1978.

[5] Negative amount.

Service Revenues and Sales ($ Millions)




Net Earnings ($ Millions)



## Interim Results of Operations (Unaudited)

(Expressed in thousands, except per share amounts)

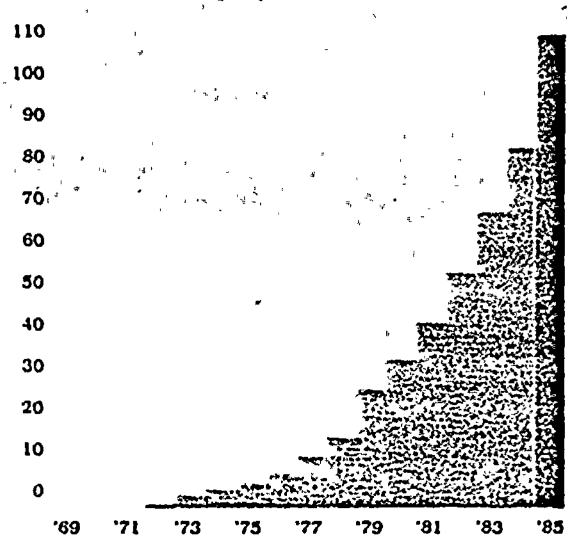
| Interim Period | Revenues and Sales 1985 | Revenues and Sales 1984 | Gross Profit 1985 | Gross Profit 1984 | Net Earnings 1985 | Net Earnings 1984[3] | Per Share 1985 | Per Share 1984 |
|---|---|---|---|---|---|---|---|---|
| First (12 weeks) | $ 47,610 | $ 40,367 | $15,615 | $12,930 | $ 8,625[1] | $ 4,069 | $ .40[1] | $.19 |
| Second (12 weeks) | 50,898 | 42,691 | 16,994 | 14,140 | 5,474 | 4,619 | .25 | .22 |
| Third (12 weeks) | 52,117 | 43,889 | 17,142 | 14,626 | 5,596 | 4,686 | .26 | .23 |
| Fourth (16 weeks) | 70,455 | 58,683 | 24,007 | 19,706 | 7,490 | 6,054 | .35 | .29 |
| Total | $221,080 | $185,630 | $73,758 | $61,402 | $27,185[1] | $19,428 | $1.26[1] | $.93 |

[1]Includes net earnings of $3,706,000 or $.17 per share for the cumulative effect of change in accounting for investment tax credits as more fully described in Note 1 to the Consolidated Financial Statements appearing on page 37.

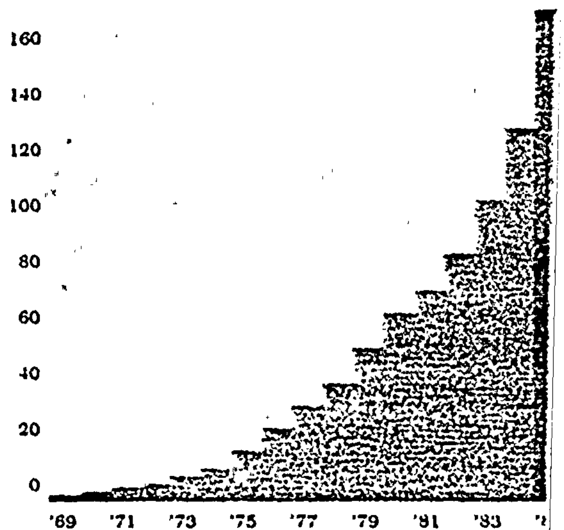
[2]Restated for three-for-two stock split on December 9, 1985, in the form of a 50 percent stock dividend.

[3]If the flow-through method of accounting for investment tax credits had been in effect in years prior to 1985, net earnings would have been $440,000 ($.02 per share) higher for the full year 1984.

Shareholders' Equity ($ Millions)




Total Assets ($ Millions)



Company is already serving over 30,000 customers in this market.

In August, the Company acquired Custom Organics, Inc. Located in Chicago, Custom Organics was a recycler of solvents and chemical intermediates. The facility is capable of recycling a broad range of industrial solvents including chlorinated, fluorinated and flammable solvents and thus has added a new dimension to Safety-Kleen's recycling capabilities. The addition of Dr. Gilbert Gavlin, Custom's founder, and his professional staff has also enhanced Safety-Kleen's technological base.

**Capital Expansion.** Capital expenditures in 1985 totaled almost $33 million. We anticipate 1986 expenditures to exceed $40 million. These expenditures are primarily for expansion and improvements to our solvent recycle centers and branches and for additions and replacements of field service vehicles. In addition, we are currently in the process of adding 18 "accumulation centers." These centers will service branches, collecting drums of waste from the dry cleaner program and other future small quantity generator programs. As truckload quantities are collected, they will be transported from the accumulation centers to the recycle centers. Eventually, we anticipate approximately 25 accumulation centers. We believe that the combination of 162 branches and 25 accumulation centers in the United States, all of which will be permitted as hazardous waste transfer and storage facilities, will put us in a unique position to serve small quantity generators of hazardous wastes. We know of no other company in the United States that has such a network of facilities.

**Director Changes.** Robert Burns and Clinton Youle will both retire as Directors effective with the May 9, 1986 Shareholders' meeting. Both have served as Directors since 1974, the year in which Safety-Kleen was spun-off from Chicago Rawhide, the former parent company. Both Bob and Clint have provided many years of valuable guidance to the Company. We thank them for their distinguished service and wish them the best in their retirement.

Richard T. Farmer, Chairman of the Board and Chief Executive Officer of Cintas Corporation, will stand for election as a new Director at our May 9, 1986 Shareholders' meeting. Mr. Farmer has been with Cintas since 1957 and has served in his present position since 1968. Under his leadership, Cintas has experienced very rapid and profitable growth. We are very pleased that he has agreed to serve as a Safety-Kleen Director.

**Stock Split.** On November 14, 1985, the Board of Directors declared a three-for-two stock split which was issued to shareholders on December 9, 1985, in the form of a 50% stock dividend. On January 6, 1986, the Company paid a quarterly cash dividend of $.08 per common share on the post-split shares. The stock split was the Company's fourth since the initial public offering in April, 1979, following a two-for-one split in November, 1980, and three-for-two splits in December, 1982 and December, 1984. The cash dividend represents a 20% increase in the payout. The Company previously paid $.10 per share on the pre-split shares. This was the sixth dividend increase the initial public offering.

**Outlook.** Our established long-range goals are to ach average growth of 15% to 20% per year in revenues and 2 to 25% in net earnings over the next five years. At the beginning of this report, we said that in 1985 net earni grew in excess of 20% for the fifteenth consecutive ye To gain a better perspective of this record, we recently researched data on all industrial companies who file rep with the Securities And Exchange Commission (some 6,500 companies) and found that only two other companies have ever recorded fifteen or more consecutive years of 20% earnings growth (before extraordinary ite Those companies are Automatic Data Processing, Inc. and McDonald's Corp. Both achieved sixteen consecu years of 20% or more earnings growth. It is gratifying t be in such distinguished company. We hope that Safety-Kleen will be able to tie the records of these two fine companies in 1986.

This record has not gone unnoticed by the investment community. Each month, Kidder, Peabody & Co. publish a list of the 50 highest Price/Earnings ratio stocks on t New York Stock Exchange. Safety-Kleen has been on t top 50 list each month since listing on the New York St Exchange in June, 1983.

We are confident that our established long-range sales and earnings goals can be achieved over the ne e ye To attain these goals, we believe that the core p ear service can grow in real terms at the rate of five seve percent per year with price increases approximating th rate of inflation. Over this time period, we expect the nev services to grow in revenues at the rate of 25 to 30% p year in the aggregate. These newer services accounted approximately 23% of revenues in 1985. By 1990, we exp them to account for almost one-third of total revenues.

With the continued support of our customers, shareholders, employees and suppliers, we look forward to a bright future for Safety-Kleen.

Russell A. Gwillim
Chairman of the Board

Donald W. Brinckman
President and Chief Executive Officer

# Reclamation: The Best Alternative

Reclamation, simply stated, is the process of taking waste material and making it usable again. This concept is not new, but in light of increasing environmental concerns, reclamation is being recognized as the best alternative to other waste handling methods.

Once, the world's natural resource supply was thought of as limitless. There would always be resources available, or modern technology would continue to develop materials and processes that would replace or extend nature's resources. The realization that resources are limited is now more widely understood, and once they are gone, there may be no substitute. Even the most visible resource, our drinking water, can become contaminated and made useless by the very technology counted on to improve the quality of life.

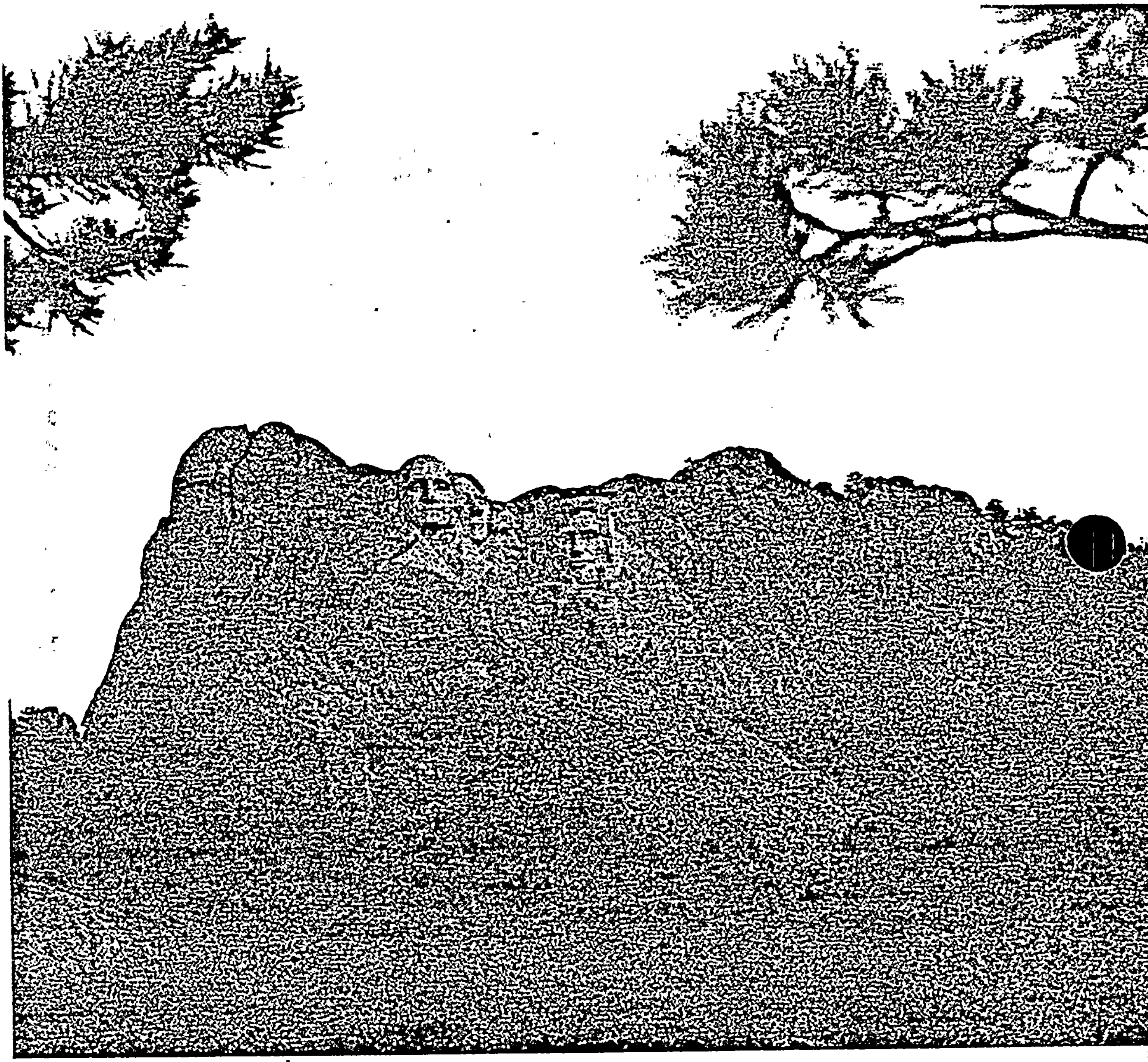
Looking toward the end of the twentieth century, we now face an environment that has become contaminated through generations of neglect. The new priority is to accept the challenge to conserve our resources and protect the environment from further damage. The process of reclamation does this—and its time has finally come.

In 1968, parts washing was usually performed with a brush and a bucket of gasoline, and the dirty gasoline usually found its way into the sewer system or onto the ground. Thus a valuable resource was discarded and the quality of ground water was compromised. Safety-Kleen's red "sink-on-a-drum" changed that through the utilization of a unique service concept. The Company would provide a parts cleaner machine for customers, use fresh mineral-spirits solvent to accomplish the task, and remove the spent solvent from the place of business.

Service to the customer was the top priority of Safety-Kleen then, just as it is now. The small company grew with such speed that environmentally sound disposal of large quantities of spent solvent began to become a problem. The Company had to figure out what to do with it. Reclamation of this material was the only reasonable alternative that the Company could accept. Disposing of the solvent by any other means would waste precious resources and possibly cause environmental damage.

In March 1970, after just fifteen months under the Company's present structure, Safety-Kleen opened its first recycle center in Elgin, Illinois. Since then, six more have been added to assure customers that wastes will be handled properly.

Safety-Kleen can best serve customers by providing a needed service, and taking disposal problems off their hands through the process of reclamation. On the following pages, the Company's commitment to conservation of resources and preservation of the environment will be discussed, explaining how the concepts of marketing and reclamation have been intertwined—helping to create a better environment. As a result of this business philosophy, Safety-Kleen, in 1985, achieved its seventeenth consecutive year of record revenues and fifteenth straight year of net earnings growth in excess of 20 percent. This result graphically illustrates how business and a healthy environment can coexist—through reclamation—the best alternative.



# The Problem—Proper Waste Disposal

Over the last twenty years, there has been increasing awareness that our waste disposal methods have been detrimental to a clean, healthy environment. In the 1960's, the primary concern centered on air quality. In the 1970's, this concern was extended to include contamination of our lakes and streams. Additionally, we became aware that our "ample" petroleum supply was not unlimited. In the 1980's, the contamination of groundwater was added to the list of concerns—a common supply that half the population of the U.S. depends upon for its everyday needs.

Public concern is now centering on what to do to rectify this situation. In 1976, Congress enacted the Resource Conservation and Recovery Act (RCRA) that directed the U.S. Environmental Protection Agency (EPA) to issue regulations that would stop or reduce further indiscriminate dumping of material found to be hazardous. Generators of hazardous waste material were required to dispose of defined hazardous wastes properly.

In addition, generators of hazardous waste were held responsible for their waste from its "cradle to grave." This provision of the law meant that the generator was liable for his waste and any environmental damage this waste caused, forever—even after "proper disposal."

"Large Quantity Generators" (those generating more than 2200 pounds or 1000 kilograms of hazardous waste in a single month) were also required to complete a manifest describing the hazardous waste content for each shipment.

*Man and nature have worked together in the past to preserve the environment in such a way that everyone and everything can enjoy the beauty of our natural, uncontaminated surroundings. Safety-Kleen's alternative to waste and contamination—reclamation—offers the best solution to the problem of disposal.*

In November 1984, Congress reauthorized RCRA, and this time, instructed the EPA to add further regulations covering a group of generators called "Small Quantity Generators" (or SQG's). This group includes any business or person that generates from 220 to 2200 pounds (100 to 1000 kilograms) of hazardous waste in any single calendar month.

The typical SQG businesses that are most affected by the new rules are service stations and other automotive repair facilities; manufacturing firms that use cleaning or degreasing solvents in their operations; and dry cleaner plants that generate still bottoms or used filter cartridges as part of the cleaning process.

These firms are required to dispose of the hazardous material in a responsible manner. If the waste is taken off-site for processing or disposal, a manifest must also be completed to accompany the shipment to the final treatment or disposal site. As the Resource Conservation and Recovery Act did in 1976, the reauthorized version again affirmed that generators of hazardous waste are responsible for their waste from "cradle to grave."

In those states authorized by the Federal government to operate the hazardous waste regulatory program, the states may have even more stringent regulations governing hazardous waste generators than is called for in the federal legislation. The laws of these states take precedence over the regulations of the U.S. EPA. There are even four states whose laws govern hazardous waste generators of as little as one pound of hazardous waste per month.

The environmental statutes are meant to do two things—conserve resources and protect the environment. Indiscriminate disposal of hazardous waste is no longer an option available to the generator, and proper disposal of the waste is everyone's concern.

The Congressional Budget Office recently estimated, using figures for 1983, that the United States annually generates nearly 266 million metric tons of hazardous waste. This quantity, almost beyond the limits of comprehension, points out the magnitude of the problem. It certainly will not go away by itself, because it has been ignored for years while the quantities of hazardous wastes have been multiplying.

If the environment is suffering because of this waste—and we now know that it is—industry and a responsible populace must face the challenge and respond to it. Safety-Kleen has, for over seventeen years, been doing its part through services to its customers, and disposal of the waste through reclamation. To Safety-Kleen, these wastes are a precious resource that can be used again—and the environment is protected from further damage.

## The Response—Serving Customers' Needs

The potential environmental problems posed by hazardous wastes require a positive response by all who generate, transport, store, or dispose of these wastes. Safety-Kleen has developed specific services for customers that not only help them solve their requirements for proper disposal in an environmentally sound manner, but also contribute to the conservation of valuable resources.

As a result, Safety-Kleen has experienced rapid growth over the past seventeen years. The Company has shown that doing small tasks well, while performing needed services for customers, can be done profitably—with a positive impact on the environment.

Safety-Kleen offers five services. In each one, resources are recovered and used again. What follows is a description of each of these services offered to distinct customer groups, and their relation to the Company's overall emphasis on reclamation as the way to both preserve the environment and conserve valuable resources.

**Parts Cleaner Service.** The core of Safety-Kleen's services began with two sizes of parts cleaners in 1968, and a unique marketing concept. In this service, the Safety-Kleen rep will provide the customers with a parts cleaner for his use; deliver a drum of clean mineral-spirits solvent to clean the parts; inspect and maintain the machine; and finally remove the spent mineral-spirits solvent from the customer's premises. Today, the basic parts cleaner service remains, from the customer's viewpoint, essentially unchanged.

Safety-Kleen has also established a parts cleaner service to users who own their own machines. This service, known as Customer Owned Machine Service (COMS), provides solvent service to these customers, along with the inherent benefit of reclamation of their spent solvent.

The Immersion Cleaner service provides a sealed drum containing an air motor agitated parts basket, along with a blend of chlorinated solvents, to firms having a need to remove heavy buildups of varnish and gum from such metal items as carburetors and automotive transmission parts. When the chlorinated blend is spent, the Safety-Kleen rep supplies clean solvent and returns the spent material to the branch. This material is also reclaimed by the Company.

A newer, light-weight parts cleaner, designed for the vast "do-it-yourself" handyman market as well as low-volume repair shops not requiring larger parts cleaners or more frequent solvent service, is a more recent addition to the parts cleaner service. The customer purchases the unit, which consists of a cleaning sink and self-contained solvent reservoir, from a local automotive or industrial distributor. When the user needs fresh solvent, he simply detaches the reservoir and returns it to his distributor for a tank of clean solvent.

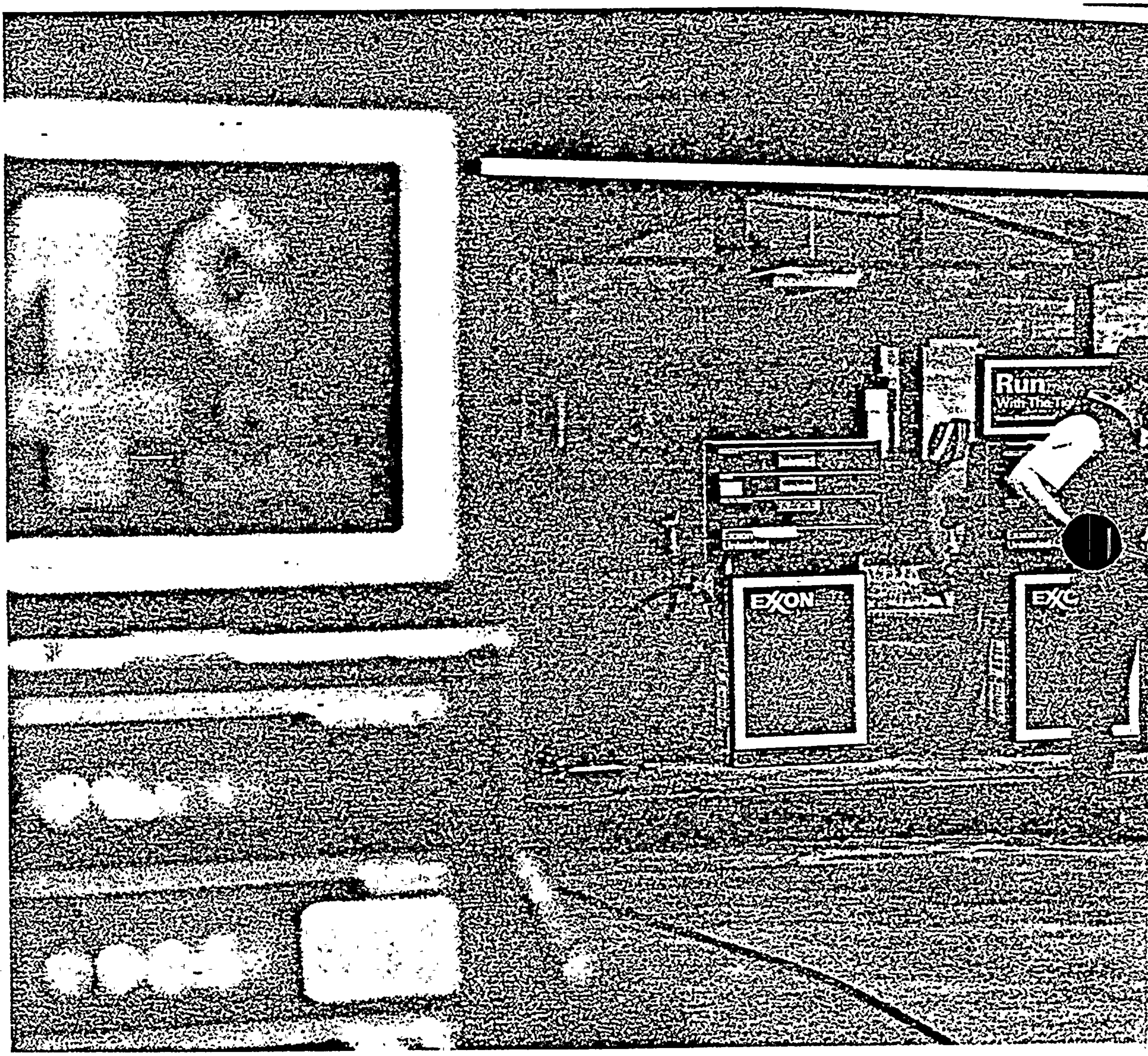
Periodically, the Safety-Kleen branch serving the distributor delivers clean solvent to him, and retrieves spent material for reclamation. This service provides the individual consumer with an alternative to the old "brush and bucket of gasoline" method of parts cleaning. The adverse environmental impact of the many thousands who are still using this method for cleaning parts is significant—and Safety-Kleen offers an economical and better disposal alternative to this type of environmental contamination.

There are over 279,000 businesses served by Safety-Kleen's parts cleaner service. They include automotive repair facilities and small manufacturing operations as well as large industrial firms. These businesses are served by 1,120 Safety-Kleen sales representatives operating out of 230 branches worldwide.

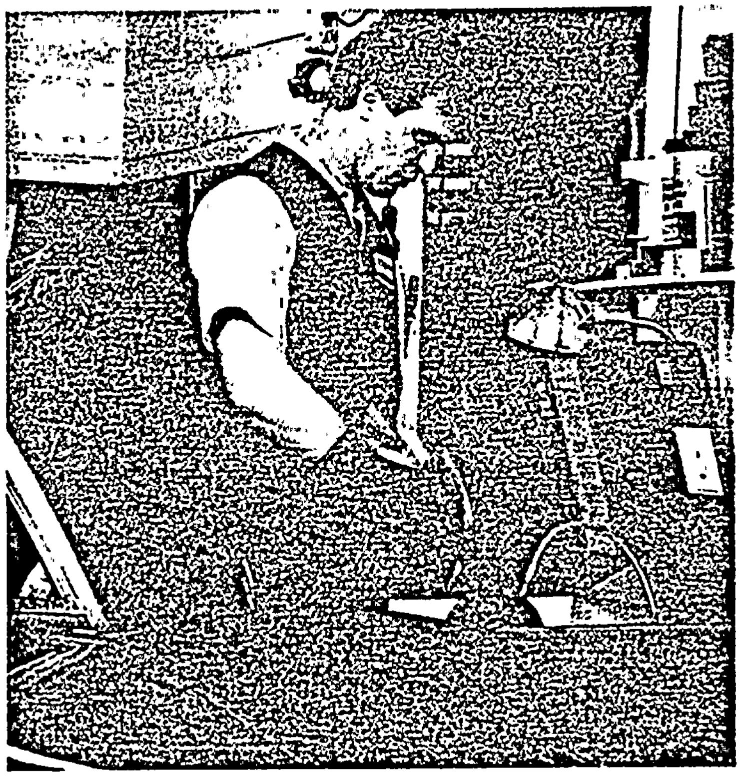
After the Safety-Kleen rep performs his services at these numerous businesses each day, a large amount of spent solvent has been collected. All of the solvent is stored at the branch, under conditions that meet or exceed governmental regulations, until a scheduled Safety-Kleen truck loads it for transportation to the recycle center.

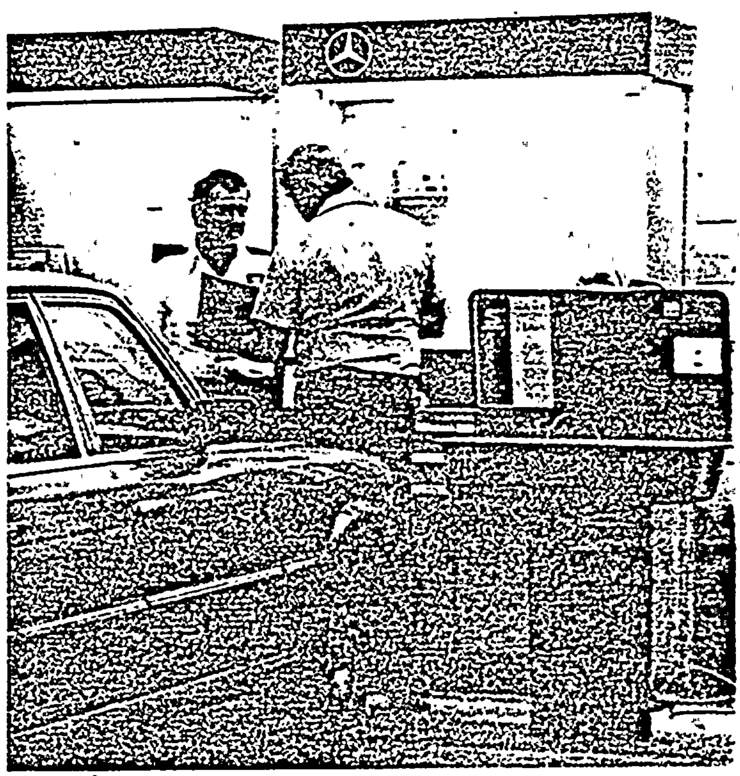
Through the Safety-Kleen rep and the branch network, the Company delivers and recovers the mineral-spirits and chlorinated solvents used by its customers in the parts cleaner service. Instead of disposing of hazardous waste cleaning solvent in an environmentally damaging way, Safety-Kleen offers an alternative to these businesses that is economical, practical and safe. A disposal problem is thus eliminated because of the Company's reclamation program. Natural resources are conserved, and the environment is protected from further contamination.

*Safety-Kleen's parts cleaner service is used by over 279,000 businesses throughout the United States, Canada, the United Kingdom, West Germany, France, Japan and Puerto Rico. Geographically, these customers are located in small hamlets or large metropolitan centers. They are served by 1120 sales representatives who operate out of 230 branches worldwide.*



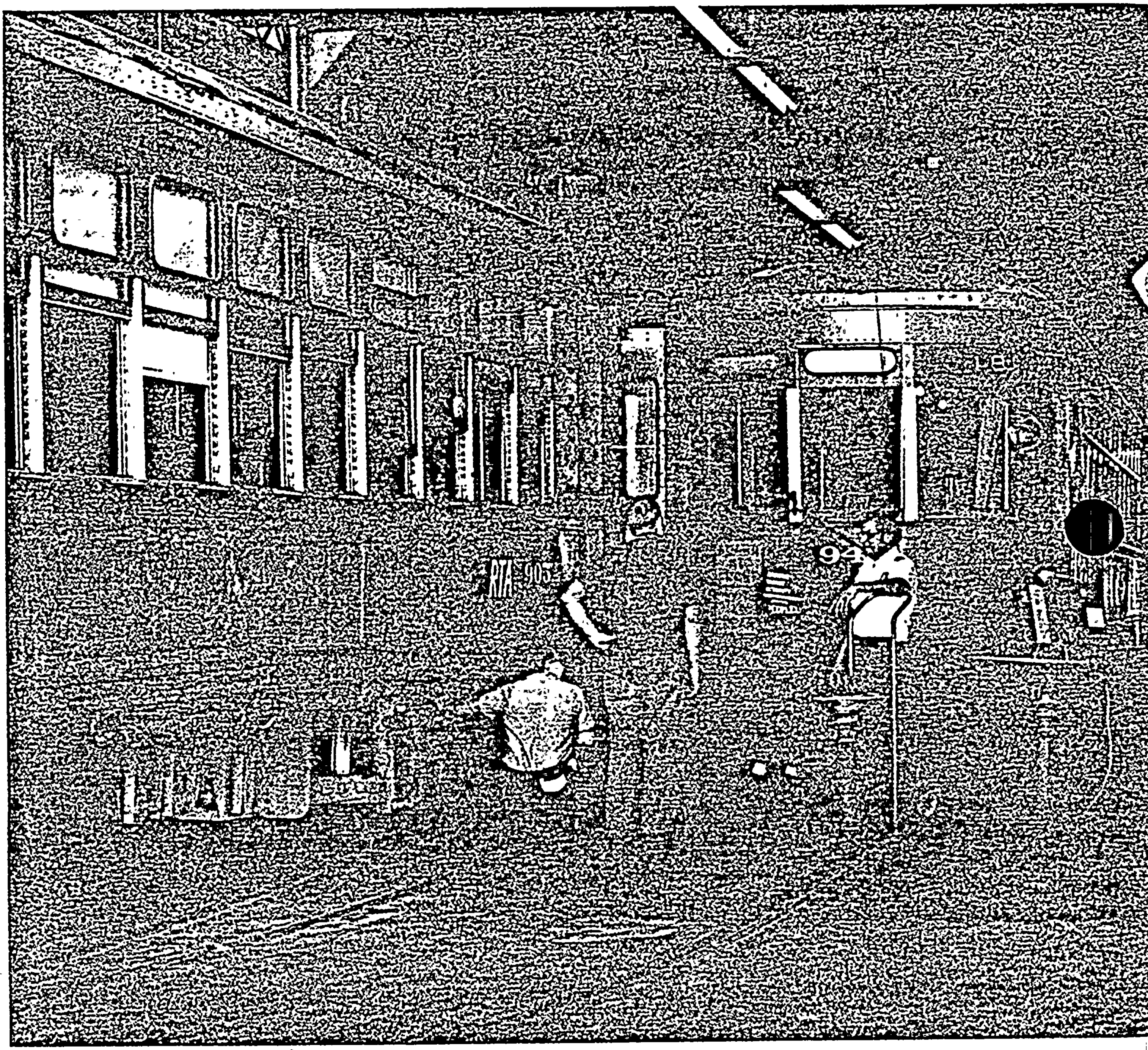

*The process of reclamation starts at the customer's plac of business. Safety-Kleen's reps provide a parts cleaner machine, fresh solvent, and machine maintenance. Firm engaged in automotive repair are the largest gr f customers using the Company's parts cleaner s e.*

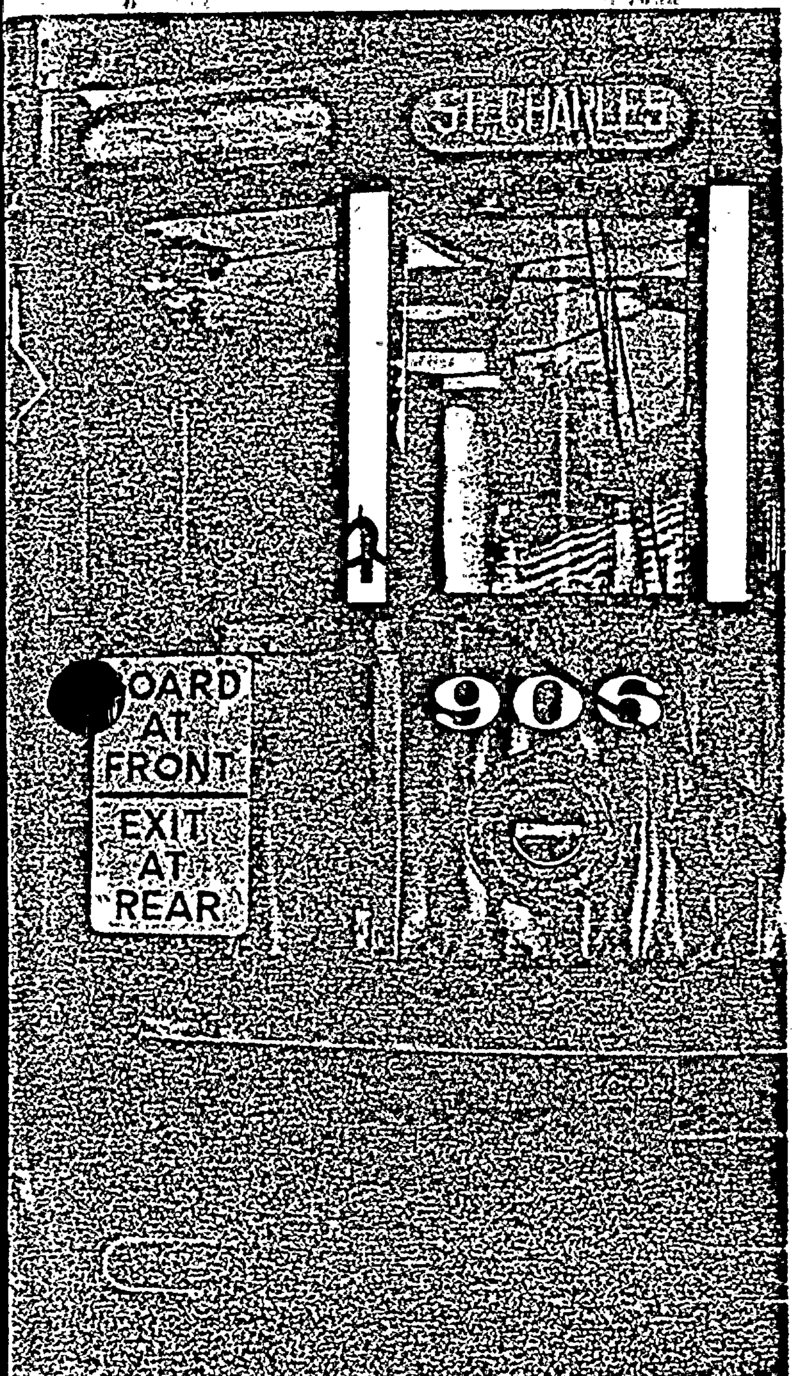


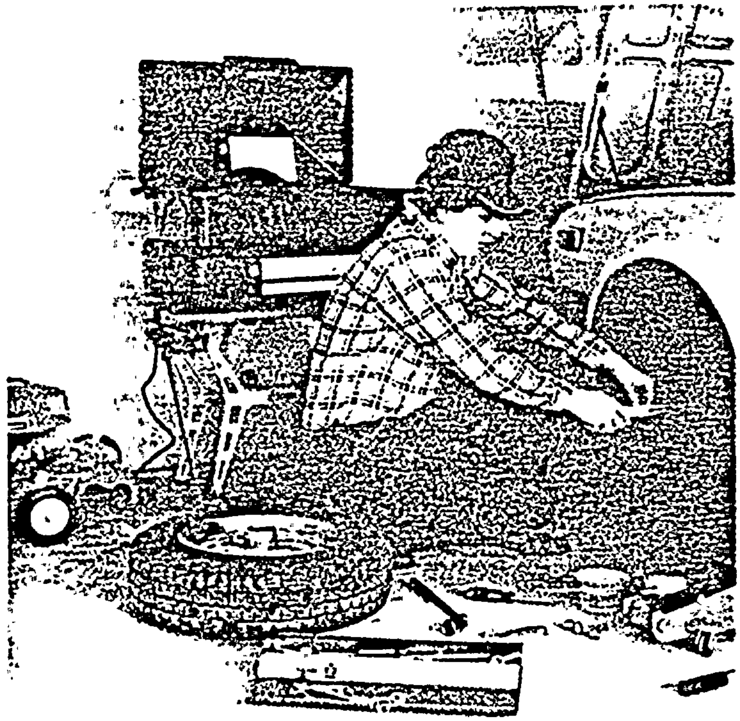
*Mineral-spirits solvent is used in this service to clean and degrease small metal parts during repair work.*

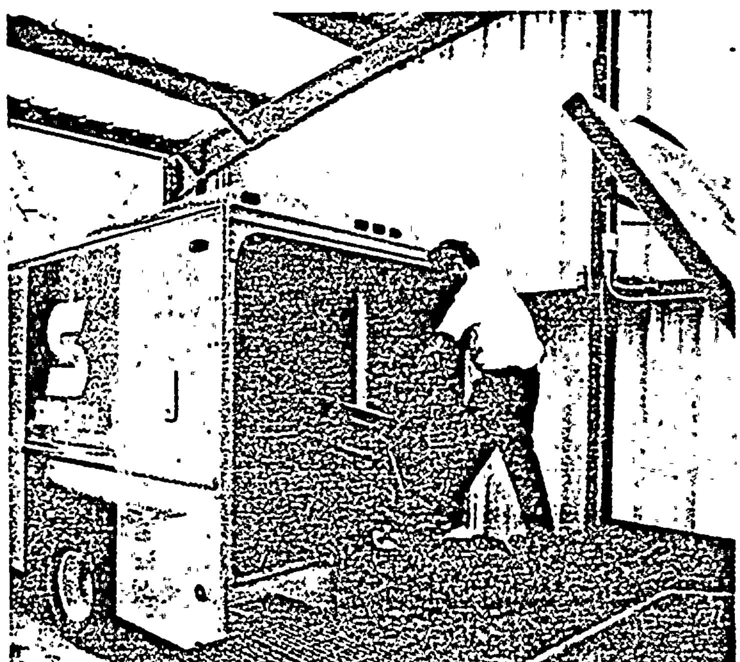
*[illegible]edetermined interval, the Safety-Kleen rep services th[illegible]achine and provides clean solvent for customer use. The spent solvent is removed from the premises.*



*An increasing number of parts cleaners are being used by industry for cleaning and degreasing metal parts. Safety-Kleen provides this service for one or one-hundred machines—performing a task that is both necess[illegible] industrial users, and beneficial to the environme[illegible]*

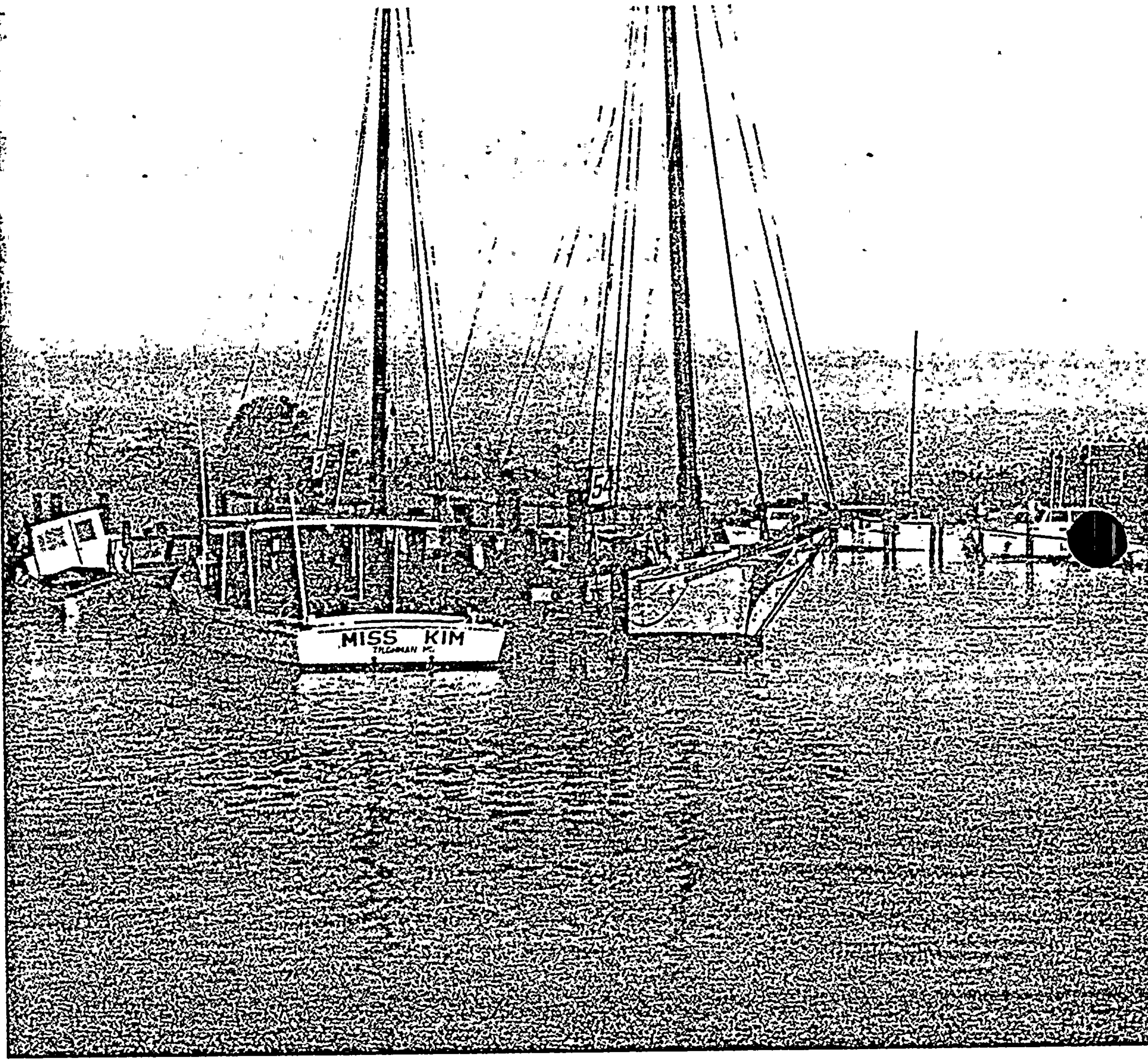




*Safety-Kleen sells, through distributors, a smaller parts cleaner designed for the "do-it-yourself" market and low-income repair shop. The unique marketing concept assures that the spent solvent is reclaimed.*

*Spent mineral-spirits solvent is collected at branches until a scheduled Safety-Kleen tanker picks it up for transport to the recycle center.*




*Safety-Kleen provides restaurants with recyclable Fire-Shield™ aluminum grease filters, and Soaking Centers containing a biodegradable solution used for removing polymerized grease from kitchen cookware. This necessary service fits the Company's philosophy of conserving resources and helping protect the environment.*

**Restaurant Service.** Some years ago, Safety-Kleen entered the restaurant service industry in selected U.S. metropolitan areas. The original concept was to provide cleaning services for the greasy mesh exhaust filters that were found in almost all food preparation establishments at that time. Another concept so vital to the new business was the necessity of having a support organization in place during the first critical years. Thanks to the branch network established for the core parts cleaner service, restaurant services had a solid base from which to grow.

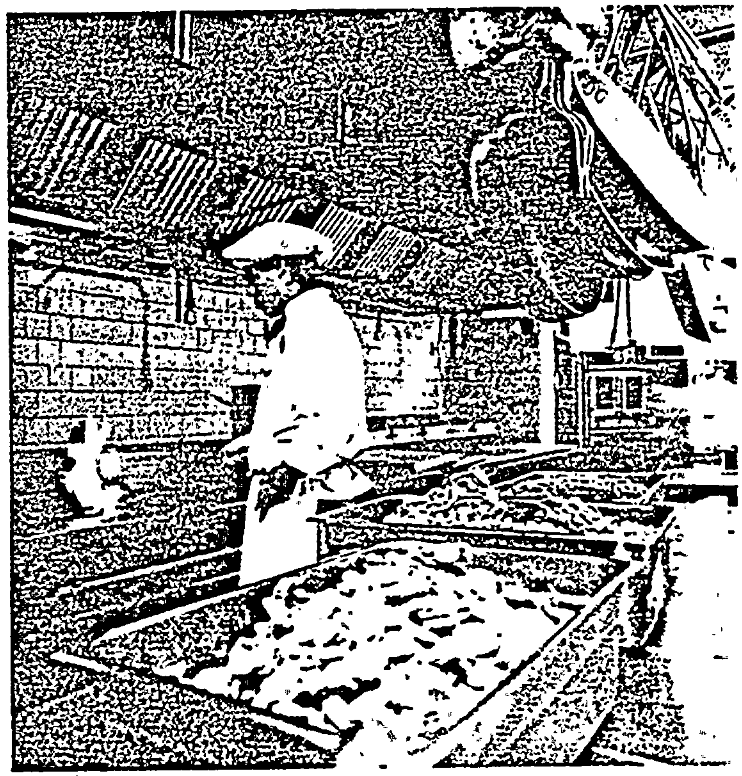
After entering the market, Safety-Kleen developed a new type of filter—the UL-listed Fire-Shield™ grease filter. Because the filter holds less grease, it minimizes the propagation of flames into the duct work should a fire start in the cooking area. In addition, these aluminum filters are recyclable, keeping with Safety-Kleen's stated philosophy of resource recovery.

During a typical service call, the Safety-Kleen rep installs new Fire-Shield™ baffle filters in the kitchen's cooking exhaust system. Greasy used filters are taken to the branch and compacted into bales. Periodically, a supply [illegible] from one of the Company's six distribution centers [illegible]s off supplies and loads the used filter bales for transport back to the distribution center for sale to smelters.

In 1985, a hood and duct cleaning service was added to the restaurant services program. This service provides for the removal of accumulated grease from hoods, ducts, blower motors and fans that are part of the kitchen exhaust system, and includes the application of a fire retardant for further protection. It is now being offered in selected major metropolitan areas, and is expected to expand in 1986.

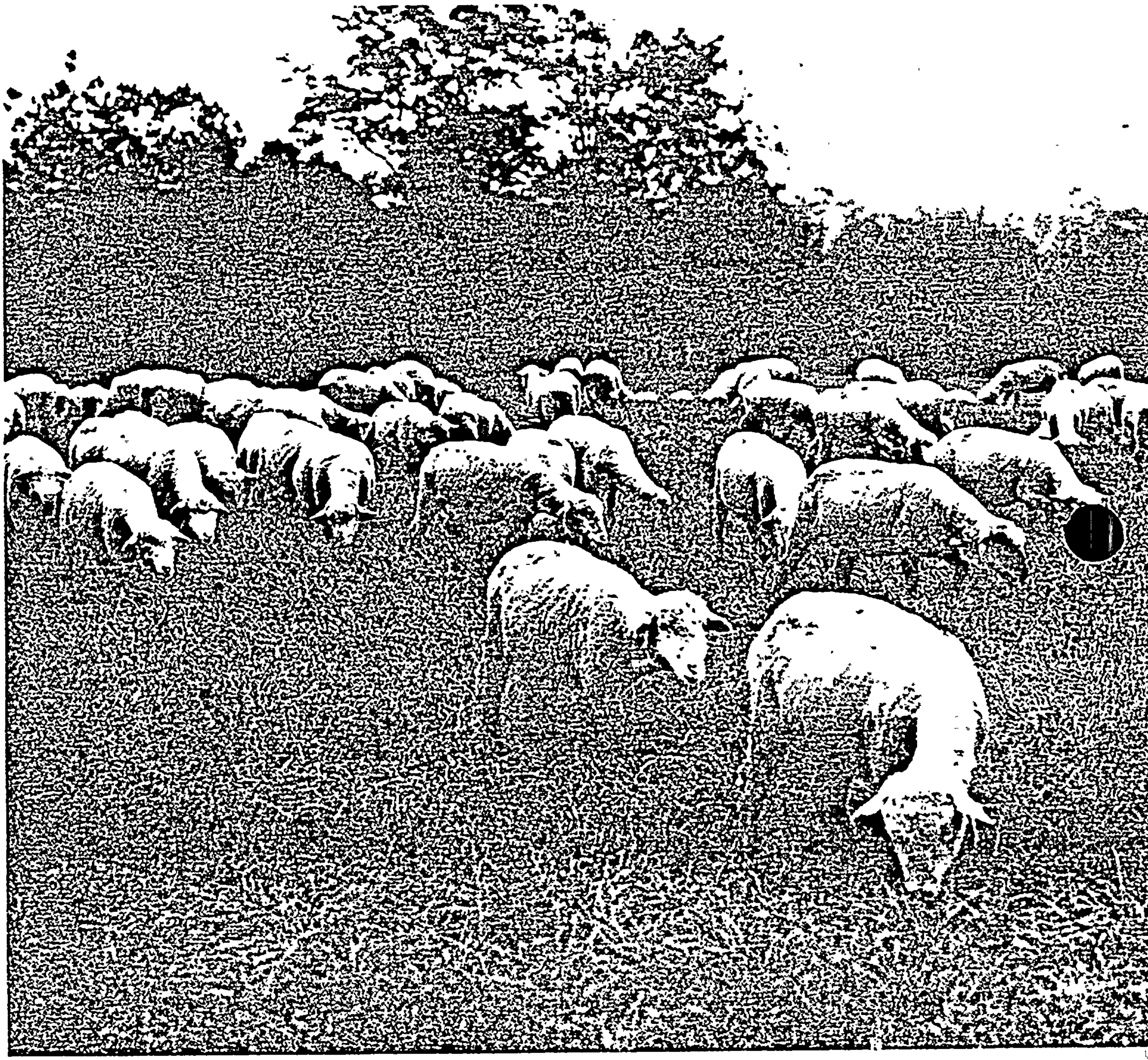
Another service offered to restaurants is the Soaking Center that removes polymerized grease from virtually all metal and glass kitchen cookware. In 1985, there were some 10,400 units in use at over 10,000 restaurants throughout the country.

At the end of 1985, restaurant services was established in 85 branches in the U.S. that served over 32,400 customers. In 1986, the Company plans to implement the program in 11 additional branches.



*Fire-Shield™ grease filters collect grease that is funneled to a retention cup—away from cooking flames. This reduces the risk of fire spreading into the exhaust system. The filters are replaced by the Safety-Kleen rep at predetermined intervals. Dirty filters are then collected and sold [illegible]elters for their aluminum content.*

*Nationwide, over 32,000 customers are served by Safety-Kleen's restaurant services.*



*Responsible use of resources, and the reclamation of spent resources, benefit our total environmental struc- ture. Safety-Kleen's wool buffing pad service is used b over 30,000 customers who depend on this s for fresh pads to do a buffing and polishing job ri*

**Paint Refinishing.** This is another service built upon Safety-Kleen's existing branch network. In addition, it is a service that fits the material recovery philosophy of the Company.

Independent autobody repair shops, automobile dealerships, auto assembly plants, fiberglass boat manufacturers and marble products companies use Safety-Kleen's wool buffing pad service in their finishing or manufacturing operations.

Clean buffing pads are supplied to customers at pre-set intervals. Dirty pads no longer usable by the firm are collected during the service call, and taken to the branch where they are stored until one of Safety-Kleen's over-the-road trucks picks them up for delivery to one of the five company-owned pad processing plants.

Because Safety-Kleen's buffing pads are reclaimed, customers benefit in two ways. First, they have a choice of tuft lengths that allow selecting the best pad for a specific situation to obtain faster and better results. Second, since the pads are less expensive, more pads can be used on a job to do it right.

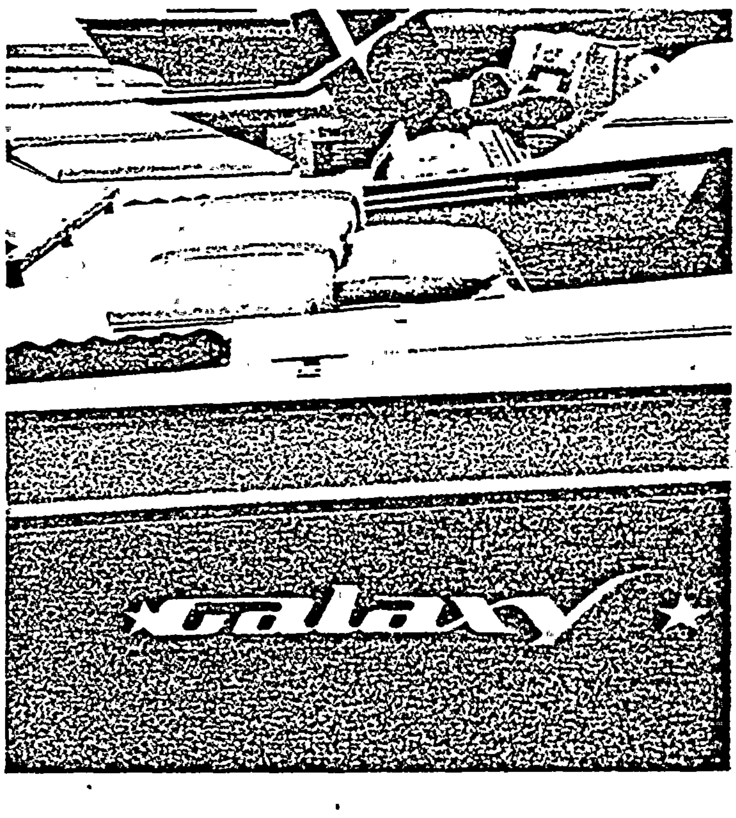
...5, the Abrasive Blaster service for use by autobody s...s to remove paint and rust from hard-to-reach surfaces was introduced into the paint refinishing program. The Abrasive Blaster service includes the use of the blasting machine, a supply of the abrasive material, and periodic machine inspection and maintenance by the Safety-Kleen paint refinishing specialist.

For some time, the Company has been aware of the hazardous waste generated by body shops and spray painters to clean spray guns. As 1985 ended, Safety-Kleen began to study the feasibility of reclaiming this waste, and will continue to do so in 1986.

Safety-Kleen's paint refinishing service had about 31,000 customers at the end of 1985. They were served by 144 paint refinishing specialists working out of 142 branches.

This service again demonstrates the Company's commitment to reclaiming and reusing resources to the maximum level possible. By doing so, resources are conserved, and customers realize better quality results and savings in labor and material costs.

*At each service call, the paint refinishing specialist delivers clean pads and other allied products, and picks up used pads for cleaning.*



*...dition to automobile dealers, independent body ...s, and automobile manufacturers, other customers ...ude marble product firms and fiberglass boat manufacturers.*

*Through proper disposal of solvents, further contamination of our streams, lakes and groundwater can be reduced. Safety-Kleen's industrial solvents program reclaims solvent waste streams from large-volu[illegible]indu- trial users through recycling into their discrete [illegible]o- nents. The recycled material is then sold for us[illegible]ain*

**Industrial Solvents.** Safety-Kleen's many years of experience in handling and processing mineral-spirits and chlorinated solvents became the basis for a program to reclaim bulk quantities of industrial solvents.

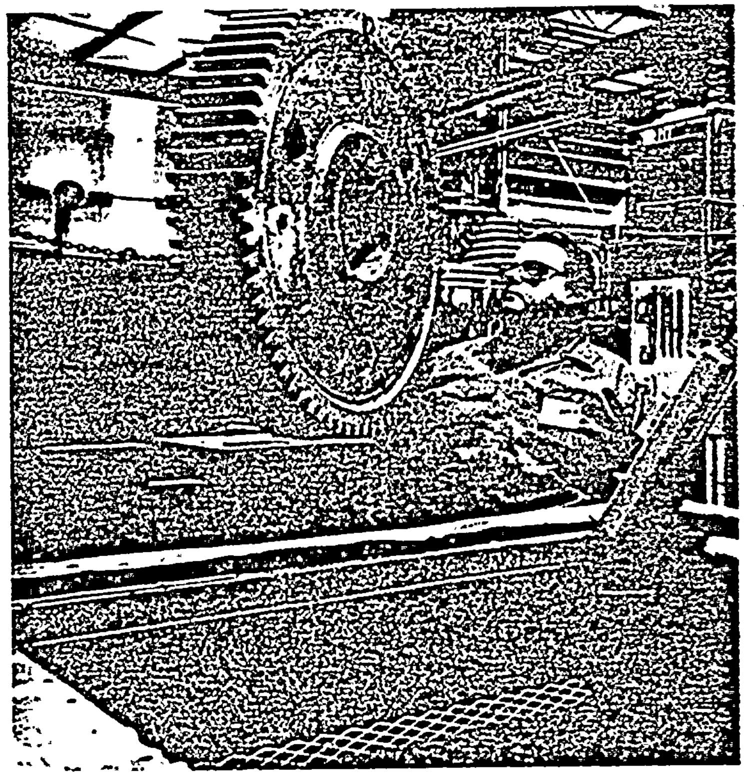
In this service, the Company concentrates on firms engaged in metalworking, electronics, aeronautics and tool-and-die manufacture. Typically, these firms use large quantities of chlorinated solvents to remove grease and dirt prior to plating, coating, bonding or painting metal surfaces. Safety-Kleen collects their large hazardous waste solvent streams, recycles them, and sells the finished product for use again.

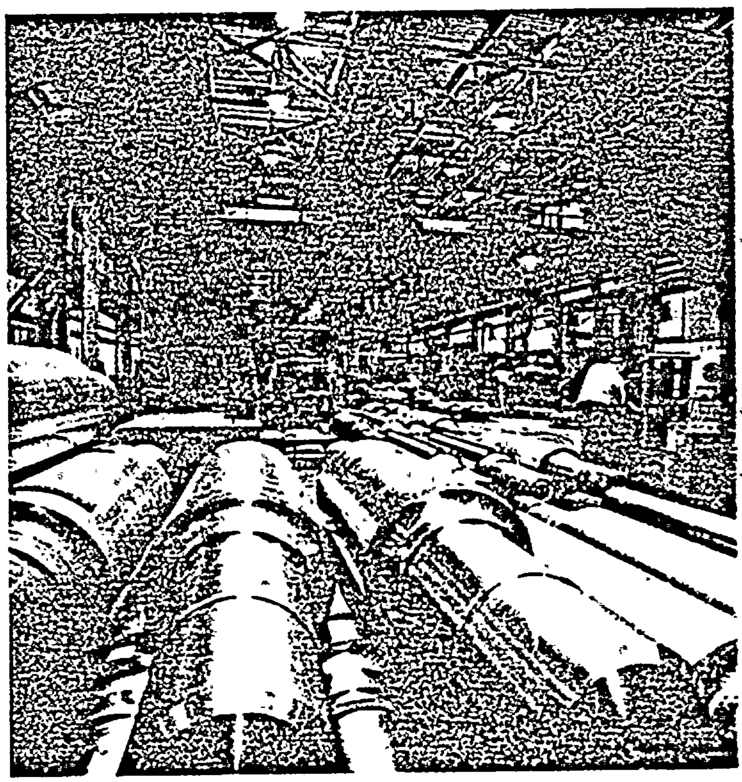
At the heart of the program are Safety-Kleen's specially trained industrial sales engineers. They call on industrial buyers and environmental engineers, counseling them on proper ways to segregate and identify their solvent waste for maximum recovery levels. In addition, they assist the customer in the complex matter of manifest preparation.

The sales engineer arranges for the removal of the customer's waste solvent for reclamation. He also sells virgin and recycled solvents in any quantity needed by the customer—from a few drums to a tanker load.

In 1985, Safety-Kleen added to its industrial solvents recycling capability through the acquisition of Custom Organics, Inc., a Chicago-based recycling company. In addition to chlorinated solvents, the Company can now reclaim fluorinated and other exotic industrial waste streams that are purified directly to high quality products, or converted chemically to still higher value products.

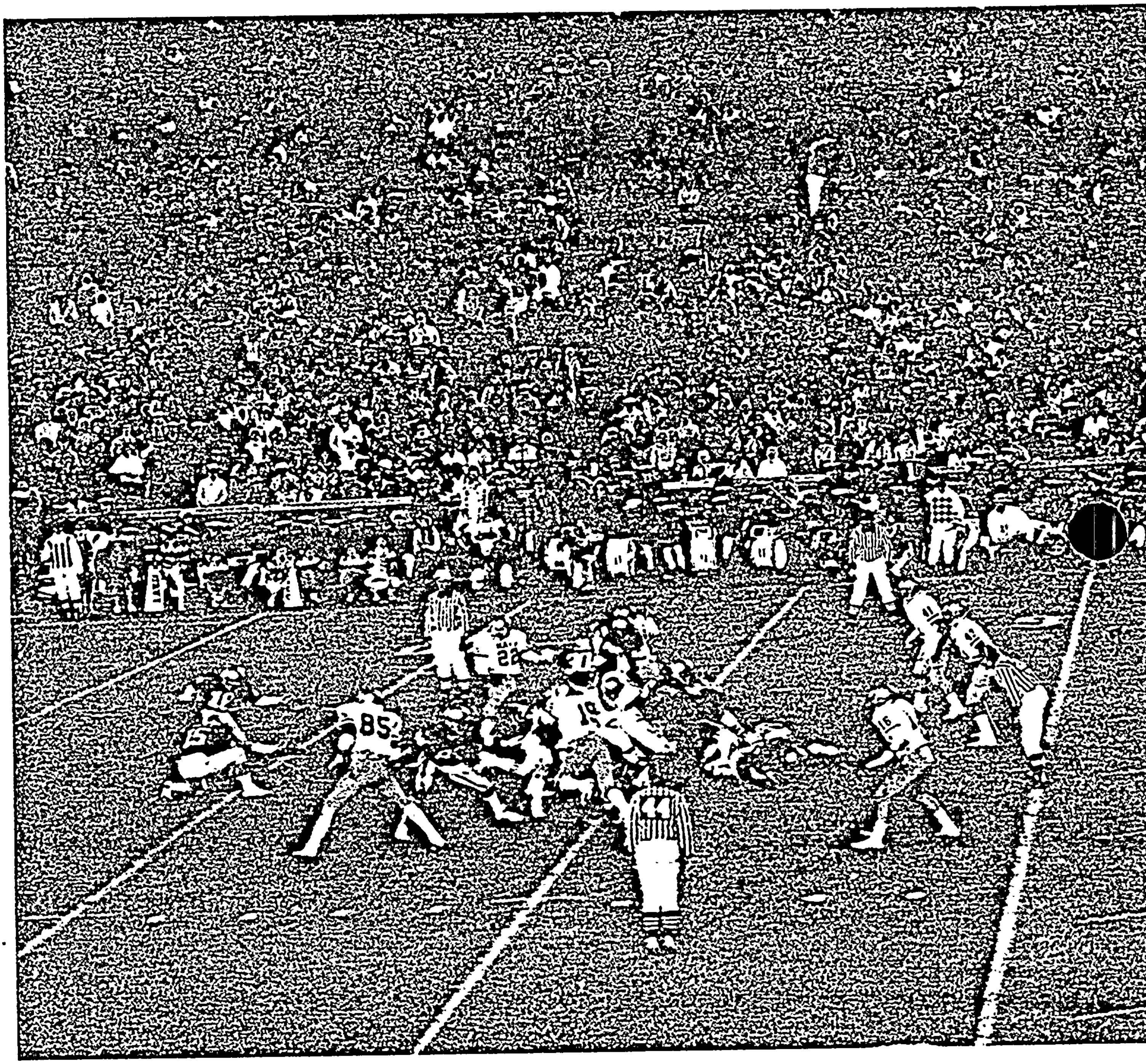
In 1986, the Company intends to continue building on this expanded capability. By providing a needed service to larger quantity generators of hazardous waste, Safety-Kleen is assuring that the waste is handled properly—through the process of reclamation—for the benefit of everyone.





*Precision-formed parts are commonly stripped of oils by vapor degreasers using industrial cleaning solvent.*

*Safety-Kleen's industrial solvents program is oriented towards businesses that use large quantities of cleaning solvents to clean and degrease metal parts before painting, coating, plating or bonding metal surfaces. The Company's sales engineers call on these firms to counsel them on proper ways to segregate and identify spent solvent, assist in manifest preparation, and supply clean solvent and remove spent solvent for reclamation.*



*People create the need for companies to use cleaning solvents. The dry cleaning process generates hazardous waste material that will, if not disposed of properly, possibly contaminate the environment. Safety-Kleen's cleaner program was started to help these small quantity generators solve their disposal problems.*

**Dry Cleaner Service.** Safety-Kleen's newest service began in 1984 with a dry cleaner test market as a result of the reauthorization of the Resource Conservation and Recovery Act.

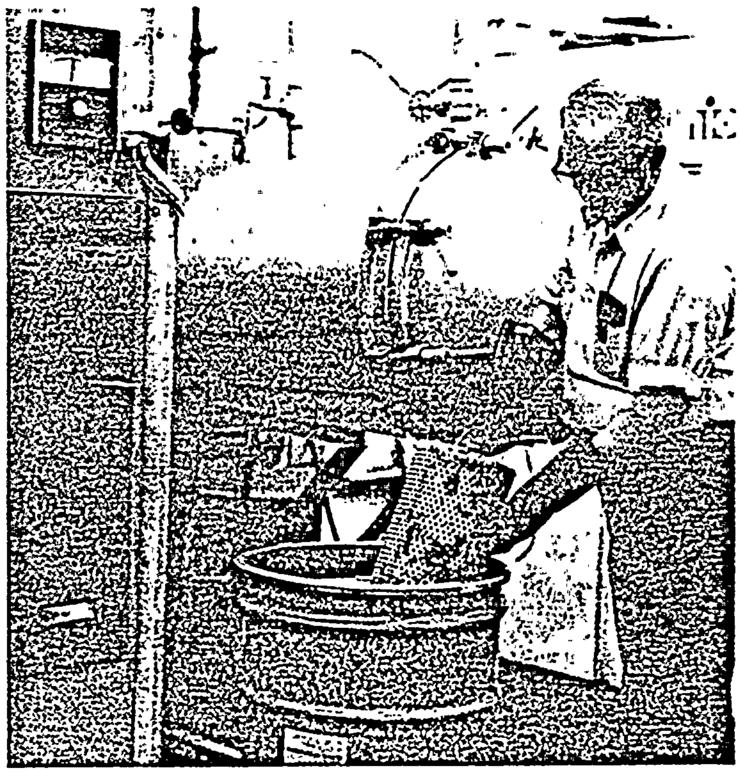
This legislation directed the U.S. EPA to increase the regulation of "Small Quantity Generators," and defined these generators as those who generate over 220 pounds, but less than 2200 pounds, of hazardous waste in any single calendar month.

For those businesses identified as SQG's, the manifesting requirements for proper disposal of their hazardous waste, plus the knowledge that they are responsible for the waste at all times—even after disposal—posed not only the time consuming problem of paperwork, but also the fear of doing something wrong and suffering the penalties imposed by the law.

Dry cleaners were one of the major SQG groups identified by the EPA, and Safety-Kleen's new dry cleaner service was ready to help them with their disposal problems. The Company's unique disposal service for dry cleaners is considerably less expensive than other alternatives available to them. On a regularly scheduled basis, the Safety-Kleen rep picks up the dry cleaner's spent filter cartridges and still bottoms, and the Company recycles the solvent for use as Safety-Kleen feedstock.

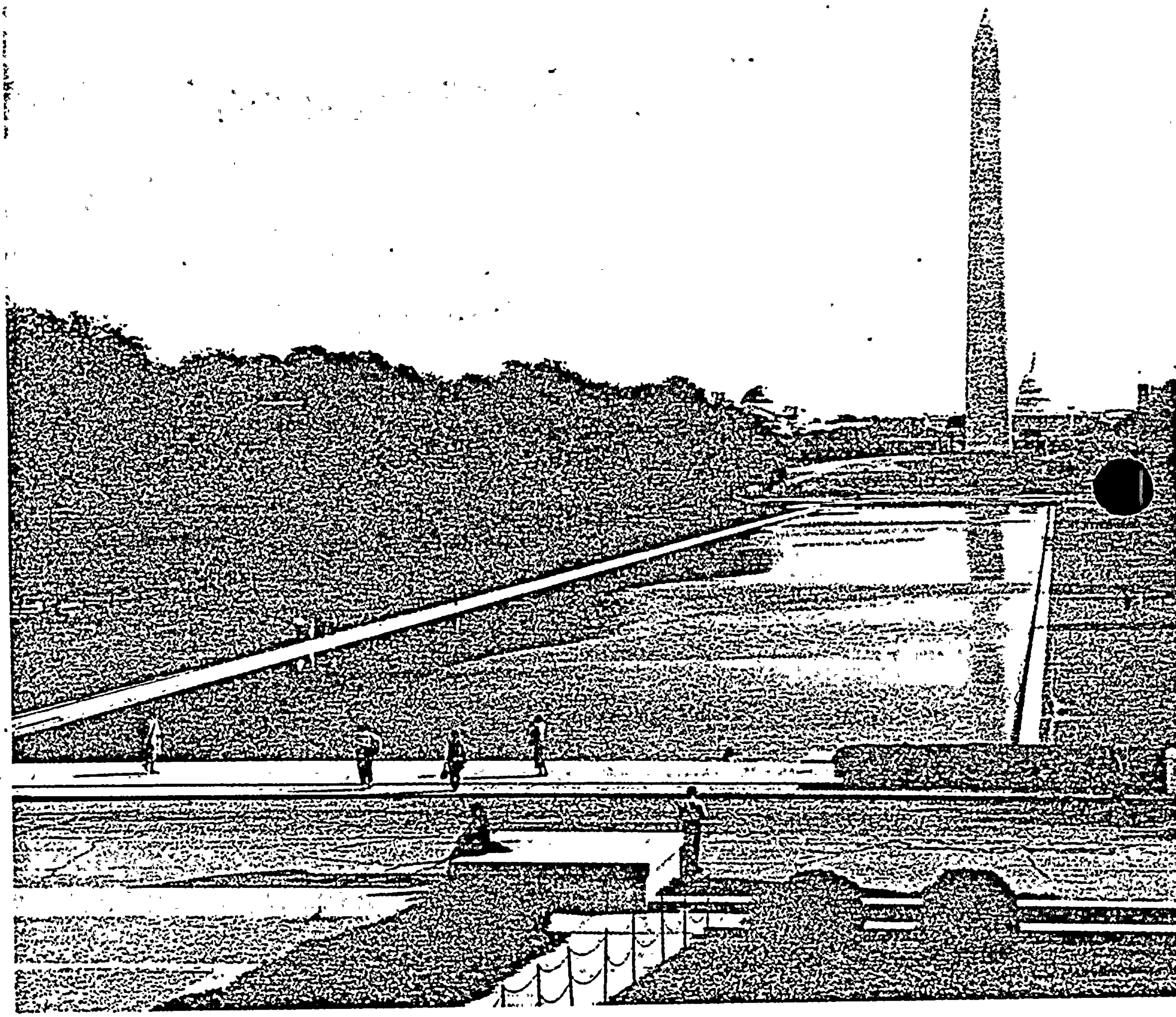
Safety-Kleen's dry cleaner service has many benefits. The customer realizes a significant cost savings that could add up to thousands of dollars a year when compared to landfill or incineration disposal methods; and at the same time, he knows that his hazardous waste is being handled responsibly by the nation's largest solvent recycling specialist.

In 1985, over 7,700 dry cleaners were added to this service that now totals over 9,400 customers in the U.S. In 1986, a newly designed filter cartridge along with the sale of reclaimed dry cleaning solvent, will enable dry cleaners to benefit from a single-source solvent supply/solvent recovery program—again taking advantage of the inherent savings the Company's "closed-loop" solvent system provides.



*Safety-Kleen reps provide secure drums to the dry cleaner for storage of spent filter cartridges and still bottoms.*

*At predetermined intervals, the Safety-Kleen rep drops off empty drums, and picks up drums containing the cartridges and still bottoms. These drums are taken to one of the Company's recycle centers where the contents are processed, and all remaining solvent is recycled to be used again.*



*Federal environmental regulations are making it virtually impossible for any generator of hazardous waste to dispose of it—knowingly or unknowingly—in a manner that could cause environmental contamination.*

# The Process—Reclaiming the Waste

The process of reclamation begins at the customer's place of business. It is here that Safety-Kleen performs the services that have been at the heart of the Company's growth over the past seventeen years.

Dirty restaurant grease filters and used auto refinishing buffing pads are replaced with clean. Periodically, one of Safety-Kleen's over-the-road trucks picks up the collected material at the branch—transporting filters to one of the distribution centers for sale to aluminum smelters, and pads to one of the Company's five pad processing plants.

In the three other services, mineral-spirits solvent and dry cleaner filter cartridges and still bottoms are collected at the branch, and then transported to a nearby recycle center. Industrial solvent waste streams are taken directly from customers' plants to the recycle center.

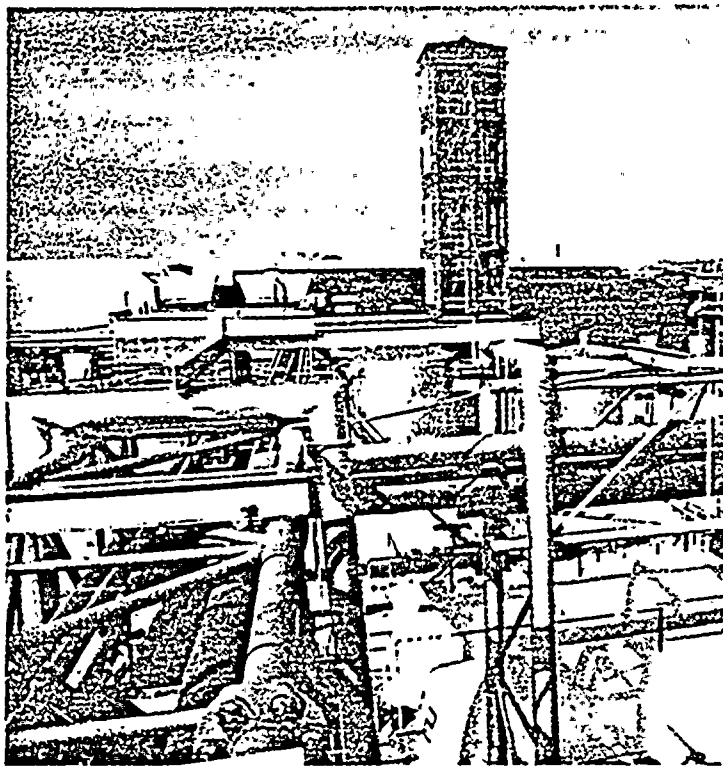
Safety-Kleen did not choose the process of recycling by accident. It was the result of the same careful thought processes and planning that went into the marketing program for the parts cleaner concept. When the Company opened its first recycle center at Elgin, Illinois in 1970, recycling of all the spent mineral-spirits solvent was the [illegible] answer to Safety-Kleen's own disposal problem. [illegible] economics of recycling were not advantageous, but the Company elected to recover the solvent.

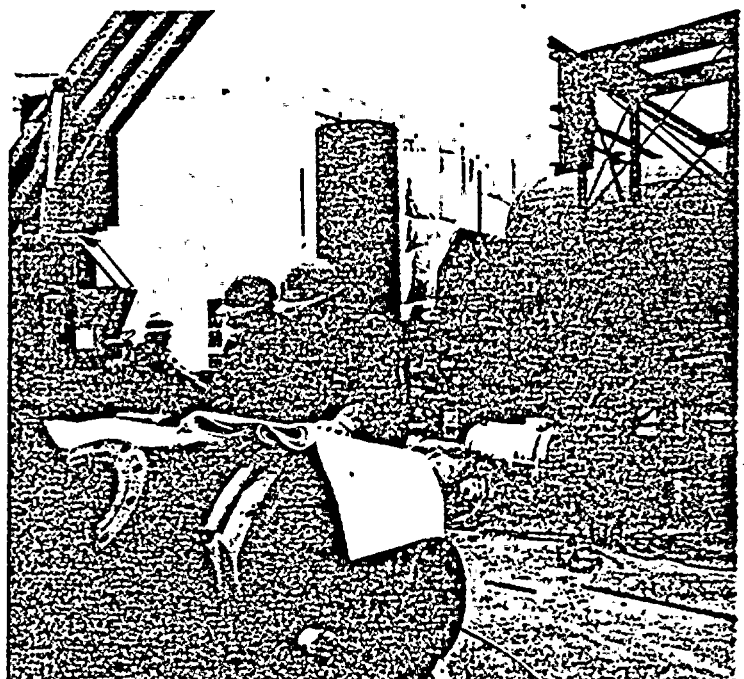
Since the mid-1970's with the first enactment of RCRA, increasingly tougher standards and regulations have been placed on generators of hazardous waste material. In some states, even more stringent regulations are in force—all brought on by the public's understandable concern for environmental safeguards to ensure a quality of life everyone now, and in the future, has a right to expect. All of these public and private pressures for a clean environment are quickly narrowing the choice of hazardous waste disposal alternatives available to generators. The economic and environmental benefits of recycling hazardous waste is now becoming too attractive to ignore.

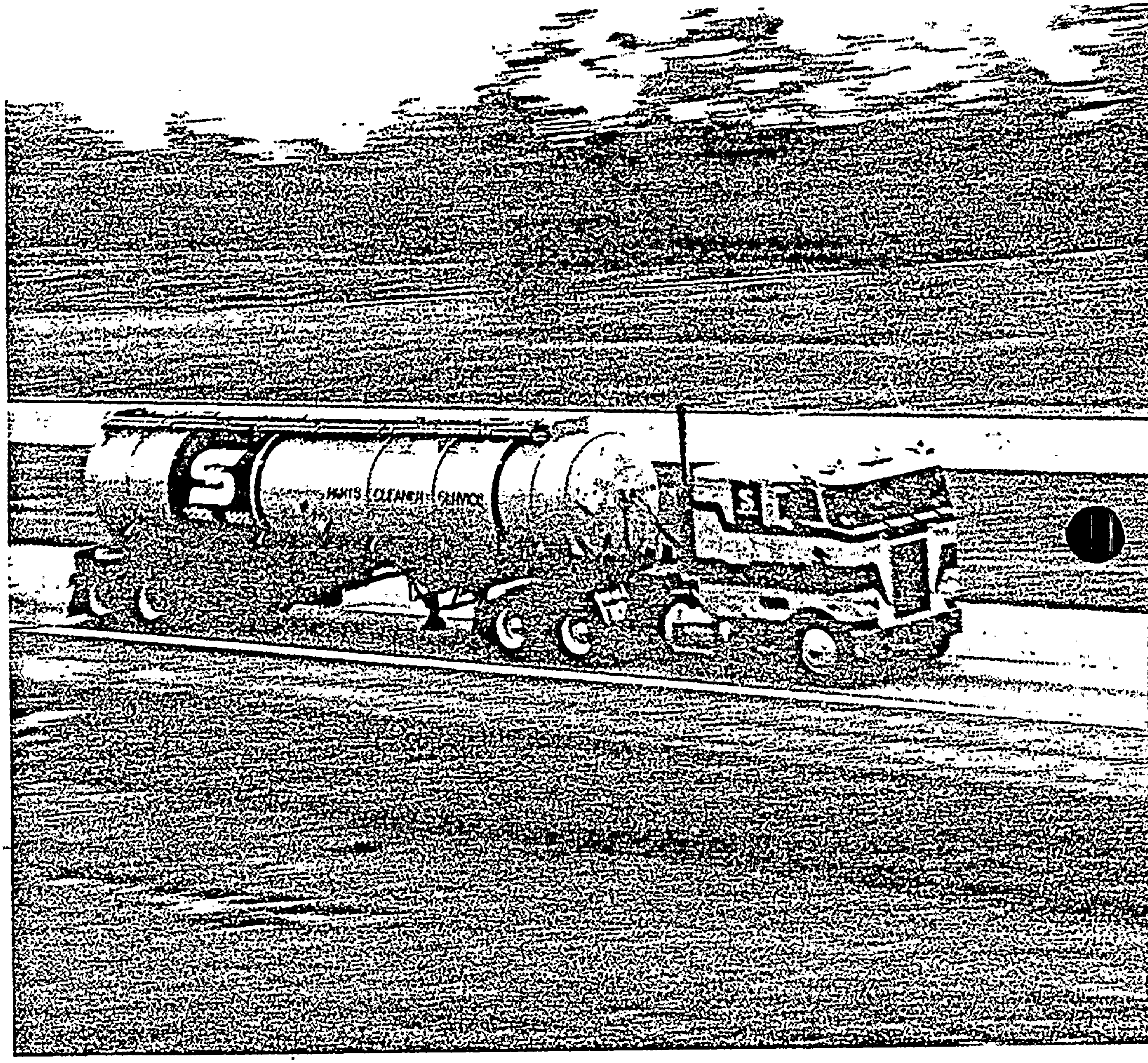
There are disposal alternatives other than recycling, but when compared to the benefits of recycling, these methods are considerably less desirable. Disposal of waste in a

*In 1985, Safety-Kleen acquired Custom Organics, Inc., a Chicago recycler. This acquisition gave the Company the capability to recycle larger quantities of chlorinated solvents, as well as fluorinated and other exotic cleaning solvents.*

*To meet the requirements for continuing growth, Safety-Kleen has undertaken expansion programs at [illegible] recycle centers in Lexington, South Carolina and Denton, Texas. The Company's other recycle centers are scheduled for expansion in the near future.*







landfill is expensive, and of course, the "cradle to grave" liability for this waste continues to be with the generator. There is always the possibility the waste will seep onto the soil and into the groundwater, and sometime in the future, the generators using the site may be held responsible for the cost of the landfill's cleanup. Disposal through incineration of the waste is also a very expensive solution to the problem. It does get rid of the waste at an extremely high cost both monetarily and environmentally. It destroys precious, reusable resources, and should be considered as a method of "last resort."

Safety-Kleen operates seven company-owned recycle centers in the U.S. These are located in Elgin, Illinois; Hebron, Ohio; Clayton, New Jersey; Lexington, South Carolina; Denton, Texas; Reedley, California; and with the 1985 acquisition of Custom Organics, Inc., Chicago, Illinois. It is here, at these recycle centers, that the spent solvent collected from customers throughout the nation is processed to produce an end product that is virtually equal to virgin solvent in both its chemical properties and working performance.

It is also at the recycle centers that spent filter cartridges and still bottoms from the dry cleaner service are processed through a complex, multi-stage procedure. To make sure that virtually all of the dry cleaning solvent is recovered from the material, the Company's internally developed Safety-Therm process is used—a process that reduces the volume of waste that must be disposed of to a powdery, virtually inert material. This residue is then handled by licensed disposal firms.

*Critical supply and retrieval link between branch, recycle center, and back to branch, is the Safety-Kleen fleet of over-the-road vehicles.*

In 1985, Safety-Kleen reclaimed about 27 million gallons of usable mineral-spirits solvent from some 29 million gallons of spent solvent it processed. The Company's remarkable recovery rate of 93 percent is the highest in the solvent recycling industry.

To better illustrate the efficiency of the Company's recycling process, the following example is appropriate. Of every 100 gallons of mineral-spirits solvent delivered to parts cleaner customers, the Safety-Kleen rep retrieves about 70 gallons after customer use. The balance is either carried off on cleaned parts, or through normal evaporation loss.

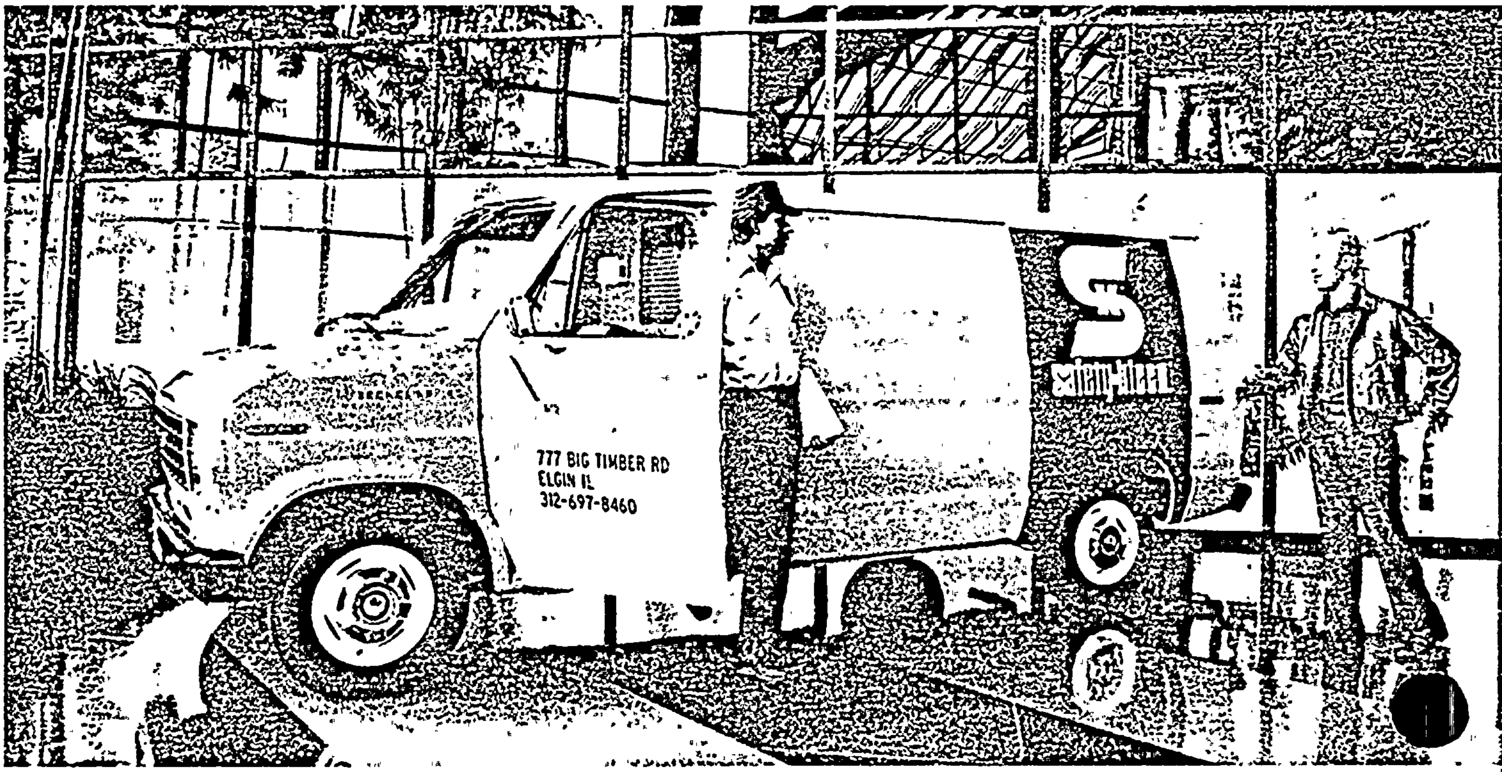
Of the 70 gallons returned to the recycle center for processing, Safety-Kleen recovers 65 gallons for reuse. Four more gallons are recovered as reusable petroleum oils, and only one gallon is transferred to licensed disposal firms for final handling.

The large quantities of chlorinated solvents used by industrial plants are recycled using a specially designed fractionating tower. This technology can separate a mixture or blend of chlorinated solvents into their discrete components. With the addition of the capabilities the acquisition of Custom Organics, Inc. brought to Safety-Kleen in 1985, not only can larger quantities of chlorinated solvents be handled, but also more exotic waste streams can be processed to extremely high levels of purity for reuse by industry.

Safety-Kleen considers spent solvents to be valuable resources that should never be destroyed or disposed of in a manner that could cause possible environmental damage. As long as there are ways to reclaim this material for use again and again, it must be done. That is why the Company has invested so heavily to perfect the various reclamation processes it uses, and is continuing to invest in reclamation technology—not only for present services, but also for future opportunities.

As 1985 ended, the recycle centers in Lexington, South Carolina and Denton, Texas were in the process of major expansions that will be completed in early 1986. Plans for expansion at three other centers have been approved and work is expected to begin during the present year. At the Hebron, Ohio recycle center, a new tank storage area is under construction to replace the tanks lost in a fire in late November, 1985. It is expected that this project will be completed in the first half of 1986.

As a result of the Company's physical improvements in 1985 and 1986, Safety-Kleen will be in an even stronger position to meet the challenges presented not only by existing services, but by those of newer opportunities as well. The Company is investing in new concepts that will return positive results to shareholders, customers and the environment.




1985 was a year in which Safety-Kleen again achieved record sales for the seventeenth straight year, and net earnings growth in excess of 20 percent for the fifteenth consecutive year. It was also a year in which many small businesses found out they were "Small Quantity Generators" of hazardous waste. The Company, with its extensive branch network and highly specialized services supported by its extensive reclamation technology, continued to assist them within the area of Safety-Kleen's expertise—and continued to explore new ways to help these many businesses with their newly discovered obligations.

As a result of Safety-Kleen's reclamation commitment, millions of gallons of spent solvent have not been allowed to contaminate the environment—but to be purified for use again and again. It is mathematically possible that a small amount of spent solvent collected in 1968 when the Company began its core service is still being reclaimed and used again. This possibility is intriguing because it shows the vast potential that reclamation efforts can play in conserving resources and protecting the environment. Landfill disposal of spent resources arms a time bomb for future environmental damage. Destruction of spent resources wastes material that will possibly cause shortages of a needed commodity in the future. Safety-Kleen's answer—*reclamation*—is *the best alternative.*

*On September 30, 1985, Safety-Kleen's new corporate headquarters was officially completed. A sculpture by internationally recognized sculptor, J. Seward Johnson Jr., was unveiled. In his dedication remarks, Donald W. Brinckman stated: "Today we observe our Company's seventeenth anniversary. What could be more appropriate on this date than to dedicate this sculpture and the Corporate Headquarters that houses it to the spirit that has been the heart of the Company's success—our relationship with our customers through the efforts of our field organization. The cast bronze tablet commemorating this event states it simply and well: Dedicated to a special relationship between company and c[illegible]r, united by the service excellence of our Safety-K[illegible]eld organization."*

# Financial Reports

## Contents



## Selected Financial Data

(Expressed in thousands, except per share amounts)

| | | | | | Fiscal Year Ended |
|---|---|---|---|---|---|
| | Dec. 28, 1985 | Dec. 29, 1984 | Dec. 31, 1983 | Jan. 1, 1983 | Jan. 2, 1982 |
| **Income Statement Data** | | | | | |
| Service revenues and sales | $221,080 | $185,630 | $162,771 | $149,244 | $134,887 |
| Net earnings | 27,185 | 19,428 | 15,759 | 13,024 | 10,977 |
| Earnings per share | 1.26 | .93 | .76 | .64 | .55 |
| Cash dividends per share | .280 | .200 | .133 | .100 | .059 |
| **Balance Sheet Data** | | | | | |
| Current assets | 77,047 | 63,493 | 58,214 | 46,695 | 44,337 |
| Current liabilities | 30,865 | 26,572 | 20,714 | 18,349 | 17,439 |
| Working capital | 46,182 | 36,921 | 37,500 | 28,346 | 26,898 |
| Total assets | 176,885 | 140,537 | 109,548 | 91,451 | 78,613 |
| Long-term debt | 11,700 | 7,103 | 8,023 | 9,000 | 9,871 |
| Shareholders' equity | 113,643 | 89,230 | 70,302 | 55,946 | 44,120 |

[1] The above data has been restated to reflect three-for-two stock splits on December 6, 1982, December 10, 1984 and December 9, 1985.

[2] 1985 net earnings include $3,706,000 ($.17 per share) for the cumulative effect of change in accounting for investment tax credits as more fully described in Note 1 to the Consolidated Financial Statements appearing on page 37.

[3] The Consolidated Balance Sheet as of December 29, 1984, has been restated to include the accounts of Custom Organics, Inc., as more fully described in Note 2 to the Consolidated Financial Statements appearing on page 38.

[4] 1981 net earnings include $975,000 ($.05 per share) for U.S. income tax benefits resulting from the sale of the Company's West Germany subsidiary.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Summary

The following table sets forth for the periods indicated (i) percentages which certain items reflected in the financial data bear to consolidated revenues and sales of the Company and (ii) the percentage increase of such items as compared to the indicated prior period:

| | Relationship to Consolidated Revenues and Sales Fiscal Years | | | Period to Period Increase (Decrease) Fiscal Years | |
|---|---|---|---|---|---|
| | 1985 | 1984 | 1983 | 1984-85 | 1983-84 |
| Revenues and Sales | | | | | |
| Service revenues | 84.2% | 83.5% | 84.9% | 20.0% | 12.2% |
| Sales (primarily allied products) | 15.8 | 16.5 | 15.1 | 14.5 | 24.4 |
| | 100.0 | 100.0 | 100.0 | 19.1 | 14.0 |
| Costs and Expenses | | | | | |
| Branch operating costs and expenses and cost of sales | 66.6 | 66.9 | 67.9 | 18.6 | 12.4 |
| Selling and administrative expenses | 15.5 | 15.9 | 15.8 | 16.1 | 14.7 |
| Interest, net | (.8) | (1.7) | (1.3) | (41.1) | 42.9 |
| | 81.3 | 81.1 | 82.4 | 19.4 | 12.3 |
| Earnings Before Taxes and Cumulative Effect of Change in Accounting Principle | 18.7 | 18.9 | 17.6 | 17.9 | 22.0 |
| Income Taxes | 8.1 | 8.4 | 7.9 | 14.2 | 20.4 |
| Earnings Before Cumulative Effect of Change in Accounting Principle | 10.6 | 10.5 | 9.7 | 20.9 | 23.3 |
| Cumulative Effect of Change in Accounting for Investment Tax Credits | 1.7 | — | — | N/A | N/A |
| Net Earnings | 12.3% | 10.5% | 9.7% | 39.9 | 23.3 |

## Trends

During the five fiscal years ended December 28, 1985, the Company's revenues and earnings before cumulative effect of change in accounting principle grew at compounded rates of 13.8 percent and 24.3 percent, respectively. This was largely attributable to growth in service revenue in the Company's parts cleaner, restaurant, paint refinishing, dry cleaner and industrial solvents services; as well as allied product sales growth in the parts cleaner and paint refinishing markets.

## Inflation and Changes in Prices

The Company uses a substantial volume of petroleum-based solvents in its parts cleaner service. The cost of solvents rose significantly from 1974 through 1980. During 1981, these costs rose at a lesser rate than the overall rate of inflation. During 1982, 1983 and 1984, the average cost of virgin solvents purchased for use in the United States operations declined approximately 9%, 9% and 2%, respectively. During 1985, the average cost of virgin solvent remained virtually unchanged from the 1984 average cost, however the 1985 year end cost was approximately 5% below the 1984 year end cost. Approximately two-thirds of the Company's solvent requirements are met by recycling, leaving one-third to be purchased.

The Company has been able to raise its prices in the past to compensate for cost increases. Management expects to be able to raise prices in the future to compensate for cost increases.

## Liquidity and Capital Resources

The Company's working capital increased from $36,921,000 at December 29, 1984 to $46,182,000 at December 28, 1985.

Capital additions in 1985 totaled $32,900,000. Commitments for capital expenditures as of December 28, 1985 were approximately $16 million.

In connection with the expansion of the Company's Lexington, South Carolina and Denton, Texas solvent recycling plants, $5,700,000 of Industrial Development Revenue Bonds were issued during 1985. Unexpended funds, in the amount of $3,623,000 are included in Other Assets in the December 28, 1985 Consolidated Balance Sheet. These funds are expected to be expended as the projects are completed during the first half of 1986.

In December, 1985, the Company contributed $4,800,000 to a Voluntary Employee Beneficiary Association (VEBA) trust fund as discussed in Note 8 to the Consolidated Financial Statements appearing on page 41. The VEBA trust fund balance of $5,484,000 at the end of 1985 is included in Prepaid expenses in the December 28, 1985 Consolidated Balance Sheet. These funds are expected to be paid out during 1986 for covered employee benefits.

In November, 1985, a fire occurred at the Company's Hebron, Ohio solvent recycling center. Certain portions of that facility's tank farm as well as other property, assets and equipment were destroyed in the fire. The Company is insured for the replacement cost of all assets lost in the fire as well as extra expense incurred in restoring the facility to its pre-fire operating condition. As of December 28, 1985, the Company was in the process of restoring this facility. Restoration is currently expected to be completed in the first half of 1986. Insurance refunds receivable in connection with this fire, in the amount of $3,344,000, are included in Prepaid expenses in the December 28, 1985 balance sheet.

The Company expects to be able to finance growth in its existing service areas through internally generated funds for the foreseeable future.

## Results of Operations

*Revenues and Sales.* Total service revenues and sales derived from the Company's parts cleaner service amounted to $169,782,000 in 1985, $155,127,000 in 1984 and $142,076,000 in 1983. Total service revenues and sales derived from the newer service areas, primarily restaurant services, automotive paint refinishing services, dry cleaner services and the exchange and recycling of industrial solvents amounted to $51,298,000 in 1985 (including revenues of Custom Organics, Inc., acquired on August 6, 1985), $30,503,000 in 1984 and $20,695,000 in 1983.

Service revenues and sales from the Company's parts cleaner service increased $14,655,000, or nine percent in 1985 over 1984. Of this increase, ninety-three percent was derived from service revenues while seven percent was due to growth in allied product sales. Parts cleaners in service at the end of 1985 were 4.4 percent above the end of 1984. In addition, the average time interval between services shortened slightly from the end of 1984 to the end of 1985. The combination of more machines in service and the shorter average service interval resulted in 5.9 percent additional services performed in 1985 over 1984. The average price per service in 1985 was four percent higher than in 1984.

Service revenues and sales from the Company's parts cleaner service increased $13,051,000, or nine percent, in 1984 over 1983. Of this increase, eighty-two percent was derived from service revenues, while eighteen percent was due to growth in allied product sales. Parts cleaners in service at the end of 1984 were 4.2 percent above the end of 1983. In addition, the average time interval between services shortened slightly from the end of 1983 to the end of 1984. The combination of more machines in service and the shorter average service interval resulted in 6.5 percent additional services performed in 1984 over 1983. The average price per service in 1984 was two percent higher than in 1983.

Service revenues and sales from the Company's parts cleaner service increased $6,082,000 or five percent in 1983 over 1982. Of this increase, eighty-four percent was derived from service revenues, while sixteen percent was due to growth in allied product sales. Parts cleaners in service at the end of 1983 were 2.1 percent above the end of 1982, however

the average time interval between services lengthened slightly during 1983. The lengthening of the service interval during 1983 more than offset the effect of the increase in machines and 1.3 percent fewer services were performed in 1983 as compared to 1982. The average price per service in 1983 was six percent higher than in 1982.

The combined revenues of the Company's newer service areas increased sixty-eight percent in 1985 over 1984, forty-seven percent in 1984 over 1983, and fifty-six percent in 1983 over 1982.

*Branch Operating Costs and Expenses and Cost of Sales.* Branch operating costs and expenses and cost of sales improved slightly to 66.6 percent of sales in 1985 as compared to 66.9 percent of sales in 1984.

Branch operating costs and expenses and cost of sales represented 66.9 percent of sales in 1984 as compared to 67.9 percent of sales in 1983. This improvement in overall margins is due to higher gross margins in the parts cleaner service and an improvement in the newer service areas from a combined loss at the gross profit level in 1983 to a combined profit in 1984. The improvement in gross margins in the parts cleaner service is primarily due to the higher unit volume of services, price increases and lower cost of virgin solvents. The improvement in the combined gross profit in the newer service areas is primarily due to additional revenues derived from higher unit volume sales and the favorable effects of spreading the fixed and semi-variable cost components over a larger revenue base.

Branch operating costs and expenses and cost of sales represented 67.9 percent of sales in 1983 as compared to 70.7 percent of sales in 1982. This improvement in overall margins is due to higher gross margins in the parts cleaner service and a reduction in combined losses in the newer service areas. The improvement in gross margins in the parts cleaner service is primarily due to higher prices charged for longer-interval services, price increases and lower cost of virgin solvents. The reduction in combined losses in the newer service areas is primarily due to additional revenues derived from higher unit volume sales and the favorable effects of spreading the fixed and semi-variable cost components over a larger revenue base.

*Selling and Administrative Expenses.* Selling and administrative expenses rose at a lesser rate than revenues in 1985 and at a greater rate than revenues in 1984. Included in this category is an expense of $81,000 in 1985, an expense of $38,000 in 1984 and an expense of $483,000 in 1983 for stock appreciation rights as more fully described in Note 7 to the Consolidated Financial Statements appearing on page 40. Exclusive of stock appreciation rights, selling and administrative expenses rose sixteen percent from 1984 to 1985 and seventeen percent from 1983 to 1984. The increases in both years were primarily due to additional employees and employee expenses, increases in salaries and benefits, and increases in other compensation based upon sales and consolidated earnings. The acquisition of Custom Organics, Inc., also contributed to the 1985 increase.

*Interest, net.* In 1985, 1984 and 1983, respectively, $380,000, $1,437,000 and $1,194,000 of income is included in Interest, net in connection with the purchase of Federal income tax benefits as discussed in Note 9 to the Consolidated Financial Statements appearing on page 42. These amounts are included in Interest, net with no corresponding income tax effect. Exclusive of amounts recorded in connection with tax benefits, Interest, net declined by $247,000 from 1984 to 1985 primarily due to lower interest rates. Exclusive of amounts recorded in connection with tax benefits, Interest, net increased by $710,000 from 1983 to 1984 primarily due to higher investment balances and higher interest rates.

*Income Taxes.* The effective income tax rate was forty-three percent in 1985, forty-four percent in 1984 and forty-five percent in 1983. The effective 1985 rate is lower than 1984 primarily due to the favorable effects of the change to the flow-through accounting method for investment tax credits (as more fully described in Note 1 to the Consolidated Financial Statements appearing on page 37) and a lower statutory tax rate in the United Kingdom, partly offset by lower Interest, net recorded in connection with the purchase of tax benefits. The effective 1984 rate is lower than 1983 primarily due to a lower statutory tax rate in the United Kingdom.

## Report of Independent Public Accountants

To the Board of Directors and Shareholders of Safety-Kleen Corp.:

We have examined the consolidated balance sheets of Safety-Kleen Corp. (a Wisconsin corporation) and Subsidiaries as of December 28, 1985, and December 29, 1984, and the related consolidated statements of earnings, shareholders' equity and changes in financial position for each of the three fiscal years in the period ended December 28, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Safety-Kleen Corp. and Subsidiaries as of December 28, 1985, and December 29, 1984, and the results of their operations and the changes in their financial position for each of the three fiscal years in the period ended December 28, 1985, in conformity with generally accepted accounting principles which, except for the change (with which we concur) in accounting for investment tax credits as discussed in Note 1, were applied on a consistent basis.

Arthur Andersen & Co.

Chicago, Illinois,
February 4, 1986.

## Consolidated Statements of Earnings

Safety-Kleen Corp. and Subsidiaries

(Expressed in thousands, except per share amounts)

| Fiscal Year Ended | Dec. 28, 1985 | Dec. 29, 1984 | Dec. 31, 1983 |
|---|---|---|---|
| Revenues and Sales | | | |
| Service revenues | $186,081 | $155,065 | $138,205 |
| Sales (primarily allied products) | 34,999 | 30,565 | 24,566 |
| | 221,080 | 185,630 | 162,771 |
| Costs and Expenses | | | |
| Branch operating costs and expenses and cost of sales | 147,322 | 124,228 | 110,515 |
| Selling and administrative expenses | 34,356 | 29,579 | 25,790 |
| Interest, net | (1,869) | (3,173) | (2,220) |
| | 179,809 | 150,634 | 134,085 |
| Earnings Before Taxes and Cumulative Effect of Change in Accounting Principle | 41,271 | 34,996 | 28,686 |
| Income Taxes (Notes 1 and 9) | 17,792 | 15,568 | 12,927 |
| Earnings Before Cumulative Effect of Change in Accounting Principle | 23,479 | 19,428 | 15,759 |
| Cumulative Effect of Change in Accounting for Investment Tax Credits (Note 1) | 3,706 | — | — |
| Net Earnings | $ 27,185 | $ 19,428 | $ 15,759 |
| Per Share (Note 1) | | | |
| Before cumulative effect of change in accounting principle | $ 1.09 | $ .93 | $ .76 |
| Cumulative effect of change in accounting for investment tax credits (Note 1) | .17 | — | — |
| Net Earnings | $ 1.26 | $ .93 | $ .76 |

The accompanying notes are an integral part of these financial statements.

# Consolidated Statements of Shareholders' Equity

Safety-Kleen Corp. and Subsidiaries

(Amounts expressed in thousands)

| Common Shares Outstanding | | Total Shareholders Equity | Common Stock | Paid-In Surplus | Retained Earnings | Cumulative Translation Adjustments |
|---|---|---|---|---|---|---|
| 9,005,385 | Balance at January 1, 1983 | $ 55,946 | $ 901 | $ 6,051 | $ 49,900 | $ (906) |
| – | Net earnings | 15,759 | – | – | 15,759 | – |
| – | Cash dividends–$.30 per share | (2,722) | – | – | (2,722) | – |
| 79,124 | Stock options exercised | 1,152 | 8 | 1,144 | – | – |
| – | Tax benefits arising from stock option transactions | 234 | – | 234 | – | – |
| 27,420 | Stock issued for businesses acquired | 315 | 2 | 313 | – | – |
| – | Change in cumulative translation adjustments (Note 4) | (382) | – | – | – | (382) |
| 9,111,929 | Balance at December 31, 1983 | 70,302 | 911 | 7,742 | 62,937 | (1,288) |
| – | Net earnings | 19,428 | – | – | 19,428 | – |
| 4,601,670 | Stock issued as a result of a split-up effected in the form of a 50% stock dividend (Note 7) | – | 461 | (461) | – | – |
| – | Cash dividends–$.30 per share | (4,136) | – | – | (4,136) | – |
| 102,184 | Stock options exercised | 1,611 | 10 | 1,601 | – | – |
| – | Tax benefits arising from stock option transactions | 172 | – | 172 | – | – |
| – | Change in cumulative translation adjustments (Note 4) | (970) | – | – | – | (970) |
| 13,815,783 | Balance at December 29, 1984 | 86,407 | 1,382 | 9,054 | 78,229 | (2,258) |
| 298,228 | Adjustment for the pooling of interests of Custom Organics, Inc. (Note 2) | 2,823 | 30 | 39 | 2,754 | – |
| 14,114,011 | Restated balance at Dec. 29, 1984 | 89,230 | 1,412 | 9,093 | 80,983 | (2,258) |
| – | Net earnings (Note 1) | 27,185 | – | – | 27,185 | – |
| 7,140,316 | Stock issued as a result of a split-up effected in the form of a 50% stock dividend (Note 7) | – | 714 | (714) | – | – |
| – | Cash dividends–$.28 per share | (5,937) | – | – | (5,937) | – |
| 187,201 | Stock options exercised | 1,841 | 18 | 1,823 | – | – |
| – | Tax benefits arising from stock option transactions | 174 | – | 174 | – | – |
| – | Change in cumulative translation adjustments (Note 4) | 1,150 | – | – | – | 1,150 |
| 21,441,528 | Balance at December 28, 1985 | $113,643 | $2,144 | $10,376 | $102,231 | $(1,108) |

The accompanying notes are an integral part of these financial statements.

# Consolidated Balance Sheets

Safety-Kleen Corp. and Subsidiaries

(Expressed in thousands)

| | December 28, 1985 | December 29, 1984 |
|---|---|---|
| **Assets** | | (Note 2) |
| **Current Assets** | | |
| Cash | $ 3,645 | $ 1,032 |
| Short-term investments, at cost (approximates market) | 17,947 | 16,484 |
| Trade accounts receivable, less allowances of $1,996,000 in 1985 and $1,724,000 in 1984 | 25,298 | 21,548 |
| Refundable taxes | 753 | 3,405 |
| Inventories (Note 5) | 16,617 | 13,168 |
| Prepaid expenses (Note 8) | 8,831 | 5,886 |
| Other (Note 9) | 3,956 | 1,970 |
| | 77,047 | 63,493 |
| Equipment at Customers and Components, at Cost, Less Accumulated Depreciation of $18,512,000 in 1985 and $16,210,000 in 1984 | 19,654 | 16,595 |
| **Property, at Cost** | | |
| Land | 3,396 | 3,184 |
| Buildings and improvements | 19,695 | 17,085 |
| Leasehold improvements | 14,525 | 11,312 |
| Machinery and equipment | 37,771 | 30,404 |
| Autos and trucks | 27,723 | 17,581 |
| | 103,110 | 79,566 |
| Less accumulated depreciation and amortization | 29,173 | 22,068 |
| Property, net | 73,937 | 57,498 |
| Other Assets | 6,247 | 2,951 |
| | $176,885 | $140,537 |
| **Liabilities and Shareholders' Equity** | | |
| **Current Liabilities** | | |
| Dividends payable | $ 1,715 | $ 1,381 |
| Notes payable | 135 | 1,396 |
| Current portion of long-term debt | 1,000 | 1,065 |
| Trade accounts payable | 9,974 | 8,624 |
| Accrued salaries, wages and employee benefits | 6,461 | 5,804 |
| Other accrued expenses | 5,172 | 4,689 |
| Income taxes payable | 6,408 | 3,613 |
| | 30,865 | 26,572 |
| Long-Term Debt, Less Current Portion (Note 6) | 11,700 | 7,103 |
| **Other Liabilities and Deferrals** | | |
| Deferred income taxes | 20,569 | 12,823 |
| Deferred investment tax credits (Note 1) | – | 4,260 |
| Other | 108 | 549 |
| | 20,677 | 17,632 |
| Commitments and Contingent Liabilities (Note 10) | | |
| **Shareholders' Equity** | | |
| Common stock ($.10 par value; authorized 25,000,000 shares; issued and outstanding 21,441,528 in 1985, and 14,114,011 in 1984) (Note 7) | 2,144 | 1,412 |
| Paid-in surplus | 10,376 | 9,093 |
| Retained earnings (Note 6) | 102,231 | 80,983 |
| Cumulative translation adjustments (Note 4) | (1,108) | (2,258) |
| | 113,643 | 89,230 |
| | $176,885 | $140,537 |

The accompanying notes are an integral part of these balance sheets.

# Consolidated Statements of Changes in Financial Position

Safety-Kleen Corp. and Subsidiaries

| Fiscal Year Ended | Dec. 28, 1985 | Dec. 29, 1984 | Dec. 31, 1983 |
|---|---|---|---|
| | (Expressed in thousands) | | |
| Sources of Funds | | | |
| Operations | | | |
| Net earnings (Note 1) | $27,185 | $19,428 | $15,759 |
| Items not requiring funds | | | |
| Depreciation of equipment at customers | 3,170 | 2,771 | 2,644 |
| Other depreciation and amortization | 8,611 | 5,835 | 4,550 |
| Deferred investment tax credits (Notes 1 and 9) | (4,260) | 753 | 36 |
| Deferred income taxes (Note 9) | 7,517 | 6,458 | 2,701 |
| Other | 1 | (282) | (213) |
| Total funds from operations | 42,224 | 34,963 | 25,477 |
| Other Sources | | | |
| Issuance of Industrial Development Revenue Bonds | 5,700 | – | – |
| Recovery of investment in tax benefits (Note 9) | 528 | 1,970 | – |
| Net book value of equipment at customers, plant and equipment retired | 2,447 | 193 | 261 |
| Stock options exercised and related tax benefits (Note 7) | 2,015 | 1,783 | 1,386 |
| Total other sources | 10,690 | 3,946 | 1,647 |
| Total sources | 52,914 | 38,909 | 27,124 |
| Application of Funds | | | |
| Equipment at customers and component additions | 6,329 | 3,487 | 1,974 |
| Property, plant and equipment additions | 26,571 | 29,405 | 9,776 |
| Cash dividends declared | 5,937 | 4,136 | 2,722 |
| Increase in Industrial Development Revenue Bond Trust Funds | 3,623 | – | – |
| Reduction of long-term debt | 1,103 | 964 | 977 |
| Non-current portion of investment in tax benefits (Note 9) | – | – | 881 |
| Cumulative translation adjustments (Note 4) | (979) | 743 | 282 |
| Other, net | 1,069 | 360 | 1,358 |
| Total application | 43,653 | 39,095 | 17,970 |
| Increase (Decrease) in Working Capital | $ 9,261 | $ (186) | $ 9,154 |
| Details of Increase (Decrease) in Working Capital | | | |
| Increase (Decrease) in current assets | | | |
| Cash | $ 2,613 | $ (1,093) | $ (32) |
| Short-term investments | 1,463 | (363) | 3,737 |
| Trade accounts receivable | 3,750 | 2,810 | 1,678 |
| Refundable taxes | (2,652) | (1,602) | 4,657 |
| Inventories | 3,449 | 1,112 | 700 |
| Prepaid expenses | 2,945 | 4,224 | (294) |
| Other | 1,986 | (1,266) | 1,073 |
| Total increase in current assets | 13,554 | 3,822 | 11,519 |
| Decrease (Increase) in current liabilities | | | |
| Dividends payable | (334) | (1,381) | – |
| Notes payable | 1,261 | 142 | 104 |
| Current portion of long-term debt | 65 | 230 | (393) |
| Trade accounts payable | (1,350) | (1,229) | 471 |
| Accrued expenses | (1,140) | (1,313) | (1,659) |
| Income taxes payable | (2,795) | (457) | (888) |
| Total (increase) in current liabilities | (4,293) | (4,008) | (2,365) |
| Increase (Decrease) in Working Capital | $ 9,261 | $ (186) | $ 9,154 |

The accompanying notes are an integral part of these financial statements.

# Notes to Consolidated Financial Statements

## 1. Summary of Significant Accounting Policies

### Principles of Consolidation

The Consolidated Financial Statements include the accounts of the Company and its subsidiaries, after elimination of all significant intercompany balances and transactions. The Company's fiscal year ends on the Saturday closest to December 31.

### Inventories

Substantially all domestic allied product and solvent inventories are stated at last-in, first-out cost (LIFO). All other inventories are priced at the lower of first-in, first-out cost (FIFO) or market. Inventory costs include material, labor and manufacturing overhead.

### Equipment at Customers and Related Depreciation

Equipment at customers is capitalized at factory or purchased cost. Depreciation is computed using the straight-line method commencing when the units are placed in service.

### Property, Plant and Equipment and Related Depreciation

Land, buildings and improvements, leasehold improvements, machinery and equipment, and autos and trucks are capitalized at cost. Depreciation and amortization are computed principally using the straight-line method, except for autos and trucks which are depreciated using the straight-line and sum-of-the-years-digits methods.

### International License and Joint Venture Agreements

Safety-Kleen licensees operate parts cleaner service businesses in Australia, New Zealand, West Germany and Puerto Rico. License fees received by the Company are included in service revenues in the Consolidated Statements of Earnings. The Company has options to purchase the Australia and New Zealand operations on or after December 31, 1989 and the West German operation between May 1, 1988 and August 30, 1988.

During 1985, the Company entered into joint venture agreements to engage in the parts cleaner service business in France and Spain. The Company is a fifty percent equity partner in these joint venture companies with domestic corporations in each of these countries. These investments are accounted for by the equity method. The French joint venture began start-up operations in the fourth quarter of 1985, and the Spanish joint venture is expected to begin operations during the first quarter of 1986. The joint venture companies are licensees of the Company.

### Income Taxes

The Company provides for income taxes on items included in the Consolidated Statements of Earnings regardless of the period when such taxes are payable. Deferred income taxes result from timing differences between reported and taxable income. Deferred income taxes arise primarily from the excess of accelerated depreciation used for tax purposes over straight-line depreciation recorded for financial statement purposes and tax lease agreements as more fully described in Note 9.

In 1985, the Company changed its method of accounting for investment tax credits from the deferral to the flow-through method. The effect of the change was to increase earnings before cumulative effect of change in accounting principle by $673,000 or $.03 per share for the fiscal year ended December 28, 1985. The cumulative prior years effect of the change increased net earnings $3,706,000 or $.17 per share. If the flow-through method of accounting for investment tax credits had been used in prior years, 1984 and 1983 net earnings would have been $440,000 or $.02 per share, and $203,000 or $.01 per share, respectively, higher than as reported.

### Earnings Per Share

Earnings per share amounts are based on the average shares of common stock outstanding during each year and common stock equivalents of dilutive stock options. Earnings per share amounts have been restated to give effect to the three-for-two stock splits in December, 1985, and December, 1984, both effected in the form of 50 percent stock dividends.

2. Acquisition of Custom Organics, Inc.

Effective August 6, 1985, the Company acquired all of the outstanding shares of Custom Organics, Inc. in exchange for 457,500 shares of the Company's common stock (adjusted for the three-for-two stock split on December 9, 1985). The acquisition has been accounted for as a pooling of interests, and accordingly, the Consolidated Financial Statements have been restated to include the accounts of Custom Organics, Inc. for the twenty-four weeks ended June 15, 1985 (the interim period prior to the acquisition). The effect of the restatement was to increase sales and net earnings by $2,953,000 and $259,000, respectively, for the twenty-four weeks ended June 15, 1985. Earnings per share for that period remain unchanged. The Consolidated Balance Sheet as of December 29, 1984, has also been restated to include the accounts of Custom Organics, Inc. The Consolidated Statements of Earnings, Changes in Financial Position and Shareholders' Equity for periods prior to December 29, 1984, have not been restated because the effect is not material.

3. Segment Information

The Company operates in three countries: the United States, Canada and the United Kingdom. Principally, the same services and products are provided in each country. A summary of certain data with respect to these operations for the fiscal years ended December 28, 1985, December 29, 1984 and December 31, 1983 is as follows:

| | (Expressed in thousands) | | |
|---|---|---|---|
| | 1985 | 1984 | 1983 |
| Service Revenues and Sales | | | |
| United States | $206,400 | $172,161 | $149,463 |
| Canada and United Kingdom | 14,680 | 13,469 | 13,308 |
| Consolidated | $221,080 | $185,630 | $162,771 |
| Total Assets | | | |
| United States | $164,288 | $131,566 | $100,671 |
| Canada and United Kingdom | 12,597 | 8,971 | 8,877 |
| Consolidated | $176,885 | $140,537 | $109,548 |
| Net Earnings (Note 1) | | | |
| United States | $ 25,609 | $ 18,074 | $ 14,848 |
| Canada and United Kingdom | 1,576 | 1,354 | 911 |
| Consolidated | $ 27,185 | $ 19,428 | $ 15,759 |

The Company operates primarily in one business segment—providing services and products for degreasing and metal preparation. Total revenues, assets and earnings/losses of other segments are less than ten percent of the respective consolidated totals.

4. Foreign Currency Translation

The Company applies the provisions of Statement of Financial Accounting Standards No. 52 in translating the financial statements of its consolidated foreign subsidiaries.

Exchange losses were $87,000 in 1985, $128,000 in 1984 and $110,000 in 1983. These losses are included in selling and administrative expenses.

## 5. Inventories

LIFO inventories at December 28, 1985, and December 29, 1984, were $7,206,000 and $7,138,000, respectively. Under the FIFO method of accounting (which approximates current or replacement cost), inventories would have been $2,983,000 and $2,739,000 higher, respectively.

Major classes of inventory are:

| | (Expressed in thousands) | |
|---|---|---|
| | December 28, 1985 | December 29, 1984 |
| Allied products and related items | $ 8,071 | $ 5,582 |
| Solvent | 3,856 | 3,909 |
| Other | 4,690 | 3,677 |
| Total inventories | $16,617 | $13,168 |

## 6. Financial Arrangements and Long-Term Debt

Long-term debt at December 28, 1985, and December 29, 1984 consisted of the following:

| | (Expressed in thousands) | |
|---|---|---|
| | December 28, 1985 | December 29, 1984 |
| 9¼% Senior Notes payable to an insurance company, due in annual installments of $800,000 from 1986 to 1992 | $ 5,600 | $6,400 |
| Obligations under Licking County, Ohio 8% Industrial Development Revenue Bonds, Series 1980, due $200,000 annually from 1986 to 1992 | 1,400 | 1,600 |
| Obligations under Lexington County, South Carolina Industrial Development Revenue Bonds, Series 1985, interest of 63% of floating prime rate, due $300,000 annually from 1991 to 2000 | 3,000 | — |
| Obligations under City of Denton, Texas Industrial Development Authority, Industrial Development Revenue Bonds, Series 1985, interest of 61.5% of floating prime rate, due $270,000 annually from 1991 to 2000 | 2,700 | — |
| Other | — | 168 |
| | 12,700 | 8,168 |
| Less current portion | 1,000 | 1,065 |
| Total long-term debt | $11,700 | $7,103 |

Maturities of long-term debt are $1,000,000 in each of the five fiscal years succeeding December 28, 1985.

The interest rates on the Lexington, SC, and City of Denton, TX Industrial Development Revenue Bonds are subject to change if changes in the Federal income tax laws affect the taxability of the interest income to the holder of these bonds.

The 9¼ percent Senior Notes and the Industrial Development Revenue Bonds include provisions, among others, relative to additional borrowings, maintenance of working capital, and restrictions on the amount of retained earnings available for dividends. Under the most restrictive of these covenants, the Company must maintain a current ratio, as defined, of 1.5 to 1.0. At December 28, 1985, the current ratio, as defined, was 2.4 to 1.0. At that date, $72,896,000 of retained earnings were restricted as to payment of cash dividends.

The Company has established with a U.S. bank an unsecured line of credit totaling $2,500,000 at the prime interest rate with compensating balances equal to 15 percent of the line of credit. The Company intends to continue this line of credit during fiscal 1986.

## 7. Capital Stock

### Stock Splits

In December, 1985, and December, 1984, three-for-two stock splits were effected in the form of stock dividends by issuance of an additional share of $.10 par value common stock for each two shares then outstanding. The par value of the shares issued was transferred from paid-in surplus to common stock. The number of shares and per share amounts below have been restated to reflect such distributions.

### 1985 Stock Option Plan

On May 10, 1985, stockholders approved the 1985 Stock Option Plan. Under the Plan, options to purchase up to 750,000 shares of the Company's common stock may be granted to officers and other key employees at a price of 100 percent of the quoted market price at date of grant. Options granted under the Plan may be either Incentive Stock Options or Non-Qualified Stock Options. Stock appreciation rights (SAR's) may be granted in conjunction with Non-Qualified Stock Options whereby the grantee may surrender exercisable Non-Qualified Options and receive a cash payment equal to the difference between the option price and the market value of the common stock on the exercise date. Incentive Options, Non-Qualified Options and SAR's become exercisable at such time or times, and are subject to such conditions, as determined at the time of grant by the Compensation Committee of the Board of Directors. At December 28, 1985, 158,762 Incentive Stock Options were outstanding at an average price of $24.41. As of December 28, 1985, there have been no grants of Non-Qualified Stock Options with or without SAR's. As of December 28, 1985, there were no options exercisable and 591,238 options were available for grant. During fiscal year 1985, there were no Incentive Options, Non-Qualified Options or SAR's exercised.

### 1980 Stock Option Plan

Under the Company's 1980 Stock Option Plan, as amended, options for 1,350,000 common shares were available for grant to officers and other key employees at a price of 100 percent of the quoted market price at date of grant. Options are exercisable 25 percent annually, on a cumulative basis, starting one year from date of grant and terminating five years after the grant date.

In addition to stock options, SAR's were available for grant. Compensation expense was charged or credited for outstanding SAR's as the market value of the Company's common stock changed. SAR charges to compensation expense amounted to $81,000 in 1985, $38,000 in 1984 and $483,000 in 1983. At December 28, 1985, there were no outstanding options with SAR's. Other option plan data for the three fiscal years ended December 28, 1985 are presented below.

| 1980 Stock Option Plan Data | 1985 | 1984 | 1983 |
|---|---|---|---|
| Options outstanding at end of year | | | |
| Number of options | 401,715 | 690,490 | 741,375 |
| Average price per share | $11.24 | $10.82 | $7.09 |
| Options exercised during the year | | | |
| Number of options | 252,748 | 204,600 | 138,825 |
| Average price per share | $5.81 | $5.12 | $4.88 |
| Number of options exercisable at end of year | 86,860 | 222,900 | 174,600 |
| Options available for grant at end of year | — | — | 314,550 |

No additional options may be granted under the plan after December 31, 1984.

### Stock Purchase Plans

Under the Employee Stock Purchase Plan, approved by the shareholders on May 10, 1985, a total of 375,000 shares of the Company's common stock may be purchased by employees of the Company and designated subsidiaries, through payroll deductions, at 90 percent of the quoted market price for the date preceding the date of grant. Employees with less than one year of service or who hold options under either the 1980 or 1985 Stock Option Plans are not eligible to participate in this Plan. Under the predecessor plan, approved by shareholders in 1980, 675,000 shares of the Company's common stock were available for

purchase. The provisions of the predecessor plan were substantially identical to the 1985 plan. Data for the Stock Purchase Plan and predecessor plan for the three years ended December 28, 1985 are presented below.

| Stock Purchase Plan Data | 1985 | 1984 | 1983 |
|---|---|---|---|
| Options outstanding at end of year | | | |
| Number of options | 50,755 | 58,050 | 59,625 |
| Average price per share | $19.50 | $12.90 | $13.86 |
| Options exercised during the fiscal year | | | |
| Number of options | 54,467 | 37,350 | 92,700 |
| Average price per share | $12.95 | $13.08 | $7.02 |
| Number of options exercisable at end of year | – | – | 7,650 |
| Options available for grant at end of year | 323,763 | – | 330,300 |

8. Pension and Employee Benefit Plans

The Company has pension plans covering substantially all employees including certain employees in foreign countries. The annual cost of the Company's domestic pension plans is determined using an actuarial cost method which relates pension cost to direct compensation. The prior service portion of plan changes and revisions to actuarial assumptions is amortized in equal annual amounts over thirty years. Aggregate provisions under these plans were $784,000 in 1985, $718,000 in 1984 and $683,000 in 1983. Pension costs are funded as employees become eligible to participate, generally after completing one year of service.

A summary of accumulated plan benefits and plan net assets for the Company's domestic pension plans, computed as of the actuarial valuation dates, is presented below.

| | January 1, 1985 | January 1, 1984 |
|---|---|---|
| Actuarial present value of accumulated plan benefits | | |
| Vested | $2,980,000 | $2,319,000 |
| Nonvested | 1,203,000 | 1,042,000 |
| | $4,183,000 | $3,361,000 |
| Net assets available for benefits | $7,245,000 | $6,523,000 |

The weighted average assumed rate of return used in determining the actuarial present value of plan benefits was 9.2 and 9.3 percent for the 1985 and 1984 valuations, respectively.

Under the provisions of Statements of Financial Accounting Standards Nos. 35 and 36, the actuarial present value of accumulated plan benefits reflects employees' salaries earned to date and does not consider the impact of future salary increases from inflation or otherwise. Plan assets exceed the above-described calculation of the actuarial present value of accumulated plan benefits primarily because the Company's funding policy, in accordance with the recommendations of the Company's actuary and commonly recognized funding techniques, considers future salary increases.

The Company's foreign pension plans do not report pursuant to ERISA and do not otherwise determine the actuarial value of accumulated benefits or net assets available for benefits as calculated and disclosed above. Those plans are funded by purchase of insurance contracts and vested benefits are fully funded.

During 1984, the Company established a Voluntary Employee Beneficiary Association (VEBA). The VEBA is an irrevocable trust created to fund employee medical and life insurance benefits. VEBA trust balances of $5,484,000 and $4,100,000, respectively, are included in Prepaid expenses in the December 28, 1985 and December 29, 1984, Consolidated Balance Sheets.

In 1985, the Company offered a postretirement medical insurance plan to its domestic employees retiring prior to the normal retirement age of 65. Retirees are eligible to continue this medical coverage until age 65. Retirees electing this coverage are required to pay premiums for the insurance. Claims paid under the provisions of this plan are paid by the Company's employee medical plan which is funded by the VEBA trust. During 1985, there were two participants in the plan and the costs incurred were not material.

## 9. Income Taxes

The components of earnings before taxes, and cumulative effect of change in accounting principle, consisted of the following:

| | (Expressed in thousands) | | |
|---|---|---|---|
| | 1985 | 1984 | 1983 |
| Domestic | $38,644 | $32,581 | $26,713 |
| Foreign | 2,627 | 2,415 | 1,973 |
| | $41,271 | $34,996 | $28,686 |

The provisions for income taxes are comprised of the following:

| | (Expressed in thousands) | | |
|---|---|---|---|
| | 1985 | 1984 | 1983 |
| U.S. Federal | | | |
| Current | $ 6,919 | $ 5,324 | $ 7,410 |
| Deferred | | | |
| Related to tax depreciation in excess of book depreciation | 2,659 | 2,329 | 1,621 |
| Investment tax credits (Note 1) | – | 753 | 36 |
| Related to tax lease agreements | 4,173 | 2,081 | 1,031 |
| Related to contributions to VEBA Trust (Note 8) | 413 | 1,886 | – |
| Decrease in prepaid taxes | 93 | 108 | 104 |
| Foreign | | | |
| Current | 1,051 | 1,097 | 1,123 |
| Deferred, primarily related to book depreciation in excess of tax depreciation | – | (36) | (57) |
| State | 2,484 | 2,026 | 1,659 |
| | $17,792 | $15,568 | $12,927 |

The following table reconciles the statutory U.S. Federal income tax rate to the Company's effective tax rate:

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Statutory U.S. Federal income tax rate | 46.0% | 46.0% | 46.0% |
| Increase (Decrease) resulting from— | | | |
| Provision for state income taxes, net of Federal income tax benefit | 3.3 | 3.1 | 3.1 |
| Amortization of deferred investment tax credits (Note 1) | – | (2.5) | (2.6) |
| Flow through of investment tax credits (Note 1) | (4.4) | – | – |
| Other | (1.8) | (2.2) | (1.4) |
| Effective tax rate | 43.1% | 44.4% | 45.1% |

In 1983, 1982 and 1981, the Company entered into several "tax lease" agreements to purchase tax benefits. The total cash price paid by the Company was approximately $21.1 million.

Under these agreements, which vary in length from nine to twenty-two and one-half years, the Company purchased the tax benefits, including investment tax credits, related to equipment with a cost of approximately $74.5 million. This equipment was simultaneously leased back to the original owners, who continue to have legal title to the assets and bear all risks of ownership. At the end of the lease agreements, "tax ownership" reverts to the original owners for a nominal price.

For financial statement purposes, the cash payment of $21.1 million was treated as an investment. The investment has been reduced as a result of a reduction in taxes which otherwise would have been payable, net of income recognized on the investment. Investment tax credits were utilized to reduce Federal income taxes payable in the year of equipment purchase. Depreciation and other items related to the agreements were used to

reduce taxes under the Company's normal tax accounting methods.

The investment tax credits and depreciation deductions the Company is entitled to take on its tax return as a result of these transactions will generate a tax deferral in excess of the cash price paid. This deferral will ultimately be paid by the Company as net lease income is reported for tax purposes. The Company will be in a favorable cash flow position for most of the life of each lease.

The transactions also include notes to the sellers for the difference between the cash price of $21.1 million and the asset cost of $74.5 million. Payments on these notes, including interest, are due in amounts and at times exactly equal to the sellers' obligations to make lease payments to the Company. Since these amounts completely offset one another, there will be no actual payment or receipt of cash and therefore, the notes and lease obligations are not reported in the Company's Consolidated Financial Statements.

Interest income is recorded at a constant rate during the time period when the investment exceeds the tax savings. Interest expense is recorded at a constant rate on the deferred income taxes in the time period after the investment is fully recovered. Income and expense recorded for these agreements is included in Interest, net with no corresponding income tax effect. In 1985, 1984 and 1983, the Company recorded $380,000, $1,437,000 and $1,194,000, respectively, of interest income, net in connection with these agreements. At December 28, 1985, the Company's Consolidated Balance Sheet reflects a remaining investment of $532,000 in Current Assets—Other.

## 10. Commitments and Contingent Liabilities

### Leases

The Company leases substantially all of its branches over initial periods of five to ten years, with options for renewal for one similar period. These leases generally provide that the Company pay operating maintenance expenses and tax increases and do not contain provisions for the Company to purchase the leased properties. The Company leases substantially all pre-1982 additions to its domestic service truck fleet under terms that are noncancelable during the first year and are on a year-to-year rental basis thereafter. These leases provide that the Company pay all operating expenses and taxes and also that the Company be responsible for most of the gain or loss on disposition of the trucks upon termination or cancellation of the leases. Since 1982, the Company has purchased substantially all additions and replacements to the service truck fleet.

Lease rental expenses for all operating leases were $5,713,000 in 1985, $6,235,000 in 1984 and $6,201,000 in 1983.

Aggregate minimum future rentals are payable as follows:

| Periods | (Expressed in thousands) |
|---|---|
| 1986 | $ 5,034 |
| 1987 | 4,232 |
| 1988 | 3,524 |
| 1989 | 2,795 |
| 1990 | 2,274 |
| Future Years | 9,058 |
| Total | $26,917 |

### Employment Contract

Donald W. Brinckman, President and Chief Executive Officer, has an employment contract which includes a provision that the Company will offer to repurchase any shares of the Company's common stock owned by Mr. Brinckman at his death at the then fair market value in an amount not to exceed $2,500,000.

## Directors

Russell A. Gwillim, Chairman of the Board, Safety-Kleen Corp.
Kenneth L. Block, Chairman, A. T. Kearney & Co., Inc.
Donald W. Brinckman, President and Chief Executive Officer, Safety-Kleen Corp.
Robert M. Burns, retired Chairman of the Automotive Group, Colt Industries
Edgar D. Jannotta, Managing Partner, William Blair & Company
Karl G. Otzen, President, Gerhard & Company
Paul D. Schrage, Senior Executive Vice President, McDonald's Corporation
W. Gordon Wood, Marketing Consultant
Clinton Youle, Financial Consultant

## Officers and Divisional Vice Presidents

Donald W. Brinckman, President, Chief Executive Officer and Director
David A. Dattilo, Vice President Corporate Branch Sales and Service
Burton E. Ericson, Vice President General Counsel
Kenneth R. Gordon, Vice President Technical Services
Joseph F. Hamlet, Vice President International
William P. Kasko, Vice President Operations
Wallace K. Louder, Vice President Information Systems
Robert W. Willmschen, Jr., Vice President Finance/Administration and Secretary
Leonard F. Martinez, Jr., Controller and Assistant Secretary
Laurence M. Rudnick, Treasurer
Dale T. Vranik, Vice President Branch Sales and Service, Western Division
Harry A. Logue, Vice President Branch Sales and Service, Eastern Division
Roy D. Bullinger, Vice President Branch Sales and Service, Central Division
Clyde R. Phillips, Vice President Restaurant Services

# Corporate Data

**Corporate Offices**

[illegible]

**Auditors**

[illegible]

**Annual Meeting**

[illegible]

[illegible]

**Stock Symbol**

[illegible]

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the twelve weeks ended March 22, 1986 Commission File #1-8513

SAFETY-KLEEN CORP.
(Exact name of registrant as specified in its charter)

Wisconsin
(State or other jurisdiction of incorporation or organization)

39-6090019
(I.R.S. Employer Identification No.)

777 Big Timber Road, Elgin, Illinois 60120
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code (312) 697-8460

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceeding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ____

Shares of common stock, outstanding at March 22, 1986 were 21,483,043.

## SAFETY-KLEEN CORP. AND SUBSIDIARIES

## PART I. FINANCIAL STATEMENTS

The condensed financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, these statements contain all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the financial position as of March 22, 1986 and December 28, 1985, changes in financial position for the twelve-week periods ended March 22, 1986 and March 23, 1985, and the results of operations for the twelve-week periods ended March 22, 1986 and March 23, 1985. The 1986 interim results reported herein may not necessarily be indicative of the results of operations for the full year 1986.

SAFETY-KLEEN CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(dollar amounts are in thousands)

ASSETS

| | March 22, 1986 | Dec. 28, 1985 |
|---|---|---|
| Current assets: | | |
| Cash | $ 5,487 | $ 3,645 |
| Short-term investments, at cost (approximates market) | 19,052 | 17,947 |
| Trade accounts receivable, less allowances of $2,016 and $1,996, respectively | 26,801 | 25,298 |
| Refundable taxes | 473 | 753 |
| Inventories (Note 1) | 16,866 | 16,617 |
| Prepaid expenses | 8,705 | 8,831 |
| Other | 2,359 | 3,956 |
| Total current assets | 79,743 | 77,047 |
| Equipment at customers and components, at cost, less accumulated depreciation of $19,294 and $18,512, respectively | 20,443 | 19,654 |
| Property, plant and equipment, at cost | 110,674 | 103,110 |
| Less accumulated depreciation and amortization | 30,923 | 29,173 |
| | 79,751 | 73,937 |
| Other assets | 4,930 | 6,247 |
| | $184,867 | $176,885 |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | March 22, 1986 | Dec. 28, 1985 |
|---|---|---|
| Current liabilities: | | |
| Dividends payable | $ 1,718 | $ 1,715 |
| Notes payable | - | 135 |
| Current portion of long-term debt | 1,934 | 1,000 |
| Trade accounts payable | 12,037 | 9,974 |
| Accrued expenses | 9,569 | 11,633 |
| Income taxes payable | 6,048 | 6,408 |
| Total current liabilities | 31,306 | 30,865 |
| Long-term debt, less current portion | 10,850 | 11,700 |
| Other liabilities and deferrals: | | |
| Deferred income taxes | 24,407 | 20,569 |
| Other | 108 | 108 |
| | 24,515 | 20,677 |
| Shareholders' equity (Notes 2 and 3): | | |
| Common stock ($.10 par value; authorized 25,000,000 shares; issued and outstanding 21,483,043 shares and 21,441,528 shares, respectively) | 2,148 | 2,144 |
| Paid-in surplus | 10,655 | 10,376 |
| Retained earnings | 106,153 | 102,231 |
| Cumulative translation adjustments | (760) | (1,108) |
| | 118,196 | 113,643 |
| | $184,867 | $176,885 |

The accompanying notes are an integral part of these balance sheets.

## SAFETY-KLEEN CORP. AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF EARNINGS
(dollar amounts are in thousands except per share data)

| | Twelve Weeks Ended | |
|---|---|---|
| | Mar. 22, 1986 | Mar. 23, 1985 (Note 5) |
| Revenues and sales: | | |
| Service revenues | $ 46,701 | $ 39,705 |
| Sales (primarily allied products) | 7,656 | 7,905 |
| Total service revenues and sales | 54,357 | 47,610 |
| Costs and expenses: | | |
| Branch operating costs and expenses and cost of sales | 35,819 | 31,995 |
| Selling and administrative expenses | 8,907 | 7,306 |
| Interest, net | (390) | (467) |
| | 44,336 | 38,834 |
| Earnings before taxes and cumulative effect of change in accounting principle | 10,021 | 8,776 |
| Income taxes | 4,381 | 3,857 |
| Earnings before cumulative effect of change in accounting principle | 5,640 | 4,919 |
| Cumulative effect of change in accounting for investment tax credits (Note 4) | - | 3,706 |
| Net earnings | $ 5,640 | $ 8,625 |
| Earnings per common and common equivalent share (Notes 2 and 3): | | |
| Before cumulative effect of change in accounting principle | $ .26 | $ .23 |
| Cumulative effect of change in accounting for investment tax credits | - | .17 |
| | $ .26 | $ .40 |
| Average number of common and common equivalent shares outstanding (Notes 2 and 3) | 21,737,800 | 21,543,300 |
| Cash dividends per common share | $ .080 | $ .066 |

The accompanying notes are an integral part of these financial statements.

SAFETY-KLEEN CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
(dollar amounts are in thousands)

| | Twelve Weeks Ended | |
|---|---|---|
| | Mar. 22, 1986 | Mar. 23, 1985 (Note 5) |
| Sources of funds: | | |
| Funds from operations | $ 12,545 | $ 9,226 |
| Recovery of investment in tax benefits | - | 522 |
| Net book value of equipment at customers, plant and equipment retired | 228 | 89 |
| Other sources | 1,204 | 475 |
| Total sources | 13,977 | 10,312 |
| Application of funds: | | |
| Cash dividends declared | 1,718 | 1,387 |
| Equipment at customers and component additions | 1,479 | 1,451 |
| Property, plant and equipment additions | 8,127 | 5,882 |
| Other | 398 | 235 |
| Total application | 11,722 | 8,955 |
| Increase in working capital | $ 2,255 | $ 1,357 |
| Details of increase in working capital: | | |
| Increase (Decrease) in current assets: | | |
| Cash | $ 1,842 | $ 368 |
| Short-term investments | 1,105 | 3,304 |
| Trade accounts receivable | 1,503 | (150) |
| Refundable taxes | (280) | (1,616) |
| Inventories | 249 | 5 |
| Prepaid expenses | (126) | (507) |
| Other | (1,597) | 134 |
| Total increase in current assets | 2,696 | 1,538 |
| Decrease (Increase) in current Liabilities: | | |
| Dividends payable | (3) | (7) |
| Notes payable | 135 | 339 |
| Current portion of long-term debt | (934) | 15 |
| Trade accounts payable | (2,063) | (792) |
| Accrued expenses | 2,064 | 1,505 |
| Income taxes payable | 360 | (1,241) |
| Total (increase) in current liabilities | (441) | (181) |
| Increase in working capital | $ 2,255 | $ 1,357 |

The accompanying notes are an integral part of these financial statements.

1. INVENTORIES

LIFO inventories at March 22, 1986 and December 28; 1985 were $7,078,000 and $7,206,000, respectively. Under the FIFO method of accounting (which approximates current or replacement cost), inventories would have been $2,861,000 and $2,983,000 higher, respectively, than those reported at March 22, 1986 and December 28, 1985. Major classes of inventories at March 22, 1986 and December 28, 1985 were as follows:

| | Mar. 22, 1986 | Dec. 28, 1985 |
|---|---|---|
| | (Expressed in thousands) | |
| Allied products and related items | $ 7,615 | $ 8,071 |
| Solvent | 4,364 | 3,856 |
| Other | 4,887 | 4,690 |
| Total inventories | $16,866 | $16,617 |

2. STOCK SPLIT

The 1985 per share amounts have been restated to reflect a three-for-two stock split on December 9, 1985, effected in the form of a 50% stock dividend.

3. EARNINGS PER SHARE

Earnings per common and common equivalent share have been calculated based on the average number of shares of common stock outstanding plus additional shares for dilutive stock options and the Employee Stock Purchase Plan.

4. ACCOUNTING CHANGE

In 1985, the Company changed its method of accounting for investment tax credits from the deferral to the flow-through method. The cumulative prior years' effect of the change increased net earnings $3,706,000 or $.17 per share.

5. ACQUISITION OF CUSTOM ORGANICS, INC.

Effective August 6, 1985, the Company acquired Custom Organics, Inc. The acquisition was accounted for as a pooling of interests. Accordingly, the Consolidated Financial Statements for the twelve weeks ended March 23, 1985 were restated to include the accounts of Custom Organics, Inc. The effect of the restatement was to increase sales and net earnings by $1,467,000 and $127,000, respectively, for the twelve weeks ended March 23, 1985. Earnings per share remained unchanged.

6. INTERIM REPORTING PERIODS

The Company's interim reporting periods are twelve weeks each for the first three reporting periods of the year, seventeen weeks for the fourth reporting period of 1986, and sixteen weeks for the fourth reporting period of 1985.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Financial Condition

The Company's working capital increased from $46,182,000 at December 28, 1985 to $48,437,000 at March 22, 1986. This growth is reflected primarily in cash, short-term investments and trade accounts receivables which increased $4,450,000 during the twelve weeks ended March 22, 1986, offset by a reduction in current assets—other of $1,597,000.

### Results of Operations

### Comparison of the Twelve-Week Periods Ended March 22, 1986 and March, 23, 1985

#### Revenues and Sales

Service revenues for the twelve weeks ended March 22, 1986 increased $6,996,000 or 17.6% over the comparable period in 1985. The Company's parts cleaner service contributed approximately 56% of the increase. During the twelve weeks ended March 22, 1986, the parts cleaner service volume and average service charge were 3.6% and 8.0% higher, respectively, than the comparable 1985 period. The remaining increase in service revenues was derived primarily from higher unit volume in restaurant services, automotive paint refinishing services, dry cleaner services and the exchange and recycling of industrial solvents. Sales, primarily allied products, declined $249,000 or 3.1% from the comparable period of 1985, due primarily to the absence of sales during the first twelve weeks of 1986 from the Company's formerly-owned map distribution operations, which were sold during the fourth interim period of 1985.

#### Branch Operating Costs and Expenses and Cost of Sales

Branch operating costs and expenses and cost of sales in the twelve weeks ended March 22, 1986 were up 12% over the comparable period of 1985, primarily due to the increased level of business activity. This increase is less than the 14% increase in revenues and sales. The resulting improvement in the gross profit margin is due to higher unit volume, higher average service charges and a decline in the cost of virgin solvent used in the Company's domestic parts cleaner service.

#### Selling and Administrative Expenses

Selling and administrative expenses increased by $1,601,000 or 22%, primarily due to additional employees; increases in salaries, benefits, and other compensation based upon sales and consolidated earnings; increases in insurance costs; and increases in other general corporate expenses related to the increased level of business activity.

#### Income Taxes

The effective income tax rate was 43.7% for the twelve weeks ended March 22, 1986 and 43.9% for the comparable 1985 period.

SAFETY-KLEEN CORP. AND SUBSIDIARIES

PART II.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits
(3)b. By-laws of the Registrant, amended on February 10, 1986.

(b) Reports on Form 8-K
None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 2, 1986

By: (signed) Donald W. Brinckman
Donald W. Brinckman
President and Chief Executive Officer

Date: May 2, 1986

By: (signed) Robert W. Willmschen, Jr.
Robert W. Willmschen, Jr.
Vice President Finance/Administration and Secretary

Date: May 2, 1986

By: (signed) Leonard F. Martinez, Jr.
Leonard F. Martinez, Jr.
Controller and Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the twelve weeks ended June 14, 1986 Commission File #1-8513

SAFETY-KLEEN CORP.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Wisconsin | 39-6090019 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

777 Big Timber Road, Elgin, Illinois 60123
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code (312) 697-8460

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ____

Shares of common stock, outstanding at June 14, 1986 were 21,525,900.

## SAFETY-KLEEN CORP. AND SUBSIDIARIES

## PART I. FINANCIAL STATEMENTS

The condensed financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, these statements contain all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the financial position as of June 14, 1986 and December 28, 1985, changes in financial position for the twenty-four-week periods ended June 14, 1986 and June 15, 1985, and the results of operations for the twelve-week and twenty-four-week periods ended June 14, 1986 and June 15, 1985. The 1986 interim results reported herein may not necessarily be indicative of the results of operations for the full year 1986.

# SAFETY-KLEEN CORP. AND SUBSIDIARIES
## CONSOLIDATED BALANCE SHEETS
(dollar amounts are in thousands)

### ASSETS

| | June 14, 1986 | Dec. 28, 1985 |
|---|---|---|
| Current assets: | | |
| Cash | $ 4,933 | $ 3,645 |
| Short-term investments, at cost (approximates market) | 21,217 | 17,947 |
| Trade accounts receivable, less allowances of $1,849 and $1,996, respectively | 27,214 | 25,298 |
| Refundable taxes | 473 | 753 |
| Inventories (Note 1) | 17,235 | 16,617 |
| Prepaid expenses | 7,594 | 8,831 |
| Other | 2,395 | 3,956 |
| Total current assets | 81,061 | 77,047 |
| Equipment at customers and components, at cost, less accumulated depreciation of $20,078 and $18,512, respectively | 20,960 | 19,654 |
| Property, plant and equipment, at cost | 117,788 | 103,110 |
| Less accumulated depreciation and amortization | 33,001 | 29,173 |
| | 84,787 | 73,937 |
| Other assets | 3,955 | 6,247 |
| | $190,763 | $176,885 |

### LIABILITIES AND SHAREHOLDERS' EQUITY

| | June 14, 1986 | Dec. 28, 1985 |
|---|---|---|
| Current liabilities: | | |
| Dividends payable | $ 1,722 | $ 1,715 |
| Notes payable | - | 135 |
| Current portion of long-term debt | 1,134 | 1,000 |
| Trade accounts payable | 11,185 | 9,974 |
| Accrued expenses | 9,946 | 11,633 |
| Income taxes payable | 7,101 | 6,408 |
| Total current liabilities | 31,088 | 30,865 |
| Long-term debt, less current portion | 10,000 | 11,700 |
| Other liabilities and deferrals: | | |
| Deferred income taxes | 26,249 | 20,569 |
| Other | 109 | 108 |
| | 26,358 | 20,677 |
| Shareholders' equity (Notes 2 and 3): | | |
| Common stock ($.10 par value; authorized 75,000,000 shares and 25,000,000 shares, respectively; issued and outstanding 21,525,900 shares and 21,441,528 shares, respectively) | 2,152 | 2,144 |
| Paid-in surplus | 10,956 | 10,376 |
| Retained earnings | 110,910 | 102,231 |
| Cumulative translation adjustments | (701) | (1,108) |
| | 123,317 | 113,643 |
| | $190,763 | $176,885 |

The accompanying notes are an integral part of these balance sheets.

SAFETY-KLEEN CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS
(dollar amounts are in thousands except per share data)

| | Twelve Weeks Ended | | Twenty-Four Weeks Ended | |
|---|---|---|---|---|
| | June 14, 1986 | June 15, 1985 (Note 5) | June 14, 1986 | June 15, 1985 (Note 5) |
| Revenues and sales: | | | | |
| Service revenues | $ 49,671 | $ 42,343 | $ 96,372 | $ 82,048 |
| Sales (primarily allied products) | 8,665 | 8,555 | 16,321 | 16,460 |
| Total service revenues and sales | 58,336 | 50,898 | 112,693 | 98,508 |
| Costs and expenses: | | | | |
| Branch operating costs and expenses and cost of sales | 37,606 | 33,904 | 73,425 | 65,899 |
| Selling and administrative expenses | 9,600 | 7,584 | 18,507 | 14,890 |
| Interest, net | (299) | (439) | (689) | (906) |
| | 46,907 | 41,049 | 91,243 | 79,883 |
| Earnings before taxes and cumulative effect of change in accounting principle | 11,429 | 9,849 | 21,450 | 18,625 |
| Income taxes | 4,950 | 4,375 | 9,331 | 8,232 |
| Earnings before cumulative effect of change in accounting principle | 6,479 | 5,474 | 12,119 | 10,393 |
| Cumulative effect of change in accounting for investment tax credits (Note 4) | - | - | - | 3,706 |
| Net earnings | $ 6,479 | $ 5,474 | $ 12,119 | $ 14,099 |
| Earnings per common and common equivalent share (Notes 2 & 3): | | | | |
| Before cumulative effect of change in accounting principle | $ .30 | $ .25 | $ .56 | $ .48 |
| Cumulative effect of change in accounting for investment tax credits | - | - | - | .17 |
| Net earnings | $ .30 | $ .25 | $ .56 | $ .65 |
| Average number of common and common equivalent shares outstanding (Notes 2 and 3) | 21,806,600 | 21,592,100 | 21,773,400 | 21,570,200 |
| Cash dividends per common share | $ .080 | $ .067 | $ .160 | $ .133 |

The accompanying notes are an integral part of these financial statements.

SAFETY-KLEEN CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
(dollar amounts are in thousands)

| | Twenty-Four Weeks Ended | |
|---|---|---|
| | June 14, 1986 | June 15, 1985 (Note 5) |
| Sources of funds: | | |
| Funds from operations | $ 23,994 | $ 19,371 |
| Recovery of investment in tax benefits | - | 528 |
| Net book value of equipment at customers, plant and equipment retired | 368 | 173 |
| Decrease in Industrial Revenue Bond Trust Fund | 2,176 | - |
| Other sources | 588 | 1,018 |
| Total sources | 27,126 | 21,090 |
| Application of funds: | | |
| Cash dividends declared | 3,440 | 2,781 |
| Equipment at customers and component additions | 2,836 | 2,967 |
| Property, plant and equipment additions | 15,459 | 11,805 |
| Other | 1,600 | 1,627 |
| Total application | 23,335 | 19,180 |
| Increase in working capital | $ 3,791 | $ 1,910 |
| Details of increase in working capital: | | |
| Increase (Decrease) in current assets: | | |
| Cash | $ 1,288 | $ 2,956 |
| Short-term investments | 3,270 | 1,833 |
| Trade accounts receivable | 1,916 | 1,670 |
| Refundable taxes | (280) | (1,646) |
| Inventories | 618 | 1,823 |
| Prepaid expenses | (1,237) | (1,247) |
| Other | (1,561) | (289) |
| Total increase in current assets | 4,014 | 5,100 |
| Decrease (Increase) in current Liabilities: | | |
| Dividends payable | (7) | (12) |
| Notes payable | 135 | 622 |
| Current portion of long-term debt | (134) | 21 |
| Trade accounts payable | (1,211) | (2,629) |
| Accrued expenses | 1,687 | 1,353 |
| Income taxes payable | (693) | (2,545) |
| Total (increase) in current liabilities | (223) | (3,190) |
| Increase in working capital | $ 3,791 | $ 1,910 |

The accompanying notes are an integral part of these financial statements.

SAFETY-KLEEN CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. INVENTORIES

LIFO inventories at June 14, 1986 and December 28, 1985 were $7,420,000 and $7,206,000, respectively. Under the FIFO method of accounting (which approximates current or replacement cost), inventories would have been $2,106,000 and $2,983,000 higher, respectively, than those reported at June 14, 1986 and December 28, 1985. Major classes of inventories at June 14, 1986 and December 28, 1985 were as follows:

| | June 14, 1986 | Dec. 28, 1985 |
|---|---|---|
| | (Expressed in thousands) | |
| Allied products and related items | $ 7,316 | $ 8,071 |
| Solvent | 4,731 | 3,856 |
| Other | 5,188 | 4,690 |
| Total inventories | $17,235 | $16,617 |

2. STOCK SPLIT

The 1985 per share amounts have been restated to reflect a three-for-two stock split on December 9, 1985, effected in the form of a 50% stock dividend.

3. EARNINGS PER SHARE

Earnings per common and common equivalent share have been calculated based on the average number of shares of common stock outstanding plus additional shares for dilutive stock options and the Employee Stock Purchase Plan.

4. ACCOUNTING CHANGE

In 1985, the Company changed its method of accounting for investment tax credits from the deferral to the flow-through method. The cumulative prior years' effect of the change increased net earnings $3,706,000 or $.17 per share.

5. ACQUISITION OF CUSTOM ORGANICS, INC.

Effective August 6, 1985, the Company acquired Custom Organics, Inc. The acquisition was accounted for as a pooling of interests. Accordingly, the Consolidated Financial Statements for the twelve weeks and twenty-four weeks ended June 15, 1985 were restated to include the accounts of Custom Organics, Inc. The effect of the restatement was to increase sales and net earnings by $1,486,000 and $132,000, respectively, for the twelve weeks ended June 15, 1985, and by $2,953,000 and $259,000, respectively, for the twenty-four weeks ended June 15, 1985. Earnings per share remained unchanged.

6. INTERIM REPORTING PERIODS

The Company's interim reporting periods are twelve weeks each for the first three reporting periods of the year, seventeen weeks for the fourth reporting period of 1986, and sixteen weeks for the fourth reporting period of 1985.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Financial Condition

The Company's working capital increased from $46,182,000 at December 28, 1985 to $49,973,000 at June 14, 1986. This growth is reflected primarily in cash, short-term investments and trade accounts receivables which increased $6,474,000 during the twenty-four weeks ended June 14, 1986, offset by a reduction in current assets-other and prepaid expenses of $2,798,000.

## Results of Operations

### Comparison of the Twelve-Week Periods Ended June 14, 1986 and June 15, 1985

#### Revenues and Sales

Service revenues for the twelve weeks ended June 14, 1986 increased $7,328,000 or 17.3% over the comparable period in 1985. The Company's parts cleaner service contributed approximately 58% of the increase. During the twelve weeks ended June 14, 1986, the parts cleaner service volume and average service charge were 3.9% and 8.0% higher, respectively, than the comparable 1985 period. The remaining increase in service revenues was derived primarily from combined higher unit volume and prices in restaurant services, automotive paint refinishing services and dry cleaner services. Sales, primarily allied products, increased $110,000 or 1.3% from the comparable period of 1985. This sales increase was diminished by the absence of sales during the second-twelve weeks of 1986 from the Company's formerly-owned map distribution operations, which were sold during the fourth interim period of 1985. Excluding revenues of the map distribution operations, sales increased 8% over the comparable twelve-week period of 1985, primarily due to increased sales in the Company's parts cleaner, automotive paint refinishing, restaurant and dry cleaner service areas.

#### Branch Operating Costs and Expenses and Cost of Sales

Branch operating costs and expenses and cost of sales in the twelve weeks ended June 14, 1986 were up 11% over the comparable period of 1985, primarily due to the increased level of business activity. This increase is less than the 15% increase in revenues and sales. The resulting improvement in the gross profit margin is largely due to higher unit volume, higher average service charges and a decline in the cost of virgin solvent used in the Company's domestic parts cleaner service.

#### Selling and Administrative Expenses

Selling and administrative expenses increased by $2,016,000 or 27%, primarily due to additional employees including the addition of fourteen Sales Managers in 1986 for the Company's dry cleaner services program; increases in salaries, benefits, and other compensation based upon sales and consolidated earnings; increases in insurance costs; and increases in other general corporate expenses related to the increased level of business activity.

Income Taxes

The effective income tax rate was 43.3% for the twelve weeks ended June 14, 1986 and 44.4% for the comparable 1985 period. The decline in the effective tax rate is due to a lower statuary tax rate in the United Kingdom combined with a higher proportionate share of earnings realized from the Company's United Kingdom operations during the twelve weeks ended June 14, 1986 than the comparable 1985 period.

## Comparison of the Twenty-Four-Week Periods Ended June 14, 1986 and June 15, 1985

### Revenues and Sales

Service revenues for the twenty-four weeks ended June 14, 1986 increased $14,324,000 or 17.5% over the comparable period in 1985. The Company's parts cleaner service contributed approximately 57% of the increase. During the twenty-four weeks ended June 14, 1986, the parts cleaner service volume and average service charge were 3.7% and 8.0% higher, respectively, than the comparable 1985 period. The remaining increase in service revenues was derived primarily from combined higher unit volume and prices in restaurant services, automotive paint refinishing services and dry cleaner services. Sales, primarily allied products, declined $139,000 or 0.8% from the comparable period of 1985, due primarily to the absence of sales during the twenty-four weeks of 1986 from the Company's formerly-owned map distribution operations, which were sold during the fourth interim period of 1985. Excluding revenues of the map distribution operations, sales increased 5% over the comparable twenty-four-week period of 1985, primarily due to increased sales in the Company's automotive paint refinishing, restaurant and dry cleaner service areas.

### Branch Operating Costs and Expenses and Cost of Sales

Branch operating costs and expenses and cost of sales in the twenty-four weeks ended June 14, 1986 were up 11% over the comparable period of 1985, primarily due to the increased level of business activity. This increase is less than the 14% increase in revenues and sales. The resulting improvement in the gross profit margin is largely due to higher unit volume, higher average service charges and a decline in the cost of virgin solvent used in the Company's domestic parts cleaner service.

### Selling and Administrative Expenses

Selling and administrative expenses increased by $3,617,000 or 24%, primarily due to additional employees including the addition of fourteen Sales Managers in 1986 for the Company's dry cleaner services program; increases in salaries, benefits, and other compensation based upon sales and consolidated earnings; increases in insurance costs; and increases in other general corporate expenses related to the increased level of business activity.

### Income Taxes

The effective income tax rate was 43.5% for the twenty-four weeks ended June 14, 1986 and 44.2% for the comparable 1985 period. The decline in the effective tax rate is due to a lower statuatory tax rate in the United Kingdom combined with a higher proportionate share of consolidated earnings realized from the Company's United Kingdom operations during the twenty-four weeks ended June 14, 1986 than the comparable 1985 period.

SAFETY-KLEEN CORP. AND SUBSIDIARIES

PART II.

Item 2. CHANGES IN SECURITIES

During the Annual Meeting of Shareholders, held May 9, 1986, certain amendments to the Company's Articles of Incorporation were approved by shareholders which have the effect of modifying the rights of common shareholders. The information required by this Item 2 is incorporated herein by reference to "Proposal 3" and "Proposal 4", appearing on pages 10 to 16, of the Company's definitive proxy statement dated April 2, 1986.

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

The Annual Meeting of Shareholders was held on May 9, 1986. Matters submitted to and approved by the shareholders included the following four proposals:

| Brief Description | Number of Votes Affirmative | Negative |
|---|---|---|
| a. Amend the Company's Articles of Incorporation to increase the number of its authorized shares of common stock from 25,000,000 to 75,000,000. | 17,685,366 | 982,988 |
| b. Amend the Company's Articles of Incorporation to provide for a classified Board of Directors and related changes. | 14,605,553 | 2,370,544 |
| c. Amend the Company's Articles of Incorporation to change the shareholder vote required for certain corporate actions. | 15,110,568 | 1,746,501 |
| d. Adopt restated Articles of Incorporation consisting of the Articles of Incorporation as amended to date. | 16,884,365 | 1,428,223 |

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

(3)a. Articles of Incorporation of the Registrant.

(28). Proxy Statement, dated April 2, 1986 (incorporated herein by reference to the Company's definitive proxy statement previously filed with the Securities and Exchange Commission).

(b) Reports on Form 8-K
None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: July 24, 1986 By:(signed) Donald W. Brinckman
Donald W. Brinckman
President and Chief Executive Officer

Date: July 24, 1986 By:(signed) Robert W. Willmschen, Jr.
Robert W. Willmschen, Jr.
Vice President Finance/Administration and Secretary

Date: July 24, 1986 By:(signed) Leonard F. Martinez, Jr.
Leonard F. Martinez, Jr.
Controller and Assistant Secretary

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B.A.T

# British-American Tobacco Company Limited

REPORT AND ACCOUNTS
FOR THE YEAR TO
31 DECEMBER 1985

# British-American Tobacco Company Limited

BAT Co Ltd

Contents



## Notice of meeting

Notice is hereby given that the eighty third annual general meeting of British-American Tobacco Company Limited will be held at Westminster House, 7 Millbank, London SW1P 3JE, on Tuesday 27 May 1986 at 11.30 am for the transaction of the following business:

1 To receive and consider the accounts for the year ended 31 December 1985 and the reports of the directors and auditors thereon.

2 To elect directors.

3 To re-elect the auditors.

4 To authorise the directors to fix the auditors' remuneration.

By order of the board

Cannar, *Secretary*
ch 1986

Note:
Only the holders of ordinary shares are entitled to attend or be represented at the meeting. A member entitled to attend and vote is entitled to appoint a proxy to attend and vote instead of him. Such proxy need not be a member of the company.

# British-American Tobacco Company Limited

BAT Co Ltd

Contents



**Notice of meeting**

Notice is hereby given that the eighty third annual general meeting of British-American Tobacco Company Limited will be held at Westminster House, 7 Millbank, London SW1P 3JE, on Tuesday 27 May 1986 at 11.30 am for the transaction of the following business:

1 To receive and consider the accounts for the year ended 31 December 1985 and the reports of the directors and auditors thereon.

2 To elect directors.

3 To re-elect the auditors.

4 To authorise the directors to fix the auditors' remuneration.

By order of the board

N B Cannar, *Secretary*
24 March 1986

Note:
Only the holders of ordinary shares are entitled to attend or be represented at the meeting. A member entitled to attend and vote is entitled to appoint a proxy to attend and vote instead of him. Such proxy need not be a member of the company.

# Report of the Directors of BAT Co Ltd

**Board of Directors**
**Chairman**
Eric Alfred Albert Bruell

**Other Directors**
Lionel Cyril Francis Blackman
(resigned 18 January 1985)

Barry David Bramley
(resigned 29 July 1985)

Ronald Alexander Charles Crichton

John Rutherford Crosby

Norman Davis
(appointed 1 May 1985)

William John Dickson

Alfred Michael Heath

David George Heywood

Michael Warren Marjoram

Hector Alexander Morini
(resigned 18 January 1985)

Raymond John Pritchard
(resigned 15 May 1985)

Pascal John Ricketts

Edward John Worlidge
(resigned 1 April 1985)

In pursuance of the articles of association Messrs D G Heywood, M W Marjoram and P J Ricketts retire from the board at the annual general meeting and will be proposed for re-election.

**Directors' interests**
According to the Company's register the interests at 31 December 1985, of the persons who at that date were directors, in the share and loan capital and share option schemes of B.A.T Industries p.l.c. and its subsidiaries, all of which are beneficial, are shown below. The holdings at 1 January 1985 or date of appointment are shown in brackets where these differ.

| | B.A.T Industries p.l.c. Ordinary 25p Shares | Share Options |
|---|---|---|
| E A A Bruell | 19,524 (15,640) | 133,151 (137,961) |
| R A C Crichton | Nil | 79,090 (75,620) |
| J R Crosby | 21,004 (9,124) | 52,181 (67,631) |
| N Davis | Nil | 26,270 (12,110) |
| W J Dickson | Nil | 97,943 (94,013) |
| A M Heath | Nil | 89,801 (86,261) |
| D G Heywood | 17,300 (23,420) | 52,713 (50,053) |
| M W Marjoram | 33,360 (38,900) | 73,131 (69,371) |
| P J Ricketts | 41,269 (46,269) | 129,431 (126,661) |

The directors' holdings were unchanged at 24 March 1986, except as shown below:

| | | |
|---|---|---|
| J R Crosby | 17,844 | 48,341 |
| A M Heath | Nil | 66,721 |
| M W Marjoram | 36,284 | 67,691 |

Details of the share option schemes are included in the Report and Accounts of B.A.T Industries p.l.c.

No director had any material interest in a contract of significance (other than service contracts) with the Company or with any subsidiary during the year.

**Secretary and registered office**
N B Cannar, Westminster House,
7 Millbank, London SW1P 3JE

**Registrar**
Lloyds Bank Plc, Registrar's Department,
Goring-by-Sea, Worthing,
West Sussex BN12 6DA

**Auditors**
Deloitte Haskins & Sells,
128 Queen Victoria St, London EC4P 4JX

Deloitte Haskins & Sells have indicated their willingness to continue in office.

Resolutions proposing their re-appointment as auditors of the Company and authorising the directors to fix their remuneration will be submitted to the annual general meeting.

## Holding Company
B.A.T Industries p.l.c., incorporated in the UK, owns the whole of the equity share capital of BAT Co Ltd and is its ultimate holding company.

## Principal Activities
The Group manufactures tobacco products, and has substantial investments in overseas companies engaged in tobacco, food, paper, printing and packaging, hotel and other industrial activities.

Over 300 cigarette brand names are in use throughout the world and in addition an extensive range of smoking tobacco; cigars and cigarettes is manufactured.

The companies of the Group, as well as being large buyers of tobacco from the traditional markets such as the USA, Canada, Brazil and the Near East, have also pioneered tobacco growing by independent farmers in other parts of the world. Many companies continue to give technical assistance to farmers growing tobacco crops.

## Changes in the Group
As stated in the 1984 Report and Accounts, the interests of BAT Co Ltd in its Brazilian subsidiaries and associated companies were transferred at net asset value to the ultimate holding company with effect from 1 January 1985. The comparative figures include £209 million profit before taxation and £58 million taxation in respect of the companies transferred.

There have been significant developments in the Group's Chilean operations. In May, the Group acquired 100% of Consorcio Agro-industrial de Malloa SA, a company engaged in the fruit juice business and, the following month, purchased the remaining 50% share in Evercrisp Snack Productos de Chile SA, previously held by AMATIL Limited, an associated company of B.A.T Industries p.l.c.

This diversification was followed, at the end of June, by an increase in the Group's interest in its principal Chilean subsidiary from 50·1% to 62·8%. The corporate structure was subsequently amended to reflect the above changes through the creation of a holding company, Empresas CCT SA, and the name of the tobacco subsidiary was changed to Chiletabacos SA.

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During February 1986, the Group sold its 29·9% investment in Molins PLC. In these accounts the Group's share of associated companies' profits, taxation and extraordinary items include the results of Molins PLC for the 12 months to 30 June 1985. The Group's investment is included in the balance sheet as a current investment at the subsequent disposal value.

## Review of the Year
The Group traded satisfactorily during the year and the directors do not envisage any major changes in the Group's activities in the foreseeable future. A detailed review of performance is contained in the Report and Accounts of B.A.T Industries p.l.c.

## Reserves
Group reserves decreased by £303 million as a result of dividends of £85 million in respect of current year profits, special dividends of £255 million arising from the transfer of subsidiaries and associated companies to the ultimate holding company, the effect of exchange movements on the opening net assets and premiums on the acquisition of new subsidiaries during the year. Company reserves increased by £1 million.

## Research and development activities
Research and development is undertaken to support the main operating components of the business – the growing and blending of tobacco leaf, and the design, production and marketing of cigarette products.

Research is also undertaken into various aspects of the current medical controversy on smoking, including continued significant funding of independent medical studies.

## Company status
BAT Co Ltd is not a close company for the purpose of company taxation.

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The Company continues to support the concept of voluntary systems of employee involvement and actively follows an employee relations policy which includes giving information about the business and consulting employees about matters directly relating to their own jobs.

The Company continues to consolidate and develop mechanisms for employee involvement such as participation in B.A.T Industries' employee share option schemes, employee representation on pensions, health and safety and job evaluation committees and the publication of in-house journals and newsletters. Following the extensive economic education programme which was carried out in 1984, pilot briefing sessions were attended during 1985 by many employees immediately after interim and final results had been announced. These sessions were aimed at consolidating employees' understanding of the realities of the business.

During 1985 a [illegible] was introduced to provide eligible employees with personalised statements giving details of their accrued pension benefits and life insurance cover. Updated statements will be issued in future on [illegible] basis.

Progress has been made during 1985 to improve the quality of communication from the point of view of both content and presentation.

MAY 13 1986

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# Report of the Directors of BAT Co Ltd *continued*

**Employees**
The geographical spread of the average number of persons employed by the Group is as follows:

| | 1985 | 1984 |
|---|---|---|
| United Kingdom | 2,830 | 3,634 |
| Europe | 2,619 | 2,684 |
| Caribbean/Central America | 2,242 | 2,298 |
| Latin America | 7,779 | 26,977 |
| Asia/Australasia | 15,218 | 16,726 |
| Africa | 9,206 | 9,499 |
| | 39,894 | 61,818 |

| | | |
|---|---|---|
| The industrial spread is: | | |
| Tobacco | 37,365 | 56,488 |
| Other activities | 2,529 | 5,330 |
| | 39,894 | 61,818 |

**Employment of the disabled in the United Kingdom**
The Group's policy on recruitment is based on the ability of a candidate to perform the job. Full and fair consideration is given to applications for employment from the disabled where they have the appropriate skills and abilities to perform the job. If a disabled applicant proves a suitable candidate for employment, modification of facilities and the provision of special equipment and aids is considered favourably.

If employees become disabled during the course of their employment with the Group and as a result are unable to perform their normal jobs, every effort is made to offer suitable alternative employment to them, to provide assistance with re-training and to deal with their cases as compassionately as possible.

It is Group policy to encourage the training a[illegible] ther development of all employees where this is of benefit to the individual and to the company concerned. This of course includes the provision of training to meet the special needs of disabled employees.

# Report of the Auditors

**To the members of British-American Tobacco Company Limited**

We have audited the financial statements on pages 5 to 20 in accordance with approved Auditing Standards.

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and the Group at 31 D[illegible]mber 1985 and of the profit and funds provided and applied of the Group for the year then ended and comply with the Companies Act 1985.

Deloitte Haskins & Sells,
Chartered Accountants,
London, 24 March 1986

# Accounting Policies

1. Group accounts

(a) The accounts are prepared by consolidating the accounts of BAT Co Ltd and its subsidiaries at 31 December. The directors endeavour, where practicable, to secure that the year-ends of subsidiary companies coincide with that of BAT Co Ltd. In the opinion of the directors, it is impracticable to alter the dates of certain subsidiary companies whose accounts are made up to 30 September as this would involve undue expense.

(b) The results of subsidiaries acquired during the year are included from the date of acquisition of a controlling interest at which date, for the purposes of consolidation, the purchase consideration is allocated between the underlying net assets acquired, other than goodwill, on the basis of their fair value.

(c) The results of subsidiaries which are sold outside the B.A.T Industries group are included up to the date of disposal. The profit or loss on sale is calculated by reference to the net asset value at the date of disposal.

(d) Associated companies comprise investments in companies, which are not subsidiaries, where the Group's interest in the equity capital is long term and exceeds 20%. The Group's share of the profits of these companies is included in the profit and loss account and the investments are shown in the Group's balance sheet at the Group's share of the net tangible assets of the companies less provisions consistent with the concept of prudence. The Group's share of the profits and assets is based on the latest information published by the companies. The Company's balance sheet includes the investment in associated companies at cost.

2. Other investments are stated at cost of acquisition or director's valuation.

3. Stocks are valued on consistent bases, in the main at average cost including overheads (where appropriate), or net realisable value, whichever is the lower.

4. Intangible assets – Trademarks, patents and goodwill, including that arising in connection with the acquisition of subsidiaries, associated companies and other investments, are set off during the year of purchase against reserves and shown in the reserve movements in note 21 on page 16.

5. Tangible fixed assets include assets held under finance leases which are capitalised at their fair value with a corresponding amount treated as a liability.

6. Depreciation on tangible fixed assets is calculated to amortise their cost over their useful lives by equal annual instalments, having regard to their location and the industry in which they are employed. No depreciation is provided on freehold land except where its cost cannot be separately identified in which case the aggregate cost of the land and buildings is depreciated at the rate applicable to the buildings.

The rates of depreciation used are generally within the following ranges:

| | |
|---|---|
| Freehold buildings | 2·5% – 4% |
| Leasehold buildings – long leases | 2·5% – 4% |
| – short leases | over the period of the lease |
| Plant and machinery | 7% – 10% |
| Other equipment and fittings | 10% – 20% |
| Motor vehicles | 20% – 25% |

7. Turnover comprises net sales to external customers and includes value added, sales and excise taxes. UK VAT and other duty and excise taxes are shown separately in note 1 on page 10.

8. Research and development revenue expenditure is charged against profits as incurred.

9. Taxation provided is that which became chargeable on the profits of the period together with deferred taxation calculated as indicated below:

(a) To the extent that Advance Corporation Tax (ACT) on dividends paid and proposed cannot be offset against Corporation Tax or deferred taxation provided, it is written off. Amounts so written off are carried forward for tax purposes and may be offset against taxation of subsequent periods.

(b) No account is taken of tax which may be payable on the realisation of investments or in the event of the distribution of profits retained by subsidiaries, associated companies or other investments.

(c) Deferred taxation is provided for on timing differences using the liability method except where it can be demonstrated with reasonable probability that the tax deferral will continue for the foreseeable future. Timing differences arise on items of income and expenditure which are recognised for tax purposes in different periods from those in which they are recognised in the profit and loss account.

10. Foreign currencies – All assets, liabilities, turnover and profits expressed in currencies other than sterling are translated to sterling at rates of exchange ruling at the end of the financial year.

11. Differences on exchange are dealt with as follows:

(a) Those arising on the retranslation to sterling (using rates of exchange ruling at the end of the year) of overseas net assets at the beginning of the year, after taking into account related foreign currency borrowings, are taken direct to reserves as shown in note 21 on page 16.

(b) Other exchange differences are reflected in trading profit.

# Group Profit and Loss Account

| For the year ended 31 December | | | | £ millions |
|---|---|---|---|---|
| | | 1985 | | 1984 |
| Turnover including duty and excise taxes (note 1) | | 2,513 | | 3,775 |
| Operating income (note 1) | | 1,191 | | 1,569 |
| Operating charges (note 2) | | 945 | | 1,272 |
| Trading profit | | 246 | | 297 |
| Net interest (note 5) | | 31 | | 153 |
| | | 277 | | 450 |
| Share of associated companies' profit before taxation (page 19) | | 35 | | 59 |
| Profit on ordinary activities before taxation | | 312 | | 509 |
| Taxation on ordinary activities (note 6) | | 110 | | 166 |
| Profit on ordinary activities after taxation | | 202 | | 343 |
| Attributable to minority shareholders | | 30 | | 72 |
| Attributable to BAT Co Ltd shareholders | | 172 | | 271 |
| Extraordinary items less taxation (note 10) | | (11) | | — |
| Profit for the year (note 7) | | 161 | | 271 |
| Dividends in respect of current year profits (note 8) | 85 | | 90 | |
| Special dividends (note 8) | 255 | 340 | 50 | 140 |
| | | (179) | | 131 |
| Reduction in reserves (note 21) | | | | |
| BAT Co Ltd and subsidiaries | | (176) | | 114 |
| Associated companies | | (3) | | 17 |
| | | (179) | | 131 |
| Earnings per share (note 9) | | 34·6p | | 54·5p |

The comparatives include the results of the Brazilian subsidiaries and associated companies (see page 3, Changes in the Group).

Notes are shown on pages 5, 7 and 10 to 18.

# Group Turnover and Profit Analyses

£ millions

| | 1985 | % | 1984 | % |
|---|---|---|---|---|
| **Turnover including duty and excise taxes** | 2,513 | | 3,775 | |
| **Geographical analysis** | | | | |
| United Kingdom | 254 | 10 | 229 | 6 |
| Europe | 448 | 18 | 450 | 12 |
| Caribbean/Central America | 125 | 5 | 165 | 4 |
| Latin America | 595 | 24 | 1,559 | 41 |
| Asia/Australasia | 800 | 32 | 999 | 27 |
| Africa | 291 | 11 | 373 | 10 |
| | 2,513 | 100 | 3,775 | 100 |

The above analysis is based on the area of manufacture.

| | 1985 | % | 1984 | % |
|---|---|---|---|---|
| **Industrial analysis** | | | | |
| Tobacco | 2,487 | 99 | 3,713 | 98 |
| Other activities | 26 | 1 | 62 | 2 |
| | 2,513 | 100 | 3,775 | 100 |

| | 1985 | % | 1984 | % |
|---|---|---|---|---|
| **Trading Profit** | 246 | | 297 | |
| **Geographical analysis** | | | | |
| United Kingdom | 37 | 15 | 26 | 9 |
| Europe | 16 | 6 | 13 | 4 |
| Caribbean/Central America | 24 | 10 | 27 | 9 |
| Latin America | 62 | 25 | 103 | 35 |
| Asia/Australasia | 68 | 28 | 82 | 28 |
| Africa | 39 | 16 | 46 | 15 |
| | 246 | 100 | 297 | 100 |

Royalty income less related expenditure is included in the geographical area in which the licensor is located.

| | 1985 | % | 1984 | % |
|---|---|---|---|---|
| **Industrial analysis** | | | | |
| Tobacco | 245 | 100 | 289 | 97 |
| Other activities | 1 | | 8 | 3 |
| | 246 | 100 | 297 | 100 |

# Balance Sheets

31 December £ millions

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| **Assets** | | | | |
| **Fixed assets** | | | | |
| Tangible fixed assets (note 13) | 375 | 551 | 13 | 13 |
| Investments in Group companies (note 15) | | | 125 | 180 |
| Investments in associated companies (note 16) | 103 | 226 | 4 | 8 |
| Other investments and long term loans (note 17) | 35 | 43 | 32 | 38 |
| | 513 | 820 | 174 | 239 |
| **Current assets** | | | | |
| Stocks (note 18) | 480 | 649 | 2 | 6 |
| Debtors (note 19) | 196 | 288 | 55 | 85 |
| Current investments (note 20) | 234 | 150 | 222 | 116 |
| Short term deposits | 111 | 237 | 1 | 1 |
| Cash at bank and in hand | 60 | 98 | 4 | 5 |
| | 1,081 | 1,422 | 284 | 213 |
| **Total assets** | 1,594 | 2,242 | 458 | 452 |
| **Liabilities** | | | | |
| **Capital and reserves** | | | | |
| Share capital | 135 | 135 | 135 | 135 |
| Other reserves | 253 | 410 | 28 | 17 |
| Profit and loss account | 415 | 509 | 94 | 104 |
| Associated companies | 79 | 131 | | |
| Interest of BAT Co Ltd shareholders (note 21) | 882 | 1,185 | 257 | 256 |
| Interest of minority shareholders in subsidiaries | 115 | 220 | | |
| | 997 | 1,405 | 257 | 256 |
| **Provisions for liabilities and charges (note 22)** | 59 | 72 | 16 | 15 |
| **Creditors (note 24)** | | | | |
| Borrowings | 99 | 122 | 9 | 11 |
| Other creditors | 439 | 643 | 176 | 170 |
| | 538 | 765 | 185 | 181 |
| **Total funds employed** | 1,594 | 2,242 | 458 | 452 |

On behalf of the board
E A A Bruell, D G Heywood, *Directors*
24 March 1986

Notes are shown on pages 5, 7 and 10 to 18.

# Group Funds Statement

Funds provided and applied for the year ended 31 December £ millions

| | Total movements 1985 | Total movements 1984 | Transfer of subsidiaries and associated companies to the ultimate holding company included in total movements 1985 (1984 nil) | Acquisitions and disposals included in total movements 1985 | Acquisitions and disposals included in total movements 1984 |
|---|---|---|---|---|---|
| **Funds provided** | | | | | |
| Net profit attributable to BAT Co Ltd before extraordinary items | 172 | 271 | | | |
| Extraordinary items | (11) | | | (7) | |
| Dividends in respect of current year profits | (85) | (90) | | | |
| | 76 | 181 | | (7) | |
| Special dividends | (255) | (50) | (255) | | |
| Reserve movements | (124) | (7) | | 2 | (18) |
| Net (decrease)/increase in BAT Co Ltd shareholders' interest for the year | (303) | 124 | (255) | (5) | (18) |
| (Decrease)/increase in | | | | | |
| Interest of minority shareholders | (105) | 34 | (75) | (3) | (2) |
| Provisions for unfunded pensions | (13) | 7 | (1) | | |
| Deferred taxation | 1 | 3 | | 1 | |
| Borrowings – due beyond one year | (5) | (2) | (2) | | |
| | (425) | 166 | (333) | (7) | (20) |
| **Funds applied** | | | | | |
| Tangible fixed assets | | | | | |
| Expenditure | 64 | 109 | | 8 | 37 |
| Disposals and exchange differences | (203) | 44 | (122) | | |
| Depreciation of the year | (37) | (52) | | | |
| Net tangible fixed assets | (176) | 101 | (122) | 8 | 37 |
| Other fixed assets | (131) | 54 | (78) | (25) | 2 |
| | (307) | 155 | (200) | (17) | 39 |
| Working capital | | | | | |
| Stocks | (169) | 9 | (85) | 5 | 7 |
| Debtors | (92) | 28 | (123) | 2 | 15 |
| Current investments, deposits and cash | (80) | 21 | (153) | 7 | (63) |
| | (341) | 58 | (361) | 14 | (41) |
| Borrowings – due within one year | (18) | 7 | (10) | 2 | 5 |
| Other provisions and creditors | (205) | 40 | (218) | 2 | 13 |
| (Decrease)/increase in working capital | (118) | 11 | (133) | 10 | (59) |
| (Decrease)/increase in net assets | (425) | 166 | (333) | (7) | (20) |

The directors consider it inappropriate to prepare this statement on a cash flow basis because of the restrictions in many parts of the world on the transfer of assets, including cash, between individual companies in the Group.

## Notes to the Financial Statements

£ millions

| | 1985 | 1984 |
|---|---|---|
| **1 Turnover and operating income** | | |
| Turnover including duty and excise taxes | 2,513 | 3,775 |
| Duty and excise taxes | 1,357 | 2,258 |
| | 1,156 | 1,517 |
| Other operating income | 35 | 52 |
| | 1,191 | 1,569 |

Duty and excise taxes include UK VAT of £5 million (1984 £5 million).

| | 1985 | 1984 |
|---|---|---|
| **2 Operating charges** | | |
| Raw materials and consumables | 462 | 640 |
| Change in stock of finished goods and work in progress | (25) | (9) |
| Staff costs | 203 | 283 |
| Depreciation | 37 | 52 |
| Other operating charges | 268 | 306 |
| | 945 | 1,272 |
| Staff costs comprise: | | |
| Wages and salaries | 157 | 219 |
| Social security costs | 24 | 41 |
| Other pension costs | 22 | 23 |
| | 203 | 283 |

Information in respect of the number of persons employed by the Group is given on page 4.

Depreciation includes £2 million (1984 £1 million) in respect of assets held under finance leases.

| | 1985 | 1984 |
|---|---|---|
| Other operating charges include: | | |
| Rent of machinery and equipment (operating leases) | 1 | 2 |
| Rent of land and buildings (operating leases) | 5 | 6 |
| Research and development expenses | 11 | 12 |
| Provisions for unfunded pensions | 8 | 10 |
| Finance charges in respect of finance leases | 1 | 1 |
| Auditors' fees (BAT Co Ltd £140,000 1984 £136,000) | 0·91 | 0·98 |

| | 1985 | 1984 |
|---|---|---|
| **3 Directors' remuneration** | | |
| As managers: | | |
| Emoluments (including pension contributions) | 0·80 | 0·94 |
| Pensions | 0·06 | 0·07 |
| Compensation for loss of office | 0·34 | - |

£ millions

## 4 Emoluments of directors

The table shows the numbers of directors of BAT Co Ltd whose emoluments, excluding pension contributions, are within the following ranges:

| Emoluments £ | 1985 | 1984 | Emoluments £ | 1985 | 1984 |
|---|---|---|---|---|---|
| 95,001 – 100,000 | 1 | – | 65,001 – 70,000 | – | 1 |
| 90,001 – 95,000 | – | 1 | 55,001 – 60,000 | – | 2 |
| 85,001 – 90,000 | 3 | 1 | 45,001 – 50,000 | 2 | – |
| 80,001 – 85,000 | 1 | 2 | 35,001 – 40,000 | 1 | – |
| 75,001 – 80,000 | – | 2 | 5,001 – 10,000 | – | 1 |
| 70,001 – 75,000 | 1 | 1 | 0 – 5,000 | 2 | – |

The Chairman and two other directors, being directors of the ultimate holding company and receiving emoluments in that capacity, are excluded from this table.

The emoluments of the highest paid director are £98,698 for the year to 31 December 1985 (1984 £93,759).

## 5 Net interest

| | 1985 | 1984 |
|---|---|---|
| Interest received | 45 | 174 |
| Less interest paid | 14 | 21 |
| Net interest | 31 | 153 |
| Interest received comprises income from: | | |
| Fellow subsidiaries | 23 | 20 |
| Current investments | 1 | |
| (unlisted) | 24 | 20 |
| Short term deposits | 21 | 154 |
| | 45 | 174 |
| Interest paid: | | |
| Short term – bank loans and overdrafts | 10 | 14 |
| – other loans | 3 | 5 |
| of which £5 million (1984 £7 million) on loans repayable by instalments | 13 | 19 |
| Long term – bank loans | | 2 |
| – other loans | 1 | |
| | 14 | 21 |

## 6 Taxation on ordinary activities

| | 1985 | 1984 |
|---|---|---|
| UK Corporation Tax on profits which became chargeable during the period at 41·25% (1984 46·25%) | 57 | 83 |
| Less double taxation relief | 54 | 80 |
| UK taxation | 3 | 3 |
| Overseas taxation | 94 | 141 |
| Current taxation | 97 | 144 |
| Deferred taxation | 2 | 1 |
| Adjustments in respect of prior years | (3) | (1) |
| Taxation charge BAT Co Ltd and subsidiaries | 96 | 144 |
| Share of associated companies' taxation | 14 | 22 |
| Total taxation | 110 | 166 |

The charge for UK taxation has been reduced by £10 million (1984 £7 million) in respect of ACT and £9 million (1984 £7 million) in respect of group loss relief, both as a result of surrender by the ultimate holding company.

Notes to the Financial Statements £ millions

**7 Profit for the year**
As permitted by section 228(7) of the Companies Act 1985, the profit and loss account of BAT Co Ltd has not been separately presented in these financial statements.
The profit for the year dealt with in the accounts of BAT Co Ltd was £341 million (1984 £140 million) which includes the receipt of a special dividend of £220 million (1984 nil).

| **8 Dividends of BAT Co Ltd** | 1985 | 1984 |
|---|---|---|
| 5% Preference stock (3·5% net) | ·16 | ·16 |
| 6% Preference stock (4·2% net) | ·25 | ·25 |
| Ordinary shares | | |
| Interims paid in respect of current year profits | 85·00 | 90·00 |
| | 85·41 | 90·41 |
| Special dividends arising from the transfer of subsidiaries and associated companies to the ultimate holding company | 255·08 | |
| Special dividend paid out of profits of prior years | | 50·00 |
| | 340·49 | 140·41 |

| **9 Earnings per share** | | |
|---|---|---|
| Earnings per ordinary share are based on equity earnings of £172 million (1984 £271 million) and the 497 million issued ordinary shares of 25p each. | 34·6p | 54·5p |

| **10 Extraordinary items less taxation (1984 nil)** | |
|---|---|
| Provision for loss on disposal of an associated company | (6) |
| Taxation | (1) |
| Extraordinary items BAT Co Ltd and subsidiaries | (7) |
| Share of associated company's extraordinary items | (4) |
| Total extraordinary items | (11) |

**11 Restrictions on transfer of assets**
There are restrictions in many parts of the world on the transfer of assets, including cash, between individual companies in the Group.

| **12 Operating leases** | Land and buildings 1985 | Land and buildings 1984 | Other 1985 | Other 1984 |
|---|---|---|---|---|
| Annual commitments under non-cancellable operating leases comprise: | | | | |
| Leases which expire | | | | |
| Within 1 year | 1 | 1 | 1 | 2 |
| Beyond 1 year and within 5 years | 2 | 1 | 1 | 4 |
| Beyond 5 years | 2 | 2 | | |
| | 5 | 4 | 2 | 6 |

The majority of leases of land and buildings are subject to rent reviews.

Notes to the Financial Statements £ millions

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| | 1985 | 1984 |
|---|---|---|
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| 6% Preference stock (4·2% net) | ·25 | ·25 |
| Ordinary shares | | |
| Interims paid in respect of current year profits | 85·00 | 90·00 |
| | 85·41 | 90·41 |
| Special dividends arising from the transfer of subsidiaries and associated companies to the ultimate holding company | 255·08 | |
| Special dividend paid out of profits of prior years | — | 50·00 |
| | 340·49 | 140·41 |

**9 Earnings per share**

| | 1985 | 1984 |
|---|---|---|
| Earnings per ordinary share are based on equity earnings of £172 million (1984 £271 million) and the 497 million issued ordinary shares of 25p each. | 34·6p | 54·5p |

**10 Extraordinary items less taxation (1984 nil)**

| | |
|---|---|
| Provision for loss on disposal of an associated company | (6) |
| Taxation | (1) |
| Extraordinary items BAT Co Ltd and subsidiaries | (7) |
| Share of associated company's extraordinary items | (4) |
| Total extraordinary items | (11) |

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There are restrictions in many parts of the world on the transfer of assets, including cash, between individual companies in the Group.

**12 Operating leases**

| | Land and buildings 1985 | Land and buildings 1984 | Other 1985 | Other 1984 |
|---|---|---|---|---|
| Annual commitments under non-cancellable operating leases comprise: | | | | |
| Leases which expire | | | | |
| Within 1 year | 1 | 1 | 1 | 2 |
| Beyond 1 year and within 5 years | 2 | 1 | 1 | 4 |
| Beyond 5 years | 2 | 2 | | |
| | 5 | 4 | 2 | 6 |

The majority of leases of land and buildings are subject to rent reviews.

£ millions

## 13 Tangible fixed assets

| | Freehold land & buildings | Leasehold land & buildings | Plant, machinery & equipment | Assets in course of construction | Total |
|---|---|---|---|---|---|
| **Group** | | | | | |
| Cost: | | | | | |
| 1 January 1985 | 186 | 52 | 620 | 20 | 878 |
| Differences on exchange | (26) | (8) | (78) | (4) | (116) |
| Subsidiaries acquired | 2 | | 8 | | 10 |
| Transfer of subsidiaries | (57) | | (171) | (6) | (234) |
| Expenditure | 7 | 1 | 37 | 11 | 56 |
| Reallocations | 1 | | 10 | (11) | |
| Disposals | (2) | | (17) | | (19) |
| 31 December 1985 | 111 | 45 | 409 | 10 | 575 |
| Depreciation: | | | | | |
| 1 January 1985 | 42 | 10 | 275 | | 327 |
| Differences on exchange | (7) | (1) | (33) | | (41) |
| Subsidiaries acquired | | | 2 | | 2 |
| Transfer of subsidiaries | (13) | | (99) | | (112) |
| Charged to Profit and Loss Account | 2 | 1 | 34 | | 37 |
| Adjustments on disposals | | | (13) | | (13) |
| 31 December 1985 | 24 | 10 | 166 | | 200 |
| *Net values at 31 December 1985* | 87 | 35 | 243 | 10 | 375 |
| *Net values at 31 December 1984* | 144 | 42 | 345 | 20 | 551 |
| **Company** | | | | | |
| Cost: | | | | | |
| 1 January 1985 | 4 | | 19 | | 23 |
| Expenditure | | | 1 | | 1 |
| 31 December 1985 | 4 | | 20 | | 24 |
| Depreciation: | | | | | |
| 1 January 1985 | 1 | | 9 | | 10 |
| Charged to Profit and Loss Account | | | 1 | | 1 |
| 31 December 1985 | 1 | | 10 | | 11 |
| *Net values at 31 December 1985* | 3 | | 10 | | 13 |
| *Net values at 31 December 1984* | 3 | | 10 | | 13 |

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Cost of land on which no depreciation is provided | 16 | 27 | 2 | 2 |
| Leasehold land and buildings comprise: | | | | |
| *Net value of long leasehold* | 26 | 32 | | |
| *Net value of short leasehold* | 9 | 10 | | |
| | 35 | 42 | | |
| Net values of assets held under finance leases | 19 | 16 | - | - |

Notes to the Financial Statements £ millions

**14 Future capital expenditure**

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Authorised by the directors of BAT Co Ltd or its subsidiaries but not provided for in these accounts is estimated at | 30 | 44 | 3 | 2 |
| of which contracts have been placed for | 19 | 25 | 1 | 1 |

**15 Investments in Group companies**

| | Shareholdings (at cost) | Loans | Company Total |
|---|---|---|---|
| 1 January 1985 | 27 | 153 | 180 |
| Acquisitions and advances | 11 | | 11 |
| Disposals and repayments | | (66) | (66) |
| 31 December 1985 | 38 | 87 | 125 |

**16 Investments in associated companies**

| | Shareholdings (at net asset value) | Loans | Group Total |
|---|---|---|---|
| 1 January 1985 | 218 | 8 | 226 |
| Differences on exchange | (24) | | (24) |
| Transfer of associated companies to the ultimate holding company | (69) | (7) | (76) |
| Reduction in reserves (see page 19) | (3) | | (3) |
| Acquisitions and advances | 3 | | 3 |
| Disposals and repayments | (22) | (1) | (23) |
| 31 December 1985 | 103 | - | 103 |

| | Shareholdings (at cost) | Company Total |
|---|---|---|
| 1 January 1985 | 8 | 8 |
| Disposals and repayments | (4) | (4) |
| 31 December 1985 | 4 | 4 |

| | Group (at net asset value) 1985 | Group (at net asset value) 1984 | Company (at cost) 1985 | Company (at cost) 1984 |
|---|---|---|---|---|
| Shareholdings: | | | | |
| Listed in the UK | | 23 | | 4 |
| Listed abroad | 61 | 90 | 1 | 1 |
| (Stock exchange value Group £89 million 1984 £98 million Company £20 million 1984 £49 million) | 61 | 113 | 1 | 5 |
| Unlisted at directors' valuation | 42 | 105 | 3 | 3 |
| | 103 | 218 | 4 | 8 |

£ millions

## 17 Other investments and long term loans

| | Group | | | Company | | |
|---|---|---|---|---|---|---|
| | Other investments | Long term loans | Holding company | Other investments | Long term loans | Holding company |
| 1 January 1985 | 14 | 4 | 25 | 12 | 1 | 25 |
| Transfer of subsidiaries | | (2) | | | | |
| Acquisitions and advances | | 4 | | | 4 | |
| Disposals and repayments | (6) | (4) | – | (6) | (4) | – |
| 31 December 1985 | 8 | 2 | 25 | 6 | 1 | 25 |

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Other investments and long term loans comprise: | | | | |
| Unlisted – equity at directors' valuations | 7 | 7 | 6 | 6 |
| Unlisted – other | 3 | 11 | 1 | 7 |

Other investments include an investment in Tabacanaria SA, a company incorporated and registered in Spain, operating in the Canary Islands. BAT Co Ltd's interest in the 2,543,514 registered shares of 1,000 pesetas each, which are not listed, is 41% but the existence of a majority shareholder precludes its treatment as an associated company. The latest available audited information is for the year to 31 December 1984 and shows a deficiency in reserves of £2 million and a profit for the year of £1 million.

## 18 Stocks

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Raw materials and components | 350 | 486 | 1 | 5 |
| Consumable stores | 32 | 43 | 1 | 1 |
| Finished goods | 79 | 103 | | |
| Goods purchased for resale | 19 | 17 | | |
| Total | 480 | 649 | 2 | 6 |

## 19 Debtors

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Trade debtors | 121 | 189 | 2 | 3 |
| Other debtors | 55 | 70 | 9 | 8 |
| Prepayments and accrued income | 14 | 28 | | |
| Receivable from subsidiaries | | | 41 | 70 |
| Receivable from fellow subsidiaries | 6 | 1 | 3 | 4 |
| Total | 196 | 288 | 55 | 85 |

£ millions

## 17 Other investments and long term loans

| | Group | | | Company | | |
|---|---|---|---|---|---|---|
| | Other investments | Long term loans | Holding company | Other investments | Long term loans | Holding company |
| 1 January 1985 | 14 | 4 | 25 | 12 | 1 | 25 |
| Transfer of subsidiaries | | (2) | | | | |
| Acquisitions and advances | | 4 | | | 4 | |
| Disposals and repayments | (6) | (4) | | (6) | (4) | |
| 31 December 1985 | 8 | 2 | 25 | 6 | 1 | 25 |

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Other investments and long term loans comprise: | | | | |
| Unlisted – equity at directors' valuations | 7 | 7 | 6 | 6 |
| Unlisted – other | 3 | 11 | 1 | 7 |

Other investments include an investment in Tabacanaria SA, a company incorporated and registered in Spain, and operating in the Canary Islands. BAT Co Ltd's interest in the 2,543,514 registered shares of 1,000 pesetas each, which are not listed, is 41% but the existence of a majority shareholder precludes its treatment as an associated company. The latest available audited information is for the year to 31 December 1984 and shows a deficiency in reserves of £2 million and a profit for the year of £1 million.

## 18 Stocks

| | Group | | Company | |
|---|---|---|---|---|
| | 1985 | 1984 | 1985 | 1984 |
| Raw materials and components | 350 | 486 | 1 | 5 |
| Consumable stores | 32 | 43 | 1 | 1 |
| Finished goods | 79 | 103 | | |
| Goods purchased for resale | 19 | 17 | | |
| Total | 480 | 649 | 2 | 6 |

## 19 Debtors

| | Group | | Company | |
|---|---|---|---|---|
| | 1985 | 1984 | 1985 | 1984 |
| Trade debtors | 121 | 189 | 2 | 3 |
| Other debtors | 55 | 70 | 9 | 8 |
| Prepayments and accrued income | 14 | 28 | | |
| Receivable from subsidiaries | | | 41 | 70 |
| Receivable from fellow subsidiaries | 6 | 1 | 3 | 4 |
| Total | 196 | 288 | 55 | 85 |

Notes to the Financial Statements £ millions

## 20 Current investments

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Listed in the UK (Stock exchange value £15 million) | 15 | | 15 | |
| Unlisted – equity at directors' valuations | 2 | 9 | | |
| Unlisted – other | 12 | 22 | 2 | |
| | 29 | 31 | 17 | |
| Loan to holding company due within one year | | 3 | | |
| Loans to fellow subsidiaries due within one year | 205 | 116 | 205 | 116 |
| | 234 | 150 | 222 | 116 |

The investment in the ordinary and preference share capital of Molins PLC is included above at its February 1986 disposal value (see page 3, Changes in the Group).

## 21 Interest of BAT Co Ltd shareholders

| | Share capital | Other reserves | Profit and loss account | Associated companies | Total |
|---|---|---|---|---|---|
| **Group** | | | | | |
| 1 January 1985 | 135 | 410 | 509 | 131 | 1,185 |
| Differences on exchange | | (58) | (46) | (22) | (126) |
| Reduction in reserves (see page 6) | | | (176) | (3) | (179) |
| Premium on acquisition of new subsidiaries | | 2 | | | 2 |
| Transfers | | (101) | 128 | (27) | |
| 31 December 1985 | 135 | 253 | 415 | 79 | 882 |
| **Company** | | | | | |
| 1 January 1985 | 135 | 17 | 104 | | 256 |
| Retained profit | | | 1 | | 1 |
| Transfers | | 11 | (11) | | |
| 31 December 1985 | 135 | 28 | 94 | | 257 |

| | Authorised, issued and fully paid 1985 | 1984 |
|---|---|---|
| The share capital comprises: | | |
| Ordinary shares of 25p each | 124 | 124 |
| 5% (now 3·5% + tax credit) Cumulative preference stock | 5 | 5 |
| 6% (now 4·2% + tax credit) Second cumulative preference stock | 6 | 6 |
| | 135 | 135 |

## 22 Provisions for liabilities and charges

| | Group Unfunded pensions | Group Deferred taxation | Group Other | Group Total | Company Unfunded pensions | Company Deferred taxation | Company Other | Company Total |
|---|---|---|---|---|---|---|---|---|
| 1 January 1985 | 52 | 10 | 10 | 72 | 11 | 1 | 3 | 15 |
| Differences on exchange | (9) | (1) | (2) | (12) | | | | |
| Transfer of subsidiaries | (1) | | (1) | (2) | | | | |
| Provided in respect of the year | 8 | 2 | 3 | 13 | 2 | 2 | | 4 |
| Utilised during year | (8) | | (1) | (9) | (1) | | | (1) |
| Other movements | (3) | | | (3) | (3) | 1 | | (2) |
| 31 December 1985 | 39 | 11 | 9 | 59 | 9 | 4 | 3 | 16 |

£ millions

## 23 Pensions

Group companies provide for pension commitments in accordance with the best accepted local practice in each territory. For the majority of companies the pension liability is funded externally, and the appropriate contributions are paid over to trustees.

The provisions for unfunded pensions of £39 million (1984 £52 million) in note 22 arise in territories where the pension liability is recognised and is covered by assets retained within the company. The provisions also contain amounts recognised by companies to meet future pension liabilities in excess of those which have been funded externally. In certain territories no separate provision is made for unfunded pensions and all pension payments are charged against the profit for the year. The liability as at 31 December 1985 for such unfunded pensions has been estimated to be £1 million (1984 £22 million – mainly relating to the Brazilian subsidiaries transferred to the ultimate holding company on 1 January 1985).

## 24 Creditors

| | Total | | Payable within one year | | Payable beyond one year | |
|---|---|---|---|---|---|---|
| **Group** | 1985 | 1984 | 1985 | 1984 | 1985 | 1984 |
| Trade creditors | 53 | 84 | 53 | 84 | | |
| Sales taxes, duty and excise | 151 | 250 | 151 | 250 | | |
| Obligations under finance leases | 16 | 14 | 4 | 2 | 12 | 12 |
| Bills payable | 23 | 21 | 22 | 21 | 1 | |
| Accrued charges and deferred income | 25 | 30 | 23 | 29 | 2 | 1 |
| Taxation on profits – UK | 1 | 4 | 1 | | | 4 |
| – overseas | 68 | 98 | 57 | 85 | 11 | 13 |
| Other taxation and social security | 13 | 26 | 13 | 26 | | |
| Amounts due to holding company and fellow subsidiaries | 64 | 64 | 64 | 64 | | |
| Sundry creditors | 25 | 52 | 25 | 51 | | 1 |
| Total (all unsecured) | 439 | 643 | 413 | 612 | 26 | 31 |
| Borrowings (page 18 note 25) | 99 | 122 | 63 | 81 | 36 | 41 |
| | 538 | 765 | 476 | 693 | 62 | 72 |

| Obligations under finance leases payable beyond one year comprise: | 1985 | 1984 |
|---|---|---|
| Due beyond 5 years | 2 | 3 |
| Due between 2 and 5 years | 7 | 6 |
| Due between 1 and 2 years | 3 | 3 |
| | 12 | 12 |

| | Total | | Payable within one year | | Payable beyond one year | |
|---|---|---|---|---|---|---|
| **Company** | 1985 | 1984 | 1985 | 1984 | 1985 | 1984 |
| Trade creditors | 1 | 1 | 1 | 1 | | |
| Sales taxes, duty and excise | | 1 | | 1 | | |
| Accrued charges and deferred income | 1 | | 1 | | | |
| Taxation on profits – UK | | 4 | | | | 4 |
| – overseas | 2 | 1 | 2 | 1 | | |
| Other taxation and social security | 1 | 1 | 1 | 1 | | |
| Amounts due to holding company and fellow subsidiaries | 61 | 62 | 61 | 62 | | |
| Amounts due to subsidiaries | 110 | 100 | 110 | 76 | | 24 |
| Total (all unsecured) | 176 | 170 | 176 | 142 | | 28 |
| Borrowings (page 18 note 25) | 9 | 11 | 5 | 7 | 4 | 4 |
| | 185 | 181 | 181 | 149 | 4 | 32 |

Notes to the Financial Statements £ millions

## 25 Borrowings

| | Group Total borrowings 1985 | Group Total borrowings 1984 | Company Total borrowings 1985 | Company Total borrowings 1984 |
|---|---|---|---|---|
| Miscellaneous – long term | 2 | 4 | | |
| Miscellaneous – short term | 14 | 24 | | 1 |
| Bank loans and overdrafts | 79 | 90 | 1 | 6 |
| Loan from a fellow subsidiary | 4 | 4 | 4 | 4 |
| Loans from subsidiaries | | | 4 | |
| | 99 | 122 | 9 | 11 |
| Secured borrowings | 17 | 18 | – | – |

| | Group Bank loans and overdrafts 1985 | Group Bank loans and overdrafts 1984 | Group Total borrowings 1985 | Group Total borrowings 1984 | Company Bank loans and overdrafts 1985 | Company Bank loans and overdrafts 1984 | Company Total borrowings 1985 | Company Total borrowings 1984 |
|---|---|---|---|---|---|---|---|---|
| Repayable as follows: | | | | | | | | |
| Due beyond 5 years (all repayable by instalments) | 6 | 2 | 7 | 4 | | | | |
| Due between 2 and 5 years | 10 | 21 | 14 | 26 | | | 2 | 2 |
| Due between 1 and 2 years | 10 | 6 | 15 | 11 | | | 2 | 2 |
| | 26 | 29 | 36 | 41 | | | 4 | 4 |
| Due within 1 year | 53 | 61 | 63 | 81 | 1 | 6 | 5 | 7 |
| Total | 79 | 90 | 99 | 122 | 1 | 6 | 9 | 11 |
| Total amount due on long term loans which are repayable by instalments | 9 | 6 | 11 | 10 | | | | |

## 26 Contingent liabilities

There are uncalled liabilities on investments and contingent liabilities in respect of litigation, overseas taxes, guarantees and social benefits in various countries.

BAT Co Ltd has guaranteed borrowings by subsidiaries and fellow subsidiaries of £43 million (1984 £52 million). In addition, jointly with a fellow subsidiary, BAT Co Ltd has guaranteed £488 million (1984 £424 million) of borrowings by B.A.T Industries p.l.c.

## 27 Deferred taxation

| | Group 1985 | Group 1984 | Company 1985 | Company 1984 |
|---|---|---|---|---|
| Had provision been made for deferred taxation in respect of all timing differences, the liability would have been as follows: | | | | |
| Stock relief in respect of overseas stocks | 10 | 12 | | |
| Excess of capital allowances over depreciation after the setting off of ACT of £14 million (1984 nil) | 40 | 52 | 3 | 3 |
| Losses available for set off against future taxable profits | (1) | (7) | | |
| Other timing differences | (5) | (3) | 1 | (1) |
| | 44 | 54 | 4 | 2 |
| ACT available for set off against the above liability | | (9) | | |
| | 44 | 45 | | |

There is a provision for deferred taxation of £11 million (1984 £10 million) in note 22 as it is considered that a liability may arise in the foreseeable future as a result of the reversal of timing differences in respect of accelerated depreciation.

As indicated in note 9(b) on page 5 the above figures do not take into account tax which may be payable on the realisation of investments or in the event of the distribution of profits retained by subsidiaries or associated companies.

# Associated Companies

## Principal Investments

£ millions

| | | Latest available information | Total issued capital | BAT Co Ltd's % beneficial interest |
|---|---|---|---|---|
| **Denmark** | | | | |
| Skandinavisk Holding AS *tobacco, wholesaling, furniture manufacturing, office supplies, agricultural machinery* | #'A' Ordinary | 30/6/85 | 22 | 33 |
| | #'B' Ordinary | | 3 | 33 |
| | #'C' Ordinary | | 10 | 33 |
| **India** | | | | |
| ITC Ltd *tobacco, hotels, board, packaging and printing* | +Ordinary | 30/6/85 | 17 | 31 (34) |
| **Mexico** | | | | |
| Empresas La Moderna SA de CV *tobacco* | +Ordinary | 30/9/85 | 10 | 45 |
| **Trinidad & Tobago** | | | | |
| The West Indian Tobacco Co Ltd *tobacco* | #+Ordinary | 31/12/85 | 7 | 46 |

#Held by BAT Co Ltd +Listed abroad

BAT Co Ltd's percentage beneficial interest in share capital is stated as at 31 December 1985. The interest at 31 December 1984 is shown in brackets where this differs.

## Profit and Loss Account

| | Year to 31 December 1985 Total | Year to 31 December 1985 Group's share | Year to 31 December 1984 Total | Year to 31 December 1984 Group's share |
|---|---|---|---|---|
| Turnover | 1,844 | 628 | 1,978 | 696 |
| Trading profit | 86 | | 166 | |
| Interest received less paid | 6 | | (7) | |
| Profit before taxation | 92 | 35 | 159 | 59 |
| Taxation | 37 | 14 | 54 | 22 |
| Net profit after taxation before extraordinary items | 55 | 21 | 105 | 37 |
| Extraordinary items | | (4) | | - |
| Net profit after extraordinary items | | 17 | | 37 |
| Dividends (see below) | | 20 | | 18 |
| Group's share of associated companies' retentions (note 16 page 14) | | (3) | | 19 |
| Attributable to minority shareholders in subsidiaries | | - | | 2 |
| Attributable to BAT Co Ltd shareholders (note 21 page 16) | | (3) | | 17 |
| Dividends comprise distributions by: | | | | |
| Listed associated companies | | 17 | | 9 |
| Unlisted associated companies | | 3 | | 9 |
| | | 20 | | 18 |

# Associated Companies

## Principal Investments

£ millions

| | | Latest available information | Total issued capital | BAT Co Ltd's % beneficial interest |
|---|---|---|---|---|
| **Denmark** | | | | |
| Skandinavisk Holding AS *tobacco, wholesaling, furniture manufacturing, office supplies, agricultural machinery* | #'A' Ordinary | 30/6/85 | 22 | 33 |
| | #'B' Ordinary | | 3 | 33 |
| | #'C' Ordinary | | 10 | 33 |
| **India** | | | | |
| ITC Ltd *tobacco, hotels, board, packaging and printing* | +Ordinary | 30/6/85 | 17 | 31 (34) |
| **Mexico** | | | | |
| Empresa La Moderna SA de CV *tobacco* | +Ordinary | 30/9/85 | 10 | 45 |
| **Trinidad & Tobago** | | | | |
| The West Indian Tobacco Co Ltd *tobacco* | #+Ordinary | 31/12/85 | 7 | 46 |

#Held by BAT Co Ltd +Listed abroad

BAT Co Ltd's percentage beneficial interest in share capital is stated as at 31 December 1985. The interest at 31 December 1984 is shown in brackets where this differs.

## Profit and Loss Account

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| Trading profit | 86 | | 166 | |
| Interest received less paid | 6 | | (7) | |
| Profit before taxation | 92 | 35 | 159 | 59 |
| Taxation | 37 | 14 | 54 | 22 |
| Net profit after taxation before extraordinary items | 55 | 21 | 105 | 37 |
| Extraordinary items | | (4) | | - |
| Net profit after extraordinary items | | 17 | | 37 |
| Dividends (see below) | | 20 | | 18 |
| Group's share of associated companies' retentions (note 16 page 14) | | (3) | | 19 |
| Attributable to minority shareholders in subsidiaries | | - | | 2 |
| Attributable to BAT Co Ltd shareholders (note 21 page 16) | | (3) | | 17 |
| Dividends comprise distributions by: | | | | |
| Listed associated companies | | 17 | | 9 |
| Unlisted associated companies | | 3 | | 9 |
| | | 20 | | 18 |

# Principal Subsidiaries

The principal subsidiaries in the BAT Co Ltd Group are listed below. The geographical and industrial analyses are based on the main area of operation. The country of incorporation is the same as the main country of operation except where identified.

| | % shares held by BAT | % shares attributable to BAT |
|---|---|---|
| **TOBACCO** | | |
| United Kingdom | | |
| Ardath Tobacco Co Ltd | 100 | 100 |
| BAT (UK and Export) Ltd | – | 100 |
| BAT Services Ltd | – | 100 |
| Europe | | |
| Belgium | | |
| BAT Benelux – Ets Odon Warland SA | 28 | 100 |
| Velasques Sigarenfabrieken NV | – | 100 |
| Channel Islands | | |
| The Jersey Tobacco Distributors Ltd | 100 | 100 |
| Cyprus | | |
| BAT (Cyprus) Ltd | – | 89 |
| Finland | | |
| Suomen Tupakka OY | – | 100 |
| Malta | | |
| MTC Tobacco Company Ltd | 100 | 100 |
| Netherlands | | |
| BAT Nederland BV | – | 100 |
| Henri Wintermans' Sigarenfabrieken BV | – | 100 |
| Switzerland | | |
| BAT (Suisse) SA | 77 | 99 |
| Caribbean/Central America | | |
| Costa Rica | | |
| Republic Tobacco Co | 80 | 80 |
| El Salvador | | |
| Cigarreria Morazán SA de CV | 75 | 75 |
| Honduras | | |
| Tabacalera Hondureña SA | 80 | 80 |
| Nicaragua | | |
| Tabacalera Nicaraguense SA | 60 | 60 |
| Panama | | |
| Tabacalera Istmeña SA | 100 | 100 |
| Surinam | | |
| Tobacco Company of Suriname NV | 100 | 100 |
| Barbados | | |
| British-American Tobacco Co (Barbados) Ltd | 100 | 100 |
| Guyana | | |
| Demerara Tobacco Co Ltd | 68 | 70 |
| Latin America | | |
| Argentina | | |
| Nobleza-Piccardo SAICyF | 70 | 70 |
| SA Alejandro Bianchi & Cia Ltda | – | 70 |
| Chile | | |
| Chiletabacos SA | – | 62 |
| Litografia 'Moderna' SA | – | 62 |
| Venezuela | | |
| CA Cigarrera Bigott Sucs | 85 | 100 |

| | % shares held by BAT | % shares attributable to BAT |
|---|---|---|
| **TOBACCO** | | |
| Asia/Australasia | | |
| Bangladesh | | |
| Bangladesh Tobacco Co Ltd | – | 63 |
| Hong Kong | | |
| British-American Tobacco Co (Hong Kong) Ltd | 85 | 100 |
| Indonesia | | |
| PT BAT Indonesia | 70 | 70 |
| Malaysia | | |
| Malaysian Tobacco Co Berhad | – | 64 |
| Pakistan | | |
| Pakistan Tobacco Co Ltd | 63 | 63 |
| Singapore | | |
| British-American Tobacco Co (Singapore) Ltd | – | 80 |
| Sri Lanka | | |
| Ceylon Tobacco Co Ltd | 77 | 84 |
| New Zealand | | |
| WD & HO Wills (New Zealand) Ltd | – | 86 |
| Africa | | |
| Kenya | | |
| BAT Kenya Ltd | – | 59 |
| Liberia | | |
| The Monrovia Tobacco Corporation | 95 | 95 |
| Malawi | | |
| BAT (Malawi) Ltd | – | 75 |
| Mauritius | | |
| British-American Tobacco (Mauritius) p.l.c. (incorporated in the UK) | – | 100 |
| Nigeria | | |
| *Nigerian Tobacco Co Ltd | 59 | 59 |
| Sierra Leone | | |
| Aureol Tobacco Co Ltd | 86 | 86 |
| South Africa | | |
| Utico Holdings Ltd | 63 | 63 |
| Zaire | | |
| BAT Zaire SARL | 100 | 100 |
| Zambia | | |
| BAT Zambia Ltd | – | 100 |
| Zimbabwe | | |
| BAT Zimbabwe Ltd | 85 | 85 |
| Export Leaf Tobacco Co of Africa (Pvt) Ltd | 100 | 100 |

*accounts made up to 30 September (note 1(a) page 5).

| | % shares held by BAT | % shares attributable to BAT |
|---|---|---|
| **FOODS** | | |
| Chile | | |
| Consorcio Agro-industrial de Malloa SA | – | 62 |
| Evercrisp Snack Productos de Chile SA | – | 62 |
| South Africa | | |
| Willards Foods (Pty) Ltd | – | 63 |



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# CITIZENS UTILITIES COMPANY

## FORM 10-K

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

34

FOR THE YEAR ENDED DECEMBER 31, 1985

CONFORMED

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 1985 Commission file number 0-[illegible]

CITIZENS UTILITIES COMPANY
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 06-0619596 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| High Ridge Park<br>P. O. Box 3801<br>Stamford, Connecticut | 06905 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code (203) 329-8800

Securities registered pursuant to Section 12(b) of the Act:

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock Series A, par value $.50 per share
Common Stock Series B, par value $.50 per share
(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes X No ____

State the aggregate market value of the voting stock held by nonaffiliates of the registrant as of February 21, 1986: $796,846,074

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of February 21, 1986.

| | |
|---|---|
| Common Stock Series A | 17,277,594 |
| Common Stock Series B | 3,253,355 |

DOCUMENTS INCORPORATED BY REFERENCE:

Proxy Statement for Registrant's 1986 Annual Meeting of Stockholders, incorporated by reference into Part III of this Report.

# PART I

Item 1. Description of Business

(a) General Development of Business

The Company was incorporated in Delaware in 1935 to acquire the assets and business of a predecessor public utilities corporation. Since then the Company has grown substantially as a result of internal expansion and acquisitions, so that it currently provides telephone, electric, gas, water and wastewater public utilities services in the States of Arizona, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Ohio, Pennsylvania and Vermont at the locations listed in Item 2 hereof. Except where the context indicates otherwise, as used herein the term "Company" includes Citizens Utilities Company (the "parent company") and its subsidiaries, all of which are wholly-owned. There have not been any material changes in the business of the Company during the past fiscal year, nor are any such changes presently intended by the Company.

(b) Financial Information about Industry Segments

Notes 2 and 8 of the Notes to Consolidated Financial Statements included herein set forth information about industry segments of the Company for the last three fiscal years.

(c) Narrative Description of Business

The Company provides one or more of five basic public utility services—telephone, electric, gas, water and wastewater—to more than 500 communities in ten states. Operating divisions of the parent company provide all electric and gas services, purchasing part of needed electric supplies and all needed gas supplies. All other services are provided either by divisions of the parent company or by its wholly-owned subsidiaries. The Company's geographic diversification protects against single-area downturns, while permitting participation in regional growth; its service diversification protects against adversities affecting any single category of service. This multiple diversification of services and service areas also makes the Company less dependent on the quality of regulation in any one state or type of service; no single regulatory body regulates a utility service of the Company accounting for more than 20% of its 1985 revenues. The Company is not aware of any other utility which is as diversified in both geographic areas served and variety of utility services provided.

The Company's operations are conducted primarily in smaller communities and suburban and rural areas. No material part of the Company's business is dependent upon a single customer or upon a small group of customers.

The Company, through Citizens Utilities Company of California, is a limited Partner in the Sacramento - Valley Limited Partnership which provides cellular mobile telephone service. AAlert Paging Company, a subsidiary of the Company, through its subsidiaries provides radio paging services in California, Utah and Arizona.

The Company holds franchises and certificates of convenience and necessity from numerous governmental bodies, some perpetual and others of varying durations. Water and wastewater public utility property of the Company from time to time has been the subject of condemnation proceedings initiated by municipalities or utility districts seeking to acquire and take over the operation of such property. At December 31, 1985, two properties with a combined book value of approximately $1.4 million for rate-making purposes were subject to such proceedings. Usual competitive considerations and conditions are not applicable to the public utility business. The Company's business taken as a whole and by major segments is not significantly seasonal, nor does any segment of it depend on a single customer or on a few customers, the loss of one or more of which would have a material adverse effect. Order backlog is not a significant consideration in the Company's business, and the Company has no contracts or subcontracts which may be subject to renegotiation of profits or termination at the election of the Federal government. The Company has no special working capital practices.

The Company's research and development activities are not material. There are no patents, trademarks, licenses or concessions held by the Company that are material. The Company does not engage in material operations in foreign countries nor is a material portion of is revenues derived from customers in foreign countries.

The Company employed 1,508 full time and 51 part time employees at December 31, 1985.

Pursuant to the Federal Water Pollution Control Act Amendments of 1972, National Pollutant Discharge Elimination System permits are required for wastewater treatment facilities which discharge to surface waters. Certain proposed permit conditions for one of the Company's facilities in Ohio and final permit conditions for two facilities in Illinois have been contested before the Ohio Environmental Protection Agency and the Illinois Pollution Control Board, respectively. These agencies have yet to reach a decision on the contested permit conditions. Compliance with the proposed permit conditions for the Ohio facility would result in a capital expenditure estimated at $655,000. Compliance with the contested permit conditions for the two facilities in Illinois would result in a total capital expenditure estimated at $7.1 million. These expenditures, if made, would not have any material effect on the Company; additionally, these expenditures would become part of investment for rate-making purposes on which the Company would be entitled to earn a fair rate of return.

The Company's water operations are subject to the Federal Safe Drinking Water Act and National Primary Drinking Water Regulations enacted thereunder by the United States Environmental Protection Agency. Said regulations became effective June 24, 1977 and have been subsequently amended. The Company's water operations are in substantial compliance with the National Primary Drinking Water Regulations. No material capital expenditures are anticipated to maintain compliance with these regulations.

Item 2. <u>Description of Property</u>

The administrative offices of the Company are located at High Ridge Park, Stamford, Connecticut 06905, and are leased. The Company owns property including telephone central office, outside plant and customer premises equipment; electric generation, transmission and distribution facilities; gas transmission and distribution facilities; water production, treatment, storage, transmission and distribution facilities; and wastewater treatment, transmission, collection and discharge facilities as necessary to provide the following services at the locations listed below.

The Company's Mortgage Indentures subject public utility property to the provisions of the Indentures and/or the lien of the Mortgage and securities of certain subsidiaries to the lien of the Mortgage.

| <u>State and County</u> | <u>Service(s) Provided</u> |
|---|---|
| Arizona | |
| Mohave | Electric, Telephone, Water, Wastewater |
| Santa Cruz | Electric, Gas, Water, Wastewater |
| Maricopa | Water, Wastewater |
| California | |
| Humboldt | Telephone, Water |
| Sacramento | " |
| Lassen | Telephone |
| Modoc | " |
| Plumas | " |
| Shasta | " |
| Siski[illegible] | " |
| Solano | " |
| Tehama | " |
| Amador | Water |
| Placer | " |
| San Mateo | " |
| Santa Cruz | " |
| Sonoma | " |

| State and County | Service(s) Provided |
|---|---|
| Colorado | |
| Archuleta | Gas |
| Bent | " |
| Crowley | " |
| La Plata | " |
| Otero | " |
| Hawaii | |
| Kauai | Electric |
| Idaho | |
| Shoshone | Electric, Water |
| Illinois | |
| Cook | Water, Wastewater |
| Du Page | " |
| Will | " |
| Indiana | |
| Howard | Water |
| Ohio | |
| Portage | Water |
| Franklin | Water, Wastewater |
| Pennsylvania | |
| Armstrong | Telephone |
| Clarion | " |
| Adams | Water |
| Berks | " |
| Chester | " |
| Monroe | " |
| Montgomery | " |
| Northampton | " |
| Vermont | |
| Caledonia | Electric |
| Essex | " |
| Franklin | " |
| Grand Isle | " |
| Orleans | " |

Item 3. Legal Proceedings

On September 9, 1981, Kaufman & Broad of Illinois, Inc. ("K&B"), a land subdivider, commenced an action in the Circuit Court of Cook County, Illinois (the "Court"), against Citizens Utilities Company's (the "Company's") subsidiary, Citizens Utilities Company of Illinois ("Citizens"), essentially for reformation of an agreement dated March 12, 1971, supplemented August 25, 1978, under which there had been continuous full performance by both parties for ten years, and asserting punitive damages of $10,000,000. This action was subsequently consolidated with an action Citizens commenced against K&B and its surety for amounts owed under the agreement. Pre-trial proceedings are continuing. In September, 1983, K&B commenced proceedings before the Illinois Commerce Commission (the "Commission") raising essentially the same issues that were dismissed by the Court in 1982. On October 30, 1984, the Commission dismissed these proceedings, giving K&B leave to amend its complaint. K&B has appealed this dismissal in Circuit Court; the Illinois Attorney General, on behalf of the Commission, has moved to dismiss the appeal. The Company believes all of K&B's actions are without substance.

There are no material pending regulatory proceedings other than rate matters. There are no other material pending legal proceedings other than ordinary routine litigation incident to the business within the general meaning of this term.

Item 4. Submission of Matters to Vote of Security Holders

None in fourth quarter 1985.

Executive Officers

Information as to Executive and Other Officers of the Company follows:

| Name | Age | Current Position and Office | Served in Position Since |
|---|---|---|---|
| Richard L. Rosenthal | 70 | Chairman of the Board<br>and Director<br>Chairman, Executive Committee | June 11, 1970<br>May 15, 1946<br>January 16, 1981 |
| Ishier Jacobson | 63 | President and Director<br>Chief Executive Officer;<br>Ex Officio Member Executive<br>Committee | June 11, 1970<br><br><br>January 16, 1981 |
| Hampton D. Graham, Jr. | 40 | Treasurer and Financial<br>Administrative Officer | June 17, 1983 |
| Richard B. Hieber | 47 | Vice President - Electric | May 1, 1984 |
| Robert L. O'Brien | 43 | Vice President - Revenue<br>Requirements | June 1, 1981 |
| [illegible]yd T. Townsley | 55 | Vice President, Kauai<br>Electric Division | June 9, 1978 |
| David E. Chardavoyne | 37 | Assistant Vice President -<br>Water and Wastewater | June 15, 1984 |
| John H. Engel | 59 | Assistant Vice President<br>and Senior Attorney | June 15, 1984 |
| Richard K. Robinson | 53 | Assistant Vice President<br>and Controller | June 9, 1978<br>June 17, 1983 |
| George H. Rivard | 54 | Assistant Treasurer - Telephone<br>Revenue Requirements | June 6, 1980 |
| Budd S. Schwartz | 58 | Assistant Treasurer | May 1, 1975 |
| Gary T. Snyder | 36 | Assistant Treasurer | June 14, 1985 |
| Brigid M. Smith | 33 | Assistant Secretary<br>and Attorney | November 7, 1983<br>November 27, 1978 |
| Theresa M. Walsh | 56 | Assistant Secretary | January 22, 1979 |

Executive Officers

Information as to Executive and Other Officers of the Company follows:

| Name | Age | Current Position and Office | Served in Position Since |
|---|---|---|---|
| Richard L. Rosenthal | 70 | Chairman of the Board and Director<br>Chairman, Executive Committee | June 11, 1970<br>May 15, 1946<br>January 16, 1981 |
| Ishier Jacobson | 63 | President and Director<br>Chief Executive Officer;<br>Ex Officio Member Executive Committee | June 11, 1970<br><br>January 16, 1981 |
| Hampton D. Graham, Jr. | 40 | Treasurer and Financial Administrative Officer | June 17, 1983 |
| Richard B. Hieber | 47 | Vice President - Electric | May 1, 1984 |
| Robert L. O'Brien | 43 | Vice President - Revenue Requirements | June 1, 1981 |
| Boyd T. Townsley | 55 | Vice President, Kauai Electric Division | June 9, 1978 |
| David B. Chardavoyne | 37 | Assistant Vice President - Water and Wastewater | June 15, 1984 |
| John H. Engel | 59 | Assistant Vice President and Senior Attorney | June 15, 1984 |
| Richard K. Robinson | 53 | Assistant Vice President and Controller | June 9, 1978<br>June 17, 1983 |
| George H. Rivard | 54 | Assistant Treasurer - Telephone Revenue Requirements | June 6, 1980 |
| Budd S. Schwartz | 58 | Assistant Treasurer | May 1, 1975 |
| Gary T. Snyder | 36 | Assistant Treasurer | June 14, 1985 |
| Brigid M. Smith | 33 | Assistant Secretary and Attorney | November 7, 1983<br>November 27, 1978 |
| Theresa M. Walsh | 56 | Assistant Secretary | January 22, 1979 |

There is no family relationship between any of the officers of the Registrant. The term of office of each of the foregoing officers of the Registrant will continue until the next annual meeting of the Board of Directors and until a successor shall have been elected and qualified.

RICHARD L. ROSENTHAL has been associated with the Registrant since May 15, 1946. Beginning with January 16, 1981, he has been Chairman of the Board and Chairman of the Executive Committee as well as a Director. For the period May 15, 1946 through January 15, 1981, he was Chief Executive Officer and a Director. From May 15, 1946 through June 10, 1970, he was also President, and since June 11, 1970, he has been and continues to be Chairman of the Board.

ISHIER JACOBSON has been associated with the Registrant since December 20, 1954. He was an Assistant Vice President from May 1, 1957. He was a Vice President during the period June 1, 1960 through June 10, 1970 and was President, Chief Operating Officer and Director during the period June 11, 1970 through January 15, 1981. On January 16, 1981, he became President; Chief Executive Officer; Ex Officio Member, Executive Committee; and Director. On July 18, 1983, he became a director of Vermont Electric Power Company, Inc.

HAMPTON D. GRAHAM, JR. has been associated with the Registrant since July 16, 1979. He was Manager, Special Projects through April 24, 1980 and Manager, Management Information Systems Development and Operations from April 25, 1980 through May 31, 1981. He was Controller from June 1, 1981 through June 16, 1983 and has been Treasurer and Financial Administrative Officer since June 17, 1983.

RICHARD B. HIEBER has been associated with the Registrant since May 1, 1984 and served as Vice President - Electric since that date. During the period 1970 to April 1984 he was employed by Stone and Webster Management Consultants, Inc., as Senior Vice President from July 1978 to April 1984, Vice President from July 1975 to June 1978, Manager - Technical Services Division from December 1974 to June 1975, Senior Consultant from 1972 to November 1974 and Consultant from 1970 to 1972.

ROBERT L. O'BRIEN has been associated with the Registrant since March 10, 1975. He was Manager of Special Studies through June 8, 1978, Assistant Treasurer - Revenue Requirements from June 9, 1978 through May 31, 1979, Assistant Vice President and Assistant Treasurer - Revenue Requirements from June 1, 1979 through May 31, 1981 and has been Vice President - Revenue Requirements since June 1, 1981.

BOYD T. TOWNSLEY has been associated with the Registrant since May 16, 1972 and served as Manager of the Kauai Electric Division since that date. He has been Vice President, Kauai Electric Division since June 9, 1978.

DAVID E. CHARDAVOYNE has been associated with the Registrant since April 17, 1978. He was a Civil/Environmental Engineer through March 31, 1982, Manager - Engineering Studies from April 1, 1982 and Manager - Midwest Operations from April 1, 1983 through June 14, 1984 and has been Assistant Vice President - Water and Wastewater since June 15, 1984.

JOHN H. ENGEL has been associated with the Registrant since March 9, 1970. He was Attorney through June 14, 1984 and has been Assistant Vice President and Senior Attorney since June 15, 1984.

RICHARD K. ROBINSON has been associated with the Registrant since April 3, 1972. He was Controller through April 30, 1975, Assistant Treasurer from May 1, 1975 through June 8, 1978, Assistant Vice President and Assistant Treasurer from June 9, 1978 through June 16, 1983 and has been Assistant Vice President and Controller since June 17, 1983.

GEORGE H. RIVARD has been associated with the Registrant since March 18, 1970. He was a Financial Accountant through May 31, 1971, Senior Rate Accountant from June 1, 1971 through May 31, 1976, Assistant Manager of Telephone Revenue Requirements from June 1, 1976 through May 31, 1978, Manager of Telephone Revenue Requirements from June 1, 1978 through June 5, 1980 and has been Assistant Treasurer - Telephone Revenue Requirements since June 6, 1980.

BUDD S. SCHWARTZ has been associated with the Registrant since June 23, 1969. He was Internal Auditor through June 9, 1971, Assistant Controller from June 10, 1971 through May 31, 1972, Manager of Insurance and Cash Control from June 1, 1972 through April 30, 1975 and has been Assistant Treasurer since May 1, 1975.

GARY T. SNYDER has been associated with the Registrant since June 15, 1977. He was Manager of Auditing through August 31, 1982, Manager of General Accounting from September 1, 1982 through June 13, 1985 and has been Assistant Treasurer since June 14, 1985.

BRIGID M. SMITH has been associated with the Registrant since November 27, 1978 as an Attorney and also as Assistant Secretary of the Registrant since November 7, 1983.

THERESA M. WALSH has been associated with the Registrant since July 19, 1971. She was secretary to the Treasurer through January 21, 1979 and Assistant Secretary of the Registrant since January 22, 1979.

## PART II

Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters

### PRICE RANGE OF COMMON STOCK

The Company's Common Stock is traded on the over-the-counter market under NASDAQ symbols CITUA for Series A and CITUB for Series B shares. Beginning on August 23, 1983, the market prices of the Company's stock were quoted on the NASDAQ National Market System which reports the "High" and "Low" transactions for the day. The following table indicates the high and low prices per share as taken from daily quotations published in the Wall Street Journal during the periods indicated. Series A prices are adjusted also for stock dividends through 1985 to the nearest 1/8th. (See Note 6 of Notes to Consolidated Financial Statements.)

| | 1st Quarter | | 2nd Quarter | | 3rd Quarter | | 4th Quarter | |
|---|---|---|---|---|---|---|---|---|
| | High | Low | High | Low | High | Low | High | Low |
| 1985 Series A | 32-7/8 | 26-3/4 | 38-1/4 | 31-1/2 | 39-1/2 | 36-5/8 | 46-1/8 | 38-1/2 |
| Series B | 31 | 27-1/4 | 35-1/2 | 30-3/4 | 38-1/8 | 33-3/8 | 42-1/2 | 35-1/4 |
| 1984 Series A | 26-1/2 | 23-1/8 | 26-1/4 | 24-3/4 | 26-1/8 | 22 | 29-3/4 | 24-7/8 |
| Series B | 26-1/2 | 21 | 25-1/2 | 21 | 25-1/4 | 22 | 30 | 24-3/4 |

The December 31, 1985 prices were: Series A 40-1/2 high, 40 low; Series B 40-1/2 high, 40 low.

As of February 21, 1986, the approximate number of record security holders of the Company's Common Stock Series A and Series B was 18,676. This information was obtained from the Company's transfer agent.

### DIVIDENDS

Quarterly cash dividends declared and paid on Series B Common Stock were $.49 and $.45 per share, respectively, during 1985 and 1984. Semiannual stock dividends of equivalent fair value declared and issued on the Series A Common Stock were 3.1% and 2.5% for the first and second half of 1985, respectively, and 3.6% and 3.45% for the first and second half of 1984, respectively. (See Note 6 of Notes to Consolidated Financial Statements.)

Item 6. Selected Financial Data (000 Omitted Except for Per-Share Amounts)

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1985 | 1984 | 1983 | 1982 | 1981 |
| Operating revenues | $266,902 | $251,153 | $221,457 | $202,067 | $180,360 |
| Net Income | $ 50,888 | $ 44,023 | $ 38,394 | $ 33,497 | $ 29,216 |
| Income per share of common stock: | | | | | |
| Series A(1) | $2.48 | $2.12 | $1.83 | $1.58 | $1.36 |
| Series B | $2.48 | $2.24 | $2.07 | $1.89 | $1.77 |
| Total Assets | $765,822 | $663,923 | $592,390 | $538,997 | $489,475 |
| Long-term debt | $150,599 | $113,818 | $103,632 | $100,233 | $ 95,070 |
| Cash dividends declared for Series B common share | $1.96 | $1.80 | $1.64 | $1.54 | $1.46 |

(1) Prior years Series A per-share earnings adjusted for intervening stock dividends.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

(a) Liquidity and Capital Resources

Primary sources of funds were operations; 88% of net income was retained in the business, in large part attributable to stock dividends on Series A shares. During 1985, the Company issued Commercial Paper Notes Payable for the following purposes: to fund $17,500,000 of matured First Mortgage and Collateral Trust Bonds; to fund $22,340,000 of tendered 9.75% Industrial Development Revenue Bonds; and to provide supplemental funds as required for construction. Commercial Paper Notes Payable are expected to be refinanced ultimately through the issuance of senior debt securities. Also during 1985, Industrial Development Revenue Bonds aggregating $79,015,000 were issued to provide funds for construction of utility plant and to refund $37,715,000 of 9.75%, 1982 Industrial Development Revenue Bonds. Funds from the Industrial Development Revenue Bonds proceeds, from Rural Telephone Bank borrowings, and from advances for specific capital expenditures received from parties desiring utility service were also employed to pay for construction of utility plant. The Company in 1985 registered $50,000,000 of First Mortgage and Collateral Trust Bonds with the Securities and Exchange Commission which it plans to issue in 1986. Unused bank credit lines totaling $60,000,000 at year-end 1985 at all times exceeded commercial paper outstanding.

Capital expenditures for the years 1985, 1984 and 1983, respectively, were $43.3, $46.2 and $45.9 million, and for 1986 are expected to be approximately $71 million. These expenditures were and in 1986 will be for public utility facilities and related property. The Company anticipates that the funds necessary for its 1986 capital expenditures will be provided from operations, from 1985 Industrial Development Revenue Bond proceeds, from Commercial Paper Notes Payable issues, from parties desiring utility service, from senior debt and other financing at appropriate times and, if deemed advantageous, from other borrowings including short-term borrowings under bank credit lines now totaling $60 million.

(b) Results of Operations

Total operating revenues increased 6%, 13% and 10% for the years 1985, 1984 and 1983, respectively. Telephone revenues increased 8%, 28% and 13%, respectively, principally due to increased toll revenues and added customers in 1985, 1984 and 1983, and rate increases effective in the last quarter of 1983. Electric revenues increased 5%, 6% and 8%, respectively, principally due to rate increases in 1985 and 1983, and cost pass-ons, added customers and increased consumption in 1985, 1984 and 1983. Water and wastewater revenues increased 7% in 1985 and 1984 and 5% in 1983, principally due to rate increases and added customers. Gas revenues decreased 4% and 2% in 1985 and 1984 primarily due to a reduction in the wholesale cost of gas which was passed on to customers and decreased consumption due to warmer weather. Gas revenues increased 12% in 1983 principally due to a rate increase.

Total operating revenue deductions increased 6%, 14% and 9% for the years 1985, 1984 and 1983, respectively. Energy purchased for resale and fuel purchased for generation increased 4%, 5% and 8%, respectively, principally due to higher wholesale suppliers' charges in 1985 and 1983, and increased fuel requirements in 1984 and 1983. Operating and maintenance expenses increased by 6%, 13% and 4%, respectively, principally as a result of increased aggregate employee compensation in 1985, 1984 and 1983, increased maintenance costs on increased amounts of plant in service and increased energy costs for water and wastewater pumping in 1985 and 1984. Depreciation expense increased 5%, 30% and 13%, respectively, principally due to increased investment in plant in service and increased telephone depreciation rates. Provision for Federal and state income taxes increased 13%, 37% and 23%, respectively, principally due to increased taxable income. Other income and deductions increased 66%, 83% and 56%, respectively, primarily due to an increase in interest income. Interest expense increased 11% in 1985 and 1983 and 19% in 1984, primarily due to interest on Commercial Paper Notes Payable issued in 1985, on borrowings from the Rural Telephone Bank and on Industrial Development Revenue Bond proceeds used in 1985, 1984 and 1983.

Decisions of the Federal Communications Commission (FCC) in recent years have resulted in significant accounting and other changes in the telecommunications industry. The current economic effects on the Company's operations of those changes are incorporated in tariff rate and charge increases already in effect. Other changes promulgated by the FCC including revisions in long distance cost allocation policies may require additional increases in the Company's charges to its customers. The effects of these revisions are not yet fully defined, and are contingent in part on future actions by the Congress and by Federal and state regulatory agencies.

Item 8. Financial Statements and Supplementary Data

The following documents are filed as part of this Report:

1. Financial Statements:

   See Index on page F-1.

2. Supplementary Data:

   Quarterly Financial Data and Financial Reporting and Changing Prices, prepared in accordance with Financial Accounting Standards Board Statement No. 33, are included in the Financial Statements (see 1. above).

Item 9. Disagreements with Accountants on Accounting and Financial Disclosure

None.

PART III

Part III is omitted from this report because the Company intends to file with the Commission a definitive proxy statement for the 1986 Annual Meeting of Stockholders pursuant to Regulation 14A not later than 120 days after December 31, 1985. The information called for by this Part III is incorporated by reference to that proxy statement.

PART IV

ITEM 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following documents are filed as part of this Report:

1. The financial statements indexed on page F-1 of this Report.

2. The financial statement schedules required to be filed by Item 8 will be filed as a Form 8 amendment to this Report on or before April 30, 1986.

3. The Exhibits listed below:

| Exhibit No. | Description |
|---|---|
| 3.1 | Certificate of Incorporation |
| 3.2 | ByLaws |
| 3.3 | Certificate of Amendment of Restated Certificate of Incorporation |

| Exhibit No. | Description |
|---|---|
| 4.1 | Copy of Indenture of Mortgage and Deed of Trust dated as of March 1, 1947 to The Marine Midland Trust Company of New York and Baldwin Maull as Trustees |
| 4.2 | Supplemental Indenture, dated April 22, 1947 |
| 4.3 | Second Supplemental Indenture, dated September 1, 1948 |
| 4.4 | Third Supplemental Indenture, dated September 1, 1948 |
| 4.5 | Fourth Supplemental Indenture, dated April 1, 1949 |
| 4.6 | Fifth Supplemental Indenture, dated April 30, 1950 |
| 4.7 | Sixth Supplemental Indenture, dated May 1, 1950 |
| 4.8 | Seventh Supplemental Indenture, dated October 1, 1952 |
| 4.9 | Eighth Supplemental Indenture, dated December 1, 1954 |
| 4.10 | Ninth Supplemental Indenture, dated December 1, 1955 |
| 4.11 | Tenth Supplemental Indenture, dated May 1, 1960 |
| 4.12 | Eleventh Supplemental Indenture, dated November 27, 1961 |
| 4.13 | Twelfth Supplemental Indenture, dated September 11, 1962 |
| 4.14 | Thirteenth Supplemental Indenture, dated October 1, 1962 |
| 4.15 | Fourteenth Supplemental Indenture, dated November 1, 1970 |
| 4.16 | Fifteenth Supplemental Indenture, dated November 1, 1974 |
| 4.17 | Sixteenth Supplemental Indenture, dated March 1, 1975 |
| 4.18 | Seventeenth Supplemental Indenture, dated April 1, 1978 |
| 4.19 | Instrument in Writing, dated January 14, 1952 appointing a Successor Individual Trustee |
| 4.20 | Instrument in Writing, dated June 11, 1969 appointing a Successor Individual Trustee |
| 4.21 | Instrument in Writing, dated November 1, 1972 appointing a Successor Individual Trustee |
| 4.22 | Instrument in Writing, dated July 6, 1977 appointing a Successor Individual Trustee |
| 4.23 | Instrument in Writing, dated February 14, 1983 appointing a Successor Individual Trustee |

| Exhibit No. | Description |
|---|---|
| 4.1 | Copy of Indenture of Mortgage and Deed of Trust dated as of March 1, 1947 to The Marine Midland Trust Company of New York and Baldwin Maull as Trustees |
| 4.2 | Supplemental Indenture, dated April 22, 1947 |
| 4.3 | Second Supplemental Indenture, dated September 1, 1948 |
| 4.4 | Third Supplemental Indenture, dated September 1, 1948 |
| 4.5 | Fourth Supplemental Indenture, dated April 1, 1949 |
| 4.6 | Fifth Supplemental Indenture, dated April 30, 1950 |
| 4.7 | Sixth Supplemental Indenture, dated May 1, 1950 |
| 4.8 | Seventh Supplemental Indenture, dated October 1, 1952 |
| 4.9 | Eighth Supplemental Indenture, dated December 1, 1954 |
| 4.10 | Ninth Supplemental Indenture, dated December 1, 1955 |
| 4.11 | Tenth Supplemental Indenture, dated May 1, 1960 |
| 4.12 | Eleventh Supplemental Indenture, dated November 27, 1961 |
| 4.13 | Twelfth Supplemental Indenture, dated September 11, 1962 |
| 4.14 | Thirteenth Supplemental Indenture, dated October 1, 1962 |
| 4.15 | Fourteenth Supplemental Indenture, dated November 1, 1970 |
| 4.16 | Fifteenth Supplemental Indenture, dated November 1, 1974 |
| 4.17 | Sixteenth Supplemental Indenture, dated March 1, 1975 |
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| 4.19 | Instrument in Writing, dated January 14, 1952 appointing a Successor Individual Trustee |
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| 4.22 | Instrument in Writing, dated July 6, 1977 appointing a Successor Individual Trustee |
| 4.23 | Instrument in Writing, dated February 14, 1983 appointing a Successor Individual Trustee |

| Exhibit No. | Description |
|---|---|
| | The Company agrees to furnish to the Commission upon request copies of the Realty and Chattel Mortgage dated as of March 1, 1965 made by Citizens Utilities Rural Company, Inc. to the United States of America (the Rural Electrification Administration and Rural Telephone Bank), the Mortgage Note which that mortgage secures, and three subsequent supplemental Mortgage and Notes, copies of the instruments governing the long-term debt of Ohio Utilities Company, Blue Mountain Consolidated Water Company and Kauai Electric Company; and the Industrial Development Revenue Bonds. |
| 10.1 | Managerial Incentive Deferred Compensation Plan dated August, 1977; Amendment dated April 7, 1978 to Managerial Incentive Deferred Compensation Plan, August, 1977; Amendment dated June 8, 1979 to Managerial Incentive Deferred Compensation Plan, April 7, 1978; Amendment dated June 6, 1980 to Managerial Incentive Deferred Compensation Plan, June 8, 1979 |
| 10.2 | Senior Managerial Incentive Deferred Compensation Plan dated August 5, 1977; as Amended April 7, 1978; June 8, 1979; June 6, 1980; and as of January 16, 1981 |
| 10.3 | Supplemental Benefits Agreement between Citizens Utilities Company and Ishier Jacobson dated August 5, 1977 |
| 10.5 | Employment Agreement effective January 1, 1981 |
| 10.6 | Deferred Compensation Plans for Directors dated November 26, 1984 and December 10, 1984 |
| 10.7 | Amendment dated June 15, 1984, to the Managerial Incentive Deferred Compensation Plan, June 8, 1979 |
| 10.8 | Amendment dated June 15, 1984, to the Senior Managerial Incentive Deferred Compensation Plan, January 16, 1981 |
| 12. | Computation of ratio of earnings to fixed charges (this item is included herein for the sole purpose of incorporation by reference in the Company's Form S-3 No. 2-96890.) |
| 22. | Subsidiaries of the Registrant |
| 24. | Accountants' Consent dated March 27, 1986 |
| 25. | Powers of Attorney |

All items other than Exhibit numbers 3.3, 4.23, 10.6, 10.7, 10.8, 12, 22, 24 and 25 are incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1980. Exhibit number 4.23 is incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1983. Exhibit numbers 3.3, 10.6, 10.7 and 10.8 are incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1984.

(b) No Form 8-K was required during the three months ended December 31, 1985.

SIGNATURE

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

CITIZENS UTILITIES COMPANY
(Registrant)

By: /s/ Ishier Jacobson
Ishier Jacobson
President; Chief Executive Officer; Ex Officio Member, Executive Committee; and Director
March 27, 1986

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 27th day of March 1986.

| Signature | Title |
|---|---|
| Richard L. Rosenthal* (Richard L. Rosenthal) | Chairman of the Board; Chairman, Executive Committee; and Director |
| /s/ Hampton D. Graham, Jr. (Hampton D. Graham, Jr.) | Treasurer and Financial Administrative Officer |
| /s/ Richard K. Robinson (Richard K. Robinson) | Assistant Vice President and Controller |
| Norman I. Botwinik* (Norman I. Botwinik) | Member, Executive Committee and Director |
| Andrew N. Heine* (Andrew N. Heine) | Member, Executive Committee and Director |
| Irving Kristol* (Irving Kristol) | Director |
| Richard L. Rosenthal, Jr.* (Richard L. Rosenthal, Jr.) | Director |
| John L. Schroeder* (John L. Schroeder) | Director |

*By: /s/ Richard K. Robinson
(Richard K. Robinson)
Attorney-in-Fact

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

Index to Financial Statements

PEAT MARWICK

Peat, Marwick, Mitchell & Co.
Certified Public Accountants
345 Park Avenue
New York, NY 10154

ACCOUNTANTS' REPORT

. Board of Directors and Shareholders
.izens Utilities Company:

.have examined the consolidated financial statements of Citizens Utilities .pany and subsidiaries as listed in the accompanying index. Our examinations .e made in accordan.. w/ h generally accepted auditing standards and, accord-.ly, included such tests of the accounting records and such other auditing .cedures as we considered necessary in the circumstances.

.our opinion, the aforementioned consolidated financial statements present .rly the financial position of Citizens Utilities Company and subsidiaries at .ember 31, 1985 and 1984, and the results of their operations and the changes .their financial position for each of the years in the three-year period ended .ember 31, 1985, in conformity with generally accepted accounting principles .lied on a consistent basis.

Peat, Marwick, Mitchell & Co.
PEAT, MARWICK, MITCHELL & CO.

.ch 27, 1986

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1985 AND 1984

## ASSETS

| | 1985 | 1984 |
|---|---|---|
| Property, plant and equipment | $704,724,515 | $674,911,254 |
| Less accumulated depreciation | 176,532,108 | 157,550,331 |
| | 528,192,407 | 517,360,923 |
| Current assets: | | |
| Cash and cash equivalents | 8,167,721 | 59,264,665 |
| Accounts receivable: | | |
| Utility service | 20,054,982 | 17,033,296 |
| Other | 4,069,087 | 1,042,816 |
| | 24,124,069 | 18,076,112 |
| Less allowance for doubtful accounts | 283,600 | 56,500 |
| | 23,840,469 | 18,019,612 |
| Materials and supplies, at average cost or less | 4,921,927 | 4,815,979 |
| Prepayments and miscellaneous | 1,177,748 | 46,635 |
| | 38,107,865 | 82,146,891 |
| Deferred debits, investment in subsidiaries and other assets | 199,521,539 | 64,414,755 |
| | $765,821,811 | $663,922,569 |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

## SHAREHOLDERS' EQUITY AND LIABILITIES

| | 1985 | 1984 |
|---|---|---|
| Shareholders' equity: | | |
| Capital stock: | | |
| Authorized: 20,000,000 shares of Common Stock Series A, and 23,500,000 shares of Common Stock Series B, both of par value of $.50 each. | | |
| Common stock issued: | | |
| Series A, 1985 - 17,320,082 shares; 1984 - 16,514,947 shares | $ 8,660,041 | $ 8,257,474 |
| Series B, 1985 - 3,210,867 shares; 1984 - 3,162,257 shares | 1,605,433 | 1,581,128 |
| Additional paid-in capital | 230,052,464 | 200,198,936 |
| Retained earnings | 11[illegible],938,640 | 101,950,247 |
| Total shareholders' equity | 354,256,578 | 311,987,785 |
| Long-term debt | 150,599,195 | 113,817,749 |
| Current liabilities: | | |
| Accounts payable | 41,147,140 | 33,937,092 |
| Taxes other than income taxes | 4,052,779 | 4,504,676 |
| Federal and state income taxes | 2,607,213 | 6,252,956 |
| Sinking fund and other installments due within one year | 814,809 | 528,739 |
| Customers' deposits | 3,194,485 | 2,506,513 |
| Interest accrued | 3,289,136 | 2,338,936 |
| Other current liabilities | 7,141,906 | 6,265,822 |
| | 62,24[illegible],468 | 56,334,734 |
| Customer advances for construction | 81,964,359 | 76,0[illegible],966 |
| Contributions in aid of construction | 18,503,914 | 17,383,260 |
| Deferred credits | 98,250,297 | 88,387,075 |
| Commitments | | |
| | $765,821,811 | $663,922,569 |

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
FOR THE THREE YEARS ENDED DECEMBER 31, 1985

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Operating revenues: | | | |
| Telephone | $105,316,524 | $ 97,593,051 | $ 7[illegible],963 |
| Electric | 102,491,492 | 97,277,086 | 9[illegible],264,749 |
| Water and Wastewater | 42,797,926 | 40,017,834 | 37,572,916 |
| Other (including Gas of $14,585,851; $15,173,459; and $15,451,606, respectively) | 16,295,761 | 16,264,8[illegible] | 16,242,254 |
| TOTAL OPERATING REVENUES | 266,901,703 | 251,152,78[illegible] | 22[illegible],456,884 |
| Operating revenue deductions: | | | |
| Electrical energy, natural gas and fuel oil purchased | 67,091,974 | 64,319,627 | 61,445,779 |
| Operating expenses | 50,211,014 | 47,764,196 | 41,6[illegible]6,226 |
| Maintenance expenses | 17,304,375 | 16,069,654 | 14,890,914 |
| Depreciation | 31,190,799 | 29,576,971 | 22,750,866 |
| Taxes other than income taxes | 18,066,432 | 17,522,068 | 16,694,139 |
| Provision for Federal and state income taxes | 33,382,315 | 29,498,319 | 21,561,946 |
| TOTAL OPERATING REVENUE DEDUCTIONS | 217,246,909 | 204,750,935 | 179,039,870 |
| OPERATING INCOME | 49,654,794 | 46,401,846 | 42,417,014 |
| Other income and deductions: | | | |
| Allowance for equity funds used during construction | 1,748,467 | 1,174,590 | 1,114,609 |
| Other (including income of subsidiaries) net | 9,780,449 | 5,749,867 | 2,673,865 |
| TOTAL OTHER INCOME AND DEDUCTIONS | 11,528,916 | 6,924,457 | 3,788,474 |
| INCOME BEFORE INTEREST EXPENSE | 61,183,710 | 53,326,303 | 46,205,488 |
| Interest expense: | | | |
| Interest on long-term debt | 9,967,292 | 8,881,475 | 7,8[illegible],655 |
| Amortization of debt discount and expense | 165,959 | 208,596 | 208,404 |
| Allowance for borrowed funds used during construction | ( 284,634) | ( 207,545) | ( 548,986) |
| Other interest charges | 446,838 | 420,391 | 345,536 |
| TOTAL INTEREST EXPENSE | 10,295,455 | 9,303,517 | 7,811,609 |
| NET INCOME | $ 50,888,255 | $ 44,022,786 | $ 38,393,879 |
| Earnings per share of common stock: | | | |
| Series A | $2.48 | $2.12* | $1.83* |
| Series B | $2.48 | $2.24 | $2.07 |

*Adjusted for intervening stock dividends

The accompanying Notes are an integral part of these Consolidated Financial Statements.

# CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF RETAINED EARNINGS
### FOR THE THREE YEARS ENDED DECEMBER 31, 1985

| | | | | 1985 | 1984 | 1983 |
|---|---|---|---|---|---|---|
| Balance at beginning of year | | | | $101,950,247 | $ 91,850,947 | $ 82,837,182 |
| Add net income | | | | 50,888,255 | 44,022,786 | 38,393,879 |
| | | | | 152,838,502 | 135,873,733 | 121,231,061 |
| Deduct dividends paid: | | | | | | |
| In cash on Series B Common Stock, per share: 1985 - $1.96; 1984 - $1.80; 1983 - $1.64 | | | | 6,273,820 | 5,677,486 | 5,151,251 |
| In Series A Common Stock: | | | | | | |
| | 1985 | 1984 | 1983 | | | |
| June: | | | | | | |
| Rate | 3.1% | 3.6% | 3.0% | | | |
| Number of shares | 508,453 | 555,119 | 436,761 | | | |
| December: | | | | | | |
| Rate | 2.5% | 3.45% | 2.9% | | | |
| Number of shares | 422,292 | 550,710 | 434,660 | | | |
| Total shares: | 930,745 | 1,105,829 | 871,421 | 32,626,042 | 28,246,000 | 24,228,863 |
| | | | | 38,899,862 | 33,923,486 | 29,380,114 |
| Balance at end of year | | | | $113,938,640 | $101,950,247 | $ 91,850,947 |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
FOR THE THREE YEARS ENDED DECEMBER 31, 1985

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Funds provided from: | | | |
| Operations: | | | |
| Net income | $ 50,888,255 | $ 44,022,786 | $38,393,879 |
| Depreciation | 31,190,799 | 29,575,071 | 22,750,866 |
| Deferred income taxes | 8,696,469 | 8,473,105 | 9,650,864 |
| Allowance for equity funds used during construction | ( 1,748,467) | ( 1,174,390) | ( 1,114,609) |
| Miscellaneous | 1,712,118 | 1,720,956 | 1,642,164 |
| | 90,739,174 | 82,618,328 | 71,323,164 |
| Borrowings | 59,141,099 | 10,707,850 | 12,024,171 |
| Customer advances for construction and contributions in aid of construction | 6,682,459 | 6,817,637 | 893,238 |
| Increase in current liabilities, including taxes | 5,912,734 | 10,765,277 | 6,532,142 |
| Increase (Decrease) in deferred credits | 1,892,009 | ( 2,835,706) | 132,133 |
| | $164,367,475 | $108,073,386 | $90,904,848 |
| Funds used for: | | | |
| Additions to plant (excluding allowance for equity funds used during construction) | $ 41,569,220 | $ 45,042,649 | $44,804,381 |
| Cash dividends paid | 6,273,820 | 5,677,486 | 5,151,251 |
| Reduction of long-term debt | 22,359,653 | 521,679 | 8,625,196 |
| Increase in other current assets | 7,057,918 | 2,029,342 | 2,043,915 |
| Increase in deferred debits, investment in subsidiaries and other assets, net of change in cash and cash equivalents | 84,079,490 | 57,313,894 | 35,056,319 |
| Other, net | 3,027,374 | ( 2,511,664) | ( 4,776,214) |
| | $164,367,475 | $108,073,386 | $90,904,848 |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
FOR THE THREE YEARS ENDED DECEMBER 31, 1985

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Funds provided from: | | | |
| Operations: | | | |
| Net income | $ 50,888,255 | $ 44,022,786 | $38,393,879 |
| Depreciation | 31,190,799 | 29,575,071 | 22,750,866 |
| Deferred income taxes | 8,696,469 | 8,473,105 | 9,650,864 |
| Allowance for equity funds used during construction | ( 1,748,467) | ( 1,174,590) | ( 1,114,609) |
| Miscellaneous | 1,712,118 | 1,720,956 | 1,642,164 |
| | 90,739,174 | 82,618,328 | 71,323,164 |
| Borrowings | 59,141,099 | 10,707,850 | 12,024,171 |
| Customer advances for construction and contributions in aid of construction | 6,682,459 | 6,817,637 | 893,238 |
| Increase in current liabilities, including taxes | 5,912,734 | 10,765,277 | 6,532,142 |
| Increase (Decrease) in deferred credits | 1,892,009 | ( 2,835,706) | 132,133 |
| | $164,367,475 | $108,073,386 | $90,904,848 |
| Funds used for: | | | |
| Additions to plant (excluding allowance for equity funds used during construction) | $ 41,569,220 | $ 45,042,649 | $44,804,381 |
| Cash dividends paid | 6,273,820 | 5,677,486 | 5,151,251 |
| Reduction of long-term debt | 22,359,653 | 521,679 | 8,625,196 |
| Increase in other current assets | 7,057,918 | 2,029,342 | 2,043,915 |
| Increase in deferred debits, investment in subsidiaries and other assets, net of change in cash and cash equivalents | 84,079,490 | 57,313,894 | 35,056,319 |
| Other, net | 3,027,374 | ( 2,511,664) | ( 4,776,214) |
| | $164,367,475 | $108,073,386 | $90,904,848 |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
CONSOLIDATED SCHEDULE OF LONG-TERM DEBT
DECEMBER 31, 1985 AND 1984

| | 1985 | 1984 |
|---|---|---|
| First Mortgage and First Mortgage and Collateral Trust Bonds: | | |
| 8.30% Series, due March, 1985 | $ — | $ 17,500,000 |
| 5-5/8% Series, due October, 1986 | — | 275,000 |
| 5% Series, due February, 1990 | 870,000 | 900,000 |
| 5-1/2% Series, due December, 1990 | 2,251,000 | 2,251,000 |
| 4.8% Series, due December, 1991 | 4,000,000 | 4,000,000 |
| 4-5/8% Series, due October, 1992 | 4,000,000 | 4,000,000 |
| 5-1/4% Series, due May, 1994 | 280,000 | 316,000 |
| 8-7/8% Series, due March, 2005 | 16,362,000 | 16,362,000 |
| 5-1/4% Second Mortgage Bonds, due July, 1987 | 237,000 | 237,000 |
| Thirty-Five Year Mortgage Notes - Rural Electrification Administration and Rural Telephone Bank: | | |
| 2% due in quarterly installments through 2006 | 1,829,808 | 1,919,769 |
| 6% due in quarterly installments through 2008 | 2,360,817 | 2,413,374 |
| 7-1/2% due in quarterly installments through 2011 | 1,545,699 | 1,567,119 |
| 6-1/2% due in quarterly installments through 2012 | 11,040,240 | 11,194,812 |
| 6-1/2% due in quarterly installments through 2013 | 3,685,013 | 3,734,897 |
| 9% due in quarterly installments through 2015 | 13,031,826 | 12,857,700 |
| Industrial Development Revenue Bonds: | | |
| 9.75% 1982 Series, due May, 2012 (Outstanding: 1985 - $33,665,000; 1984 - $37,715,000 less proceeds held in trust: 1985 - $0; 1984 - $3,43[illegible],307) (See Note 4 for redemption dates) | 33,665,000 | 34,276,693 |
| 6-7/8% 1985 Series, due between 2015 and 2025 ($30,350,000 issued less proceeds held in trust: $27,540,031) | 2,809,969 | — |
| 7-3/8% 1985 Series, due 2015 ($9,400,000 issued less proceeds held in trust: $9,005,148) | 394,852 | — |
| Variable rate 1985 Series, due from 2015 to 2020 (interest rates ranged from 5% to 5.70% at December 31, 1985) ($39,265,000 issued less proceeds held in trust: $34,829,029) | 4,435,971 | — |
| Commercial Paper Notes Payable | 47,800,000 | — |
| Other Notes Payable, due through 1986 | — | 12,385 |
| | $150,599,195 | $113,817,749 |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements
($000 Omitted Except for Per Share Amounts)

(1) Summary of Significant Accounting Policies:

(a) Principles of Consolidation:
The consolidated financial statements include the accounts of Citizens Utilities Company and all subsidiaries after elimination of intercompany balances and transactions other than the investments in wholly-owned subsidiaries reported using the equity method of accounting.

(b) Property, Plant and Equipment:
Property, plant and equipment are stated at original cost, including general overhead and an allowance for funds used during construction, net of unamortized plant acquisition adjustments, where applicable. An allowance for funds used during construction which takes account of borrowing costs and a reasonable return on common equity is included in the cost of additions to property, plant and equipment. The allowance is not a cash item. The amount relating to equity is included in Other Income and the amount relating to borrowings is netted against Interest Expense. Maintenance and repairs are charged to operating expense as incurred. The cost, net of salvage, of routine property dispositions is charged against accumulated depreciation.

(c) Accumulated Depreciation:
Depreciation expense, calculated on the straight-line method, is based upon estimated service lives of various classifications of properties, and amounted to approximately 5% of the gross amounts of the property for the years 1985 and 1984 and 4% for 1983.

(d) Taxes, Deferred Income Taxes and Investment Tax Credits:
Deferred income tax charges result from the use for income tax purposes of accelerated depreciation methods and certain other tax deductions in excess of charges to income. The investment tax credits relating to utility properties, as defined by applicable regulatory authorities, have been deferred and are being amortized to income over the life of the related property. The preceding procedures are consistent with accepted rate-making procedures in many states where operations are conducted.

(2) Property, Plant and Equipment:

The components of property, plant and equipment at December 31, 1985 and 1984, respectively, are as follows: transmission and distribution facilities $501,629 and $476,886; production facilities $111,598 and $109,355; pumping, storage and purification facilities $49,164 and $47,017; intangibles $1,035 and $1,018; other $32,570 and $30,134; construction work in progress $8,729 and $10,501. Assets, depreciation and capital expenditures identified with business segments for 1985, 1984 and 1983, respectively, are as follows: Telephone $226,687, $21,213, $19,292; $222,999, $20,188, $21,090 and $221,326, $14,545, $24,432; Electric $136,126, $5,604, $9,967; $148,909, $5,253, $12,003 and $133,797, $4,786, $13,070; Water and Wastewater $197,637, $3,872, $12,021; $196,853, $3,652, $12,264 and $186,061, $2,956, $7,679; Other $205,372, $502, $2,038; $95,162, $483, $860 and $51,206, $464, $738.

(3) Deferred Debits, Investment in Subsidiaries and Other Assets:
The components of deferred debits, investment in subsidiaries and other assets at December 31, 1985 and 1984, respectively, are: Deferred debits: $7,518 and $4,775; Investment in subsidiaries: $184,450 and $49,681; Other assets: $7,554 and $9,959.

A summary of the combined Balance Sheets for the unconsolidated subsidiaries at December 31, 1985 and December 31, 1984, respectively, is as follows: Cash equivalents: $105,476 and $30,018; Other investments: $83,405 and $19,709; Current and accrued liabilities: $4,431 and $46; Amount due to parent: $162,237 and $32,929 and Total shareholder's equity: $22,213 and $16,752. The combined Statements of Income consist primarily of net interest income. Net income for the three years ended December 31, 1985 for the unconsolidated subsidiaries was $5,459, $1,049 and $0, respectively.

(4) Long-Term Debt:
Principal installments and maturities of presently outstanding long-term debt due through 1990, except as noted below, approximate $1,420, $1,405, $1,200, $1,234 and $4,146, respectively, (installments $1,145, $1,168, $1,200, $1,234 and $1,115, respectively, and maturities $275, $237, $0, $0 and $3,031, respectively). Approximately $606 of the above installments for each of the years 1986 through 1989 and $490 in 1990 may be deferred by certification of property additions or other credits. Accordingly, such amount is not currently payable and has been excluded from current liabilities.

The Company has sent an irrevocable notice to the trustee that the 9.75% Industrial Development Revenue Bonds issued in 1982 will be redeemed in February ($30,365) and May, 1986 ($3,300). Variable rate Industrial Development Revenue Bonds were sold in August and November, 1985 to fund the redemption of the 9.75% Series; the proceeds are being held in trust for that purpose. Holders may tender at par the 6-7/8% 1985 Series on August 1, 1988 and the 7-3/8% 1985 Series on November 1, 1990.

Commercial Paper Notes Payable have been classified as long-term debt because these obligations are expected to be refinanced ultimately through the issuance of senior securities and the Company has lines of credit which expire January 23, 1987 under which the Company may borrow from its banks up to $60,000 at the prime rate.

The indentures securing long-term debt of the Company provide, among other things, that the Company will not declare or pay any dividend (other than a stock dividend) on the common stock if the aggregate amount declared or paid after December 31, 1946 shall exceed $613 plus the aggregate consolidated net earnings of the Company and its subsidiaries subsequent to December 31, 1946. At December 31, 1985, the entire retained earnings were free of such restrictions.

(5) Deferred Credits:
The components of deferred credits at December 31, 1985 and 1984 respectively, are as follows: deferred income taxes, net $62,916 and $53,297; deferred investment tax credits $31,464 and $30,122; advances and contributions related to plant under construction and properties no longer owned $2,128 and $2,774; other $1,742 and $2,194.

(6) Capital Stock:

The common stock of the Company is in two Series, Series A and Series B. To the extent that cash dividends are paid on the Series B, stock dividends with an equivalent fair value must be paid during the same calendar year on the Series A, unless cash dividends are declared on Series A shares at the same time and in an equal amount as on Series B shares. Since the reclassification of the outstanding common stock in 1956, only stock dividends have been paid on Series A and only cash dividends have been paid on Series B. Series A is convertible into Series B at all times except between the dates of declaration and record of dividends. Series B is not convertible into Series A. The shares of both Series have identical voting rights and participate ratably in liquidation.

Earnings per share is presented for each Series separately, with historical adjustment for stock dividends for Series A only. The percentage of Series A and of Series B shares has been established for each year by relating the year-end number of Series A shares and the monthly average number of Series B shares to the total of both. The percentages have then been applied to the net income for the year to calculate the net income pools applicable to the Series A and the Series B, respectively. The net income pool applicable to the Series B has been divided by the average number of shares of Series B stock outstanding each year to obtain the Series B per-share earnings. The net income pool applicable to Series A has been divided by the year-end number of shares of Series A stock; and the resultant earnings per share of Series A have for earlier years also been adjusted for stock dividends paid in any subsequent year or years.

During 1985, 48,610 shares of Series A were converted into the same number of shares of Series B.

(7) Income Taxes:

The provision for Federal and state income taxes for the years 1985 through 1983, respectively, excluding income taxes applicable to property dispositions in 1984 and 1983 (see Note 14), is $34,016 (Federal - $28,603; state - $5,413), $31,555 (Federal - $26,749; state - $4,806) and $23,047 (Federal - $19,130; state - $3,917). Of the provisions for taxes of $34,016, $31,555 and $23,047, the amounts relating to operating income are $33,382, $29,498 and $21,562 and the amounts relating to other income are $634, $2,057 and $1,485, for the years 1985 through 1983, respectively. The deferred tax portion of income taxes totals $8,696 (Federal - $6,832; state - $523 and Investment Tax Credits - $1,341), $8,115 (Federal - $5,636; state - $1,101 and Investment Tax Credits - $1,378) and $8,532 (Federal - $6,111; state $1,205 and Investment Tax Credits - $1,216) for the years 1985 through 1983, respectively. At December 31, 1985 the cumulative amount of timing differences for which deferred income taxes have not been provided is $73,436.

(6) Capital Stock:

The common stock of the Company is in two Series, Series A and Series B. To the extent that cash dividends are paid on the Series B, stock dividends with an equivalent fair value must be paid during the same calendar year on the Series A, unless cash dividends are declared on Series A shares at the same time and in an equal amount as on Series B shares. Since the reclassification of the outstanding common stock in 1956, only stock dividends have been paid on Series A and only cash dividends have been paid on Series B. Series A is convertible into Series B at all times except between the dates of declaration and record of dividends. Series B is not convertible into Series A. The shares of both Series have identical voting rights and participate ratably in liquidation.

Earnings per share is presented for each Series separately, with historical adjustment for stock dividends for Series A only. The percentage of Series A and of Series B shares has been established for each year by relating the year-end number of Series A shares and the monthly average number of Series B shares to the total of both. The percentages have then been applied to the net income for the year to calculate the net income pools applicable to the Series A and the Series B, respectively. The net income pool applicable to the Series B has been divided by the average number of shares of Series B stock outstanding each year to obtain the Series B per-share earnings. The net income pool applicable to Series A has been divided by the year-end number of shares of Series A stock; and the resultant earnings per share of Series A have for earlier years also been adjusted for stock dividends paid in any subsequent year or years.

During 1985, 48,610 shares of Series A were converted into the same number of shares of Series B.

(7) Income Taxes:

The provision for Federal and state income taxes for the years 1985 through 1983, respectively, excluding income taxes applicable to property dispositions in 1984 and 1983 (see Note 14), is $34,016 (Federal - $28,603; state - $5,413), $31,555 (Federal - $26,749; state - $4,806) and $23,047 (Federal - $19,130; state - $3,917). Of the provisions for taxes of $34,016, $31,555 and $23,047, the amounts relating to operating income are $33,382, $29,498 and $21,562 and the amounts relating to other income are $634; $2,057 and $1,485, for the years 1985 through 1983, respectively. The deferred tax portion of income taxes totals $8,696 (Federal - $6,832; state - $523 and Investment Tax Credits - $1,341), $8,115 (Federal - $5,636; state - $1,101 and Investment Tax Credits - $1,378) and $8,532 (Federal - $6,111; state $1,205 and Investment Tax Credits - $1,216) for the years 1985 through 1983, respectively. At December 31, 1985 the cumulative amount of timing differences for which deferred income taxes have not been provided is $73,436.

Income taxes, excluding income taxes applicable to property dispositions in 1984 and 1983 (see Note 14), based on the Federal statutory rate (46%) are calculated to be $39,056, $34,766 and $28,263 for 1985, 1984 and 1983, respectively, which amounts are reconciled to the total provisions for income taxes, excluding taxes applicable to property dispositions (see Note 14), for the respective periods as follows: Allowance for funds used during construction, $913, $605 and $765; overhead expenses capitalized, $2,117, $2,352 and $3,134; depreciation based on tax service lives, ($2,853), ($2,665) and ($162); amortization of investment tax credits, $2,643, $1,927 and $1,545; state income tax provision, net of Federal income tax benefit, ($3,815), ($2,558) and ($2,190); nontaxable interest and dividend income, $4,158, $1,361 and $450; other, net $1,877, $2,189 and $1,674.

(8) Other Segment Information:
Operating income for 1985, 1984 and 1983, respectively, (before provision for income taxes of $33,382, $29,498 and $21,562 applicable to operations) by segment are: Telephone $47,894, $43,098 and $31,308; Electric $19,145, $17,225 and $17,014; Water and Wastewater $14,969, $14,207 and $14,068; Other $1,029, $1,370 and $1,589.

(9) Quarterly Financial Data (Unaudited):

| | Three Months Ended | | | |
|---|---|---|---|---|
| 1985 | March 31 | June 30 | September 30 | December 31 |
| Operating Revenues | $65,561 | $65,665 | $67,969 | $67,707 |
| Operating Income | $ 9,868 | $11,814 | $13,696 | $14,277 |
| Net Income | $ 9,865 | $11,717 | $13,924 | $15,382 |
| Earnings per share of common stock (See Note) | | | | |
| Series A* | $.47 | $.57 | $.68 | $.75 |
| Series B | $.50 | $.58 | $.69 | $.75 |
| 1984 | | | | |
| Operating Revenues | $64,112 | $61,770 | $63,350 | $61,921 |
| Operating Income | $ 9,777 | $11,544 | $12,635 | $12,446 |
| Net Income | $ 8,690 | $10,300 | $12,183 | $12,850 |
| Earnings per share of common stock (See Note) | | | | |
| Series A* | $.41 | $.49 | $.58 | $.62 |
| Series B | $.47 | $.54 | $.64 | $.65 |

NOTE:
Per-share earnings were calculated in a manner consistent with the procedures set forth in Note 6 of the Notes to Consolidated Financial Statements.
*The quarters ended March 31, June 30 and September 30, 1985 and March 31, June 30, September 30 and December 31, 1984 have been adjusted for intervening stock dividends.

(10) Pension and Retirement Plans:

The Company and its subsidiaries have noncontributory pension plans covering all employees who have met certain service and age requirements. Including amounts capitalized, the cost of these plans (1985 - $3,896; 1984 - $3,660 and 1983 - $3,665) includes amortization of past service liability and is funded as accrued.

At January 1, 1985 and 1984, respectively, the aggregate actuarial present value of accumulated plan benefits were $18,386 and $18,661 (vested - $17,163 and $17,286; nonvested - $1,223 and $1,375) and the aggregate net assets available for benefits were $50,534 and $44,393. The weighted average assumed discount rates used in determining the actuarial present value of accumulated plan benefits were 8% for 1985 and 7% for 1984.

(11) Financial Reporting and Changing Prices (Unaudited):

The following supplementary information has been prepared in accordance with Financial Accounting Standards Board Statement No. 33, Financial Reporting and Changing Prices ("FAS No. 33"), which presents and recommends experimental quantifications to indicate certain effects of changing prices attributable to inflation. This hypothetical information is presented on the basis of "current cost." Current cost values represent the estimated cost of replacing existing property, plant and equipment and were determined by applying industry construction cost index factors to historical plant balances by year of addition data in accordance with FAS No. 33 procedures.

Under FAS No. 33, the only income statement item to be calculated that differs from the Company's financial statements is depreciation expense, computed by applying the Company's current depreciation rates to current costs determined for the Company's property, plant and equipment in accordance with FAS No. 33 procedures. FAS No. 33 does not incorporate a recomputation of the provision for income taxes to reflect this increase in depreciation expense; such recomputation would decrease the provision for income taxes, offsetting approximately half of the increase in depreciation expense, and would increase net income in like amount. More generally, the significance of computing depreciation expense per FAS No. 33 should be weighed in the light of established regulatory principles which generally apply to public utility rate-making. At present, recovery of the historical costs of property, plant and equipment only is generally considered for determining allowable depreciation expense in rate-making; if and when elements of such property, plant and equipment have to be replaced at higher costs, rate-making has traditionally incorporated increased depreciation expense levels sufficient to offset those higher costs. For this reason also, inferences as to the adequacy of future cash flows in relation to future property, plant and equipment replacement requirements that might be drawn from FAS No. 33 computations for industries other than public utilities may be expected to be less valid for public utilities which, under established regulatory principles, should be able to adjust rates to provide for recovery of adequate returns on higher cost replacement property, plant and equipment.

(11) Financial Reporting and Changing Prices (Unaudited) (Continued):

Nevertheless, because such differences between property, plant and equipment adjusted for inflation to a current cost basis and the historical recorded costs of these are not recoverable under settled regulatory principles in current utility rate-making, this difference is described by FAS No. 33 as a "reduction to net recoverable cost." Another effect of inflation considered by FAS No. 33 is that monetary assets lose purchasing power and monetary liabilities are repaid with dollars having a lesser purchasing power; the net change in these computed on a current cost basis is a "gain from the decline in purchasing power of net amounts owed." However, this "gain" is not taken into account in the FAS No. 33 calculation of net income adjusted for changing prices.

FAS No. 33 information must be understood to be an experimental, hypothetical effort to present in numerical fashion some approximation of the effect of changing prices due to inflation. This information is not an actual measure in any sense. Moreover, basic regulation of utilities associates revenues with costs. When costs - including depreciation - increase, in due course they are offset by increases in revenues obtained under established regulatory procedures.

CITIZEN'S UTILITIES COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements - (Continued)

(11) Financial Reporting and Changing Prices (Unaudited) (Continued):

INCOME ADJUSTED HYPOTHETICALLY FOR CHANGING PRICES
PER FAS NO. 33
FOR THE YEAR ENDED DECEMBER 31, 1985

| | Current Cost Average 1985 Dollars |
|---|---|
| Net Income, as reported in the Statement of Income | $50,888 |
| Depreciation Expense adjusted hypothetically per FAS No. 33 | 20,550 |
| Hypothetical Net Income adjusted | $30,338 (1) |
| Hypothetical Decrease in specific prices (current cost) of property, plant and equipment held during the year | ($ 3,217) |
| Hypothetical Adjustment to net recoverable cost per FAS No. 33 | 40,918 |
| Hypothetical Effect of increase in general price level | (36,527) |
| Hypothetical Excess of increase in specific prices over increase in general price level after adjustment to net recoverable cost | 1,174 |
| Hypothetical Gain from decline in purchasing power of net amounts owed | 5,679 |
| | $ 6,853 |

(1) For hypothetical per-share earnings resulting, see "Earnings per share of Common Stock" in the "Five Year Comparison of Supplementary Financial Data Adjusted Hypothetically per FAS No. 33."

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements - (Continued)

(11) Financial Reporting and Changing Prices (Unaudited) (Continued):

FIVE YEAR COMPARISON OF SUPPLEMENTARY FINANCIAL DATA
ADJUSTED HYPOTHETICALLY PER FAS NO. 33
(Average 1985 Dollars)

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1985 | 1984 | 1983 | 1982 | 1981 |
| Hypothetical Operating Revenues, except for 1985 | $266,902 | $260,114 | $239,120 | $[illegible]25,202 | $213,334 |
| Current Cost Information | | | | | |
| Hypothetical Net Income | $ 30,338 | $ 24,402 | $ 19,777 | $ 17,966 | $ 16,893 |
| Hypothetical Earnings per share of common stock | | | | | |
| Series A | $1.19 | $1.18 | $ .94 | $ .84 | $ .78 |
| Series B | $1.[illegible]8 | $1.24 | $1.07 | $1.01 | $1.02 |
| Hypothetical excess (deficiency) of increase in general price level over increase in specific prices after adjustment to net recoverable cost | ($ 1,174) | ($ 641) | ($ 1,688) | $ 602 | $ 26,690 |
| Hypothetical Net Assets at year-end | $348,630 | $318,613 | $290,502 | $264,900 | $242,314 |
| General Information | | | | | |
| Hypothetical gain from decline in purchasing power of net amounts owed | $ 5,679 | $ 7,169 | $ 8,193 | $ 9,129 | $ 21,124 |
| Hypothetical cash dividends declared per share of common stock, except for 1985 | | | | | |
| CPI | $1.96 | $1.86 | $1.77 | $1.72 | $1.73 |
| GNPD | $1.96 | $1.86 | $1.76 | $1.72 | $1.73 |
| Hypothetical market price per share of common stock at year-end, except for 1985 (average of bid - asked or high - low) | | | | | |
| Series A | 40-1/4 | 29-1/4 | 32-1/8 | 25-5/8 | 20 |
| Series B | 40-1/4 | 29-1/2 | 27 | 24-3/8 | 19-1/2 |
| Average Consumer Price Index (CPI) | 322.2 | 311.1 | 298.4 | 289.1 | 2[illegible]2.6 |
| Average Gross National Product Implicit Price Deflator (GNPD) | 111.7 | 108.1 | 103.9 | 100.0 | 94.0 |

(12) Commitments:

The Company has budgeted expenditures for facilities in 1986 of approximately $70,975 and certain commitments have been entered into in connection therewith.

(13) Additional Paid-In Capital:

The increase in additional paid-in capital during years 1985, 1984 and 1983 amounting to $29,654, $27,693 and $23,793, respectively, represents the excess of fair value over par value of shares of Common Stock Series A issued as stock dividends.

(14) Property Dispositions:

Amounts received in condemnation proceedings and settlements, included in 1984 and 1983 Other income, net, less the carrying value of the property and the costs including income tax effect of $377 and $1,271 in 1984 and 1983, respectively, (primarily deferred taxes) related to the proceedings and settlements, resulted in no significant net gain or loss.

The tax effect of these transactions reflects the excess of the carrying value of the property per books over the tax basis of the property resulting from capitalization of overheads for book purposes and differences in tax service lives, the tax effect of such items having been reflected as reductions in prior years' income tax provisions, together with deferred taxes provided in prior years on the use of accelerated depreciation methods for tax purposes.



END

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

RECEIVED MAY 19 1986

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended March 31, 1986 Commission File Number 0-1291

CITIZENS UTILITIES COMPANY
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 06-0619596 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| High Ridge Park<br>P. O. Box 3801<br>Stamford, Connecticut | 06905 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code (203) 329-8800

NONE
Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No ____

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of May 8, 1986.

| | |
|---|---|
| Common Stock Series A | 17,259,471 |
| Common Stock Series B | 3,271,478 |

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

CONSOLIDATED CONDENSED BALANCE SHEETS

MARCH 31, 1986 AND DECEMBER 31, 1985

| | 3-31-86 | 12-31-85 |
|---|---|---|
| **ASSETS** | | |
| Property, plant and equipment | $711,353,216 | $704,724,515 |
| Less accumulated depreciation | 184,157,580 | 176,532,108 |
| | 527,195,636 | 528,192,407 |
| Current assets: | | |
| Cash and cash equivalents | 8,353,544 | 8,167,721 |
| Accounts receivable | 23,282,024 | 23,840,469 |
| Other | 5,475,530 | 6,099,675 |
| | 37,111,098 | 38,107,865 |
| Deferred debits, investment in subsidiaries and other assets | 214,434,005 | 199,521,539 |
| | $778,740,739 | $765,821,811 |
| **SHAREHOLDERS' EQUITY AND LIABILITIES** | | |
| Shareholders' equity: | | |
| Common stock issued, $.50 par value: | | |
| Series A | $ 8,634,425 | $ 8,660,041 |
| Series B | 1,631,049 | 1,605,433 |
| Additional paid-in capital | 230,052,464 | 230,052,464 |
| Retained earnings | 123,479,339 | 113,938,640 |
| Total shareholders' equity | 363,797,277 | 354,256,578 |
| Long-term debt | 151,726,005 | 150,599,195 |
| Current liabilities: | | |
| Long-term debt due within one year | 814,809 | 814,809 |
| Other | 60,430,143 | 61,432,659 |
| | 61,244,952 | 62,247,468 |
| Customer advances for construction and contributions in aid of construction | 100,823,103 | 100,468,273 |
| Deferred credits, including reserve for deferred income taxes and deferred investment tax credits | 101,149,402 | 98,250,297 |
| | $778,740,739 | $765,821,811 |

PART I. FINANCIAL INFORMATION (Continued)

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED MARCH 31, 1986 AND 1985

| | 1986 | 1985 |
|---|---|---|
| Operating revenues | $69,042,883 | $65,560,875 |
| Operating revenue deductions, other than provision for income taxes | 51,792,055 | 49,907,316 |
| Provision for income taxes | 6,553,107 | 5,785,707 |
| Operating income | 10,697,721 | 9,867,852 |
| Other income and deductions (Note 3) | 3,678,185 | 2,494,756 |
| Interest expense (Note 3) | 3,078,395 | 2,497,553 |
| Net income | $11,297,511 | $ 9,865,055 |
| Earnings per share of Common Stock (Note 2): | | |
| Series A | $ .55 | $ .47* |
| Series B | $ .55 | $ .50 |
| Dividends per share: | | |
| Number of common shares outstanding at March 31: | | |
| Series A Common Stock | 17,268,850 | 16,485,409 |
| Series B Common Stock | 3,262,099 | 3,191,795 |
| Distribution: | | |
| In cash on Series B Common Stock paid quarterly | $ .54 | $ .49 |
| In Series A shares on Series A Common Stock paid semi-annually - rate | - 0 - | - 0 - |

*Adjusted for intervening stock dividends.

PART I. FINANCIAL INFORMATION (Continued)

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF CHANGES IN FINANCIAL POSITION

FOR THE THREE MONTHS ENDED MARCH 31, 1986 AND 1985

| | 1986 | 1985 |
|---|---|---|
| Funds provided from: | | |
| Operations | $22,442,361 | $20,735,044 |
| Borrowings | 31,600,818 | 20,967,397 |
| Decrease (Increase) in other current assets | 1,182,590 | ( 279,185) |
| Other | 639,914 | 1,624,795 |
| | $55,865,683 | $43,048,051 |
| Funds used for: | | |
| Additions to plant (excluding allowance for equity funds used during construction) | $ 7,454,613 | $ 7,141,412 |
| Cash dividends | 1,756,812 | 1,561,232 |
| Reduction in long-term debt | 30,474,008 | 17,633,414 |
| Decrease (Increase) in other current liabilities, including taxes | 1,002,516 | ( 564,684) |
| Increase in deferred debits, investment in subsidiaries, other assets, cash and cash equivalents | 15,114,089 | 17,233,514 |
| Other | 63,645 | 43,163 |
| | $55,865,683 | $43,048,051 |

PART I. FINANCIAL INFORMATION (Continued)
CITIZENS UTILITIES COMPANY AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(1) The consolidated financial statements include the accounts of Citizens Utilities Company and all subsidiaries after elimination of intercompany balances and transactions other than the investments in wholly-owned subsidiaries reported using the equity method of accounting. All adjustments necessary to a fair statement of the results for the interim periods have been made.

(2) The Common Stock of the Company is in two series, Series A and Series B. To the extent that cash dividends are paid on the Series B, stock dividends with an equivalent fair value must be paid during the same calendar year on the Series A, unless cash dividends are declared on Series A shares at the same time and in an equal amount as on Series B shares. Since the reclassification of the outstanding common stock in 1956, only stock dividends have been paid on Series A and only cash dividends have been paid on Series B. Series A is convertible into Series B at all times except between the dates of declaration and record of dividends. Series B is not convertible into Series A. The shares of both Series have identical voting rights and participate ratably in liquidation.

Earnings per share is presented for each Series separately, with historical adjustment for stock dividends for Series A only. The percentage of Series A and of Series B shares has been established for each period by relating the period-end number of Series A shares and the monthly average number of Series B shares to total of both. The percentages have then been applied to the net income for the period to calculate the net income pools applicable to the Series A and Series B, respectively. The net income pool applicable to the Series B has been divided by the average number of shares of Series B stock outstanding each period to obtain the Series B per-share earnings. The net income pool applicable to Series A has been divided by the period-end number of shares of Series A stock; and the resultant earnings per share of Series A have for earlier periods also been adjusted for stock dividends paid in any subsequent period or periods.

(3) In accordance with applicable regulatory systems of account, an allowance for funds used during construction is included in the cost of additions to property, plant and equipment and is allowed in rate base for rate making purposes. The allowance is not a cash item. The amount relating to equity is included in Other income and the amount relating to borrowings is netted against Interest expense.

PART I. FINANCIAL INFORMATION (Continued)
CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

(a) Liquidity and Capital Resources

For the three months ended March 31, 1986, the primary source of additional funds was operations; 84% of net income was retained in the business. Funds from 1985 Industrial Development Revenue Bond proceeds were also used to pay for construction of utility plant. Additional funds were received as advances for specific capital expenditures from parties desiring utility service. The Company has lines of credit with banks under which it may borrow up to $60,000,000 at the prime rate. In February, 1986, $30,365,000 of 9.75% Industrial Development Revenue Bonds were redeemed using part of the proceeds of the 1985 Industrial Development Revenue Bond issues which carry materially lower interest rates. On April 15, 1986, $50,000,000 of 7-7/8% First Mortgage and Collateral Trust Bonds due 1996 were issued primarily to provide funds to repay $47,800,000 of Commercial Paper Notes Payable.

(b) Results of Operations

Operating revenues for the three months ended March 31, 1986 increased over first quarter 1985 revenues by $3,482,008, primarily due to: an increase of $1,728,945 in electric operating revenues, resulting principally from rate increases and increased number of customers; an increase of $1,626,332 in telephone operating revenues, resulting principally from increased number of customers and increased toll revenues; an increase of $731,874 in water and wastewater operating revenues, resulting principally from rate increases, increased water usage and an increased number of customers; and a decrease of $977,713 in gas operating revenues, resulting principally from pass-ons of decreases in purchased gas costs and decreased consumption due to warmer weather.

Operating revenue deductions, other than provision for income taxes, increased over first quarter 1985 by $1,884,739 due primarily to: increased maintenance expense, increased aggregate employee compensation, increased depreciation on increased plant in service and increased taxes other than income taxes due to increased revenues and increased salaries and wages. The provision for income taxes increased over the first quarter 1985 by $767,400 primarily due to increased taxable income. Other income and deductions increased over the first quarter 1985 by $1,183,429 primarily due to an increase in interest income. Interest expense increased over the first quarter 1985 by $580,842 primarily due to increased Commercial Paper Notes Payable and additional drawdowns of 1985 Industrial Development Revenue Bonds, offset in part by the reduction of interest expense on 1975 8.30% First Mortgage and Collateral Trust Bonds which matured March 1, 1985.

## PART II. OTHER INFORMATION
## CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

Item 1. Legal Proceedings

On September 9, 1981, Kaufman & Broad of Illinois, Inc. ("K&B"), a land subdivider, commenced an action in the Circuit Court of Cook County, Illinois (the "Court"), against Citizens Utilities Company's (the "Company's") subsidiary, Citizens Utilities Company of Illinois ("Citizens"), essentially for reformation of an agreement dated March 12, 1971, supplemented August 25, 1978, under which there had been continuous full performance by both parties for ten years, and asserting punitive damages of $10,000,000. This action was subsequently consolidated with an action Citizens commenced against K&B and its surety for amounts owed under the agreement. Pre-trial proceedings are continuing. Trial has been set to begin on August 19, 1986. In September, 1983, K&B commenced proceedings before the Illinois Commerce Commission (the "Commission") raising essentially the same issues that were dismissed by the Court in 1982. On October 30, 1984, the Commission dismissed these proceedings, giving K&B leave to amend its complaint. K&B has appealed this dismissal in Circuit Court; the Illinois Attorney General, on behalf of the Commission, has moved to dismiss the appeal. The Company believes all of K&B's actions are without substance.

There are no material pending regulatory proceedings other than rate matters. There are no other material pending legal proceedings other than ordinary routine litigation incident to the business within the general meaning of this term.

Item 6. Reports on Form 8-K

(b) No 8-K was required during the three months ended March 31, 1986.

CITIZENS UTILITIES COMPANY AND SUBSIDIARIES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CITIZENS UTILITIES COMPANY
(Registrant)

Date May 14, 1986

Ishier Jacobson
President; Chief Executive Officer; Ex Officio Member, Executive Committee; and Director

Date May 14, 1986

Hampton D. Graham, Jr.
Treasurer and
Financial Administrative Officer

Date May 14,

Richard K. Robinson
Assistant Vice President and
Controller



END