# *annual* report

EarthWear

2005



COMPANY HISTORY AND OPERATIONS EarthWear Clothiers was founded in Boise, Idaho, by James Williams and Calvin Rogers in 1973 to make high-quality clothing for outdoor sports, such as hiking, skiing, fly-fishing, and whitewater kayaking. Over the years, the company's product lines have grown to include casual clothing, accessories, shoes, and soft luggage. EarthWear offers its products through three retailing options: catalogs, retail outlets, and its website.

The company strives to provide excellent, high-quality products at reasonable prices. EarthWear has a commitment to excellence in customer service and an unconditional guarantee. The company is also conscious of its environmental responsibilities. All company facilities are insulated, recycle, and conserve power. The company continuously monitors the environmental impact of its products. The company believes that many of its customers share this concern for the environment.

The company offers its products principally through regular mailings of its monthly catalogs in the United States, Europe, and Japan. EarthWear has ten U.S. outlet stores, four in the U.K., two in Germany, and two in Japan. The company also offers its products over the Internet (www.mhhe.com/earthwear). During 2005, the Company expanded its global presence by launching sites in France, Italy, Ireland, and several eastern European countries. Currently, revenue from catalog sales, retail outlets, and the website are 74 percent, 5 percent, and 21 percent, respectively. Management expects that Internet sales will grow significantly in the future, perhaps replacing catalogs as the major source of sales.

EarthWear was incorporated in Idaho in 1975 and became a Delaware corporation in 1986 when it went public.

# COMPANY

## History and Background

**COMPANY GROWTH STRATEGY** EarthWear's growth strategy has three elements. First, the company attempts to increase sales by expanding its customer base and by increasing sales to existing customers through improved product offerings. Second, the company seeks to generate additional sales by targeted mailings of special issues of its catalogs and by offering its products through its website. Third, the company is pursuing additional opportunities to expand its merchandising skills internationally.

**CATALOGS AND SALES OPERATIONS** During 2005 the company mailed 12 issues of its regular monthly catalog with an average of 75 pages per issue from its U.S. operations. Worldwide, the company mailed approximately 160 million full-price catalogs. EarthWear views each catalog issue as a unique opportunity to communicate with its customers. Products are described in visual and editorial detail, and the company uses such techniques as background stories and distinctive covers to stimulate the readers' interest.

Each issue of the regular catalog offers certain basic product lines for men and women. The regular catalog also offers seasonal merchandise. In addition, EarthWear mails two end-of-season clearance catalogs. The company mails its catalogs to prospective customers who are identified based on lists of magazine subscribers and lists of households meeting certain demographic criteria. In addition, the company identifies prospective new customers through its national advertising campaign.

In 1991 the company introduced its first business specialty catalog, which offered its products to groups and companies for corporate incentive programs. EarthWear's embroidery capabilities allow for the design and monogram of unique logos or emblems for groups and companies. In 2005 the company mailed five issues of its corporate sales catalogs.

The international business segment includes operations in Japan, Germany, and the United Kingdom, and various Internet sites. Catalogs mailed in those countries are written in the local languages and denominated in local currencies. In the spring of 2005, EarthWear launched local websites in each of these countries in their respective languages and currencies.

**CUSTOMER DATABASE** A principal factor in the company's success has been the development of its own list of active customers. At the end of 2005 the company's mailing list consisted of about 21.1 million persons, approximately 7 million of whom were viewed as customers because they had made at least one purchase from the company within the last 24 months. The company routinely updates and refines the database before mailing catalogs to monitor customer interest as reflected in criteria such as the regency, frequency, dollar amount, and product type of purchases.

EarthWear believes that its customer database has desirable demographic characteristics and is well suited to the products offered in the company's catalogs. A survey conducted by the company in the United States during 2004 indicated that approximately 50 percent of its customers were in the 35–54 age group and had median incomes of $62,000.

The company advertises nationally to build its reputation and to attract new customers. In 2005 this advertising campaign appeared in about 40 national magazines, as well as on five national cable television networks. In addition, the company advertises in approximately 75 national, regional, and local publications in Canada, the United Kingdom, Germany, and Japan. EarthWear also advertises on a number of Internet search engines and websites.

**PRODUCT DEVELOPMENT** EarthWear concentrates on clothing and other products that are aimed at customers interested in outdoor activities. The company products are styled and quality crafted to meet the changing tastes of the company's customers rather than to mimic the changing fads of the fashion world. At the same time, the company seeks to maintain customer interest by developing new products, improving existing core products, and reinforcing its value positioning.

The company continues to incorporate innovations in fabric, construction, and detail that add value and excitement and differentiate EarthWear from the competition. In order to ensure that products are manufactured to the company's quality standards at reasonable prices, product managers, designers, and quality assurance specialists develop the company's own products.

EarthWear deals directly with its suppliers and seeks to avoid intermediaries. All goods are produced by independent manufacturers except for most of its soft luggage, which is assembled at the company's facilities. During 2005 the company purchased merchandise from approximately 300 domestic and foreign manufacturers. One manufacturer and one intermediary accounted for about 14 and 29 percent of the company's received merchandise, respectively, in 2005. In 2005 about 80 percent of the company's merchandise was imported, mainly from Asia, Central America, Mexico, and Central America. The company will continue to take advantage of worldwide sourcing without sacrificing customer service or quality standards.



ORDER ENTRY, FULFILLMENT, AND DELIVERY EarthWear has toll-free telephone numbers that customers can call 24 hours a day, seven days a week (except Christmas Day) to place orders or to request a catalog. Approximately 90 percent of catalog orders are placed by telephone. Telephone calls are answered by the company's well-trained sales representatives, who utilize online computer terminals to enter customer orders and to retrieve information about product characteristics and availability. The company's three U.S. telephone centers are located in Boise, Idaho; Reston, Virginia; and Canton, Ohio. International telephone centers are located in London, England; Tokyo, Japan; and Mannheim, Germany.

The company's order entry and fulfillment system permits shipment of in-stock orders on the following day, but orders requiring monogramming or inseaming typically require one or two extra days. The company's sales representatives enter orders into an online order entry and inventory control system. Customers using the company's Internet site see color photos of the products, their availability, and prices. When ordering a product over the Internet, the customer completes a computer screen that requests information on product code, size, color, and so on. When the customer finishes shopping for products, he or she enters delivery and credit card information into a computer-based form. EarthWear provides assurance through CPA WebTrust℠ that the website has been evaluated and tested to meet WebTrust℠ principles and criteria. This assurance service is provided by the company's independent auditors, Willis & Adams, LLP.

Orders are generally shipped by United Parcel Service (UPS) at various tiered rates that depend on the total dollar value of each customer's order. Other expedited delivery services are available at additional charge. Domestically, the company utilizes two-day UPS service at standard rates, enhancing its customer service. Comparable services are offered in international markets.

**MERCHANDISE LIQUIDATION** Liquidations (sales of overstock and end-of-season merchandise at reduced prices) were approximately 12 percent, 11 percent, and 8 percent of net sales in 2005, 2004, and 2003, respectively. Most liquidation sales were made through catalogs and other print media. The balance was sold principally through the company's outlet retail stores.

**COMPETITION** The company's principal competitors are retail stores, including specialty shops, department stores, and other catalog companies. Direct competitors include Eddie Bauer, Land's End, L. L. Bean, Patagonia, and Timberland. The company may also face increased competition from other retailers as the number of television shopping channels and the variety of merchandise offered over the Internet increase. The apparel retail business in general is intensely competitive. EarthWear competes principally on the basis of merchandise value (quality and price), its established customer list, and customer service, including fast order fulfillment and its unqualified guarantee.

EarthWear

**TRADEMARKS** The company uses the trademarks of "EarthWear" and "EWC" on products and catalogs.

**SEASONALITY OF BUSINESS** The company's business is highly seasonal. Historically, a disproportionate amount of the company's net sales and most of its profits have been realized during the fourth quarter. If the company's sales were materially different from seasonal norms during the fourth quarter, the company's annual operating results could be materially affected. Accordingly, results for the individual quarters do not necessarily indicate results to be expected for the entire year. In 2005, 37 percent of the company's total revenue came in the fourth quarter.

**EMPLOYEES** The company believes that its skilled and dedicated workforce is one of its key resources. Employees are not covered by collective bargaining agreements, and the company considers its employee relations to be excellent. As a result of the highly seasonal nature of the company's business, the size of the company's workforce varies, ranging from approximately 3,500 to 5,300 individuals in 2005. During the peak winter season of 2005, approximately 2,700 of the company's 5,300 employees were temporary employees.

**EXECUTIVE OFFICERS OF THE COMPANY**
James G. Williams, 65, is chairman of the board and former chief executive officer. Mr. Williams was one of the two original founders of EarthWear. He stepped down as chief executive officer in December 1999.

Calvin J. Rogers, 57, is president and chief executive officer of the company. Mr. Rogers was one of the two original founders of the company. He assumed his present position in December 1999.

Dominique DeSantiago, 56, is executive vice president and chief operating officer. Mr. DeSantiago joined the company as chief operating officer in June 1991. He was promoted to vice president in October 1994. Mr. DeSantiago was previously employed by Eddie Bauer in various capacities.

Linda S. McDaniel, 45, is senior vice president of sales. She joined the company in July 1996. Ms. McDaniel served as divisional vice president, merchandising, with Patagonia between 1986 and 1990. Ms. McDaniel was the president and chief executive officer for Mountain Goat Sports from 1990 until 1996. She has been serving as a director of the company since November 1997.

James C. ("JC") Watts, 45, is senior vice president and chief financial officer. Mr. Watts joined the company in May 1996, assuming his current position. He was previously employed by Federated Department Stores.

Mary Ellen Tornesello, 47, is senior vice president of operations. Ms. Tornesello joined the company in 1994 as operations manager. She served as vice president of operations from 1995 until 1997, at which time she assumed her present position.



**Market Information** The common stock of the company is listed and traded on NASDAQ under the symbol EWCC. The high and low prices of the company's common stock for 2005 were $52.50 and $21.75 per share. The closing price of the company's stock on December 31, 2005, was $40.25 per share.

**Shareholders** As of December 31, 2005, the number of shareholders of record of common stock of the company was 2,120. This number excludes shareholders whose stock is held in nominee or street name by brokers.

**Independent Auditors** The company has been audited by Willis & Adams since incorporation in 1975.



EarthWear

# EARTHWEAR CLOTHIERS



## Consolidated Statements of Operations

*(In thousands, except per share data)*

| | For the period ended December 31 | | |
|---|---|---|---|
| | **2005** | 2004 | 2003 |
| **Net Sales** | **$ 950,484** | $ 857,885 | $ 891,394 |
| Cost of sales | **$ 546,393** | $ 472,739 | 490,530 |
| Gross Profit | **$ 404,091** | $ 385,146 | 400,864 |
| Selling, general, and administrative expenses | **$ 364,012** | $ 334,994 | 353,890 |
| Nonrecurring charge (credit) | **-** | (1,153) | 8,190 |
| **Income from operations** | **40,079** | 51,305 | 38,784 |
| Other income (expense): | | | |
| Interest expense | **(983)** | (1,229) | (5,027) |
| Interest income | **1,459** | 573 | 10 |
| Other | **(4,798)** | (1,091) | (1,593) |
| Total other income (expense), net | **(4,322)** | (1,747) | 6,609 |
| Income before income taxes | **35,757** | 49,559 | 32,175 |
| Income tax provision | **13,230** | 18,337 | 11,905 |
| **Net income** | **$ $22,527** | $ 31,222 | $ 20,270 |
| **Basic earnings per share** | **1.15** | 1.60 | 1.02 |
| **Diluted earnings per share** | **1.14** | 1.56 | 1.01 |
| Basic weighted average shares outstanding | **19,531** | 19,555 | 19,806 |
| Diluted weighted average shares outstanding | **19,774** | 20,055 | 19,996 |

CONSOLIDATED

Financial Statements

EarthWear

# EARTHWEAR CLOTHIERS

## Consolidated Balance Sheets

*(In thousands)*



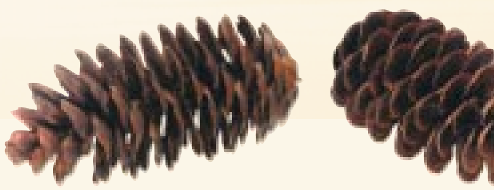
| | December 31 | |
|---|---|---|
| **Assets** | **2005** | 2004 |
| **Current Assets:** | | |
| Cash and cash equivalents | **$ 48,978** | $ 49,668 |
| Receivables, net | **12,875** | 11,539 |
| Inventory | **122,337** | 105,425 |
| Prepaid advertising | **11,458** | 10,772 |
| Other prepaid expenses | **6,315** | 3,780 |
| Deferred income tax benefits | **7,132** | 6,930 |
| Total current assets | **209,095** | 188,115 |
| **Property, plant, and equipment, at cost** | | |
| Land and buildings | **70,918** | 66,804 |
| Fixtures and equipment | **67,513** | 66,876 |
| Computer hardware and software | **64,986** | 47,466 |
| Leasehold improvements | **3,010** | 2,894 |
| Total property, plant, and equipment | **206,426** | 184,040 |
| Less accumulated depreciation and amortization | **85,986** | 76,256 |
| Property, plant and equipment, net | **120,440** | 107,784 |
| Intangibles, net | **423** | 628 |
| Total assets | **$ 329,959** | $ 296,527 |
| **Liabilities and shareholders' investment** | | |
| **Current liabilities:** | | |
| Lines of credit | **$ 11,011** | $ 7,621 |
| Accounts payable | **62,509** | 48,432 |
| Reserve for returns | **5,890** | 5,115 |
| Accrued liabilities | **26,738** | 28,440 |
| Accrued profit sharing | **1,532** | 1,794 |
| Income taxes payable | **8,588** | 6,666 |
| Total current liabilities | **116,268** | 98,067 |
| **Deferred income taxes** | **9,469** | 5,926 |
| **Shareholders' investment:** | | |
| Common stock, 26,121 shares issued | **261** | 261 |
| Donated capital | **5,460** | 5,460 |
| Additional paid-in capital | **20,740** | 19,311 |
| Deferred compensation | **(79)** | (153) |
| Accumulated other comprehensive income | **3,883** | 1,739 |
| Retained earnings | **317,907** | 295,380 |
| Treasury stock, 6,546 and 6,706 shares at cost, respectively | **(143,950)** | (129,462) |
| Total shareholders' investment | **204,222** | 192,535 |
| Total liabilities and shareholders' investment | **$ 329,959** | $ 296,527 |

# EARTHWEAR CLOTHIERS

## Consolidated Statements of Stockholders' Investment

*(In thousands)*

| | Comprehensive Income | Common Stock | Donated Capital | Additional Paid-In Capital | Deferred Compensation | Accumulated Other Comprehensive Income | Retained Earnings | Treasury Stock | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2002** | | $ 261 | $5,460 | $17,197 | ($681) | $569 | $243,888 | ($108.931) | $157,763 |
| Purchase of treasury stock | | | | | | | | (23,112) | (23,112) |
| Issuance of treasury stock | | | | | | | | 1,199 | 1,199 |
| Tax benefit of stock options exercised | | | | 349 | | | | | 349 |
| Deferred compensation expense | | | | | 424 | | | | 424 |
| Comprehensive income: | | | | | | | | | |
| Net income | $20,270 | | | | | | 20,270 | | 20,270 |
| Foreign currency translation adjustments | 733 | | | | | 733 | | | 733 |
| Comprehensive income | $21,003 | | | | | | | | |
| **Balance, December 31, 2003** | | $ 261 | $5,460 | $17,546 | ($257) | $1,302 | $264,158 | ($130,844) | $157,626 |
| Purchase of treasury stock | | | | | | | | (2,935) | (2,935) |
| Issuance of treasury stock | | | | | | | | 4,317 | 4,317 |
| Tax benefit of stock options exercised | | | | 1,765 | | | | | 1,765 |
| Deferred compensation expense | | | | | 103 | | | | 103 |
| Comprehensive income: | | | | | | | | | |
| Net income | $31,222 | | | | | | 31,222 | | 31,222 |
| Foreign currency | 60 | | | | | 60 | | | 60 |
| translation adjustments | 377 | | | | | 377 | | | 377 |
| Comprehensive income | $31,659 | | | | | | | | |
| **Balance, December 31, 2004** | | $ 261 | $5,460 | $19,311 | ($154) | $1,739 | $295,380 | ($129,463) | $192,534 |
| Purchase of treasury stock | | | | | | | | (18,192) | (18,192) |
| Issuance of treasury stock | | | | | | | | 3,704 | 3,704 |
| Tax benefit of stock options exercised | | | | 1,429 | | | | | 1,429 |
| Deferred compensation expense | | | | | 75 | | | | 75 |
| Comprehensive income: | | | | | | | | | |
| Net income | $22,527 | | | | | | 22,527 | | 22,527 |
| Foreign currency translation adjustments | (1,151) | | | | | (1,151) | | | (1,151) |
| Unrealized gain on forward contracts | 3,295 | | | | | 3,295 | | | 3,295 |
| Comprehensive income | $24,671 | | | | | | | | |
| **Balance, December 31, 2005** | | **$ 261** | **$5,460** | **$20,740** | **($79)** | **$3,883** | **$317,907** | **($143,950)** | **$204,222** |



EARTHWEAR CLOTHIERS

## Consolidated Statements of Cash Flows

*(In thousands)*



| | For the period ended December 31 | | |
|---|---|---|---|
| **Cash flows from (used for) operating activities:** | **2005** | 2004 | 2003 |
| **Net income** | **$22,527** | $ 31,222 | $ 20,270 |
| Adjustments to reconcile net income to | | | |
| net cash flows from operating activities: | | | |
| Non-recurring charge (credit) | | (1,153) | 8,190 |
| Depreciation and amortization | **$15,231** | 13,465 | 12,175 |
| Deferred compensation expense | **$75** | 103 | 424 |
| Deferred income taxes | **$3,340** | 5,376 | (3,866) |
| Loss on disposal of fixed assets | **$284** | 602 | 381 |
| Changes in assets and liabilities excluding | | | |
| the effects of divestitures: | | | |
| Receivables, net | **($1,336)** | 2,165 | (3,666) |
| Inventory | **($16,912)** | 37,370 | 13,954 |
| Prepaid advertising | **($686)** | 3,110 | (1,849) |
| Other prepaid expenses | **($2,534)** | 1,152 | (1,628) |
| Accounts payable | **$14,078** | (8,718) | 2,716 |
| Reserve for returns | **$775** | 439 | 692 |
| Accrued liabilities | **($709)** | (4,982) | 4,545 |
| Accrued profit sharing | **($262)** | 328 | (1,320) |
| Income taxes payable | **$1,923** | (2,810) | (3,834) |
| Tax benefit of stock options | **$1,429** | 1,765 | 349 |
| Other | **$2,144** | 437 | 733 |
| Net cash from (used for) operating activities | **$39,367** | 79,871 | 48,269 |
| **Cash flows from (used for) investing activities:** | | | |
| Cash paid for capital additions | **(28,959)** | (18,208) | (30,388) |
| Net cash flows used for investing activities | **(28,959)** | (18,208) | (30,388) |
| **Cash flows from (used for) financing activities:** | | | |
| Proceeds from (payment of) short-term debt | **3,390** | (17,692) | 4,228 |
| Purchases of treasury stock | **(18,192)** | (2,935) | (23,112) |
| Issuance of treasury stock | **3,704** | 4,317 | 1,199 |
| Net cash flows used for financing activities | **(11,097)** | (16,310) | (17,685) |
| **Net increase (decrease) in cash and cash equivalents** | **(690)** | 45,352 | 197 |
| **Beginning cash and cash equivalents** | **49,668** | 4,317 | 4,120 |
| **Ending cash and cash equivalents** | **$ 48,978** | $ 49,668 | $ 4,317 |
| **Supplemental cash flow disclosures:** | | | |
| Interest paid | **$ 987** | $ 1,229 | $ 5,000 |
| Income taxes paid | **6,278** | 13,701 | 18,107 |

EarthWear

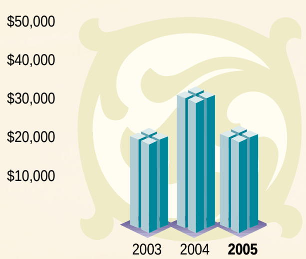
# EARTHWEAR CLOTHIERS

## Five-Year Consolidated Financial Summary (unaudited)

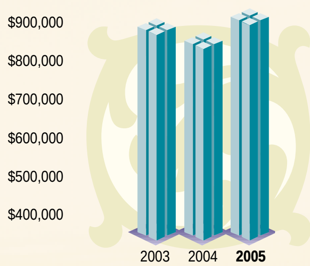
*(In thousands, except per share data)*

| | For the period ended December 31 | | | | |
|---|---|---|---|---|---|
| | **2005** | 2004 | 2003 | 2002 | 2001 |
| **Income statement data:** | | | | | |
| Net Sales | **950,484** | 857,885 | 891,394 | 821,359 | 503,434 |
| Pretax Income | **35,757** | 49,559 | 32,175 | 66,186 | 38,212 |
| Percent of net sales | **3.8%** | 5.8% | 3.6% | 8.1% | 7.6% |
| Net income | **22,527** | 31,222 | 20,270 | 41,698 | 22,929 |
| **Per share of common stock:** | | | | | |
| Basic earnings per share | **1.15** | 1.60 | 1.02 | 2.01 | 1.54 |
| Diluted earnings per share | **1.14** | 1.56 | 1.01 | 2.00 | 1.53 |
| Common shares outstanding | **19,531** | 19,555 | 19,806 | 20,703 | 14,599 |
| **Balance sheet data:** | | | | | |
| Current assets | **209,095** | 188,115 | 191,297 | 194,445 | 122,418 |
| Current liabilities | **116,268** | 98,067 | 133,434 | 118,308 | 65,505 |
| PPE and intangibles | **120,863** | 108,412 | 105,051 | 87,312 | 46,658 |
| Total assets | **329,959** | 296,527 | 296,347 | 281,757 | 170,121 |
| Noncurrent liabilities | **9,496** | 5,926 | 5,286 | 5,686 | 4,211 |
| Shareholders' investment | **204,222** | 192,535 | 157,627 | 157,763 | 100,405 |
| **Other data:** | | | | | |
| Net working capital | **92,827** | 90,048 | 57,863 | 76,136 | 56,913 |
| Capital expenditures | **28,959** | 18,208 | 30,388 | 31,348 | 8,316 |
| Depreciation and amortization expense | **15,231** | 13,465 | 12,175 | 9,833 | 6,101 |
| Return on average shareholders' investment | **11%** | 18% | 13% | 28% | 24% |
| Return on average assets | **7%** | 11% | 7% | 16% | 15% |

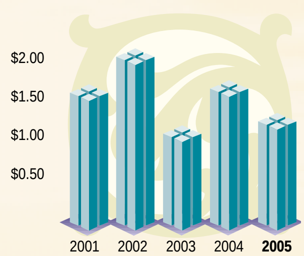
NET INCOME




NET SALES




NET INCOME PER SHARE



## NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**NATURE OF BUSINESS** EarthWear markets high quality clothing for outdoor sports, casual clothing, accessories, shoes, and soft luggage. The company manages its business in three operating segments consisting of core, business-to-business, and international. The company's primary market is the United States; other markets include Canada, Europe, and Japan.

**PRINCIPLES OF CONSOLIDATION** The consolidated statements include the accounts of the company and its subsidiaries after elimination of intercompany accounts and transactions.

**USE OF ESTIMATES** The preparations of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ from these estimates.

**REVENUE RECOGNITION** The company records revenue at the time of shipment for catalog and e-commerce sales and at the point for sale for stores. The company provides a reserve for returns.

**RESERVE FOR LOSSES ON CUSTOMER RETURNS** At the time of sale, the company provides a reserve equal to the gross profit on projected merchandise returns, based on prior returns experience.

**INVENTORY** Inventory is stated at the last-in, first-out (LIFO) cost, which is lower than market. If the first-in, first-out method of accounting for inventory had been used, inventory would have been approximately $10.8 million and $13.7 million higher than reported at December 31, 2005 and 2004, respectively.

**ADVERTISING** The company expenses the costs of advertising for magazines, television, radio, and other media the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits. Direct-response advertising consists primarily of catalog production and mailing costs, which are generally amortized within three months from the date catalogs are mailed.

**DEPRECIATION** Depreciation expense is calculated using the straight-line method over the estimated useful lives of the assets, which are 20 to 30 years for buildings and land improvements and 5 to 10 years for leasehold improvements and furniture, fixtures, equipment, and software. The company allocates one half year of depreciation to the year of addition or retirement.

**INTANGIBLES** Intangible assets consist primarily of goodwill, which is amortized over 15 years on a straight-line basis.

**FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK** The company uses import letters of credit to purchase foreign-sourced merchandise. The letters of credit are primarily U.S. dollar-denominated and are issued through third-party financial institutions to guarantee payment for such merchandise within the agreed-upon time periods. At December 31, 2005, the company had outstanding letters of credit of approximately $23 million, all of which had expiration dates of less than one year.

**FOREIGN CURRENCY TRANSLATIONS AND TRANSACTIONS** Financial statements of the foreign subsidiaries are translated into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52. Translation adjustments are recorded in accumulated other comprehensive income, which is a component of stockholders' equity.

## NOTE B: STOCKHOLDERS' EQUITY

**COMMON STOCK** The company currently is authorized to issue 70 million shares of $0.01 par value common stock.

**TREASURY STOCK** The company's board of directors has authorized the purchase of a total of 12.7 million shares of the company's common stock. A total of 6.5 million and 6.7 million had been purchased as of December 31, 2005 and 2004, respectively.

**STOCK AWARDS AND GRANTS** The company has a restricted stock award plan. Under the provisions of the plan, a committee of the company's board may award shares of the company's common stock to its officers and key employees. Such shares vest over a 10-year period on a straight-line basis.

The granting of these awards has been recorded as deferred compensation based on the fair market value of the shares at the date of the grant. Compensation expense under these plans is recorded as shares vest.

**STOCK OPTIONS** The company has 3.5 million shares of common stock that may be issued pursuant to the exercise of options granted under the company's stock option plan. Options are granted at the discretion of a committee of the company's board of directors to officers and key employees of the company. No option may have an exercise price less than the fair market value per share of the common stock at the date of the grant.

## NOTE C: LINES OF CREDIT

The company has unsecured domestic lines of credit with various U.S. banks totaling $150 million. There were $23.4 million amounts outstanding at December 31, 2005 compared to $20.2 million outstanding at December 31, 2004. In addition, the company has unsecured lines of credit with foreign banks totaling the equivalent of $30 million for its wholly owned subsidiaries. At December 31, 2005, $11 million was outstanding at interest rates averaging 4.6 percent, compared with $7.6 million at December 31, 2004.

## NOTE D: LONG-TERM DEBT

There was no long-term debt at December 31, 2005 and 2004.

## NOTE E: LEASES

The company leases store and office space and equipment under various lease arrangements. The leases are accounted for as operating leases.

## NOTE F: RETIREMENT PLANS

The company has a retirement plan that covers most regular employees and provides for annual contributions at the discretion of the board of directors. Included in the plan is a 401(k) feature that allows employees to make contributions.

## MANAGEMENT'S DISCUSSION AND ANALYSIS:

The year 2005 was a year during which we've seen the results of our strategic initiatives of the last two years take hold. Sales momentum picked up towards the end of the third quarter and continued strongly through our all-important holiday season, and we reported a double-digit increase in both revenue and earnings for the fourth quarter. This success enabled us to complete the year with an annual 3.2 percent increase in total revenue, but a 27.8 percent decrease in earnings, mainly due to the weakness of the first nine months. Our strong finish for the year was gratifying in the face of a difficult economy.

**MANAGEMENT'S DISCUSSION AND ANALYSIS: RESULTS OF OPERATIONS FOR 2005 COMPARED TO 2004**

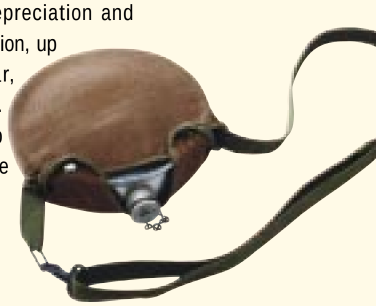
**TOTAL REVENUE INCREASED BY 3.2 PERCENT** Total revenue for the year just ended was $950.5 million, compared with $857.9 million in the prior year, an increase of 3.2 percent. Seasonally strong sales resulted in a higher level of backorders during the fourth quarter and a first-time fulfillment rate of 85 percent for the year as a whole, slightly below the prior year's rate. Overall merchandise sales growth was primarily attributable to changes in circulation, which included adding back our post-Thanksgiving catalog and our January full-price catalog, shifting the timing of our fall/winter mailings, increased page circulation and improved merchandise selection and creative presentations.

**NET INCOME DECREASED** Net income for 2005 was $22.5 million, down 27.8 percent from the $31.2 million earned in 2004. Diluted earnings per share for the year just ended were $1.14, compared with $1.56 per share for the prior year. The diluted weighted average number of common shares outstanding was 19.8 million for 2005 and 20.0 million for 2004.

**GROSS PROFIT MARGIN** Gross profit for the year just ended was $404 million, or 42.5 percent of total revenue, compared with $385 million, or 41.6 percent of total revenue, for the prior year. Liquidations were about 11 percent of net merchandise sales in 2005, compared with 12 percent in the prior year. In 2005, the cost of inventory purchases was down 2.0 percent, compared with deflation of 2.7 percent in 2004. This reduction was a result of improved sourcing. As a result, the LIFO inventory reserve was reduced by $2.8 million and $3.8 million in 2005 and 2004, respectively.

**SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES** Selling, general and administrative (SG&A) expenses increased 9.2 percent to $364 million in 2005, compared with $334 million in the prior year. As a percentage of sales, SG&A was 38.3 percent in 2005 and 36.2 percent in the prior year. The increase in the SG&A ratio was primarily the result of higher catalog costs associated with increased page circulation, as well as higher information services expenses as we continue to invest in the Internet and upgrade systems capabilities. The cost of producing and mailing catalogs represented about 39 percent and 38 percent of total SG&A in 2005 and 2004, respectively.

**CREDIT LINES AND CAPITAL EXPENDITURES** Interest expense on lines of credit was down in 2005 due to lower average borrowing levels. Interest expense decreased to $1.0 million in 2005, compared to $1.2 million in 2004. We spent $29 million in cash on capital expenditures, which included $20 million for computer hardware and software. In addition, the company acquired a new airplane by exchanging two of its own aircraft in 2005. Also, we purchased about $18 million in treasury stock. No long-term debt was outstanding at year-end 2005. Depreciation and amortization expense was $15.2 million, up 13.1 percent from the prior year, mainly due to computer software. Rental expense was $10.4 million, up 3.4 percent from 2004, primarily due to additional computer hardware.



# MANAGEMENT Report on Financial Statements and Internal Control Over Financial Reporting

To the Stockholders

**EarthWear Clothiers, Inc.**

Management of EarthWear Clothiers, Inc. (the "Company") is responsible for the preparation, consistency, integrity, and fair presentation of the consolidated financial statements. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applied on a consistent basis and, in management's opinion, are fairly presented. The financial statements include amounts that are based on management's informed judgments and best estimates.

Management has established and maintains comprehensive systems of internal control that provide reasonable assurance as to the consistency, integrity, and reliability of the preparation and presentation of financial statements; the safeguarding of assets; the effectiveness and efficiency of operations; and compliance with applicable laws and regulations. The concept of reasonable assurance is based upon the recognition that the cost of the controls should not exceed the benefit derived. Management monitors the systems of internal control and maintains an independent internal auditing program that assesses the effectiveness of internal control. Management assessed the Company's internal control over financial reporting for financial presentations in conformity with accounting principles generally accepted in the United States of America. This assessment was based on criteria for effective internal control over financial reporting established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report). Based on this assessment, management believes that the Company maintained effective internal control over financial reporting for financial presentations in conformity with accounting principles generally accepted in the United States of America as of December 31, 2005.

The Board of Directors exercises its oversight role with respect to the Company's systems of internal control primarily through its Audit Committee, which is comprised solely of outside directors. The Committee oversees the Company's systems of internal control and financial reporting to assess whether their quality, integrity, and objectivity are sufficient to protect shareholders' investments.

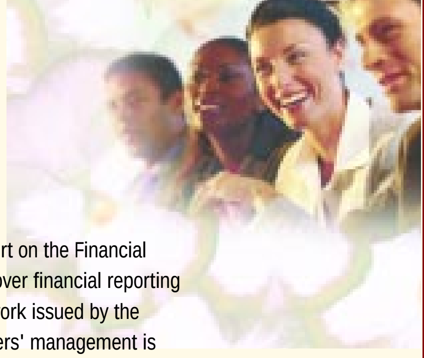
The Company's consolidated financial statements have been audited by Willis & Adams LLP ("Willis & Adams"), independent auditors. As part of its audit, Willis & Adams considers the Company's internal control to plan the audit and determine the nature, timing, and extent of auditing procedures considered necessary to render its opinion as to the fair presentation, in all material respects, of the consolidated financial statements, which is based on independent audits made accordance with the standards of the Public Company Accounting Oversight Board (United States). Management's assertion that the Company maintained effective internal control over financial reporting for financial presentations in conformity with accounting principles generally accepted in the United States of America has been audited by Willis & Adams. Management has made available to Willis & Adams all the Company's financial records and related data, and information concerning the Company's internal control over financial reporting, and believes that all representations made to Willis & Adams during its audits were valid and appropriate.

**Calvin J. Rogers**

*President and Chief Executive Officer*

**James C. Watts**

*Senior Vice President and Chief Financial Officer*





# REPORT of Independent Registered Public Accounting Firm

To the Stockholders

**EarthWear Clothiers, Inc.**

We have audited management's assessment, included in the accompanying Management Report on the Financial Statements and Internal Control, that EarthWear Clothiers maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). EarthWear Clothiers' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that EarthWear Clothiers maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, EarthWear Clothiers maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of EarthWear Clothiers and our report dated February 15, 2006 expressed an unqualified opinion.

Willis & Adams

**Willis & Adams, CPAs**

Boise, Idaho
February 15, 2006

# REPORT of Independent Registered Public Accounting Firm

To the Stockholders

**EarthWear Clothiers, Inc.**

We have audited the consolidated balance sheets of EarthWear Clothiers as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of EarthWear Clothiers' internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 15, 2006 expressed an unqualified opinion on management's assessment that EarthWear Clothiers maintain effective internal control and an unqualified opinion that internal control was effective.

Willis & Adams

**Willis & Adams, CPAs**

Boise, Idaho
February 15, 2006