Net sales declined in 2001, primarily due to decreased sales for wood products and printing papers. Market-related downtime occurred at most operations during the year and contributed significantly to the decline in sales. Net sales for the pulp and paper segment increased slightly as a result of a significant increase in sales of tissue products. Operating costs rose in all segments as the result of increased costs for labor, materials and especially energy. Energy costs declined significantly during the second half of the year, but still represented a year-over-year cost increase. Operating costs were somewhat offset by cost reductions attributed to more effective use of our collective purchasing power, which is an outgrowth of a company-wide integrated maintenance and purchasing system.

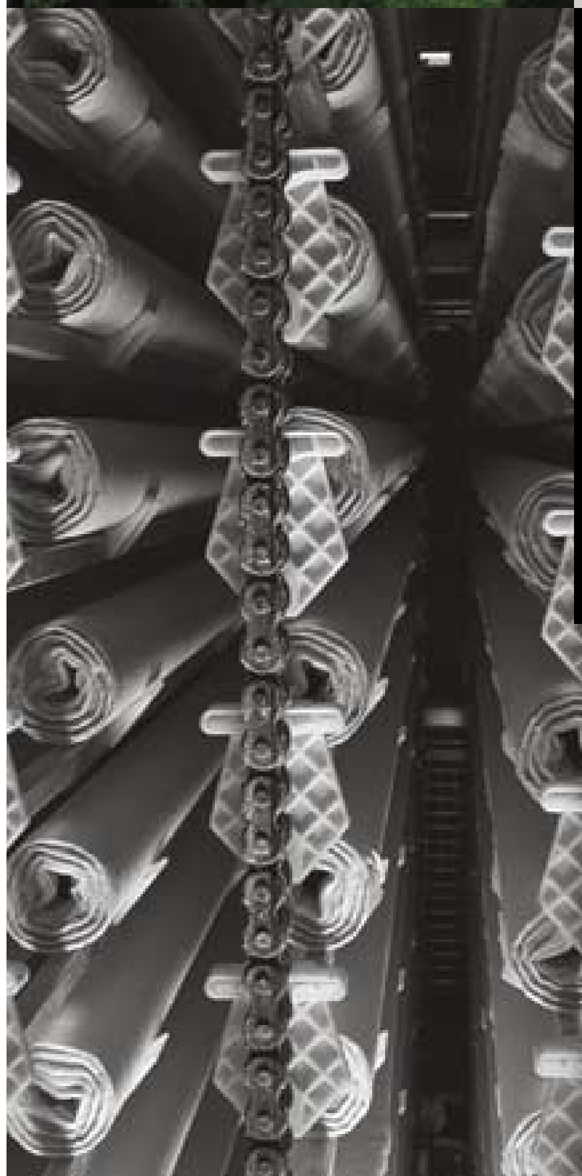
Noncash charges for depreciation, depletion and amortization rose to $169.4 million from $161.8 million in 2000, primarily due to increased amortization expense resulting from debt refinancing activities. Capital expenditures were just over $50 million, down from $166 million in 2000.

RESOURCE

Operations: Arkansas, Idaho, Minnesota and Oregon
Products: 1.5 million acres of timberland producing a variety of softwood and hardwood species and 17,000 acres of agricultural land growing hybrid poplar.
Sales & Distribution: Arkansas, Idaho and Minnesota.

WOOD PRODUCTS

Operations: Arkansas, Idaho and Minnesota
Products: Oriented strand board (OSB), lumber, plywood and particleboard.
Sales & Distribution: Throughout the United States.



PULP AND PAPER

Operations: Lewiston, Idaho; Cypress Bend, Arkansas; Las Vegas, Nevada, and Benton Harbor, Michigan
Products: Bathroom and facial tissue, towels and napkins packaged for various store labels; bleached paperboard for packaging liquids and other products and for paper cups and plates; bleached softwood pulp.
Sales & Distribution: Bleached paperboard products and pulp worldwide; tissue products throughout the United States and Canada.

PRINTING PAPERS

Operations: Cloquet and Brainerd, Minnesota
Products: Premium coated printing papers for use in annual reports, art reproductions and high-quality advertising; bleached hardwood pulp.
Sales & Distribution: Printing papers throughout the United States and Canada; pulp worldwide.

RESOURCE

	2001	2000	1999
Sales ($ in 000's)			
Internal sales	$367,737	$315,116	$298,859
External sales	38,073	37,208	38,699
Total	$405,810	$352,324	$337,558

Resource segment operating income fell from $61.4 million in 2000 to $55.3 million in 2001 as a result of reduced fee harvest in Idaho and lower overall log realizations in Arkansas and Idaho. Net sales rose from $352.3 million in 2000 to $405.8 million in 2001, largely because of increased resale of wood fiber procured from outside sources to other operating segments in Arkansas, Minnesota and Idaho.

During the year Potlatch's Boardman, Oregon, hybrid poplar operation was third-party certified by the Forest Stewardship Council (FSC). The company also secured a wood fiber supply agreement with a nearby Oregon sawmill, which is chain-of-custody certified by FSC. Certification will allow Boardman to supply non-structural lumber at premium prices to the select but growing market for FSC-certified hardwood lumber. Harvesting at the Boardman plantation began in late 2000, in accordance with the change in management focus we announced last year.

The Resource segment also progressed in establishing an International Standards Organization (ISO) based Environmental Management System in Idaho, Minnesota and Arkansas as a prelude to third-party certification of all 1.5 million acres of its timberland under the ISO 14000 environmental standards and certification of its timberland stewardship through the American Forest & Paper Association's Sustainable Forestry Initiative (SFI℠). The company expects certification for both ISO 14000 and SFI to be completed by year-end.

Our resource managers are also exploring new revenue opportunities through the sale of development rights as conservation easements, the leasing of timberlands for recreational purposes such as hunting and camping, and the sale of higher and better use properties.

WOOD PRODUCTS

	2001	2000	1999
Sales* ($ in 000's)	$500,526	$539,596	$621,602
Shipments:			
Oriented strand board			
(m. sq. ft., 3/8" basis)	1,127,474	1,083,695	1,099,563
Lumber (m. bd. ft.)	709,434	624,057	606,547
Plywood (m. sq. ft., 3/8" basis)	142,424	171,438	218,467
Particleboard			
(m. sq. ft., 3/4" basis)	66,049	68,209	69,587
Realizations ($ per unit):			
Oriented strand board			
(m. sq. ft., 3/8" basis)	$129	$172	$205
Lumber (m. bd. ft.)	359	380	433
Plywood (m. sq. ft., 3/8" basis)	259	280	309
Particleboard			
(m. sq. ft., 3/4" basis)	195	239	245

*Excludes internal sales.

Wood Products reported an operating loss of $27.4 million, compared to a loss of $18.3 million in 2000. Although domestic housing remained relatively stable, supported by recent mortgage interest rate cuts, lumber and panel markets performed poorly during 2001. Major retailers continued to shed inventories, and lumber imports climbed after the Canadian softwood lumber agreement expired on March 31. Oriented strand board (OSB) prices fell 25 percent and plywood prices dropped more than eight percent from their already low levels of 2000. A modest improvement through the second quarter was offset by a sharp decline in the third and fourth quarters, particularly in the weeks after September 11. Potlatch, and others in the industry, adjusted production to meet reduced demand by taking market-related downtime during the fourth quarter.

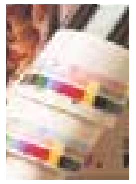
At the same time, almost all of our wood products facilities achieved record productivity in 2001, due in part to increased machine uptime and reliability resulting from a maintenance plan for excellence that employs new procedures and takes full advantage of a company-wide equipment inventory database. For example, our Clearwater Lumber mill in Lewiston, Idaho, actually increased volume output despite five weeks of downtime during 2001, while our Bemidji, Minnesota, OSB operation held output levels constant in the face of 18 days of market-related curtailments. Southern Lumber in Warren, Arkansas, also had record production despite three weeks downtime.

Late in the year, our Bemidji OSB plant began producing two new OSB panel products. LuminOx is a new foil-covered panel with thermal-resistance qualities that will reduce building cooling requirements in warm climates such as Southern California. The plant also began producing a new addition to the Sturd-I-Floor line that will resist edge-warping in subflooring exposed to damp climates for long periods on construction sites.

PRINTING PAPERS

	2001	2000	1999
Sales* ($ in 000's)	$461,728	$501,948	$454,734
Shipments (tons):			
Printing papers	362,766	362,692	378,973
Pulp**	147,424	103,005	–
Realizations ($ per ton):			
Printing papers	$1,031	$1,139	$1,113
Pulp	317	480	–

*Excludes internal sales.
**Excludes pulp used internally.



The company's Printing Papers segment reported an operating loss of $36.7 million in 2001, compared with operating income of $1.5 million in 2000. Net sales declined eight percent, from $503.4 million in 2000 to $464.0 million in 2001, while realizations for pulp and printing papers dropped 34 percent and nine percent respectively. Poor markets resulted in extended market-related shutdowns in the fourth quarter.

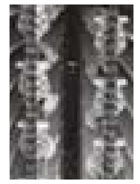
Domestic producers of both pulp and printing papers faced increasing competition from imports during the year as the result of the continuing strength of the U.S. dollar. Potlatch shipments of pulp increased in 2001, reflecting steady production improvements at the new Cloquet, Minnesota, pulp mill, which continued to set monthly production records during the year and is now producing at rates of over 1,200 tons per day. Our pulp customers continue to be exceptionally pleased by the quality of Cloquet's hardwood pulp. Paper operations at both Cloquet and Brainerd, Minnesota, also set production records during the year.

While the coated printing papers market was adversely affected by the economic downturn, the Printing Papers segment successfully increased premium market share through a combination of quality enhancements and customer service. The division successfully introduced two new highline products – Vintage® Silk and Potlatch McCoy™ Uncoated text and cover, giving designers and printers yet another dimension in our grade line. (The financial section of this annual report is printed on new Potlatch McCoy Uncoated text.)

PULP AND PAPER

	2001	2000	1999
Sales* ($ in 000's)	$751,669	$730,018	$693,353
Shipments (tons):			
Paperboard	606,396	574,744	612,826
Tissue	160,748	148,607	140,527
Pulp**	37,787	41,175	75,655
Realizations ($ per ton):			
Paperboard	$ 642	$ 687	$ 610
Tissue	1,782	1,715	1,665
Pulp	273	466	315

*Excludes internal sales.
**Excludes pulp used internally.

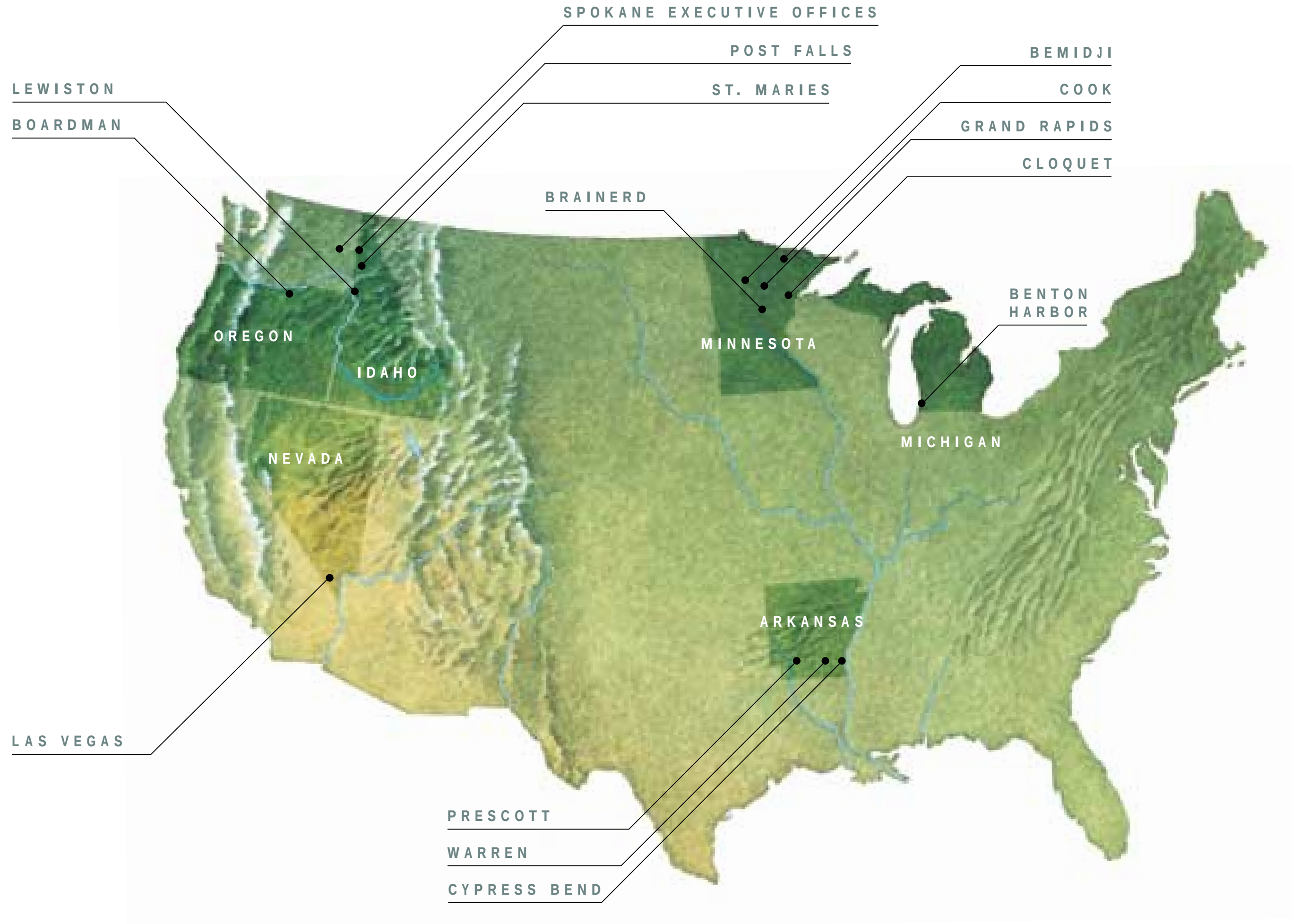


The Pulp and Paper segment incurred an operating loss of $14.5 million in 2001 as compared with operating income of $12.9 million in the previous year. Segment sales increased from $730.1 million to $751.7 million, largely as a result of a $35.1 million increase in net sales for tissue products. Tissue product shipments were eight percent higher and net sales realizations increased four percent compared to 2000. Net pulp sales declined $7.5 million, reflecting an eight percent drop in shipments and a 41 percent decrease in sales realizations. Segment expenses increased by $49.0 million over the prior year due to increased paperboard and tissue shipments and higher energy and fiber costs.

Market conditions were difficult for paperboard throughout the year. However, Cypress Bend's new high-brightness Candesce™ paperboard is making market inroads as existing and new folding boxboard customers come to appreciate the product's exceptional printability. The new product was made possible by capital investments in late 2000 at the wet and dry ends of the board machine, and responds to a need expressed by both current and potential customers.

Potlatch's consumer tissue manufacturing facilities performed well during 2001, setting production records at Lewiston and Las Vegas, Nevada, and laid the groundwork for additional expansion in the private-label business by leasing a converting facility to serve our customers in eastern markets. In May 2001, Potlatch started a leased converting operation at Benton Harbor, Michigan, near Chicago.

FINANCIAL INFORMATION



REGIONAL LAND BASES

Arkansas, Idaho, Minnesota, Oregon (a)

SAWMILLS (CAPACITY)

Prescott, Arkansas
170,000 m. bd. ft.
Warren, Arkansas (b)
210,000 m. bd. ft.
Lewiston, Idaho
180,000 m. bd. ft.
St. Maries, Idaho
90,000 m. bd. ft.
Bemidji, Minnesota
85,000 m. bd. ft.

PLYWOOD MILL (CAPACITY) (c)

St. Maries, Idaho
145,000 m. sq. ft.

ORIENTED STRAND BOARD MILLS (CAPACITY) (c)

Bemidji, Minnesota
515,000 m. sq. ft.
Cook, Minnesota
435,000 m. sq. ft.
Grand Rapids, Minnesota
355,000 m. sq. ft.

PARTICLEBOARD MILL (CAPACITY) (d)

Post Falls, Idaho
70,000 m. sq. ft.

BLEACHED KRAFT PULP MILLS (CAPACITY)

Cypress Bend, Arkansas
260,000 tons
Lewiston, Idaho
500,000 tons
Cloquet, Minnesota
425,000 tons

BLEACHED PAPERBOARD MILLS (CAPACITY)

Cypress Bend, Arkansas
280,000 tons
Lewiston, Idaho
355,000 tons

PRINTING PAPER MILLS (CAPACITY)

Brainerd, Minnesota
155,000 tons
Cloquet, Minnesota
230,000 tons

TISSUE MILL (CAPACITY)

Lewiston, Idaho
170,000 tons

TISSUE CONVERTING FACILITIES (CAPACITY)

Lewiston, Idaho
120,000 tons
Las Vegas, Nevada
40,000 tons
Benton Harbor, Michigan (e)
5,000 tons

(a) Potlatch owns a 22,000-acre plantation in Boardman, Oregon, 17,000 acres of which is planted in hybrid poplar.
(b) There are two sawmills in Warren.
(c) 3/8" basis
(d) 3/4" basis
(e) Leased facility

LAND BASES | SOLID WOOD CONVERTING | PULP MANUFACTURING | PAPER AND PAPERBOARD MANUFACTURING | TISSUE CONVERTING

ARKANSAS

498,000 acres
Southern yellow pine,
various fine hardwoods

PULPWOOD
Own:
636,000 tons
Purchased:
779,000 tons

PULPWOOD SALES
543,000 tons

SAWTIMBER
Own:
712,000 tons
Purchased:
894,000 tons

LOG SALES
127,000 tons

3 SAWMILLS
Capacity:
380,000 m. bd. ft.
Production:
375,000 m. bd. ft.

CHIP SALES
246,000 tons

PULPWOOD FIBER
Own:
45,000 cunits (c)
Purchased:
218,000 cunits (c)

FIBER FROM MILLS
Own:
22,000 cunits (c)
Purchased:
34,000 cunits (c)

PURCHASED FIBER
24,000 cunits (c)

CYPRESS BEND PULP MILL
Bleached kraft pulp
Capacity:
260,000 tons
Production:
258,000 tons

OWN PULP
258,000 tons

CYPRESS BEND PAPERBOARD
Bleached paperboard
Capacity:
280,000 tons
Production:
276,000 tons

IDAHO

671,000 acres
Western white pine,
white fir, red cedar,
Douglas-fir, larch

PULPWOOD
Own:
52,000 m. bd. ft.
Purchased:
41,000 m. bd. ft.

PULPWOOD SALES
1,000 m. bd. ft.

SAWTIMBER
Own:
206,000 m. bd. ft.
Purchased:
40,000 m. bd. ft.

LOG SALES
58,000 m. bd. ft.

2 SAWMILLS
Capacity:
270,000 m. bd. ft.
Production:
250,000 m. bd. ft.

1 PLYWOOD MILL (a)
Capacity:
145,000 m. sq. ft.
Production:
141,000 m. sq. ft.

1 PARTICLEBOARD MILL (b)
Capacity:
70,000 m. sq. ft.
Production:
67,000 m. sq. ft.

PULPWOOD FIBER
Own:
81,000 cunits (c)
Purchased:
65,000 cunits (c)

FIBER FROM MILLS
Own:
108,000 cunits (c)
Purchased:
22,000 cunits (c)

PURCHASED FIBER
401,000 cunits (c)

LEWISTON PULP MILL
Bleached kraft pulp
Capacity:
500,000 tons
Production:
458,000 tons

PULP SALES
38,000 tons

OWN PULP
322,000 tons

OWN PULP (d)
98,000 tons

OWN WASTE PAPER
19,000 tons

PURCHASED PULP
66,000 tons

LEWISTON PAPERBOARD
Bleached paperboard
Capacity:
355,000 tons
Production:
320,000 tons

LEWISTON TISSUE
Tissue
Capacity:
170,000 tons
Production:
175,000 tons

OWN TISSUE
125,000 tons

LEWISTON
Capacity:
120,000 tons
Production:
115,000 tons

OWN TISSUE
46,000 tons

PURCHASED TISSUE
2,000 tons

LAS VEGAS
Capacity:
40,000 tons
Production:
41,000 tons

OWN TISSUE
1,000 tons

PURCHASED TISSUE
1,000 tons

BENTON HARBOR
Capacity:
5,000 tons
Production:
1,000 tons

MINNESOTA

333,000 acres
Aspen, jack pine,
red pine, balsam fir

PULPWOOD
Own:
143,000 tons
Purchased:
1,548,000 tons

PULPWOOD SALES
156,000 tons

SAWTIMBER/OSB LOGS
Own:
246,000 tons
Purchased:
1,905,000 tons

LOG SALES
5,000 tons

1 SAWMILL
Capacity:
85,000 m. bd. ft.
Production:
86,000 m. bd. ft.

3 ORIENTED STRAND BOARD MILLS (a)
Capacity:
1,305,000 m. sq. ft.
Production:
1,134,000 m. sq. ft.

CHIP SALES
17,000 tons

PULPWOOD FIBER
Own:
37,000 cunits (c)
Purchased:
557,000 cunits (c)

FIBER FROM MILL
Own:
3,000 cunits (c)
Purchased:
12,000 cunits (c)

PURCHASED FIBER
100,000 cunits (c)

CLOQUET PULP MILL
Bleached kraft pulp
Capacity:
425,000 tons
Production:
399,000 tons

PULP SALES
147,000 tons

OWN PULP
142,000 tons

PURCHASED PULP
17,000 tons

OWN PULP
98,000 tons

PURCHASED PULP
11,000 tons

CLOQUET PAPER MILL
Printing papers
Capacity:
230,000 tons
Production:
221,000 tons

BRAINERD PAPER MILL
Printing papers
Capacity:
155,000 tons
Production:
131,000 tons

(a) $^{3}/_{8}$" basis
(b) $^{3}/_{4}$" basis
(c) One cunit equals 100 cubic feet of solid wood.
(d) Excludes 6,000 tons transferred from the Cloquet pulp mill.
Note: Fiber transfers represent quantities provided without consideration for changes in inventories.

Potlatch Corporation's management has prepared and is responsible for the financial statements, including the estimates and judgments required for their preparation. Management maintains and supports a system of internal controls and internal auditing to provide reasonable assurance that the company's assets are safeguarded and that transactions and events are recorded in accordance with management's authorization and accounting principles generally accepted in the United States. The company's accounting policies and procedures are communicated to all divisions of the organization. In addition, the company's business ethics policy requires employees to maintain a high level of ethical standards in the conduct of the company's business.

The company's financial statements have been audited by KPMG LLP. The independent auditors' report, which is based on an audit made in accordance with generally accepted auditing standards, expresses an opinion as to whether the company's financial statements, considered in their entirety, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States. In performing its audit, KPMG LLP considers the company's internal control structure to the extent it deems necessary in order to issue its opinion on the financial statements.

The board of directors' audit committee, comprised of four outside directors, meets regularly with management, the internal auditors and the independent auditors to assure that each is meeting its responsibilities regarding the objectivity and integrity of the company's financial statements. The committee reviews the scope and results of the company's internal and external audit activities, nominates the independent auditors to be appointed each year by the board of directors, and reviews with management and the independent auditors current and emerging accounting and financial requirements and practices affecting the company.

L. PENDLETON SIEGEL

Chairman of the Board and Chief Executive Officer

GERALD L. ZUEHLKE

Vice President, Finance, Chief Financial Officer and Treasurer

TERRY L. CARTER

Controller

SELECTED FINANCIAL DATA

(Dollars in thousands – except per-share amounts)	2001	2000	1999	1998	1997
Net sales	$1,751,996	$1,808,770	$1,808,388	$1,688,705	$1,693,371
Net earnings (loss)	(79,445)	(33,214)	40,947	37,232	36,059
Net cash provided by operations	85,076	93,912	204,629	217,544	154,891
Working capital	155,216	44,740	51,756	97,556	106,221
Current ratio	1.4 to 1	1.1 to 1	1.1 to 1	1.3 to 1	1.4 to 1
Long-term debt (noncurrent portion)	$1,017,522	$ 801,549	$ 701,798	$ 712,113	$ 722,080
Stockholders' equity	707,304	813,236	921,039	930,906	951,592
Long-term debt to stockholders' equity ratio	1.4 to 1	.99 to 1	.76 to 1	.76 to 1	.76 to 1
Capital expenditures	$ 50,918	$ 166,422	$ 247,651	$ 147,027	$ 158,485
Total assets	2,487,146	2,542,445	2,446,500	2,377,306	2,365,136
Basic net earnings (loss) per common share	$(2.81)	$(1.16)	$1.41	$1.28	$1.25
Average common shares outstanding (in thousands)	28,282	28,523	28,947	29,000	28,930
Diluted net earnings (loss) per common share	$(2.81)	$(1.16)	$1.41	$1.28	$1.24
Average common shares outstanding, assuming dilution (in thousands)	28,282	28,523	28,967	29,020	28,986
Cash dividends per common share	$1.17	$1.74	$1.74	$1.74	$1.71

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

OVERVIEW

We are a vertically integrated and diversified forest products company. We own approximately 1.5 million acres of timberland and operate 18 manufacturing facilities, located primarily in Arkansas, Idaho and Minnesota. Our business is organized into four segments: (i) Resource, which manages our timberlands and supplies wood fiber to our manufacturing segments and to third parties; (ii) Wood Products, which manufactures oriented strand board (OSB), plywood, lumber and particleboard; (iii) Printing Papers, which produces high-grade coated printing papers and bleached hardwood market pulp; and (iv) Pulp and Paper, which manufactures bleached paperboard, consumer tissue and bleached softwood market pulp.

FACTORS INFLUENCING OUR RESULTS OF OPERATIONS

Our operating results have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, competition, the efficiency and level of capacity utilization of our manufacturing operations, changes in our principal expenses, such as wood fiber and energy costs, changes in the production capacity of our manufacturing operations as a result of major capital spending projects, and other factors.

Our operating results generally reflect the cyclical pattern of the forest products industry. All of our pulp-based products other than tissue products are globally-traded commodity products. In addition, our wood products are subject to competition from manufacturers in Europe, North America and South America. Historical prices for our products have been volatile, and we, like other manufacturers in the forest products industry, have limited direct influence over the timing and extent of price changes for our products. Product pricing is significantly affected by the relationship between supply and demand in the forest products industry. Product supply is influenced primarily by fluctuations in available manufacturing capacity. Demand is affected by the state of the economy in general and a variety of other factors. The demand for our timber resources and wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors. The demand for most of our printing papers and pulp and paper products is primarily affected by the general state of the global economy, and the economies in North America and east Asia in particular.

The markets for our products are highly competitive and companies that have substantially greater financial resources than we do compete with us in each of our markets. Our competitors are located throughout the world, and variations in exchange rates between the U.S. dollar and other currencies, particularly the Euro, significantly affect our competitive position compared to our international competitors. We believe that the strength of the U.S. dollar relative to the Euro has resulted in significantly increased competition from European companies, particularly in our Printing Papers segment. In addition, our industry is capital intensive, which leads to high fixed costs and generally results in continued production when prices are sufficient to cover variable costs. These conditions have contributed to substantial price competition, particularly during periods of reduced demand. Certain competitors in some of our pulp-based businesses may currently be lower-cost producers than we are, and accordingly may be less adversely affected by price decreases.

In late 2000 and the first half of 2001, energy became one of our most significant operating expenses as a result of rapid and substantial price increases, before moderating during the second half of 2001. We use energy to produce electricity and steam, which are used in the paper manufacturing process and to operate our other machinery. Our energy expenses were $20.8 million greater in 2001 than in 2000. For the year 2000, energy expenses were $41.8 million greater than in 1999. Market conditions prevented us from passing these higher costs on to our customers through price increases and, accordingly, energy costs were a significant factor contributing to our net loss for 2001. Our facilities in Idaho were the most adversely affected by the increased cost of energy as a result of comparatively greater energy price increases in the northwestern U.S. During 2001, we reduced our exposure to the volatile spot market for electricity by increasing our internal production of electricity and making numerous process changes at our facilities to decrease energy consumption. This, combined with moderating electric and natural gas prices, contributed to a reduction in our energy costs in the second half of 2001, which were $55.7 million, compared to $89.3 million during the first half. During the first half of 2001, we entered into derivative contracts related to the purchase of natural gas to reduce our exposure to volatile natural gas prices. Changes in the value of these contracts were recorded as an asset or liability as of the end of each reporting period, and the corresponding gain or loss was recognized in our Statements of Earnings. For 2001, we recorded expense in the amount of $2.3 million related to these contracts, which is included in the $145.0 million of energy costs we incurred for the year. At December 31, 2001, we no longer had any of these derivative contracts outstanding, although we continue to make forward purchases of natural gas at fixed prices for use in our facilities. Our energy costs in future periods will depend principally on our ability to continue to produce internally a substantial portion of our electricity needs and on changes in prices for electricity and natural gas.

Another significant expense is the cost of wood fiber needed to supply our manufacturing facilities. Our timberlands provided approximately 53% of log requirements for our sawmill and plywood manufacturing facilities in 2001 and an average of approximately 62% over the past five calendar years. Including logs used for pulp and OSB, the percentages of our fiber requirements supplied by our timberlands were approximately 28% in 2001 and an average of approximately 37% over the past five calendar years. The percentage of our wood fiber requirements supplied by our timberlands will fluctuate based on a variety of factors, including changes in our timber harvest levels and changes in our manufacturing capacity. The cost of various types of wood fiber that we purchase in the market has at times fluctuated greatly because of economic or industry conditions. Selling prices of our products have not always increased in response to wood fiber price increases. On occasion, our results of operations have been and may in the future be adversely affected if we are unable to pass cost increases through to our customers.

Finally, changes in our manufacturing capacity, primarily as a result of capital spending programs, have significantly affected our results of operations in recent periods. In December 1999, we completed construction of our new pulp mill in Cloquet, Minnesota, increasing our annual production from 186,000 tons in 1999 at the former mill on the same site, to 399,000 tons at the new mill in 2001. In January 2001, we completed a modernization and expansion of our OSB mill in Cook, Minnesota, which resulted in an increase in annual production capacity from 250.0 million square feet to 435.0 million square feet. In addition, in September 2000, we closed

our plywood mill in Jaype, Idaho, as a result of poor plywood markets, lack of adequate raw materials and long-term transportation concerns. Each of these changes has affected our levels of net sales and expenses, as well as the comparability of our operating results from period to period. Additionally, the profitability of our manufacturing segments depends largely on our ability to operate our manufacturing facilities efficiently and at or near full capacity. Our operating results would be affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

RESULTS OF OPERATIONS

In the following period to period discussion of our results of operations, contributions by each of the segments to our consolidated net sales are reported after elimination of intersegment sales. In the segment discussion below, each segment's net sales are set forth before elimination of intersegment sales. Additionally, in discussing segment operating results, we discuss net sales realizations, which are calculated for each product line by subtracting customer freight from net sales and then dividing the result by relevant quantities of the product shipped for the period. We believe this measurement can be helpful in showing pricing trends in the pricing of our products.

YEAR ENDED DECEMBER 31, 2001
COMPARED TO YEAR ENDED DECEMBER 31, 2000

Net sales of $1,752.0 million for the year ended December 31, 2001, were slightly less than net sales of $1,808.8 million recorded for the year ended December 31, 2000. The decrease was largely due to decreases in net sales for the Wood Products and the Printing Papers segments. Net sales for Wood Products fell by $39.1 million, as a result of net sales decreases in OSB, plywood and particleboard. Printing Papers net sales declined $40.2 million compared to 2000, due to decreased net sales of coated printing papers. The decrease in net sales for these two segments was partially offset by an increase in net sales for the Pulp and Paper segment, which benefited from increased net sales of tissue products. Pulp and Paper segment net sales increased by $21.7 million in 2001. Resource segment net sales were $38.1 million, comparable to 2000's $37.2 million.

Expenses for depreciation, amortization and cost of fee timber harvested were $169.4 million for the year ended December 31, 2001, an increase of $7.5 million from the prior year amount of $161.8 million. The increase was primarily due to increased amortization expense as a result of our debt refinancing activities during the second quarter of 2001 and increased depreciation in the Wood Products segment related to the Cook OSB mill.

For the year ended December 31, 2001, materials, labor and other operating expenses rose by 2% to $1,505.0 million from $1,468.3 million in 2000. An increase in the overall volume of product shipments in 2001 and higher energy costs were largely responsible for the increase. Energy costs were $20.8 million higher in 2001, and included a $2.3 million net charge for fair value adjustments to natural gas derivative hedging contracts used during the year.

Selling, general and administrative expenses totaled $125.1 million for the year ended December 31, 2001, a $1.8 million increase from 2000's expense of $123.3 million. The increase was primarily due to increased bad debt expense incurred in 2001 as a result of a $7.6 million charge related to the insolvency of a pulp broker, and was partially offset by cost savings from the reduction in our salaried workforce in June 2000 and a decline in selling expenses related to our printing papers and consumer tissue products.

The following charges are included in the "Restructuring and other charges" line in the Statements of Earnings.

In March 2001, we recorded a $4.2 million pre-tax charge associated with a workforce reduction plan at our pulp, paperboard and consumer products operations in Idaho. In September 2001, an additional $.4 million pre-tax charge was recorded as a result of final cost determinations for pension and medical benefits. The plan permanently reduced the workforce by 124 hourly production and maintenance positions. As of December 31, 2001, all material costs associated with the plan had been incurred.

In 2000, we recorded a $27.9 million pre-tax charge to cover costs associated with a company-wide reduction and reorganization of our salaried production and administrative workforce. In establishing the initial liability, we estimated 261 employees would be terminated. As of December 31, 2001 and 2000, a total of 273 employees had been terminated under the reduction and reorganization plan. As of December 31, 2001, $27.0 million had been recorded against the accrued liability associated with the charge. We expect all remaining costs associated with the workforce reduction program to be paid in the first half of 2002.

In September 2000, we recorded an $18.5 million pre-tax charge for costs associated with the closure of our Jaype, Idaho, plywood mill. The closure was deemed necessary due to a combination of poor plywood markets, lack of adequate raw materials and long-term transportation concerns. The amounts

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

of revenues and operating income or loss attributable to the mill were not material in relation to revenues and operating income of the company as a whole. As of December 31, 2000, five salaried and 200 hourly production and maintenance employees had been terminated due to the closure. As of December 31, 2001, a total of five salaried and 207 hourly production and maintenance employees had been terminated due to the closure. The mill was dismantled in 2001, with equipment and parts used at our other facilities or sold to outside bidders. We will continue to operate a log yard at the site. As of December 31, 2001, $16.5 million had been recorded against the accrued liability associated with the charge, which represents all material costs we expect to incur. Our initial estimate of the cost to close the mill included expected costs for some aspects of maintenance and demolition that were not incurred. As a result, in December 2001, we reversed $1.8 million of the liability and recorded it as income.

Interest expense was $77.9 million for the year ended December 31, 2001, a substantial increase compared to the $59.4 million charged against income in 2000. The increase reflects greater indebtedness in 2001 as well as a higher overall weighted average interest rate on our outstanding debt.

For the year ended December 31, 2001, "Other expense, net" totaled $2.1 million, compared to expense of $3.9 million in 2000. The 2001 amount includes an $11.1 million charge for the cost of equipment removed from service and deferred litigation costs associated with our lawsuit against Beloit Corporation, which have recently been determined to be uncollectable due to a reduction in the value of assets available for distribution to unsecured creditors. Interest income of $2.6 million and gains from asset sales of $3.9 million partially offset the charge.

For the year ended December 31, 2001, we recorded an income tax benefit of $50.8 million, reflecting our net loss before taxes, based on an estimated tax rate of 39%. For the year ended December 31, 2000, we recorded a benefit of $21.2 million, also reflecting a tax rate of 39%.

We recorded a net loss of $79.4 million for the year ended December 31, 2001, compared to a net loss of $33.2 million for the year ended December 31, 2000.

The Resource segment reported operating income of $55.3 million for the year ended December 31, 2001, lower than the $61.4 million reported in 2000. Segment net sales increased to $405.8 million, compared to $352.3 million in 2000. The increase in net sales was due to increased wood fiber sales to our other operating segments in Arkansas, Idaho and Minnesota. Most of the increased volume was procured from outside sources and resold internally. Expenses for the Resource segment were $350.5 million in 2001, and were greater than the $290.9 million recorded in 2000 due to increased outside wood purchases and higher production costs.

The Wood Products segment's operating loss of $27.4 million for the year ended December 31, 2001, was greater than the operating loss of $18.3 million incurred in 2000, which included an $18.5 million pre-tax charge related to the closure of our Jaype plywood mill. Difficult market conditions prevailed throughout the year and worsened in the fourth quarter, necessitating extended shutdowns during the holiday period at most of the segment's mills, adversely affecting earnings. Net sales for the segment were $518.4 million, compared to $552.9 million reported in 2000. A decline in net sales realizations for all of the segment's product lines was largely responsible for the sales decrease. Net sales of oriented strand board decreased 20% in 2001, to $167.2 million, net sales of plywood decreased 19% to $41.9 million and net sales of particleboard decreased 31% to $13.5 million. An increased volume of shipments offset lower net sales realizations for lumber, as net sales increased to $270.4 million from $246.1 million in 2000. Expenses were $545.8 million for the segment in 2001, compared to $571.9 million in 2000. Wood fiber and energy costs increased in 2001, but overall expenses were lower due to the absence of operating costs related to the Jaype plywood mill, which we closed in September 2000.

The Printing Papers segment reported an operating loss of $36.7 million, compared to operating income of $1.5 million in 2000. As was the case in our Wood Products segment, poor market conditions also caused the Printing Papers segment to take market-related downtime during the fourth quarter of 2001. Net sales declined 8%, or $39.3 million, to $464.0 million in 2001 from $503.4 million in 2000. Net sales realizations for pulp and printing papers declined 34% and 9%, respectively, compared to 2000. A 43% increase in shipments of market pulp partially offset the decline in net sales realizations. Pulp shipments increased due to increased production at our Cloquet, Minnesota, pulp mill. Segment expenses were $500.7 million for 2001, compared to $501.8 million in 2000. Higher cost of sales, due to a greater volume of pulp shipments and higher energy costs, together with increased bad debt expense of $5.4 million related to the pulp broker insolvency, were offset by lower expenses for operating supplies and maintenance materials.

The Pulp and Paper segment incurred an operating loss of $14.5 million in 2001, versus operating income of $12.9 million in 2000. Segment net sales increased to $751.7 million for 2001, compared to $730.1 million in 2000. The increase was due to a $35.1 million increase in tissue product net sales. Tissue product shipments were 8% higher, and net sales realizations increased 4% compared to the 2000 period. A $7.5 million decline in pulp net sales, due to an 8% decrease in shipments and a 41% decrease in net sales realizations, partially offset the increase in tissue product net sales. Market-related downtime at the segment's Lewiston, Idaho, pulp and paperboard mill contributed to the unfavorable results for 2001. Higher energy and wood fiber costs, combined with increases in the volume of paperboard and tissue product shipments, were largely responsible for the $49.0 million increase in segment expenses. Also included in expenses for 2001 were the $11.1 million charge related to the Beloit Corporation lawsuit and bad debt expense of $2.2 million related to the pulp broker insolvency.

YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

Net sales of $1,808.8 million for the year ended December 31, 2000, remained essentially flat as compared to net sales of $1,808.4 million for the year ended December 31, 1999. Net sales for the Wood Products segment fell by $82.0 million, as a result of net sales decreases in OSB, lumber, and plywood. The decrease in net sales for the Wood Products segment was offset by increased net sales in both the Printing Papers and Pulp and Paper segments. Net sales for the Printing Papers segment rose $47.2 million from the prior year, attributable to hardwood market pulp sales from a full year of production at our new Cloquet pulp mill. Improved net sales of both paperboard and tissue lifted net sales of the Pulp and Paper segment by $36.7 million over 1999.

Expenses for depreciation, amortization and cost of fee timber harvested rose 8%, from $150.3 million for the year ended December 31, 1999, to $161.8 million for the year ended December 31, 2000. The increase of $11.5 million was primarily due to the increased depreciation expense associated with our new Cloquet pulp mill. Other depreciation and amortization expenses, and cost of fee timber harvested, remained substantially unchanged in 2000 from 1999.

For the year ended December 31, 2000, materials, labor and other operating expenses increased by 5% to $1,468.3 million from $1,404.6 million in 1999. Energy costs for the period increased by 33% to $124.9 million and wood fiber costs increased by 7% to $498.0 million. The increased wood fiber costs were largely attributable to increased consumption as our new Cloquet pulp mill was in operation for the full year. The increases in energy and wood fiber expenses were partially offset by lower personnel costs resulting from the reduction and reorganization of our salaried workforce in June 2000 and the closure of our Jaype, Idaho, plywood mill in September 2000.

Selling, general and administrative expenses amounted to $123.3 million for the year ended December 31, 2000, an $18.3 million decrease from expenses of $141.6 million for 1999. The decrease was experienced across most of our selling and administrative units, and was primarily attributable to the reduction in our salaried workforce, occurring in June 2000, and lower overall compensation expense in 2000.

For the year ended December 31, 2000, we recorded restructuring and other charges of $46.4 million. A $27.9 million pre-tax charge to cover costs associated with a company-wide reduction and reorganization of our salaried workforce was included in the "Restructuring and other charges" line in the Statements of Earnings in our consolidated financial statements for 2000. In establishing the initial liability, we estimated 261 employees would be terminated. As of December 31, 2000, a total of 273 employees had been terminated under the reduction and reorganization plan. In September 2000, we recorded an $18.5 million pre-tax charge for costs associated with the closure of our Jaype plywood mill. The closure was deemed necessary due to a combination of poor plywood markets, lack of adequate raw materials and long-term transportation concerns. The amounts of revenues and operating income or loss attributable to the mill were not material in relation to revenues and operating income of the company as a whole. As of December 31, 2000, five salaried and 200 hourly production and maintenance employees had been terminated due to the closure.

Interest expense for 2000 of $59.4 million was significantly higher than the $45.4 million charged against income in 1999. The difference was due to a change in the amount of interest capitalized, $4.0 million in 2000 compared to $10.3 million in 1999, with the balance reflecting the increase in debt acquired during the year. Less interest was capitalized in 2000 compared to 1999, mainly due to completing the construction of our new Cloquet pulp mill in December 1999.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

For the year ended December 31, 2000, "Other expense, net" was $3.9 million, compared to $.5 million in 1999.

For the year ended December 31, 2000, our loss before taxes was offset in part by an income tax benefit of $21.2 million associated with the loss. For the year ended December 31, 1999, we recorded a provision for tax expense of $25.1 million. Our effective tax rate amounted to 39% in 2000 and 38% in 1999.

We recorded a net loss of $33.2 million for the year ended December 31, 2000, compared to net earnings of $40.9 million for the year ended December 31, 1999.

Resource segment operating income of $61.4 million for the year ended December 31, 2000, was lower than the $68.0 million reported in 1999. Net sales for the Resource segment increased $14.8 million in 2000, as shipments increased by 4%, although net sales realizations declined slightly in Idaho. Increased expenses outstripped these gains, and lower operating income was largely due to higher costs associated with outside log purchases in Arkansas and lower net sales realizations. Also contributing to the lower operating income was a decline in the volume of third-party log sales and sawlog production in Idaho, coupled with fewer non-strategic land sales by the segment for the 2000 period compared to 1999. Increased timber harvests in Arkansas and Minnesota partially offset a decrease in timber harvests in Idaho.

Excluding an $18.5 million charge related to the permanent closure of our plywood mill in Jaype, the Wood Products segment had operating income of $.2 million for the year ended December 31, 2000, compared to operating income of $83.1 million in 1999. Net sales for the Wood Products segment dropped by $84.7 million in 2000 to $552.9 million. Compared to 1999, net sales dropped in all categories. In particular, net sales of OSB decreased by $38.9 million, or 16%, net sales of lumber fell by $25.1 million, or 9%, and net sales of plywood fell by $20.4 million, or 28%. OSB results were primarily affected by a 16% decline in net sales realizations. For lumber, net sales realizations dropped 12% and shipments increased by 3%. Net sales realizations for plywood fell by 9% and shipments declined by 22%. The decline in shipments of panel products was due, in part, to the closure of our plywood mill in Jaype, and the temporary shutdown of our Cook, Minnesota, OSB mill in early December 2000. The Cook mill was shut down to facilitate the completion of our modernization and expansion project. The mill resumed production in late January 2001.

The Printing Papers segment reported 2000 operating income of $1.5 million, compared to an operating loss of $13.8 million in 1999. The improvement resulted from lower average per-ton pulp production costs during the year and the first year of sales of our hardwood market pulp, both of which were a result of the startup of our new pulp mill in Cloquet in December 1999. Net sales for the segment rose $48.6 million from the prior year. Hardwood market pulp, sold for the first time in 2000, generated $53.8 million in net sales. Net sales of printing papers fell by $5.1 million. Net sales realizations for printing papers rose by 2%, while shipments declined 4% compared to the previous year as demand for printing papers remained soft throughout 2000. Operations were curtailed for approximately one week at our Cloquet paper mill and two weeks at our Brainerd paper mill in 2000 to help align inventory levels with existing market conditions. The segment also experienced increased expenses in 2000 primarily associated with a full year of pulp production at our new Cloquet pulp mill.

Operating income for the Pulp and Paper segment was $12.9 million in 2000, which was lower than 1999 operating income of $14.8 million. Segment net sales increased by 5%, or $36.7 million, for the period. Net sales realizations for 2000 increased by 13% for paperboard, 3% for tissue and 48% for pulp. Tissue product shipments also rose by 6%. A decline in paperboard and softwood market pulp shipments, higher energy costs during the second half of the year, especially in Idaho, and higher costs incurred to continue operations during a scheduled rebuild of the recovery boiler at our pulp and paperboard mill in Cypress Bend, Arkansas, were largely responsible for the decrease in segment operating income.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2001, our financial position included long-term debt of $1.15 billion, including current installments on long-term debt of $132.6 million. Our ratio of long-term debt to stockholders' equity was 1.4 to 1 at December 31, 2001, compared to .99 to 1 at December 31, 2000. Long-term debt increased $216.0 million during 2001. The increase was due to the issuance in June of $250.0 million of senior subordinated notes due 2011 and $200.0 million under our new bank credit facility. Repayment of $100.0 million borrowed under our old revolving credit facility, which had been classified as long-term debt, and the reclassification of $130.0 million of long-term

debt to current installments, partially offset the increase. Stockholders' equity declined $105.9 million in 2001, due to a net loss of $79.4 million and dividend payments of $33.1 million.

We had working capital of $155.2 million at December 31, 2001, an increase of $110.5 million from December 31, 2000. Items contributing to the increase in working capital included increases in restricted cash of $98.2 million and short-term investments of $30.5 million, combined with decreases in notes payable of $188.9 million and accounts payable and accrued liabilities of $25.9 million. As discussed in detail on page 42, the restricted cash amount and the repayment of our notes payable are directly related to our refinancing activities in June 2001. Partially offsetting the items increasing working capital were decreases in receivables of $28.5 million, inventories of $38.6 million and prepaid expenses of $29.9 million. A $132.3 million increase in current installments on long-term debt also partially offset the increase in working capital.

We generated net cash from operations of $85.1 million in 2001, $93.9 million in 2000 and $204.6 million in 1999. The decrease in 2001 resulted primarily from a net loss of $79.4 million in 2001 compared to a net loss of $33.2 million in 2000. The decrease in cash provided by operations in 2000 compared to 1999 was largely attributable to a net loss of $33.2 million in 2000 compared to net earnings of $40.9 million in 1999, as well as increases in working capital items, particularly inventories and prepaid expenses.

Net cash used for investing was $173.1 million in 2001, $167.5 million in 2000 and $188.8 million in 1999. The increase in 2001 was primarily attributable to the establishment of a restricted cash account totaling $98.2 million at December 31, 2001, and an increase in short-term investments of $30.5 million. These amounts were partially offset by a decline in capital expenditures of $115.5 million compared to capital expenditures in 2000. Capital spending totaled $50.9 million in 2001 and focused on routine general replacement, safety, forest resource and environmental projects. Approximately $4.0 million was spent for the completion of the modernization and expansion project at our Cook oriented strand board mill and another $6.5 million on development of our hybrid poplar plantation in Boardman, Oregon. The decline in 2000 compared to 1999 was due largely to an $81.2 million decrease in capital expenditures as compared to 1999. We made capital expenditures of approximately $187.0 million in connection with the Cloquet and Cook projects in 1999, compared to approximately $69.9 million for both these projects in 2000. The 1999 period also benefited from receipt of $50.0 million in repayment of a note issued by a third party.

Authorized but unexpended capital appropriations totaled $44.6 million at December 31, 2001, all of which is budgeted to be expended in 2002. As in 2001, spending in 2002 will be concentrated on various routine general replacement, safety, forest resource and environmental projects. Historically, we have spent less on capital expenditures than the annual amount budgeted. However, due to the lower level of planned capital expenditures in 2002, we believe it is likely we will spend close to the budgeted amount. The reduction in planned spending reflects our recently completed long-term modernization program. In 2001, we spent $39.0 million less than the $89.9 million budgeted. Spending on projects may be delayed due to the acquisition of environmental permits, acquisition of equipment, engineering, weather and other factors.

Net cash provided by financing totaled $84.2 million in 2001, compared to $73.8 million in 2000 and net cash used for financing of $15.9 million in 1999. The increase in 2001 was due primarily to our debt restructuring completed in June 2001 in which we issued $450.0 million of debt, partially offset by debt repayments of $101.7 million. We also purchased less treasury stock in 2001, spending $10.5 million versus $25.9 million in 2000. In addition, our dividend payments declined substantially in 2001, to $33.1 million from $49.7 million paid in 2000, largely as a result of a dividend rate reduction announced in August 2001. The increase in cash provided by financing in 2000 compared to 1999 was in large part the result of smaller debt repayments in 2000, totaling $10.2 million, versus repayments of $109.9 million in 1999. Partially offsetting this decline was $25.9 million used in 2000 for the repurchase of common stock.

For the first half of 2001, we funded our operating losses and other cash requirements primarily through borrowings under our bank credit agreements. On June 29, 2001, we obtained a new credit facility providing for aggregate borrowings of up to $400.0 million. The new credit facility is comprised of a four-year term loan in the amount of $200.0 million, and a three-year revolving line of credit of up to $200.0 million, including a $110.0 million subfacility for letters of credit, usage of which reduces availability under the revolving line of credit. Our obligations under the bank credit facility are secured by approximately 130,000 acres of our timberlands in Arkansas and our accounts receivable and inventory. As of December 31, 2001,

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

$199.0 million was outstanding under the four-year term loan, no borrowings were outstanding under the revolving line of credit, and approximately $103.0 million of the revolving line of credit was used to support outstanding letters of credit. These letters of credit provide credit enhancement for a portion of our outstanding revenue bonds.

Concurrent with the closing of the new credit facility, we sold $250.0 million of our senior subordinated notes due 2011 in an institutional private placement. The notes are unsecured obligations and are subordinated to our senior notes and new credit facility. The notes bear interest at a rate of 10% per annum, payable semiannually, and are redeemable at our option, in whole or in part, at any time on or after July 15, 2006, at varying redemption prices. In October 2001, we filed a registration statement with the Securities and Exchange Commission offering to exchange the private placement notes with registered notes containing essentially identical terms. The registration statement became effective on January 4, 2002, and the exchange was completed on February 6, 2002.

Both the agreement governing our new credit facility and the indenture governing our senior subordinated notes contain certain covenants that, among other things, restrict our ability and our subsidiaries' ability to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, pay dividends, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates, make capital expenditures, or change the nature of our business. The new credit facility also contains financial maintenance covenants establishing a maximum funded indebtedness to capitalization ratio, a minimum consolidated net worth requirement, and a minimum fixed charge coverage ratio. Events of default under the new credit facility and the indenture include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events involving our company. As of December 31, 2001, we obtained a waiver of the fixed charge coverage ratio covenant contained in our bank credit facility. We also obtained an amendment to the fixed charge coverage ratio for the quarters ended March 31, 2002 and June 30, 2002.

We used the gross proceeds from the sale of the senior subordinated notes and initial borrowings under the new bank credit facility to (i) repay all outstanding indebtedness under our existing bank credit facilities, (ii) pay transaction costs relating to the new credit facility and the notes offering, and (iii) fund an escrow account with $96.6 million which, together with future accrued interest, is restricted to the repayment of our $100 million 6.25% debentures due March 15, 2002. We expect that any borrowings under the revolving credit facility will be used for working capital and other corporate purposes.

On August 10, 2001, we announced that our board of directors reduced the quarterly dividend to $.15 per share, from the previous quarterly dividend rate of $.435 per share. The dividend rate is set by the board on a quarterly basis taking into account a variety of factors, including, among other things, conditions in the forest products industry and the economy generally, our operating results and cash flows, anticipated capital expenditures and compliance with the terms of our new credit facility and senior subordinated notes that limit the payment of dividends on our common stock. Although we expect to continue to pay dividends at the reduced rate, our dividend rate is subject to change from time to time based on the board's business judgment with respect to these and other relevant factors.

We believe that our cash, cash flows from operations and available borrowings under our new revolving credit facility will be sufficient to fund our operations, capital expenditures and debt service obligations for the next twelve months and for the foreseeable future. We cannot assure, however, that our business will generate sufficient cash flow from operations or that we will be in compliance with the financial covenants in the new credit facility so that future borrowings thereunder will be available to us. This will be dependent upon our future financial performance, which will be affected by general economic, competitive and other factors, including those discussed under "Factors Influencing Our Results of Operations," many of which are beyond our control.

During the first quarter of 2001, Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., Moody's Investors Service Inc. and Fitch, Inc. completed a review of their ratings on our senior unsecured long-term debt. As a result of the review, at the end of March 2001, Standard & Poor's and Fitch adjusted their ratings on this debt from BBB+ to BBB and Moody's adjusted its rating from Baa1 to

Baa3. On April 3, 2001, Standard & Poor's placed our debt on CreditWatch with negative implications, and, on June 8, 2001, adjusted its ratings on our senior unsecured long-term debt and our corporate credit rating from BBB to BBB- and retained the debt on CreditWatch with negative implications. On June 11, 2001, Fitch adjusted its ratings on our senior unsecured long-term debt from BBB to BBB-. On June 15, 2001, Moody's changed its outlook on our debt rating from stable to negative. On the same date, Moody's also assigned a Baa2 rating to our new credit facility. These changes in our debt ratings have increased our borrowing costs.

Since December 1999, we have been authorized under a stock repurchase program to repurchase up to two million shares of our common stock. Under the plan, purchases of common stock may be made from time to time through open market and privately negotiated transactions at prices deemed appropriate by management, and through our put option program. Through December 31, 2001, a total of 910,900 shares have been acquired under the stock repurchase program. We did not have any put option contracts outstanding at December 31, 2001. We do not expect to repurchase additional common stock in the foreseeable future.

ENVIRONMENT

We are subject to extensive federal and state environmental regulations at our operating facilities. We endeavor to comply with all environmental regulations and regularly monitor our activities for such compliance. Compliance with environmental regulations requires capital expenditures as well as additional operating costs. Capital expenditures specifically designated for environmental compliance totaled approximately $16 million during 2001 and are budgeted to be approximately $2 million in 2002. In addition, we made expenditures for pollution control facilities as part of major mill modernizations and expansions recently completed.

In early 1998 the Environmental Protection Agency (EPA) published the "Cluster Rule" regulations specifically applicable to the pulp and paper industry. These extensive regulations govern both air and water emissions. During 2001, we completed modifications to process equipment and operating procedures to comply with Phase I of the regulations. Phase II of the regulations relate to control of high volume, low concentration emissions at kraft pulp mills, and our compliance efforts are scheduled to be completed in 2006, at an expected cost of approximately $5 million. We do not expect that such compliance costs will have a material adverse effect on our competitive position.

Our pulp mill at Lewiston, Idaho, discharges treated mill effluent into the nearby Snake River. Federal law requires that we comply with provisions of a National Pollution Discharge Elimination System (NPDES) permit. As allowed by federal regulations, we are operating under an NPDES permit which expired in 1997, but which continues to be in force until the effective date of a new NPDES permit. Negotiations for a new permit have been ongoing since that time. The EPA published a draft NPDES permit in December 1999, which includes an end-of-the-pipe discharge temperature requirement of 68 degrees Fahrenheit, to be achieved within five years of the date a new permit becomes effective. Meeting this requirement would necessitate installation of refrigeration equipment at a total capital cost between $25 million and $30 million. Discussions are ongoing with the EPA and other agencies involved in the reissuance of the NPDES permit. There are regional precedents for a higher temperature limit. Compliance with a higher temperature limit, should it be allowed, can be achieved with process modifications and less costly equipment configurations than refrigeration. The EPA is currently implementing its Total Maximum Daily Load regulations and, once completed, the regulations must be adopted by the State of Idaho. This process is not expected to be completed until late 2003, at which point the requirements placed on the mill may be clarified. If we are required to install and operate the refrigeration equipment, we believe the pulp mill will be substantially less competitive than similar mills, none of which face such requirements.

The EPA is currently developing environmental regulations, collectively known as Maximum Achievable Control Technology rules (MACT), which could affect our wood products operations as well as our power boiler generating facilities. The MACT rules are not expected to be proposed until April 2002, and are not expected to be effective before 2006. After the proposed MACT rules are published, we will be able to reasonably estimate the capital expenditures necessary for compliance, although we do not expect such compliance costs to have a material adverse effect on our competitive position.

INCOME TAXES

Our effective tax rates for 2001, 2000 and 1999 were 39.0%, 39.0% and 38.0%, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Our exposure to market risks on our financial instruments includes interest rate risk on our outstanding variable rate debt under our revenue bonds and our bank credit facility at December 31, 2001. As of December 31, 2001, we had approximately $298.9 million of variable rate debt and credit facility debt outstanding. The interest rates applied to these borrowings are adjusted often and therefore react quickly to any movement in the general trend of market interest rates. Interest expense incurred annually related to our variable rate debt depends upon the amount outstanding during the year and the extent to which interest rates rise or fall. The maturities for debt issued under the credit facility range from March 2002 through June 2005, while the variable rate debt has maturities beginning in 2007 and extending through 2030.

All of our other long-term debt is fixed-rate and therefore changes in market interest rates do not expose us to risk for these financial instruments. However, in December 2001 we entered into a fixed-to-variable interest rate swap to hedge a portion of our 10% senior subordinated debentures. The swap has been designated as a fair value hedge and calls for the company to pay a variable interest amount, based on London Interbank Offered Rate (LIBOR) rates, and receive a fixed rate payment from a financial institution, calculated on $165.0 million of our 10% senior subordinated debentures. We assume there is no ineffectiveness in the hedge and, accordingly, a fair value increase or decrease in the swap is offset by a corresponding decrease or increase in the value of the underlying debt instrument.

At December 31, 2001, we no longer had any put option contracts outstanding, nor were we a party to any derivative financial instruments, other than interest rate swaps.

SUBSEQUENT EVENT

On March 18, 2002, we entered into an agreement to sell to a domestic subsidiary of Sappi Limited our Cloquet, Minnesota, pulp and printing paper facilities and related assets for $480 million in cash. We expect the transaction will be completed in the second quarter of 2002, pending regulatory approvals. We will also close our Brainerd, Minnesota, paper mill and exit the coated printing paper business. An after-tax loss of approximately $150 million is anticipated as a result of the sale and the shutdown of the Brainerd facility. The proceeds received will be used primarily to repay a portion of our outstanding debt. The December 31, 2001, carrying amounts of the assets and liabilities expected to be included in the transaction and closure were as follows:

(Dollars in millions)

Assets	
Current assets	$113
Plant and equipment	644
	$757
Liabilities	
Current liabilities	$ 32

COMMON STOCK: DIVIDENDS, MARKETS, PRICES AND VOTING RIGHTS

The company's common stock is traded on the New York, Chicago and Pacific Stock Exchanges. Quarterly and yearly price ranges were:

	2001		2000	
Quarter	High	Low	High	Low
1st	$34.88	$29.26	$44.88	$36.00
2nd	36.22	31.03	44.50	32.94
3rd	34.34	26.55	37.63	29.75
4th	29.80	24.90	34.38	28.56
Year	36.22	24.90	44.88	28.56

In general, all holders of Potlatch common stock who own shares 48 consecutive calendar months or longer ("long-term holders") are entitled to exercise four votes per share of stock so held, while stockholders who are not long-term holders are entitled to one vote per share. All stockholders are entitled to only one vote per share on matters arising under certain provisions of the company's charter. There were approximately 2,900 common stockholders of record at December 31, 2001.

See the discussion under the caption "Liquidity and Capital Resources" in Management's Discussion and Analysis of Financial Condition and Results of Operations on page 42 for information regarding restrictions on our ability to pay dividends. Quarterly dividend payments per common share for 2001 and 2000 were:

Quarter	2001	2000
1st	$.435	$.435
2nd	.435	.435
3rd	.15	.435
4th	.15	.435
	$1.17	$1.74

For the years ended December 31 (Dollars in thousands – except per-share amounts)	2001	2000	1999
Net sales	$1,751,996	$1,808,770	$1,808,388
Costs and expenses:			
Depreciation, amortization and cost of fee timber harvested	169,388	161,847	150,253
Materials, labor and other operating expenses	1,504,950	1,468,316	1,404,562
Selling, general and administrative expenses	125,148	123,347	141,580
Restructuring and other charges (Note 15)	2,750	46,411	–
	1,802,236	1,799,921	1,696,395
Earnings (loss) from operations	(50,240)	8,849	111,993
Interest expense, net of capitalized interest of $1,032 ($3,964 in 2000 and $10,320 in 1999)	(77,853)	(59,438)	(45,442)
Other expense, net (Note 16)	(2,145)	(3,860)	(507)
Earnings (loss) before taxes on income	(130,238)	(54,449)	66,044
Provision (benefit) for taxes on income (Note 6)	(50,793)	(21,235)	25,097
Net earnings (loss)	$ (79,445)	$ (33,214)	$ 40,947
Net earnings (loss) per common share:			
Basic	$(2.81)	$(1.16)	$1.41
Diluted	(2.81)	(1.16)	1.41

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

BALANCE SHEETS

At December 31 (Dollars in thousands – except per-share amounts)	2001	2000
ASSETS		
Current assets:		
Cash (Note 11)	$ 7,767	$ 11,652
Restricted cash (Notes 1 and 7)	98,200	–
Short-term investments (Note 11)	30,509	9
Receivables, net of allowance for doubtful accounts of $1,989 ($1,012 in 2000) (Note 7)	159,347	187,819
Inventories (Notes 2 and 7)	184,571	223,206
Prepaid expenses (Note 6)	31,274	61,153
Total current assets	511,668	483,839
Land, other than timberlands	9,042	9,044
Plant and equipment, at cost less accumulated depreciation of $1,711,888 ($1,609,210 in 2000) (Note 3)	1,462,548	1,637,374
Timber, timberlands and related logging facilities, net (Notes 4 and 7)	395,668	333,249
Other assets (Note 5)	108,220	78,939
	$2,487,146	$2,542,445
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable (Notes 7 and 11)	$ –	$ 188,943
Current installments on long-term debt (Notes 7 and 11)	132,603	325
Accounts payable and accrued liabilities (Note 8)	223,849	249,831
Total current liabilities	356,452	439,099
Long-term debt (Notes 7 and 11)	1,017,522	801,549
Other long-term obligations (Note 9)	195,258	184,147
Deferred taxes (Note 6)	210,610	293,961
Put options (Notes 10 and 11)	–	10,453
Stockholders' equity:		
Preferred stock, Authorized 4,000,000 shares	–	–
Common stock, $1 par value		
Authorized 40,000,000 shares, issued 32,721,980 shares	32,722	32,722
Additional paid-in capital	129,978	128,984
Retained earnings	661,144	773,697
Common shares in treasury 4,410,528 (4,375,546 in 2000)	(116,540)	(122,167)
Total stockholders' equity	707,304	813,236
	$2,487,146	$2,542,445

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

STATEMENTS OF CASH FLOWS

For the years ended December 31 (Dollars in thousands)	2001	2000	1999
CASH FLOWS FROM OPERATIONS			
Net earnings (loss)	$ (79,445)	$ (33,214)	$ 40,947
Adjustments to reconcile net earnings (loss) to net cash provided by operations:			
Depreciation, amortization and cost of fee timber harvested	169,388	161,847	150,253
Deferred taxes	(83,351)	18,317	21,953
Other, net	5,114	(2,129)	(3,190)
Decrease (increase) in receivables	28,472	(3,507)	(22,044)
Decrease (increase) in inventories	38,635	(26,473)	3,524
Decrease (increase) in prepaid expenses	29,879	(37,386)	3,491
Increase (decrease) in accounts payable and accrued liabilities	(23,616)	16,457	9,695
Net cash provided by operations	85,076	93,912	204,629
CASH FLOWS FROM INVESTING			
Increase in restricted cash	(98,200)	–	–
Decrease (increase) in short-term investments	(30,500)	150	–
Additions to investments	(4,784)	(4,493)	(51,720)
Reductions in investments	2,356	1,350	57,492
Collection of note receivable	–	–	50,000
Funding of qualified pension plans	(1,465)	(6)	(10)
Additions to plant and equipment, and to land other than timberlands	(37,302)	(157,243)	(237,671)
Additions to timber, timberlands and related logging facilities	(13,616)	(9,179)	(9,980)
Disposition of plant and properties	10,395	1,877	3,046
Net cash used for investing	(173,116)	(167,544)	(188,843)
CASH FLOWS FROM FINANCING			
Change in book overdrafts	(2,366)	415	(2,075)
Increase (decrease) in notes payable	(188,943)	67,479	46,525
Proceeds from long-term debt	450,000	100,000	99,935
Repayment of long-term debt	(101,749)	(10,247)	(109,948)
Long-term debt issuance fees	(15,553)	–	–
Issuance of treasury stock	5,627	861	1,250
Purchase of treasury stock	(10,453)	(25,892)	–
Dividends on common stock	(33,108)	(49,698)	(50,362)
Other, net	(19,300)	(9,165)	(1,230)
Net cash provided by (used for) financing	84,155	73,753	(15,905)
Increase (decrease) in cash	(3,885)	121	(119)
Balance at beginning of year	11,652	11,531	11,650
Balance at end of year	$ 7,767	$ 11,652	$ 11,531

Net interest paid (net of amounts capitalized) in 2001, 2000 and 1999 was $65.3 million, $59.3 million and $43.9 million, respectively.
Net income tax payments (refunds) in 2001, 2000 and 1999 were $(.1) million, $.2 million and $4.5 million, respectively.
The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

(Dollars in thousands – except per-share amounts)	Common Stock Issued Shares	Common Stock Issued Amount	Additional Paid-In Capital	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Total Stockholders' Equity
Balance, December 31, 1998	32,721,980	$32,722	$128,025	$866,024	3,803,293	$ 95,865	$930,906
Exercise of stock options and stock awards	–	–	653	–	(53,545)	(1,250)	1,903
Put options	–	–	–	–	–	3,443	(3,443)
Premium on issuance of put options	–	–	–	–	–	(1,088)	1,088
Net earnings	–	–	–	40,947	–	–	40,947
Common dividends, $1.74 per share	–	–	–	(50,362)	–	–	(50,362)
Balance, December 31, 1999	32,721,980	$32,722	$128,678	$856,609	3,749,748	$ 96,970	$921,039
Exercise of stock options and stock awards	–	–	306	–	(35,102)	(861)	1,167
Shares purchased at cost	–	–	–	–	660,900	22,253	(22,253)
Put options	–	–	–	–	–	4,240	(4,240)
Premium on issuance of put options	–	–	–	–	–	(435)	435
Net loss	–	–	–	(33,214)	–	–	(33,214)
Common dividends, $1.74 per share	–	–	–	(49,698)	–	–	(49,698)
Balance, December 31, 2000	32,721,980	$32,722	$128,984	$773,697	4,375,546	$122,167	$813,236
Exercise of stock options and stock awards	–	–	5	–	(750)	(19)	24
Shares purchased at cost*	–	–	–	–	250,000	–	–
Issuance of treasury stock	–	–	989	–	(214,268)	(5,608)	6,597
Net loss	–	–	–	(79,445)	–	–	(79,445)
Common dividends, $1.17 per share	–	–	–	(33,108)	–	–	(33,108)
Balance, December 31, 2001	32,721,980	$32,722	$129,978	$661,144	4,410,528	$116,540	$707,304

*Represents shares purchased pursuant to previously issued put option contracts. The cost of the shares ($10,453) was recorded in treasury stock at the time the put option contract was issued.

The accompanying notes and summary of principal accounting policies are an integral part of these financial statements.

CONSOLIDATION

The financial statements include the accounts of Potlatch Corporation and its subsidiaries after elimination of significant intercompany transactions and accounts. There are no significant unconsolidated subsidiaries.

Potlatch Corporation is an integrated forest products company with substantial timber resources. We are engaged principally in the growing and harvesting of timber and the manufacture and sale of wood products, printing papers and pulp and paper products. Our timberlands and all of our manufacturing facilities are located within the continental United States. The primary market for our products is the United States, although we sell a significant amount of paperboard to countries in the Pacific Rim.

USE OF ESTIMATES

The 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 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 period. Actual results could differ from those estimates and assumptions.

INVENTORIES

Inventories are stated at the lower of cost or market. The last-in, first-out method is used to determine cost of logs, lumber, plywood, particleboard and chips. The average cost method is used to determine cost of all other inventories.

EARNINGS (LOSS) PER COMMON SHARE

Earnings (loss) per common share are computed by dividing net earnings by the weighted average number of common shares outstanding in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings Per Share." The following table reconciles the number of common shares used in the basic and diluted earnings per share calculations:

	2001	2000	1999
Basic average common shares outstanding	28,281,785	28,522,659	28,946,900
Incremental shares due to:			
Common stock options	–	–	18,971
Put options	–	–	1,291
Diluted average common shares outstanding	28,281,785	28,522,659	28,967,162

Incremental shares due to common stock options of 2,162 and put options of 34,147 for the year ended December 31, 2001, and common stock options of 4,209 and put options of 40,039 for the year ended December 31, 2000, were not included in the diluted average common shares outstanding total for 2001 and 2000 due to their antidilutive effect as a result of our net losses for those years. Stock options to purchase 2,508,375, 2,025,050 and 1,949,725 shares of common stock for 2001, 2000 and 1999, respectively, were not included in the computation of diluted earnings per share because the exercise prices of the stock options were greater than the average market price of the common shares.

PROPERTIES

Property, plant and equipment are valued at cost less accumulated depreciation. Depreciation of buildings, equipment and other depreciable assets is determined using the straight-line and units of production methods of depreciation. Estimated useful lives range from 30 to 40 years for buildings and structures and 2 to 25 years for equipment.

Timber, timberlands and related logging facilities are valued at cost net of the cost of fee timber harvested and depreciation or amortization. Cost of fee timber harvested is determined annually based on costs incurred and the related current estimated recoverable volume. Recoverable volume includes growth that has occurred to-date and does not include any anticipated future cost or future growth. Permit timber is timber purchased under contracts where the company does not own the land. The cost of permit timber is capitalized in timber accounts and these costs are classified as depletion expense as the volume of timber is harvested.

Expenditures for reforestation include all costs related to stand establishment, such as site preparation, costs of seeds or seedlings, and tree planting. All reforestation expenditures representing direct costs incurred for stand establishment are capitalized in reproduction accounts until the timber reaches maturity. Costs are then depleted when harvesting activities begin. Expenditures for forest management, which consist of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expenses.

Logging roads and related facilities on land not owned by us are amortized as the related timber is removed. Logging roads and related facilities on our land are presumed to become a part of our road system unless it is known at the time of construction that the road will be abandoned. Therefore, the base cost of the road, such as the clearing, grading, and ditching, is not amortized and remains a capitalized item until abandonment or other disposition, while other portions of the initial cost, such as bridges, culverts and gravel surfacing, are depreciated over their useful lives, which range from 10 to 20 years. When it is known at the time of construction or purchase that a road will be abandoned after a given event has occurred, the total cost is amortized in the same manner as for roads on non-owned land.

Major improvements and replacements of property are capitalized. Maintenance, repairs, and minor improvements and replacements are expensed. Upon retirement or other disposition of property, applicable cost and accumulated depreciation or amortization are removed from the accounts. Any gains or losses are included in earnings.

LONG-LIVED ASSETS

We account for long-lived assets in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed of." The statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Assets to be disposed of are reported at the lower of carrying amount or fair value less cost to sell.

INCOME TAXES

The provision for taxes on income is based on earnings or loss reported in the financial statements. Deferred income taxes are recorded under the asset and liability method for the temporary differences between reported earnings and taxable income using current tax laws and rates.

ENVIRONMENT

As part of our corporate policy, we have an ongoing process to monitor, report on and comply with environmental requirements. Based on this ongoing process, accruals for environmental liabilities are established in accordance with SFAS No. 5. We estimate our environmental liabilities based on various assumptions and judgments, the specific nature of which varies in light of the particular facts and circumstances surrounding each environmental liability. These estimates typically reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities and the probable cost of these activities, and in some cases reflect assumptions and judgments as to the obligation or willingness and ability of third parties to bear a proportionate or allocated share of the cost of these activities. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and the effects of changes in governmental regulation and environmental technologies, both the precision and reliability of the resulting estimates of the related liabilities are subject to substantial uncertainties. We regularly monitor our estimated exposure to environmental liabilities and, as additional information becomes known, our estimates may change significantly. Our estimates of our environmental liabilities do not reflect potential future recoveries from insurance carriers except to the extent that recovery may from time to time be deemed probable as a result of a carrier's agreement to payment terms. In those instances in which our estimated exposure reflects actual or anticipated cost-sharing arrangements with third parties, we do not believe that we will be exposed to additional material liability as a result of non-performance by such third parties. Currently, we are not aware of any material environmental liabilities and have not accrued for any specific environmental remediation costs.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued the following Statements of Financial Accounting Standards: SFAS No. 141, "Business Combinations," which became effective July 1, 2001; SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective January 1, 2002; and SFAS No. 143, "Accounting for Asset Retirement Obligations," which is effective January 1, 2003. In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective January 1, 2002. We believe the adoption of these Statements, when applicable, will not have a material adverse effect on our financial condition or results of operations.

1 RESTRICTED CASH

In June 2001, under the terms of our new bank credit facility, we placed $96.6 million of the proceeds from borrowings under the credit facility into an interest-bearing escrow account. The escrow account's use is restricted to the repayment of our $100 million 6.25% debentures, which mature on March 15, 2002.

2 INVENTORIES

(Dollars in thousands)	2001	2000
Logs, pulpwood, chips and sawdust	$ 19,697	$ 22,108
Lumber and other manufactured wood products	12,903	14,800
Pulp, paper and converted paper products	94,432	125,914
Materials and supplies	57,539	60,384
	$184,571	$223,206
Valued at lower of cost or market:		
Last-in, first-out basis	$ 30,037	$ 34,503
Average cost basis	154,534	188,703
	$184,571	$223,206

If the last-in, first-out inventory had been priced at lower of current average cost or market, the values would have been approximately $30.0 million higher at December 31, 2001, and $23.6 million higher at December 31, 2000.

3 PLANT AND EQUIPMENT

(Dollars in thousands)	2001	2000
Land improvements	$ 72,475	$ 60,912
Buildings and structures	469,886	451,398
Machinery and equipment	2,493,889	2,412,848
Other	103,656	107,179
Construction in progress	34,530	214,247
	$3,174,436	$3,246,584

Depreciation charged against income amounted to $139.5 million in 2001 ($136.5 million in 2000 and $126.7 million in 1999).

Authorized but unexpended appropriations for capital projects totaled $46.4 million at December 31, 2001, all of which is budgeted to be expended in 2002. Historically, we have spent less on capital expenditures than the annual amount budgeted. However, due to the lower level of planned capital expenditures in 2002, we believe it is likely we will spend close to the budgeted amount. The reduction in planned spending reflects our recently completed long-term modernization program.

4 TIMBER, TIMBERLANDS AND RELATED LOGGING FACILITIES

(Dollars in thousands)	2001	2000
Timber and timberlands	$348,287	$286,293
Related logging facilities	47,381	46,956
	$395,668	$333,249

The cost of timber harvested from company-owned lands amounted to $8.9 million in 2001 ($8.3 million in 2000 and $8.8 million in 1999). The cost of permit timber harvested from non-company owned lands amounted to $14.8 million in 2001 ($14.3 million in 2000 and $12.5 million in 1999). Amortization of logging roads and related facilities amounted to $2.4 million in 2001 ($2.1 million in 2000 and $1.7 million in 1999).

5 OTHER ASSETS

(Dollars in thousands)	2001	2000
Pension assets	$ 81,092	$66,151
Other	27,128	12,788
	$108,220	$78,939

6 TAXES ON INCOME

The provision (benefit) for taxes on income is comprised of the following:

(Dollars in thousands)	2001	2000	1999
Current	$ 438	$ 1,517	$ 3,763
Deferred	(51,231)	(22,752)	21,334
Provision (benefit) for taxes on income	$(50,793)	$(21,235)	$25,097

The provision (benefit) for taxes on income differs from the amount computed by applying the statutory federal income tax rate of 35% to earnings before taxes on income due to the following:

(Dollars in thousands)	2001	2000	1999
Computed "expected" tax expense (benefit)	$(45,583)	$(19,057)	$23,115
State and local taxes, net of federal income tax benefits	(5,079)	(2,123)	2,492
Foreign sales corporation	(320)	(548)	(685)
All other items	189	493	175
Provision (benefit) for taxes on income	$(50,793)	$(21,235)	$25,097
Effective tax rate	39.0%	39.0%	38.0%

The tax effects of significant temporary differences creating deferred tax assets and liabilities at December 31 were:

(Dollars in thousands)	2001	2000
Plant and equipment	$(358,766)	$(376,899)
Timber, timberlands and related logging facilities	(50,154)	(25,807)
Postretirement benefits	63,522	59,140
Alternative minimum tax	58,235	58,236
Net operating loss carryforward	92,346	33,334
Employee benefits	19,250	21,275
Pensions	(21,601)	(16,843)
Other, net	12,805	11,972
Net deferred tax liability	(184,363)	(235,592)
Current deferred tax assets[1]	(26,247)	(58,369)
Net noncurrent deferred tax liabilities	$(210,610)	$(293,961)

1 Included in "Prepaid expenses" in the Balance Sheets.

As of December 31, 2001 and 2000, we had $236.8 million and $85.5 million, respectively, of net operating loss carryforwards that will expire in 19 to 20 years.

Our federal income tax returns have been examined and settled for all tax years through 1988. We have filed protective claims for refund associated with settlements reached for the years 1989 through 1992. The years 1993 through 1998 are currently under examination. In the opinion of management, adequate provision had been made at December 31, 2001, for income taxes that might be due as a result of these audits, and any resulting assessments will have no material effect on our consolidated earnings.

7 DEBT

(Dollars in thousands)	2001	2000
Revenue bonds fixed rate 5.9% to 7.5% due 2001 through 2026	$ 136,774	$137,044
Revenue bonds variable rate due 2007 through 2030	99,892	99,879
Debentures 6.25% due 2002	99,996	99,975
Debentures 6.95% due 2015	99,851	99,840
Credit sensitive debentures 9.125% due 2009	100,000	100,000
Medium-term notes fixed rate 8.27% to 9.46% due 2002 through 2022	164,500	165,000
Commercial paper 7.4% to 8.55%	–	100,000
Term loan variable rate due 2002 through 2005	199,000	–
Senior subordinated notes 10% due 2011	250,000	–
Other notes	112	136
	1,150,125	801,874
Less current installments on long-term debt	132,603	325
Long-term debt	$1,017,522	$801,549

The interest rate payable on the 9.125% credit sensitive debentures is subject to adjustment in accordance with the table below if certain changes in the debt rating of the debentures occur. In March 2001, Moody's adjusted its rating on our senior debt to Baa3 and in June 2001, Standard and Poor's (S&P) adjusted its rating to BBB-. Accordingly, the interest rate applied to the credit sensitive debentures increased from 9.125% to 9.425%.

Ratings		
Moody's	S&P	Applicable Rate(%)
Aaa	AAA	8.825
Aa1 – Aa3	AA+ – AA-	8.925
A1 – Baa2	A+ – BBB	9.125
Baa3	BBB-	9.425
Ba1	BB+	12.500
Ba2	BB	13.000
Ba3	BB-	13.500
B1 or lower	B+ or lower	14.000

The commercial paper was backed by our credit agreement in place at December 31, 2000, enabling us to classify up to $100.0 million of short-term borrowings as long-term debt at

December 31, 2000. The remaining balance of commercial paper outstanding at December 31, 2000, totaling $88.9 million, was classified as a portion of current notes payable in the Balance Sheets. At December 31, 2000, the weighted average annual interest rate payable on commercial paper was 7.8%. In April 2001, we replaced our commercial paper with borrowings under the long-term portion of our credit agreement.

In June 2001, we obtained a new credit facility, which provides for aggregate borrowings up to $400.0 million in the form of a four-year term loan in the amount of $200.0 million and a three-year revolving line of credit of up to $200.0 million. Our obligations under the credit facility are secured by approximately 130,000 acres of our timberlands in Arkansas and our accounts receivable and inventory. On December 31, 2001, $199.0 million was outstanding under the four-year term loan and no borrowings were outstanding under the revolving line of credit.

Also in June 2001, we sold $250.0 million of our 10% senior subordinated notes due 2011 in an institutional private placement. The notes are unsecured and are subordinated to our senior notes and our new credit facility.

Both the agreement covering our new credit facility and the indenture governing our senior subordinated notes contain certain covenants that, among other things, restrict our ability and our subsidiaries' ability to create liens, merge or consolidate, dispose of assets, incur indebtedness, pay dividends, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, make capital expenditures or change the nature of our business. The new credit facility also contains financial maintenance covenants. As of December 31, 2001, we obtained a waiver of the fixed charge coverage ratio covenant contained in our bank credit facility. We also obtained an amendment to the fixed charge coverage ratio for the quarters ended March 31, 2002 and June 30, 2002.

We used the gross proceeds from the sale of the senior subordinated notes and initial borrowings under the new credit facility to repay all outstanding indebtedness under our existing credit facilities, pay transaction costs relating to the new credit facility and notes offering, and fund an interest-bearing escrow account, the use of which is restricted to the repayment of our 6.25% debentures due March 15, 2002.

In December 2001, we entered into a fixed-to-variable interest rate swap to hedge a portion of our 10% senior subordinated debentures. The swap has been designated as a fair value hedge and calls for the company to pay a variable interest amount, based on LIBOR rates, and receive a fixed rate payment from a financial institution, calculated on $165.0 million of our 10% senior subordinated debentures. We assume there is no ineffectiveness in the hedge and, accordingly, a fair value increase or decrease in the swap is offset by a corresponding decrease or increase in the value of the underlying debt instrument.

Payments due on long-term debt during each of the five years subsequent to December 31, 2001, are as follows:

(Dollars in thousands)	
2002	$132,603
2003	17,707
2004	98,707
2005	98,708
2006	42,958

8 ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

(Dollars in thousands)	2001	2000
Trade accounts payable	$ 47,772	$ 68,707
Accrued wages, salaries and employee benefits	57,123	54,460
Accrued taxes other than taxes on income	16,324	18,393
Accrued interest	19,710	8,225
Accrued taxes on income	15,233	15,124
Book overdrafts	25,982	28,348
Accrued restructuring and mill closure charges	1,203	23,007
Other	40,502	33,567
	$223,849	$249,831

9 OTHER LONG-TERM OBLIGATIONS

(Dollars in thousands)	2001	2000
Postretirement benefits	$162,877	$151,643
Pension and related liabilities	22,795	21,323
Other	9,586	11,181
	$195,258	$184,147

10 PUT OPTIONS

In December 1999, we implemented a stock repurchase program to repurchase up to 2 million shares of stock. Under the plan purchases of common stock may be made from time to time through open market and privately negotiated transactions at prices deemed appropriate by management, and through our put option program.

In conjunction with the repurchase program, we issued put options which gave the purchaser the right to sell shares of Potlatch stock to us at prices ranging from $31.50 to $42.73 per share on specific dates in 1999, 2000 and 2001. We account for put options using the treasury stock method of accounting. We received premiums upon issuance of put options of $.4 million in 2000 and $1.1 million in 1999. Activity during 2001 and 2000 is summarized as follows:

(Dollars in thousands)	Shares Covered by Put Options	Potential Obligation
Balance, December 31, 1999	250,000	$10,287
Sales	100,000	4,240
Repurchases	(100,000)	(4,074)
Balance, December 31, 2000	250,000	10,453
Repurchases	(250,000)	(10,453)
Balance, December 31, 2001	–	$ –

Our potential obligation of $10.5 million at December 31, 2000, was classified as “Put options” in the Balance Sheets and the related offset was recorded in “Common shares in treasury” under Stockholders’ equity. At December 31, 2001, we did not have any put options outstanding and we do not expect to enter into any additional contracts in the foreseeable future.

11 DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair values of our financial instruments are as follows:

	2001		2000	
(Dollars in thousands)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash, restricted cash and short-term investments	$ 136,476	$ 136,476	$ 11,661	$ 11,661
Current notes payable	–	–	188,943	188,943
Long-term debt	1,150,125	1,160,243	801,874	816,887
Interest rate swaps	1,294	1,294	–	–
Put options	–	–	10,453	10,453

For short-term investments, current notes payable, interest rate swaps and put options, the carrying amount approximates fair value. The fair value of our long-term debt is estimated based upon the quoted market prices for the same or similar debt issues. The amount of long-term debt for which there is no quoted market price is immaterial and the carrying amount approximates fair value.

12 RETIREMENT, SAVINGS AND OTHER POSTRETIREMENT BENEFIT PLANS

Substantially all of our employees are eligible to participate in 401(k) savings plans and are covered by noncontributory defined benefit pension plans. These include both company-sponsored and multi-employer plans. In 2001, 2000 and 1999 we made matching 401(k) contributions on behalf of employees of $8.9 million, $9.8 million and $9.1 million, respectively. We also provide benefits under company-sponsored defined benefit retiree health care and life insurance plans, which cover certain salaried and hourly employees. Most of the retiree health care plans require retiree contributions and contain other cost sharing features. The retiree life insurance plans are primarily noncontributory.

The change in benefit obligation, change in plan assets, funded status and related balance sheet amounts for company-sponsored benefit plans are as follows:

	Pension Benefit Plans		Other Postretirement Benefit Plans	
(Dollars in thousands)	2001	2000	2001	2000
Benefit obligation at beginning of year	$510,763	$ 487,720	$ 172,799	$ 159,671
Service cost	13,178	13,944	3,243	3,360
Interest cost	35,754	34,181	12,942	11,641
Plan amendments	829	8,415	(1,045)	(3,782)
Actuarial losses (gains)	(1,475)	(381)	38,018	9,346
Curtailments	–	–	5,372	(1,858)
Special termination benefits	–	–	317	5,418
Mergers, sales and closures	2,835	(1,216)	–	–
Benefits paid	(34,845)	(31,900)	(12,517)	(10,997)
Benefit obligation at end of year	527,039	510,763	219,129	172,799
Fair value of plan assets at beginning of year	666,906	661,310	35,413	43,970
Actual return on plan assets	(19,458)	36,310	(3,084)	(2,098)
Employer contribution	2,666	1,186	–	–
Benefits paid	(34,845)	(31,900)	(10,131)	(6,459)
Fair value of plan assets at end of year	615,269	666,906	22,198	35,413
Funded status	88,230	156,143	(196,931)	(137,386)
Unrecognized prior service cost	29,347	31,897	(9,254)	(9,168)
Unrecognized net gain	(53,270)	(137,199)	43,308	(5,089)
Unrecognized net transition asset	(75)	(120)	–	–
Prepaid (accrued) benefit cost	$ 64,232	$ 50,721	$(162,877)	$(151,643)

The projected benefit obligation, accumulated benefit obligation and value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were $36.9 million, $33.2 million and $18.7 million, respectively, at December 31, 2001, and $17.9 million, $14.1 million and $0 million, respectively, at December 31, 2000.

Net periodic (benefit) costs were:

	Pension Benefit Plans			Other Postretirement Benefit Plans		
(Dollars in thousands)	2001	2000	1999	2001	2000	1999
Service cost	$ 13,178	$ 13,944	$ 13,870	$ 3,243	$ 3,360	$ 3,486
Interest cost	35,754	34,181	31,921	12,942	11,641	10,894
Expected return on plan assets	(60,453)	(55,553)	(49,334)	(2,847)	(3,691)	(3,621)
Amortization of prior service cost	3,356	3,075	2,477	(833)	(717)	(412)
Recognized actuarial gain	(5,378)	(3,586)	(5)	–	–	–
Recognized net initial asset	(45)	(172)	(374)	–	–	–
Other	–	–	–	–	58	–
Net periodic (benefit) cost	$(13,588)	$ (8,111)	$ (1,445)	$12,505	$10,651	$10,347

The pension benefits presented above exclude a cost of $2.7 million in 2001 for an hourly workforce reduction program and $1.9 million in 2000 for a salaried workforce reduction program and a mill closure, which are included in “Restructuring and other charges” in the Statements of Earnings. The postretirement costs presented above exclude $.5 million in 2001 for an hourly workforce reduction program and $3.9 million in 2000 for a salaried workforce reduction program, which are included in “Restructuring and other charges” in the Statements of Earnings.

Weighted average assumptions as of December 31 were:

	Pension Benefit Plans			Other Postretirement Benefit Plans		
	2001	2000	1999	2001	2000	1999
Discount rate	7.25%	7.25%	7.25%	7.25%	7.25%	7.25%
Expected return on plan assets	9.50	9.50	9.50	9.00	9.00	9.00
Rate of salaried compensation increase	5.00	5.00	5.00	–	–	–

The health care cost trend rate assumption used in determining the accumulated postretirement benefit obligation is 5.25% for 2001. The rate is scheduled for adjustment to 9.00% in 2002 and assumed to decrease 1.00% annually to 6.00% in 2005 and remain at that level thereafter. This assumption has a significant effect on the amounts reported. A one percentage point change in the health care cost trend rates would have the following effects:

(Dollars in thousands)	1% Increase	1% Decrease
Effect on total of service and interest cost components	$ 2,153	$ (1,797)
Effect on postretirement benefit obligation	24,762	(21,036)

Hourly employees at two of our manufacturing facilities participate in a multi-employer defined benefit pension plan, the Paper, Allied-Industrial, Chemical and Energy Workers International Union (PACE) Pension Fund. We also make contributions to a trust fund established to provide retiree medical benefits for these employees, which is managed by PACE. Company contributions to these plans in 2001, 2000 and 1999 amounted to $6.1 million, $5.2 million and $4.7 million, respectively.

13 STOCK COMPENSATION PLANS

We currently have three fixed stock option plans under which options are issued and outstanding. All of these plans have received shareholder approval. Options are granted with an exercise price equal to market value at the grant date and prior to 1995 may have included a stock appreciation right. Options may also be issued in the form of restricted stock and other share-based awards, none of which were outstanding at December 31, 2001. Options are fully exercisable after two years and expire not later than 10 years from the date of grant. We were originally authorized to issue up to 1.5 million, 1.7 million and 1.4 million shares under our 1989 Stock Incentive Plan, 1995 Stock Incentive Plan and 2000 Stock Incentive Plan, respectively. At December 31, 2001, no shares were available for future use under the 1989 Stock Incentive Plan, while approximately 8,000 and 826,000 shares were authorized for future use under the 1995 Stock Incentive Plan and the 2000 Stock Incentive Plan, respectively.

We apply Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for our stock options. Accordingly, no compensation cost has been recognized when options are granted under the plans. Had compensation costs for the plans been determined based on the fair value at the grant dates for option awards under those plans as prescribed by Financial Accounting Standards Board Statement No. 123, our net earnings (loss) and earnings (loss) per share would have been reduced (increased) to the pro forma amounts indicated below:

(Dollars in thousands – except per-share amounts) For the years ended December 31		2001	2000	1999
Net earnings (loss)	as reported	$(79,445)	$(33,214)	$40,947
	pro forma	(81,438)	(35,782)	38,459
Diluted earnings (loss) per share	as reported	$(2.81)	$(1.16)	$1.41
	pro forma	(2.88)	(1.25)	1.33

A summary of the status of our stock options as of December 31, 2001, 2000 and 1999 and changes during those years is presented below:

	2001		2000		1999	
Options	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
Outstanding at January 1	2,664,025	$40.41	2,529,850	$41.97	2,096,600	$41.96
Granted	488,275	28.69	469,575	32.06	541,775	41.39
Shares exercised	(750)	32.63	(18,900)	29.96	(35,650)	35.76
SARs exercised	(4,050)	32.63	(16,400)	30.37	(14,400)	35.72
Canceled or expired	(154,500)	38.08	(300,100)	41.65	(58,475)	41.85
Outstanding at December 31	2,993,000	38.63	2,664,025	40.41	2,529,850	41.97
Options exercisable	2,287,312	41.38	1,984,437	42.29	1,792,425	42.60
Options outstanding which include a stock appreciation right	120,350		142,225		187,875	
Shares reserved for future grants	834,145		1,248,680		1,496,355	
Fair value of options granted during the year	$10.02		$5.77		$9.58	

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants in 2001, 2000 and 1999, respectively: dividend yield of 2.09%, 5.43% and 4.21%; stock volatility of .275, .2707 and .2355; risk free rate of return of 5.28%, 5.21% and 6.28%; and expected term of 10 years for all grants.

The following table summarizes information about stock options outstanding at December 31, 2001:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/01	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Number Exercisable at 12/31/01	Weighted Avg. Exercise Price
$28.68 to $37.75	1,446,025	8.1 years	$32.80	740,337	$35.71
$41.25 to $48.25	1,546,975	5.1 years	44.09	1,546,975	44.09
$28.68 to $48.25	2,993,000	6.6 years	38.63	2,287,312	41.38

14 SEGMENT INFORMATION

We have divided our operations into four reporting segments: Resource, Wood Products, Printing Papers and Pulp and Paper, based upon similarities in product lines, manufacturing processes, marketing and management of our businesses. The Resource segment manages our timberland base and provides wood fiber to the manufacturing segments. The Wood Products segment produces oriented strand board, lumber, plywood and particleboard. The Printing Papers segment produces coated printing papers and pulp. The Pulp and Paper segment produces paperboard, consumer tissue and pulp.

The reporting segments follow the same accounting policies used for our consolidated financial statements and described in the summary of significant accounting policies with the exception of the valuation of inventories. All segment inventories are reported using the average cost method and the LIFO reserve is recorded at the corporate level. Management evaluates a segment's performance based upon profit or loss from operations before income taxes. Intersegment sales or transfers are recorded based on prevailing market prices.

Following is a tabulation of business segment information for each of the past three years. Corporate information is included to reconcile segment data to the consolidated financial statements.

(Dollars in thousands)	2001	2000	1999
Segment Sales:			
Resource	$ 405,810	$ 352,324	$ 337,558
Wood products:			
Oriented strand board	167,182	208,067	246,943
Lumber	270,424	246,129	271,235
Plywood	41,872	51,550	71,924
Particleboard	13,453	19,481	20,126
Other	25,515	27,680	27,416
	518,446	552,907	637,644
Printing papers:			
Printing papers	408,339	449,621	454,734
Pulp	55,707	53,755	–
	464,046	503,376	454,734
Pulp and paper:			
Paperboard	420,588	426,537	410,493
Tissue	317,696	282,625	256,764
Pulp	13,426	20,906	26,152
	751,710	730,068	693,409
	2,140,012	2,138,675	2,123,345
Elimination of intersegment sales	(388,016)	(329,905)	(314,957)
Total consolidated net sales	$1,751,996	$1,808,770	$1,808,388
Intersegment Sales or Transfers:[1]			
Resource	$ 367,737	$ 315,116	$ 298,859
Wood products	17,920	13,311	16,042
Printing papers	2,318	1,428	–
Pulp and paper	41	50	56
Total	$ 388,016	$ 329,905	$ 314,957
Operating Income (Loss):			
Resource	$ 55,337	$ 61,395	$ 68,006
Wood products	(27,390)	(18,283)	83,073
Printing papers	(36,679)	1,530	(13,816)
Pulp and paper	(14,473)	12,929	14,786
Eliminations and adjustments	2,058	1,534	1,590
	(21,147)	59,105	153,639
Corporate Items:			
Administration expense	(35,222)	(25,664)	(38,228)
Interest expense	(77,853)	(59,438)	(45,442)
Other, net	3,984	(28,452)	(3,925)
Consolidated earnings (loss) before taxes on income	$ (130,238)	$ (54,449)	$ 66,044

(Dollars in thousands)	2001	2000	1999
Depreciation, Amortization and Cost of Fee Timber Harvested:			
Resource	$ 26,527	$ 25,260	$ 23,945
Wood products	31,306	27,715	28,785
Printing papers	53,579	52,388	41,999
Pulp and paper	53,745	55,383	54,609
	165,157	160,746	149,338
Corporate	4,231	1,101	915
Total	$ 169,388	$ 161,847	$ 150,253
Assets:			
Resource	$ 434,293	$ 430,583	$ 420,326
Wood products	371,405	310,100	291,263
Printing papers	757,188	820,132	828,828
Pulp and paper	663,909	751,980	731,030
	2,226,795	2,312,795	2,271,447
Corporate	260,351	229,650	175,053
Total consolidated assets	$2,487,146	$2,542,445	$2,446,500
Capital Expenditures:			
Resource	$ 14,132	$ 20,499	$ 17,356
Wood products	15,625	75,259	26,557
Printing papers	7,186	21,831	181,944
Pulp and paper	13,898	48,200	20,850
	50,841	165,789	246,707
Corporate	77	633	944
Total	$ 50,918	$ 166,422	$ 247,651

1 Intersegment sales for 1999-2001, which were based on prevailing market prices, consisted primarily of logs, chips, pulp logs and other fiber sales to the Wood Products, Printing Papers and Pulp and Paper segments.

All of our manufacturing facilities and all other assets are located within the continental United States. However, we sell and ship products to many foreign countries. Geographic information regarding our net sales is summarized as follows:

(Dollars in thousands)	2001	2000	1999
United States	$1,655,160	$1,660,546	$1,681,704
Japan	33,856	52,661	50,741
Australia	4,378	7,245	14,759
Canada	12,962	20,870	16,944
China	9,339	22,594	16,130
Italy	9,202	14,606	13,087
Korea	15,075	12,053	5,751
Other foreign countries	12,024	18,195	9,272
Total consolidated net sales	$1,751,996	$1,808,770	$1,808,388

15 RESTRUCTURING AND OTHER CHARGES

The following is a description of the charges included in the "Restructuring and other charges" line in the Statements of Earnings.

In March 2001, we recorded a $4.2 million pre-tax charge associated with a workforce reduction program at our pulp, paperboard and consumer products operations in Idaho. In September 2001, an additional $.4 million pre-tax charge was recorded as a result of final cost determinations for pension and medical benefits. The program permanently reduced the workforce by 124 hourly production and maintenance positions. As of December 31, 2001, all material costs associated with the program had been incurred.

In 2000, we recorded a $27.9 million pre-tax charge to cover costs associated with a company-wide reduction and reorganization of our salaried production and administrative workforce. In establishing the initial liability, we estimated 261 employees would be terminated. As of December 31, 2001 and 2000, a total of 273 employees had been terminated under the reduction and reorganization program. As of December 31, 2001, $27.0 million had been recorded against the accrued liability associated with the charge. We expect all remaining costs associated with the workforce reduction program to be paid in the first half of 2002.

In September 2000, we recorded an $18.5 million pre-tax charge for costs associated with the closure of our Jaype, Idaho, plywood mill. The closure was deemed necessary due to a combination of poor plywood markets, lack of adequate raw materials and long-term transportation concerns. The amounts of revenues and operating income or loss attributable to the mill were not material in relation to revenues and operating income of the company as a whole. As of December 31, 2000, five salaried and 200 hourly production and maintenance employees had been terminated due to the closure. As of December 31, 2001, a total of five salaried and 207 hourly production and maintenance employees had been terminated due to the closure. The mill was dismantled in 2001, with equipment and parts used at our other facilities or sold to outside bidders. We will continue to operate a log yard at the site. As of December 31, 2001, $16.5 million had been recorded against the accrued liability associated with the charge, which represents all material costs we expect to incur. Our initial estimate of the cost to close the mill included expected costs for some aspects of maintenance and demolition that were not incurred. As a result, in December 2001, we reversed $1.8 million of the liability and recorded it as income.

The following table summarizes the components of the accrued liabilities and the amounts applied against them as of December 31, 2001:

(Dollars in thousands)	Accrued Compensation and Employee Benefits*	Ancillary Site Maintenance	Asset Valuation	Total
Hourly workforce reduction charge	$ 4,570	$ –	$ –	$ 4,570
Cash payments	(1,275)	–	–	(1,275)
Noncash allocations	(3,217)	–	–	(3,217)
	78	–	–	78
Salaried workforce reduction charge	27,909	–	–	27,909
Cash payments	(25,000)	–	–	(25,000)
Noncash allocations	(2,009)	–	–	(2,009)
	900	–	–	900
Mill closure charge	7,825	3,837	6,840	18,502
Cash payments	(4,358)	(1,965)	–	(6,323)
Noncash allocations	(3,852)	–	(6,281)	(10,133)
Reversal of initial charge	416	(1,678)	(559)	(1,821)
	31	194	–	225
	$ 1,009	$ 194	$ –	$ 1,203

*Noncash allocation amounts represent costs incurred for postretirement medical and pension benefits.

16 OTHER EXPENSE, NET

(Dollars in thousands)	2001	2000	1999
Interest income	$ 2,587	$ 223	$ 393
Cross border lease	–	–	4,737
Sale of timber and timberlands	3,933	2,212	3,464
Terminated timber REIT expense	–	–	(7,500)
Beloit Corporation charge	(11,116)	–	–
Other	2,451	(6,295)	(1,601)
	$ (2,145)	$(3,860)	$ (507)

17 FINANCIAL RESULTS BY QUARTER (UNAUDITED)

(Dollars in thousands – except per-share amounts)

	Three Months Ended							
	March 31		June 30		September 30		December 31	
	2001	2000	2001	2000	2001	2000	2001*	2000
Net sales	$444,047	$474,556	$456,448	$462,523	$456,640	$452,017	$394,861	$419,674
Costs and expenses:								
Depreciation, amortization and cost of fee timber harvested	40,872	40,837	41,317	38,829	43,847	41,543	43,352	40,638
Materials, labor and other operating expenses	405,531	382,359	385,022	365,826	372,962	363,630	341,435	356,501
Selling, general and administrative expenses	28,666	33,140	29,615	33,132	30,798	27,370	36,069	29,705
Restructuring and other charges	4,217	–	–	26,000	353	18,502	(1,820)	1,909
	479,286	456,336	455,954	463,787	447,960	451,045	419,036	428,753
Earnings (loss) from operations	$ (35,239)	$ 18,220	$ 494	$ (1,264)	$ 8,680	$ 972	$ (24,175)	$ (9,079)
Net earnings (loss)	$ (31,408)	$ 2,436	$ (9,789)	$ (9,444)	$ (6,551)	$ (10,503)	$ (31,697)	$(15,703)
Net earnings (loss) per common share:								
Basic	$(1.11)	$.08	$(.35)	$(.32)	$(.23)	$(.37)	$(1.12)	$(.55)
Diluted	(1.11)	.08	(.35)	(.32)	(.23)	(.37)	(1.12)	(.55)

*Includes an $11.1 million pre-tax charge related to Beloit Corporation and a $7.6 million pre-tax charge related to the insolvency of a pulp broker.

18 SUBSEQUENT EVENT (UNAUDITED)

On March 18, 2002, we entered into an agreement to sell to a domestic subsidiary of Sappi Limited our Cloquet, Minnesota, pulp and printing paper facilities and related assets for $480 million in cash. We expect the transaction will be completed in the second quarter of 2002, pending regulatory approvals. We will also close our Brainerd, Minnesota, paper mill and exit the coated printing paper business. An after-tax loss of approximately $150 million is anticipated as a result of the sale and the shutdown of the Brainerd facility. The proceeds received will be used primarily to repay a portion of our outstanding debt. The December 31, 2001, carrying amounts of the assets and liabilities expected to be included in the transaction and closure were as follows:

(Dollars in millions)

Assets	
Current assets	$113
Plant and equipment	644
	$757
Liabilities	
Current liabilities	$ 32

THE BOARD OF DIRECTORS:

We have audited the accompanying balance sheets of Potlatch Corporation and consolidated subsidiaries as of December 31, 2001 and 2000 and the related statements of earnings, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2001. 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Potlatch Corporation and consolidated subsidiaries as of December 31, 2001 and 2000 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP
Portland, Oregon
January 25, 2002, except as to Note 18, which is as of March 18, 2002.

ELEVEN-YEAR RECORD

For the years ended December 31 (Dollars in thousands – except per-share amounts)	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991
ELEVEN-YEAR SUMMARY OF CONSOLIDATED OPERATIONS											
Net sales	$1,751,996	$1,808,770	$1,808,388	$1,688,705	$1,693,371	$1,675,756	$1,721,774	$1,546,153	$1,436,236	$1,392,842	$1,302,182
Costs and expenses:											
Depreciation, amortization and cost of fee timber harvested	169,388	161,847	150,253	150,278	149,785	141,521	137,031	138,251	123,544	107,165	96,924
Materials, labor and other operating expenses	1,504,950	1,468,316	1,404,562	1,305,923	1,344,166	1,307,434	1,274,570	1,196,386	1,131,642	1,073,117	1,011,082
Selling, general and administrative expenses	125,148	123,347	141,580	133,297	106,450	104,114	90,569	82,799	83,958	83,409	74,998
Restructuring and other charges	2,750	46,411	–	–	–	–	–	–	–	–	–
	1,802,236	1,799,921	1,696,395	1,589,498	1,600,401	1,553,069	1,502,170	1,417,436	1,339,144	1,263,691	1,183,004
Earnings (loss) from operations	(50,240)	8,849	111,993	99,207	92,970	122,687	219,604	128,717	97,092	129,151	119,178
Interest expense	(77,853)	(59,438)	(45,442)	(49,744)	(46,124)	(43,869)	(47,976)	(51,137)	(46,230)	(34,902)	(28,882)
Other income (expense), net	(2,145)	(3,860)	(507)	8,712	7,789	7,508	(689)	(1,619)	14,142	30,365	(5,101)
Earnings (loss) before taxes on income, cumulative effect of accounting changes and extraordinary item	(130,238)	(54,449)	66,044	58,175	54,635	86,326	170,939	75,961	65,004	124,614	85,195
Provision (benefit) for taxes on income	(50,793)	(21,235)	25,097	20,943	18,576	24,792	62,393	26,966	26,665	45,700	29,393
Tax rate	39.0%	39.0%	38.0%	36.0%	34.0%	28.7%	36.5%	35.5%	41.0%	36.7%	34.5%
Net earnings (loss) before cumulative effect of accounting changes and extraordinary item	(79,445)	(33,214)	40,947	37,232	36,059	61,534	108,546	48,995	38,339	78,914	55,802
Cumulative effect of accounting changes, net of tax	–	–	–	–	–	–	–	–	(50,292)	–	–
Extraordinary item, net of tax	–	–	–	–	–	(3,445)	–	–	–	–	–
Net earnings (loss)	$ (79,445)	$ (33,214)	$ 40,947	$ 37,232	$ 36,059	$ 58,089	$ 108,546	$ 48,995	$ (11,953)	$ 78,914	$ 55,802
FINANCIAL RETURNS											
Percent return on beginning of the year common stockholders' equity[1]	(9.8)%	(3.6)%	4.4%	3.9%	3.8%	6.2%	12.0%	5.4%	4.0%	8.6%	6.2%
Percent return on net sales[1]	(4.5)%	(1.8)%	2.3%	2.2%	2.1%	3.5%	6.3%	3.2%	2.7%	5.7%	4.3%
PER COMMON SHARE											
Basic net earnings (loss)[1]	$ (2.81)	$ (1.16)	$ 1.41	$ 1.28	$ 1.25	$ 2.01	$ 3.72	$ 1.68	$ 1.31	$ 2.71	$ 1.92
Net cash provided by operations	$ 3.01	$ 3.29	$ 7.07	$ 7.50	$ 5.35	$ 7.78	$ 8.49	$ 6.26	$ 5.90	$ 5.04	$ 4.92
Cash dividends	$ 1.17	$ 1.74	$ 1.74	$ 1.74	$ 1.71	$ 1.67	$ 1.615	$ 1.57	$ 1.515	$ 1.425	$ 1.34
Common stockholders' equity at year end	$ 24.98	$ 28.69	$ 31.79	$ 32.19	$ 32.82	$ 33.06	$ 32.59	$ 30.85	$ 30.86	$ 32.79	$ 31.51
COMMON SHARES (IN THOUSANDS)											
Average shares outstanding	28,282	28,523	28,947	29,000	28,930	28,888	29,157	29,217	29,184	29,110	29,012
Outstanding at year end, net of treasury stock	28,311	28,346	28,972	28,919	28,995	28,866	28,962	29,224	29,199	29,144	29,033
APPROXIMATE NUMBER OF COMMON STOCKHOLDERS AT YEAR END	2,900	3,100	3,200	3,400	3,600	3,700	3,300	3,500	3,600	3,600	3,800
PRICE RANGE OF COMMON STOCK											
High	$ 36.22	$ 44.88	$ 45.50	$ 48.38	$ 52.75	$ 44.88	$ 44.13	$ 49.50	$ 51.88	$ 50.00	$ 47.00
Low	$ 24.90	$ 28.56	$ 32.50	$ 31.00	$ 39.00	$ 35.13	$ 37.13	$ 35.50	$ 38.25	$ 36.75	$ 27.75
EMPLOYMENT											
Approximate number of employees at year end	6,300	6,500	7,000	6,800	6,700	6,700	6,600	6,700	7,000	7,000	7,400
Wages, salaries and cost of employee benefits	$ 434,269	$ 459,951	$ 465,730	$ 437,601	$ 417,422	$ 410,052	$ 405,016	$ 391,160	$ 389,597	$ 376,537	$ 356,796
SELECTED PRODUCTION STATISTICS (IN THOUSANDS)											
Oriented strand board (square feet, 3/8" basis)	1,134,000	1,096,000	1,101,000	1,077,000	977,000	1,017,000	1,063,000	1,080,000	1,078,000	1,066,000	964,000
Lumber, domestic (board feet, dry)	711,000	638,000	608,000	577,000	534,000	491,000	441,000	408,000	420,000	406,000	324,000
Plywood, domestic (square feet, 3/8" basis)	141,000	172,000	222,000	191,000	254,000	240,000	289,000	298,000	312,000	331,000	310,000
Particleboard (square feet, 3/4" basis)	67,000	69,000	70,000	69,000	67,000	63,000	67,000	67,000	64,000	68,000	65,000
Printing papers (tons)	352	367	375	359	372	354	344	341	322	317	305
Pulp (air-dry tons)	1,115	1,080	925	953	899	878	873	816	811	845	870
Paperboard (tons)	596	593	596	620	614	575	582	549	545	563	562
Tissue paper (tons)	175	169	162	154	150	143	144	135	131	86	85

1 The 1993 return on equity, return on sales and loss per share after accounting changes were (1.2)%, (.8)% and $(.41), respectively.

ELEVEN-YEAR RECORD

At December 31
(Dollars in thousands)

	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991
ELEVEN-YEAR SUMMARY OF CONSOLIDATED FINANCIAL POSITION											
Current assets	$ 511,668	$ 483,839	$ 416,502	$ 407,855	$ 403,777	$ 378,111	$ 477,249	$ 371,318	$ 327,153	$ 331,845	$ 317,718
Current liabilities	356,452	439,099	364,746	310,299	297,556	260,145	349,183	228,590	198,015	178,308	192,528
Working capital	155,216	44,740	51,756	97,556	106,221	117,966	128,066	142,728	129,138	153,537	125,190
Capital assets, at cost:											
Plant and equipment, net	1,462,548	1,637,374	1,616,055	1,504,522	1,493,417	1,465,682	1,356,020	1,313,939	1,340,028	1,311,946	1,246,403
Timber, timberlands and logging facilities, net	395,668	333,249	335,194	338,617	342,503	349,466	352,321	346,199	343,044	279,669	271,906
Unexpended revenue bond funds	–	–	–	335	814	2,625	23,545	–	1,395	55	2,430
Other noncurrent assets, net	117,262	87,983	78,749	125,977	124,625	69,795	56,176	49,773	74,032	92,232	70,174
Total net assets	$2,130,694	$2,103,346	$2,081,754	$2,067,007	$2,067,580	$2,005,534	$1,916,128	$1,852,639	$1,887,637	$1,837,439	$1,716,103
CAPITALIZATION											
Long-term debt (noncurrent portion)	$1,017,522	$ 801,549	$ 701,798	$ 712,113	$ 722,080	$ 672,048	$ 616,132	$ 633,473	$ 707,131	$ 634,209	$ 563,014
Other long-term obligations	195,258	184,147	172,986	163,453	155,336	148,092	145,022	147,877	120,388	22,299	20,280
Deferred taxes	210,610	293,961	275,644	253,691	236,934	223,441	198,823	169,670	159,042	225,350	218,059
Put options	–	10,453	10,287	6,844	1,638	7,758	12,247	–	–	–	–
Stockholders' equity	707,304	813,236	921,039	930,906	951,592	954,195	943,904	901,619	901,076	955,581	914,750
Total capitalization	$2,130,694	$2,103,346	$2,081,754	$2,067,007	$2,067,580	$2,005,534	$1,916,128	$1,852,639	$1,887,637	$1,837,439	$1,716,103

For the years ended December 31
(Dollars in thousands)

	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991
ELEVEN-YEAR SUMMARY OF CONSOLIDATED FUNDS FLOW											
SOURCE OF FUNDS											
Net earnings (loss)	$ (79,445)	$ (33,214)	$ 40,947	$ 37,232	$ 36,059	$ 58,089	$ 108,546	$ 48,995	$ (11,953)	$ 78,914	$ 55,802
Depreciation, amortization and cost of fee timber harvested	169,388	161,847	150,253	150,278	149,785	141,521	137,031	138,251	123,544	107,165	96,924
Deferred taxes	(83,351)	18,317	21,953	16,757	13,493	24,618	29,153	10,628	18,069	7,291	3,903
Proceeds from long-term debt	450,000	100,000	99,935	–	50,000	197,543	124,785	–	79,525	75,124	175,020
Issuance of treasury stock	5,627	861	1,250	550	2,985	722	193	542	1,181	2,366	1,316
Decrease (increase) in investments of unexpended revenue bond funds	–	–	335	479	1,811	20,920	(23,545)	1,395	(1,340)	2,375	10,269
Total source of funds	462,219	247,811	314,673	205,296	254,133	443,413	376,163	199,811	209,026	273,235	343,234
APPLICATION OF FUNDS											
Dividends	33,108	49,698	50,362	50,472	49,462	48,254	47,096	45,870	44,214	41,476	38,869
Additions to plant and properties	50,918	166,422	247,651	147,027	158,485	239,908	170,654	104,389	201,655	179,539	267,038
Reduction of long-term debt	234,027	249	110,250	9,967	–	141,627	142,126	73,658	6,603	3,929	3,898
Purchase of treasury stock	10,453	25,892	–	3,261	–	5,042	11,285	–	–	–	–
Increase (decrease) in investments	2,428	3,143	(49,174)	25	50,004	48	773	(33,557)	(18,828)	9,911	10,534
Increase (decrease) in working capital other than cash and short-term investments	(14,339)	(6,987)	(39,418)	(11,195)	(14,971)	87,738	(69,009)	(14,983)	(19,312)	34,354	7,502
Other, net	20,809	9,423	1,384	3,209	7,927	18,634	18,891	(4,139)	(219)	12,575	(4,920)
Total application of funds	337,404	247,840	321,055	202,766	250,907	541,251	321,816	171,238	214,113	281,784	322,921
Increase (decrease) in funds	$ 124,815	$ (29)	$ (6,382)	$ 2,530	$ 3,226	$ (97,838)	$ 54,347	$ 28,573	$ (5,087)	$ (8,549)	$ 20,313

DIRECTORS

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San Francisco, California

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Retired President and Chief Operating Officer
SAFECO Corporation
Seattle, Washington

VIVIAN W. PIASECKI (1)
Retired Member
Board of Overseers
School of Nursing and Penn Nursing Network
University of Pennsylvania
Philadelphia, Pennsylvania

GREGORY L. QUESNEL (2)(4)
President and Chief Executive Officer
CNF, Inc.
Palo Alto, California

TONI REMBE (3)(4)
Partner
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San Francisco, California

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Genie Industries, Inc.
Redmond, Washington

JUDITH M. RUNSTAD (2)(4)
Of counsel,
Foster Pepper & Shefelman PLLC
Seattle, Washington

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Chairman of the Board and Chief Executive Officer

FREDERICK T. WEYERHAEUSER (2)(4)
Retired Chairman of the Board and Treasurer
Clearwater Investment Trust
Saint Paul, Minnesota

DR. WILLIAM T. WEYERHAEUSER (2)(3)
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Columbia Banking System, Inc;
Chairman
Eden Bioscience Corp;
Clinical Psychologist
Tacoma, Washington

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2. Executive Compensation and Personnel Policies Committee
3. Finance Committee
4. Nominating and Corporate Governance Committee

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Chairman of the Board and Chief Executive Officer
Age 59/With company 22 years

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President and Chief Operating Officer
Age 60/With company 41 years

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Vice President
Tax
Age 56/With company 24 years

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Vice President
Minnesota Pulp and Paper Division
Age 42/With company 16 years

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Vice President, Marketing/Service
Minnesota Pulp and Paper
Age 38/With company 16 years

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Controller
Age 53/With company 27 years

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Vice President and General Counsel
Age 61/With company 22 years

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Vice President, Marketing and Sales
Consumer Products
Age 49/With company 24 years

BARBARA M. FAILING
Vice President
Human Resources
Age 58/With company 28 years

JOHN E. HANBY
Vice President
Technology
Age 60/With company 7 years

JOHN D. HANSON
Vice President, Sales
Minnesota Pulp and Paper
Age 40/With company 17 years

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Vice President
Wood Products Division
Age 54/With company 26 years

MICHAEL L. LAPPA
Vice President
Sales and Marketing
Paperboard
Age 52/With company 1 year

CRAIG H. NELSON
Vice President
Consumer Products and Paperboard Division
Age 45/With company 22 years

DAVID J. OHMS
Vice President
Management Information Systems
Age 50/With company 23 years

JOHN R. OLSON
Vice President
Resource Management Division
Age 53/With company 23 years

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Corporate Secretary
Age 36/With company 11 years

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Assistant Treasurer
Age 42/With company 18 years

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Vice President
Public Affairs
Age 62/With company 25 years

MICHAEL S. URSO
Vice President, Marketing
Wood Products
Age 44/With company 1 year

GERALD L. ZUEHLKE
Vice President
Finance, Chief Financial Officer and Treasurer
Age 53/With company 30 years

*Ages and years of service with company calculated as of March 1, 2002.