



FORTITUDINIE

# McRae Industries

## 2013 Annual Report

# Corporate Profile

McRae Industries, Inc. was founded in 1959 as a manufacturer and distributor of children's shoes. Today, McRae Industries is involved in manufacturing, sales and distribution of high quality, reasonably priced boot products targeted to the western/lifestyle and work boot markets. In addition, we continue to take pride in manufacturing military combat boots for the U. S. Government. The company also operates other smaller businesses.

McRae Industries, Inc. corporate headquarters is located in Mount Gilead, North Carolina.

# Selected Consolidated Financial Data

The following Selected Consolidated Financial Data of the Company presented below for each of the five years in the periods indicated has been derived from our audited and consolidated financial statements.

| **Fiscal Years Ended** | **8/3/13** | **7/28/12** | **7/30/11** | **7/31/10** | **8/1/09** |
|---|---|---|---|---|---|
| *(In thousands, except per share data)* | | | | | |
| **Income Statement Data:** | | | | | |
| Net revenues | **$ 97,071** | $ 75,684 | $ 74,748 | $ 62,571 | $ 62,213 |
| Net earnings (loss) | **7,498** | 4,842 | 3,829 | 2,952 | (514) |
| Net earnings per common share | | | | | |
| Basic Earnings per share[(a)]: | | | | | |
| Class A | **4.54** | 2.73 | 2.22 | 1.79 | 0.11 |
| Class B | **.77** | 0 | 0 | 0 | 0 |
| Diluted Earnings per share[(b)]: | | | | | |
| Class A | **3.79** | 2.27 | 1.84 | 1.47 | 0.11 |
| Class B | **NA** | NA | NA | NA | NA |
| **Balance Sheet Data:** | | | | | |
| Total assets | **$ 64,909** | $ 58,763 | $ 53,811 | $ 51,348 | $ 49,763 |
| Long-term liabilities | **1,399** | 1,702 | 1,334 | 1,134 | 2,139 |
| Working capital | **44,451** | 40,582 | 36,559 | 33,892 | 32,822 |
| Shareholders' equity | **56,067** | 50,781 | 47,029 | 44,154 | 42,318 |
| Weighted average number of common shares outstanding: | | | | | |
| Class A | **2,035,034** | 2,038,902 | 2,053,042 | 2,068,866 | 2,089,686 |
| Class B | **399,878** | 414,853 | 423,697 | 432,518 | 438,915 |
| Weighted average number of common shares outstanding[(c)]: | **2,434,912** | 2,453,755 | 2,476,739 | 2,501,384 | 2,528,601 |
| Cash dividends per Class A common share: | **$ 0.36** | $ 0.36 | $ 0.36 | $ 0.36 | $ 0.36 |
| Cash dividends per Class B common share | **$ 0.27** | $ 0 | $ 0 | $ 0 | $ 0 |
| Special Cash dividend per Class A and Class B common share | **$ 0.50** | $ 0 | $ 0 | $ 0 | $ 0 |

*(a) This calculation uses the two-class method under which all undistributed earnings are allocated to Class A Common Stock in the earnings per share calculation; thus, no earnings are allocated to the holders of Class B Common Stock. See Note 1 to the consolidated financial statements included in this report.*

*(b) This calculation uses the if-converted method which assumes all Class B Common Stock is converted into Class A Common Stock; thus, there are no holders of Class B Common Stock to participate in undistributed earnings. See Note 1 to the consolidated financial statements included in this report.*

*(c) Includes both Class A and Class B Common Stock*

# Letter To Shareholders

Dear Fellow Shareholders,

It is my great pleasure to report to you that fiscal 2013 was a record breaking year for your Company in both revenue and earnings. Net revenues grew 28%, up from $75.7 million in fiscal 2012 to $97.1 million for fiscal 2013. Net earnings for fiscal 2013 amounted to $7.5 million, up nearly 56% from the $4.8 million reported for fiscal 2012. These results were attributable to growth in both our western/lifestyle boot products and work boot products.

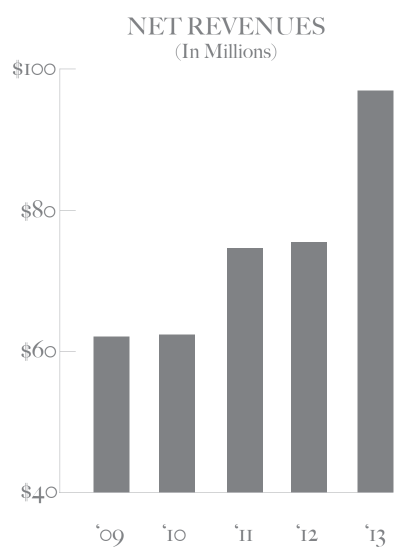
Our work boot segment, which includes the Dan Post, Laredo, Dingo, John Deere and McRae Industrial branded work boot products and our military boots, experienced a 45% improvement as net revenues grew from $23.0 million for fiscal 2012 to $33.3 million for fiscal 2013. Our western and farm work boot business net revenue grew nearly 6% year over year while our military boot business increased by approximately 88%. The increase in our military boot business resulted from higher military boot requirements for the US Government related to the two new contracts we received in July 2012 and a new military boot contract with the Israeli Government. Gross margins for the work boot segment improved from $3.6 million for fiscal 2012 to $5.6 million for fiscal 2013 primarily attributable to the significant increase in military boot sales.

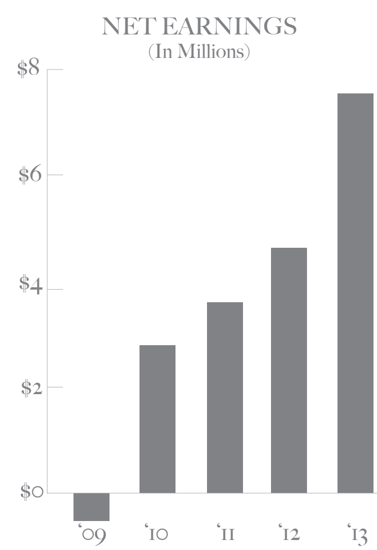
Net revenues for our western/lifestyle boot segment, which includes western wear, ladies fashion and children's footwear products, increased from $52.5 million for fiscal 2012 to $62.8 million for fiscal 2013 as demand for both men and women boots continued to be strong. All of our brands posted strong results with our premier Dan Post brand leading the way. While the demand for women's fashion products continued to grow year over year, we also experienced increasing demand for our men's products across all brands.

From a financial perspective, the Company continues to operate from a position of strength. Our working capital increased from $40.3 million at July 28, 2012 to $43.2 million at August 3, 2013. Our $10.8 million in year-end cash and cash equivalents coupled with our $6.75 million in lines of credit provide a strong base in our efforts to expand our business. As the economy continues to improve, we believe that the Company is well positioned to experience increased sales and profitability for fiscal 2014.

For fiscal 2014, we are cautiously optimistic that both our western/lifestyle segment and work boot segment will continue to perform well in both revenues and earnings. However, we are well aware of the many challenges we will face in maintaining our current growth pattern. For example, the western/lifestyle segment is now in its fourth year of significant growth,

. . . Fiscal 2013 was a record breaking year for your Company in both revenue and earnings. Net revenues grew 28%, up from $75.7 million in fiscal 2012 to $97.1 million for fiscal 2013. Net earnings for fiscal 2013 amounted to $7.5 million, up nearly 56% from the $4.8 million reported for fiscal 2012.



and history tells us that these western cycles typically last only three to four years. Is this cycle about to end or has the consumer changed their attitude by making western boots part of their wardrobe? In addition, other challenges include increased product cost, expanded competition from both old and new footwear players, and an ever changing and consolidating retail industry. All of these factors have the potential to affect sales and margins in the future.

Our military boot business has been rejuvenated by being the successful bidder on two U.S. Government solicitations for Army combat boots, one U.S. Government solicitation for Marine combat boots and an Israeli Government solicitation for military combat boots.

Significant product development efforts in our work boot segment have resulted in new technical comfort work boots for a younger workforce. These products will hopefully increase sales in this very competitive segment of the business. Our military boot business has been rejuvenated by being the successful bidder on two U.S. Government solicitations for Army combat boots, one U.S. Government solicitation for Marine combat boots and an Israeli Government solicitation for military combat boots. The U.S. Government contracts are each for a base year and four option years while the Israeli Government contract is for two years with a third option year. Traditionally, these contracts carry lower gross margins; however, we are working hard to increase efficiency and lower cost through process improvements. In addition, the Government contracts provide a wide variation on the quantity of boots they order. This factor makes it difficult to forecast military boot sales beyond six to twelve months. We also continue to invest in our commercial military boot business with the expectation that this segment will become a contributor to our business in the future.

The success that we have enjoyed over the past several years would not have been possible without a dedicated team of associates who work diligently to ensure that we produce products that our customers enjoy and are proud to wear. The Board and I would like to thank all of our teammates, from our corporate staff to our military boot business and our western and work boot business employees, for their efforts in making this year a successful year for McRae Industries.

On behalf of the Board of Directors, we thank you for your continued goodwill and support.

Sincerely,

D. Gary McRae

D. Gary McRae
President

# FINANCIAL STATEMENTS
# TABLE OF CONTENTS

Grant Thornton

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## REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Board of Directors and Shareholders of
McRae Industries, Inc. and Subsidiaries:

We have audited the accompanying consolidated financial statements of **McRae Industries, Inc.** (a Delaware corporation) **and Subsidiaries** (the Company), which comprise the consolidated balance sheets as of August 3, 2013, and July 28, 2012, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended August 3, 2013, and the related notes to the financial statements.

### Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of McRae Industries, Inc. and Subsidiaries as of August 3, 2013, and July 28, 2012, and the results of their operations and their cash flows for each of the three years in the period ended August 3, 2013, in accordance with accounting principles generally accepted in the United States of America.

Grant Thornton LLP

Charlotte, North Carolina
November 8, 2013

## CONSOLIDATED BALANCE SHEETS
*McRae Industries, Inc. and Subsidiaries*

| (In thousands, except share data) | August 3, 2013 | July 28, 2012 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 10,804 | $ 12,874 |
| Accounts and notes receivable, less allowances of $1,521 and $1,170, respectively | 15,394 | 11,782 |
| Inventories, net | 23,046 | 19,572 |
| Income tax receivable | 0 | 209 |
| Prepaid expenses and other current assets | 482 | 395 |
| Deferred tax assets | 2,168 | 1,726 |
| Total current assets | 51,894 | 46,558 |
| Property and equipment, net | 3,319 | 3,116 |
| Other assets: | | |
| Long term securities | 958 | 0 |
| Real estate held for investment | 3,626 | 3,673 |
| Amounts due from split-dollar life insurance | 2,288 | 2,288 |
| Trademarks | 2,824 | 2,824 |
| Total other assets | 9,696 | 8,785 |
| Total assets | $ 64,909 | $ 58,459 |

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

## CONSOLIDATED BALANCE SHEETS

*McRae Industries, Inc. and Subsidiaries*

| (In thousands, except share data) | August 3, 2013 | July 28, 2012 |
|---|---|---|
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 4,054 | $ 3,373 |
| Accrued employee benefits | 1,707 | 1,158 |
| Accrued payroll and payroll taxes | 1,209 | 1,003 |
| Income tax payable | 74 | 0 |
| Other | 399 | 746 |
| Total current liabilities | 7,443 | 6,280 |
| Deferred tax liabilities | 1,399 | 1,398 |
| Total liabilities | 8,842 | 7,678 |
| Commitments and contingencies (Note 8) | | |
| Shareholders' equity: | | |
| Common Stock: | | |
| Class A, $1 par value; authorized 5,000,000 shares issued and outstanding, 2,037,605 and 2,030,880 shares, respectively | 2,038 | 2,031 |
| Class B, $1 par value; authorized 2,500,000 Shares; issued and outstanding, 392,919 and 408,376 shares, respectively | 393 | 408 |
| Retained earnings | 53,636 | 48,342 |
| Total shareholders' equity | 56,067 | 50,781 |
| Total liabilities and shareholders' equity | $ 64,909 | $ 58,459 |

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

## CONSOLIDATED STATEMENTS OF OPERATIONS
*McRae Industries, Inc. and Subsidiaries*

**(In thousands, except for share and per share data)**

| **For Years Ended** | **August 3, 2013** | **July 28, 2012** | **July 30, 2011** |
|---|---|---|---|
| Net revenues | $ 97,071 | $ 75,684 | $ 74,748 |
| Cost of revenues | 67,539 | 52,329 | 54,027 |
| Gross profit | 29,532 | 23,355 | 20,721 |
| Selling, general and administrative expenses | 18,005 | 15,671 | 14,626 |
| Operating profit | 11,527 | 7,684 | 6,095 |
| Other income | 204 | 249 | 202 |
| Interest expense | (2) | (1) | (1) |
| Earnings before income taxes | 11,729 | 7,932 | 6,296 |
| Provision for income taxes | 4,231 | 3,090 | 2,467 |
| Net earnings | $ 7,498 | $ 4,842 | $ 3,829 |

Earnings per common share:

| | | | |
|---|---|---|---|
| Earnings per common share: | | | |
| Basic earnings per share: | | | |
| Class A | $ 4.54 | $ 2.73 | $ 2.22 |
| Class B | .77 | 0 | 0 |
| Diluted earnings per share: | | | |
| Class A | 3.79 | 2.27 | 1.84 |
| Class B | NA | NA | NA |
| Weighted average number of common shares outstanding: | | | |
| Class A | 2,035,034 | 2,038,902 | 2,053,042 |
| Class B | 399,878 | 414,853 | 423,697 |
| Total | 2,434,912 | 2,453,755 | 2,476,739 |

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

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
### *McRae Industries, Inc and Subsidiaries*

**(Dollars in thousands)**
**Common Stock, $1 par value**

| | Class A | | Class B | | |
|---|---|---|---|---|---|
| | **Shares** | **Amount** | **Shares** | **Amount** | **Retained Earnings** |
| **Balance, July 31, 2010** | 2,054,282 | $2,054 | 428,979 | $429 | $ 41,671 |
| Purchase of ESOP distribution shares | (10,421) | (10) | (2,638) | (3) | (155) |
| Purchase of other shares | (3,272) | (3) | | | (44) |
| Conversion of Class B to Class A Stock | 5,748 | 5 | (5,748) | (5) | 0 |
| Cash Dividend ($.36 per Class A common stock) | | | | | (739) |
| | | | | | 3,829 |
| **Balance, July 30, 2011** | 2,046,337 | $2,046 | 420,593 | $421 | $ 44,562 |
| Purchase of ESOP distribution shares | (21,843) | (22) | (5,143) | (6) | (319) |
| Purchase of other shares | (488) | 0 | (200) | 0 | (9) |
| Conversion of Class B to Class A Stock | 6,874 | 7 | (6,874) | (7) | 0 |
| Cash Dividend ($.36 per Class A common stock) | | | | | (734) |
| Net earnings | | | | | 4,842 |
| **Balance, July 28, 2012** | 2,030,880 | $2,031 | 408,376 | $408 | $ 48,342 |
| Purchase of ESOP distribution shares | (6,315) | (6) | (1,486) | (1) | (135) |
| Purchase of other shares | (1,231) | (1) | | | (18) |
| Issuance of Class A Shares | 300 | 0 | | | 5 |
| Conversion of Class B to Class A Stock | 13,971 | 14 | (13,971) | (14) | 0 |
| Cash Dividend ($.36 per Class A common stock) | | | | | (732) |
| Cash Dividend ($.27 per Class B common stock) | | | | | (107) |
| Special Cash Dividend ($.50 per Class A and B common stock) | | | | | (1,217) |
| Net earnings | | | | | 7,498 |
| **Balance, August 3, 2013** | 2,037,605 | $2,038 | 392,919 | $393 | $53,636 |

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*McRae Industries, Inc. and Subsidiaries*

**(In thousands)**

| **For Years Ended** | **August 3, 2013** | **July 28, 2012** | **July 30, 2011** |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net earnings | $ 7,498 | $ 4,842 | $ 3,829 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | | |
| Depreciation | 686 | 640 | 629 |
| Amortization of bond premiums | 11 | 0 | 0 |
| Loss (Gain) on sale of assets | (282) | 45 | (83) |
| Deferred income taxes | (441) | 26 | 161 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable, net | (3,612) | (801) | (510) |
| Inventories | (3,474) | (961) | (1,436) |
| Prepaid expenses and other current assets | (87) | (219) | (11) |
| Accounts payable | 681 | 618 | (821) |
| Accrued employee benefits | 549 | 307 | 177 |
| Accrued payroll and payroll taxes | 206 | (84) | (24) |
| Income taxes | 283 | 68 | 267 |
| Other | (347) | (9) | 56 |
| **Net cash provided by operating activities** | **1,671** | **4,472** | **2,234** |
| **Cash Flows from Investing Activities:** | | | |
| Proceeds from sale of assets | 390 | 8 | 126 |
| Proceeds from maturing bond | 75 | 0 | 0 |
| Purchase of land for investment | (59) | (23) | (258) |
| Capital expenditures | (891) | (767) | (822) |
| Purchase of securities | (1,044) | 0 | 0 |
| **Net cash used in investing activities** | **(1,529)** | **(782)** | **(954)** |
| **Cash Flows from Financing Activities:** | | | |
| Purchase of common stock | (161) | (356) | (215) |
| Issuance of common stock | 5 | 0 | 0 |
| Dividends paid | (2,056) | (734) | (739) |
| **Net cash used in financing activities** | **(2,212)** | **(1,090)** | **(954)** |
| **Net (Decrease) Increase in Cash and Cash equivalents** | (2,070) | 2,600 | 326 |
| **Cash and Cash Equivalents at Beginning of Year** | 12,874 | 10,274 | 9,948 |
| **Cash and Cash Equivalents at End of Year** | **$ 10,804** | **$ 12,874** | **$ 10,274** |

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

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Business

McRae Industries, Inc., (the "Company", which may be referred to as "we", "us" or "our"), is a Delaware corporation organized in 1983 and is the successor to a North Carolina corporation organized in 1959. Our principal lines of business are: manufacturing and selling military combat boots and importing and selling western and work boots.

### Principles of Consolidation

The consolidated financial statements include the accounts of all of the Company's wholly owned subsidiaries and other businesses over which we exercise significant control. All significant intercompany transactions and balances have been eliminated in consolidation.

Total assets and net revenues for each of our main business units are as follows:

| | (In thousands) | | |
|---|---|---|---|
| | **2013** | **2012** | **2011** |
| **Total Assets:** | | | |
| Western/Work Boots | $ 36,650 | $ 33,371 | $ 30,593 |
| Military Boots | 8,450 | 4,049 | 4,762 |
| Bar Code | 78 | 87 | 71 |

| | (In thousands) | | |
|---|---|---|---|
| | **2013** | **2012** | **2011** |
| **Total Net Revenues:** | | | |
| Western/Work Boots | $ 75,368 | $ 64,454 | $ 55,624 |
| Military Boots | 20,780 | 11,067 | 18,783 |
| Bar Code | 15 | 31 | 157 |
| Other | 908 | 132 | 184 |

### Use of Estimates

The timely preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Actual results could differ from those estimates. The economic price adjustment related to our military combat boot contract is subject to certain price variations for leather.

### Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits with banks and certificates of deposit purchased with an original maturity date of three months or less.

**Accounts Receivable**

Accounts receivable are stated at amounts expected to be collected from outstanding balances. Probable uncollectible accounts are reserved for by a charge to earnings and a credit to the allowance for doubtful accounts based on the assessment of the current status of individual accounts. Balances that are still outstanding after using reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. The Company performs on-going credit evaluations of its customers' financial condition and establishes an allowance for losses on trade receivables based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

Our western and work boot business records an allowance for sales returns which is calculated by applying historical return data to sales subject to potential returns. The allowance for sales returns, which is different from the allowance noted in the preceding paragraph, is included as a component of the valuation allowance presented on the balance sheet. This component totaled approximately $546,000 and $470,000 for fiscal 2013 and fiscal 2012, respectively.

**Inventories**

Inventories are stated at the lower of cost or market value using the last-in, first-out (LIFO) method for military boots and using the first-in, first-out (FIFO) method for all other inventories. We regularly review our FIFO basis inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast and demand requirements for the next twelve months. Actual demand and market conditions may be different from those projected by our management primarily as a result of fashion cycles and trends and the overall financial condition of competitors in the western and work boot business. A one percentage point error in our inventory allowances would approximate $6,300 and $4,000 for the fiscal years ended August 3, 2013, and July 28, 2012 respectively.

**Marketable Securities**

The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold securities to their maturity. Held-to-maturity securities are recorded as either short term or long term on the Balance Sheet, based on their contractual maturity date and are stated at amortization cost. For fiscal 2013, our held to maturity securities totaled $958,000.

**Long-Lived Assets and Other Intangibles**

The Company reviews long-lived assets with estimable useful lives for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

The Company tests identifiable intangible assets with an indefinite life for impairment annually. Furthermore, such assets are required to be tested for impairment on an interim basis if an event or circumstance indicates that it is more likely than not an impairment loss has been incurred. An impairment loss shall be recognized to the extent that the carrying amount of such assets exceeds its implied fair value. Impairment losses shall be recognized in operations. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. Based on its most recent analysis, the Company believes that no impairment exists as of August 3, 2013 and July 28, 2012 respectively.

**Revenue Recognition**

Sales of the Company are recognized as revenues when goods are shipped and title passes to the buyer. Our military boot sales to the U.S. Government under our current contract are recognized as revenues when the goods are received at their designated depot.

**Income Taxes**

The Company accounts for income taxes under the asset and liability method. Federal and state income taxes are computed at current tax rates, less tax credits. Taxes are adjusted both for items that do not have tax consequences and for the cumulative effect of any changes in tax rates from those previously used to determine deferred tax assets or liabilities. Tax provisions include amounts that are currently payable, plus changes in deferred tax assets and liabilities that arise because of temporary differences between the time when items of income and expense are recognized for financial reporting and income tax purposes. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not such assets will be realized.

The Company's policy is to recognize interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense. The Company has recognized no interest or penalties since the adoption of the accounting guidance related to accounting for uncertainty in income taxes.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax in multiple state jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal income tax examinations for fiscal years ending before 2010. However, to the extent allowed by law, the tax authorities may have the right to examine prior periods where net operating losses were generated and carried forward, and make adjustments up to the amount of the net operating loss carry forward amount.

**Earnings per Share**

Under our Articles of Incorporation, we may pay dividends on our Class A Common Stock in excess of the dividends we pay on our Class B Common Stock. As a result, we have computed our earnings per share in compliance with Accounting Standards Codification (ASC) 260, "Earnings per Share". This guidance requires companies that have multiple classes of equity securities to use the "two class" or "if converted method" in computing earnings per share.

For our primary or basic earnings per share calculation, we use the two-class method, which implies a different dividend rate for our Class B Common Stock. Consequently, all undistributed earnings are allocated to Class A Common Stock in the earnings per share calculation. The result of this calculation allocates no earnings per share to the holders of Class B Common Stock.

For our diluted earnings per share calculation, we use the if-converted method. This calculation assumes that all Class B Common Stock is converted into Class A Common Stock. As a result, there are no holders of Class B Common Stock to participate in undistributed earnings.

While we have presented our earnings per share in accordance with (ASC) 260, we believe that the holders of Class A and Class B Common Stock have equal rights to the Company's undistributed earnings. Consequently, we believe that the calculation that best expresses economic reality is to calculate earnings per share using the total Class A and Class B Common Stock outstanding.

The Company had no common stock equivalents issued or outstanding for the three-year period ended August 3, 2013.

**Advertising**

The Company charges advertising costs when incurred as a component of SG&A expenses. Advertising expense amounted to approximately $701,000, $656,000, and $627,000 for fiscal years 2013, 2012, and 2011, respectively.

**Shipping and Handling**

Shipping and handling costs that are charged to and reimbursed by the customer are recognized as revenues, while the related expenses, including buying, postage, external distribution and warehousing costs incurred by the Company are recorded as components of cost of goods sold in the consolidated statements of operations.

**Split-Dollar Life Insurance**

The Company is party to a split-dollar arrangement with respect to certain life insurance policies. We record an amount that is to be realized under the split dollar agreement. This amount is the actual premiums paid by the Company or the actual cash surrender value of the policy, whichever is less.

**Real Estate Held for Investment**

Real estate held for investment is land recorded at cost plus the cost of any improvements. Land is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

**2. INVENTORIES**

Current costs exceeded the LIFO value of inventories by approximately $762,000 and $800,000 at August 3, 2013 and July 28, 2012, respectively. Year-end inventories valued under the LIFO method were approximately $3,513,000 and $1,761,000 at August 3, 2013 and July 28, 2012, respectively. For fiscal 2013, lower FIFO pricing decreased the LIFO reserve, which increased net earnings by approximately $23,000 as compared to higher FIFO pricing for fiscal 2012 resulting in an increased LIFO reserve, which decreased net earnings by approximately $12,000.

Inventory reserves applicable to the FIFO inventories totaled approximately $627,000 and $404,000 for fiscal 2013 and fiscal 2012, respectively.

The components of inventory, net of reserves, at each year-end are as follows:

| | (In thousands) Fiscal Year Ended | |
|---|---|---|
| | **2013** | **2012** |
| Raw materials | $ 2,053 | $ 739 |
| Work-in-process | 864 | 402 |
| Finished goods | 20,129 | 18,431 |
| | $ 23,046 | $ 19,572 |

**3. PROPERTY AND EQUIPMENT**

Property and equipment are recorded at cost. Depreciation for financial reporting purposes is provided using the straight-line method over the estimated useful lives of the assets. Estimated useful lives range from three years for computer equipment to thirty-one and one-half years for buildings. Expenditures for routine maintenance and repairs are charged to expense as incurred.

Property and equipment at August 3, 2013 and July 28, 2012 consisted of the following:

| | (In thousands) Fiscal Year Ended | |
|---|---|---|
| | **2013** | **2012** |
| Land and improvements | $ 393 | $ 393 |
| Buildings | 4,125 | 4,085 |
| Machinery and equipment | 5,168 | 4,926 |
| Furniture and fixtures | 1,818 | 1,339 |
| Construction in progress | 7 | 99 |
| | 11,511 | 10,842 |
| Less: Accumulated depreciation | (8,192) | (7,726) |
| | $ 3,319 | $ 3,116 |

Depreciation expense for fiscal 2013, 2012, and 2011 was approximately $686,000, $640,000, and $629,000, respectively.

## 4. MARKETABLE SECURITIES

The components of our held to maturity securities are as follows:

| | 2013 | 2012 |
|---|---|---|
| Long term corporate notes | $ 957,585 | $ 0 |
| Total held-to-maturity securities | $ 957,585 | $ 0 |

## 5. NOTES PAYABLE AND LINES OF CREDIT

### Lines of Credit

The Company has a $5,000,000 revolving line of credit with a bank. The Company had no outstanding borrowings under this line of credit as of August 3, 2013 and July 28, 2012. This line of credit provides for interest on outstanding balances to be paid monthly at the prime rate less 1.0%. This line of credit expires in January 2014 and is secured by the inventory and accounts receivable of the Company's western and work boot subsidiary.

The Company has an additional $1,750,000 line of credit with a bank. This line is restricted to 100% of the outstanding accounts receivable due from the U.S. Government. There were no outstanding borrowings under this line of credit as of August 3, 2013 and July 28, 2012. The line of credit expires in January 2014 and provides for interest on outstanding balances to be paid monthly at the prime rate.

Total aggregate interest charges for fiscal 2013, 2012, and 2011 were approximately $2,000, $1,000, and $1,000, respectively.

## 6. EMPLOYEE BENEFIT PLANS

The Company's employee benefit program consists of an employee stock ownership plan, a 401-K retirement plan, a cash bonus program, incentive awards, and other specified employee benefits as approved by the Board of Directors.

The employee stock ownership plan (ESOP) covers substantially all employees. Its principal investments include shares of Class A Common Stock and Class B Common Stock of the Company and collective funds consisting of short-term cash, fixed-income, and equity investments. There have been no contributions to the ESOP in fiscal years 2013, 2012 or 2011.

The Company has a 401-K retirement plan, which covers substantially all employees. Employees can contribute up to 25% of their annual salary to the plan. At its sole discretion, the Board of Directors determines the amount and timing of any Company matching contribution. The Company's contribution was approximately $229,000, $195,000, and $211,000, for the fiscal years ended 2013, 2012, and 2011, respectively.

Employee benefit program expense amounted to approximately $1,931,000, $1,348,000, and $1,059,000, in 2013, 2012 and 2011, respectively.

## 7. INCOME TAXES

Significant components of the provision for income taxes are as follows (in thousands):

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| **Current expense** | | | |
| Federal | $ 4,323 | $ 2,784 | $ 2,077 |
| State | 349 | 280 | 229 |
| | 4,672 | 3,064 | 2,306 |
| **Deferred expense** | | | |
| Federal | (375) | 22 | 137 |
| State | (66) | 4 | 24 |
| | $ 4,231 | $ 3,090 | $ 2,467 |

The components of the provision (benefit) for deferred income taxes are as follows (in thousands):

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Depreciation | $ (84) | $ 160 | $ 128 |
| Accrued employee benefits | (208) | (117) | (68) |
| Allowances for doubtful accounts | (105) | (38) | (67) |
| Allowance for sales returns | (29) | (31) | (12) |
| Inventory | (49) | (182) | 105 |
| State net operating loss carry forward | 13 | (34) | 9 |
| Economic Price Adjustment Claim | 0 | 60 | (6) |
| Amortization | 72 | 72 | 72 |
| Prepaid Expenses | (51) | 136 | 0 |
| Provision for deferred income taxes | $ (441) | $ 26 | $ 161 |

Deferred tax liabilities and assets at each year-end are as follows (in thousands):

| | 2013 | 2012 |
|---|---|---|
| **Noncurrent deferred assets (liabilities)** | | |
| Amortization | $ (672) | $ (600) |
| Gain on Like Kind Exchange | (391) | (391) |
| Depreciation | (491) | (575) |
| State net operating loss carry forward | 155 | 168 |
| Net noncurrent deferred tax liabilities | (1,399) | (1,398) |
| | | |
| **Current deferred tax assets (liabilities)** | | |
| Self Insurance | 76 | 76 |
| Accrued employee benefits | 648 | 440 |
| Allowances for doubtful accounts | 371 | 266 |
| Allowance for sales returns | 208 | 179 |
| Inventory | 882 | 833 |
| Economic Price Adjustment Claim | 68 | 68 |
| Prepaid Expenses | (85) | (136) |
| Net current deferred tax assets | 2,168 | 1,726 |
| | | |
| Net deferred tax assets | $ 769 | $ 328 |

State net operating loss carry forwards of $6 million will expire through fiscal 2024.

The reconciliation of income tax computed at the U.S. federal statutory tax rate to actual income tax expense are (in thousands):

| | 2013 | | 2012 | | 2011 | |
|---|---|---|---|---|---|---|
| | **Amount** | **Percent** | **Amount** | **Percent** | **Amount** | **Percent** |
| Tax at U.S. statutory rate | $4,106 | 35.0 % | $2,697 | 34.0 % | $2,141 | 34.0 % |
| State income taxes, net of federal tax benefit | 184 | 1.6 % | 188 | 2.4 % | 167 | 2.6 % |
| Tax adjustments | (96) | -0.8 % | 143 | 1.8 % | 126 | 2.0 % |
| Other – net | 37 | 0.3 % | 62 | 0.7% | 33 | 0.5% |
| | $4,231 | 36.1 % | $3,090 | 38.9 % | $2,467 | 39.1 % |

The items included as "other-net" relate to book to tax deferrals, permanent differences, adjustment for non tax consolidated entities, and prior year tax provision to return adjustments.

Total income tax payments during fiscal years 2013, 2012 and 2011 were approximately $4,511,000, $3,116,000, and $2,095,000, respectively.

## 8. COMMITMENTS AND CONTINGENCIES

### Lease Agreements

The Company leases certain offices and equipment under non-cancelable operating leases. Rental expenses on all operating leases were $539,000, $597,000, and $534,000, for fiscal 2013, 2012, and 2011, respectively. The future non-cancelable lease payments as of August 3, 2013 are as follows:

| | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| Lease Payments | $499,000 | $500,000 | $502,000 | $503,000 |

The Company leases approximately 34,000 square feet of office and warehouse space to Connected Office Products, Inc. The original lease covered a base year period and two one-year option periods. In July 2011, the lease was amended to cover a five-year period beginning on September 1, 2011. These lease and facility charge payments are reported as a component of "Other Income". The future minimum lease and facility charge payments are as follows:

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| Lease Payments | $50,000 | $50,000 | $50,000 |
| Facility Charges | $65,844 | $67,162 | $68,504 |

### Concentrations

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash investments and receivables. The Company maintains substantially all of its cash and certificates of deposits with a financial institution in amounts that are in excess of the federally insured limits, which totaled approximately $11 million, $13 million, and $10 million, for fiscal 2013, 2012, and 2011, respectively. Management performs periodic evaluations of the relative credit standing of this financial institution.

Concentrations of credit risk with respect to receivables are minimal due to the large number of entities comprising the Company's customer base and their dispersion across many different industries. The Company does not require collateral on trade accounts receivable. As of August 3, 2013, and July 28, 2012 twenty-one customers accounted for 49% and 41% of accounts receivable, respectively.

Synthetic rubber used in our vulcanizing military boot operation is currently available and purchased from the only domestic supplier known to us. Synthetic rubber is available from foreign suppliers, however an exemption would be required from the Government to purchase synthetic rubber in the foreign market. The Vibram rubber specified outsoles is a registered product available only from Vibram USA and we are dependent on their ability to supply our needs. This supplier provided Vibram rubber outsoles for approximately $2.2 million and $1.0 million at August 3, 2013 and July 28, 2012 respectively.

Sales to the U.S. Government amounted to 19%, 13%, and 24%, of total consolidated net revenues for fiscal 2013, 2012, and 2011, respectively. Under the terms of sale to the U.S. Government, the negotiated contract prices of combat boots are subject to renegotiation if certain conditions are present. Management does not currently expect renegotiation, if any, to have a material adverse effect on the Company's consolidated financial position or results of operations.

**9. SHAREHOLDERS' EQUITY**

**Common Stock**

The Company's Bylaws provide for seven directors, two of whom are elected by the holders of the Class A Common Stock voting as a separate class, and five of whom are elected by the holders of the Class B Common Stock voting as a separate class. On all other matters (except matters required by law or the Company's Certificate of Incorporation or Bylaws to be approved by a different vote), the holders of Class A Common Stock and Class B Common Stock vote together as a single class with each share of Class A Common Stock entitled to one-tenth vote and each share of Class B Common Stock entitled to one vote. Each share of Class B Common Stock can be converted to Class A Common Stock on a share for share basis. All dividends paid on Class B Common Stock must also be paid on Class A Common Stock in an equal amount.

The Company has adopted the McRae Industries, Inc. 1998 Incentive Equity Plan (the Plan). Under the Plan, 100,000 shares of the Company's Class A Common Stock are reserved for issuance to certain key employees of the Company. At August 3, 2013, there were 100,000 shares available for future grants under the Plan.

The common stock is currently quoted in the Pink Sheets and stockholders are able to trade their shares in the over-the-counter markets or private transactions.

**10. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Management used the following methods and assumptions to estimate the fair value of financial instruments:

The fair value of our cash and cash equivalents, accounts and notes receivable, accounts payable, and accrued liabilities approximate their carrying values due to their liquid nature.

The amount due from Split-Dollar Life Insurance policies represents the value of the Company's rights under split-dollar arrangements. Under these arrangements, the Company is entitled to be repaid cumulative premiums paid, or if less, the net cash surrender value of the policies.

**11. RELATED PARTY TRANSACTIONS**

The Company leases administrative and sales office space in Clarksville, Tennessee for the western boot business from the President of Dan Post Boot Company. The annual rent is approximately $108,000.

**12. SUBSEQUENT EVENTS**

On September 5, 2013, the Company declared a cash dividend of $.09 per share on its Class A and Class B Common Stock payable on October 4, 2013 to shareholders of record on September 20, 2013.

Subsequent events have been evaluated through November 8, 2013, which is the date the financial statements were available to be issued.

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# Executive Officers & Directors

### Executive Officers

*D. Gary McRae*
Chairman of the Board, President,
Chief Executive Officer and
Treasurer

*James W. McRae*
Vice-President and Secretary

*Victor A. Karam*
President, McRae Footwear

*Marvin G. Kiser, Sr.*
Vice-President of Finance

### Directors

*D. Gary McRae*
Chairman of the Board, President,
Chief Executive Officer and
Treasurer

*James W. McRae*
Vice-President and Secretary

*Victor A. Karam*
President, McRae Footwear

*Marvin G. Kiser, Sr.*
Vice-President of Finance

*Hilton J. Cochran, Jr.**
Executive Director,
Peacehaven Community Farm

*Brady W. Dickson**
Consultant

*William H. Swan**
Retired President,
Bob Swan Company

**Members of Audit and Compensation Committees*

# Shareholder Information

### Shareholders

Requests for interim and annual reports or more information about the Company should be directed to:

Office of the Secretary
McRae Industries, Inc.
P. O. Box 1239
Mount Gilead, North Carolina 27306

### Stock

McRae's common stock is traded on the Pink Sheets (MCRAA and MCRAB).

### Transfer Agent, Registrar, and Dividend Disbursing Agent

American Stock Transfer &
Trust Company
10150 Mallard Creek Road,
Suite 307
Charlotte, North Carolina 28262

### Annual Meeting

Thursday, December 19, 2013
Corporate Offices
400 North Main Street
Mount Gilead, North Carolina 27306

### Independent Auditors

Grant Thornton LLP
201 South College St.
Suite 2500
Charlotte, North Carolina 28244

### General Counsel

K&L Gates LLP
Hearst Tower
Suite 4700
214 North Tryon Street
Charlotte, North Carolina 28202