

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

This discussion should be read in conjunction with the consolidated financial statements and notes thereto of Walter Industries, Inc. and subsidiaries, particularly Note 1 of "Notes to Consolidated Financial Statements" on pages 34 and 35, which presents an unaudited pro forma consolidated statement of operations for the year ended May 31, 1995 to illustrate the estimated effects of the Consensual Plan and related financings as if they had occurred as of June 1, 1994, and Note 15 of "Notes to Consolidated Financial Statements" on pages 49 and 50, which presents sales and operating income by operating group.

RESULTS OF OPERATIONS

Years Ended May 31, 1997 and 1996

Net sales and revenues for the year ended May 31, 1997 were \$21.4 million, or 1.4%, above the prior year with a 2.8% increase in pricing and/or product mix partially offset by a 1.4% decrease in volume. The decrease in volume was principally the result of lower coal shipments, reflecting reduced production levels. In addition, continued delays in federal spending for planned water and sewer pipeline projects resulted in lower ductile iron pressure pipe shipments. The increase in pricing primarily resulted from higher average net selling prices for homes, ductile iron pressure pipe and coal.

Homebuilding and Financing Group sales and revenues were \$27.7 million, or 6.7%, greater than the prior year. This performance reflects a 12.3% increase in the average net selling price per home sold, from \$42,300 in 1996 to \$47,500 in 1997, combined with a 3.7% increase in the number of homes sold, from 3,760 units in 1996 to 3,900 units in 1997. The higher average net selling price reflects a greater percentage of "90% complete" homes sold in the current year and price increases instituted to compensate for higher building material and labor costs. The increase in unit sales reflects the decision by Jim Walter Homes in December 1995 to reduce its financing rate from 10% to 8.5% for its "90% complete" homes on a trial basis to generate additional unit sales. In March 1996, the lower rate was formally advertised. Jim Walter Homes extended the 8.5% financing rate to the remainder of its product line ("shell" and homes sold at various "in-between" stages of interior finish) in the fourth quarter of 1997.

Jim Walter Homes' backlog at May 31, 1997 was 1,972 units (all of which are expected to be completed prior to the end of fiscal 1998) compared to 1,957 units at May 31, 1996. Time charge income (revenues received from Mid-State Homes' instalment note portfolio) increased slightly from \$231.1 million in 1996 to \$231.4 million in 1997. This increase is attributable to increased payoffs received in advance of maturity and to an increase in the average balance per account in the portfolio, partially offset by a reduction in the total number of accounts. Operating income of \$81.7 million (net of interest expense) was \$18.3 million greater than the prior year. This performance resulted from increases in the average net selling price and number of homes sold, lower interest expense in 1997 (\$119.0 million) as compared to 1996 (\$128.2 million), lower goodwill amortization in 1997 (\$28.5 million) versus 1996 (\$31.2 million), and slightly higher time charge income and homebuilding gross profit margins, partially offset by higher selling, general and administrative expenses principally resulting from changes to the base salary and commission structure at Jim Walter Homes.

Industrial Products Group sales and revenues were \$12.6 million, or 4.4%, greater than the prior year. Increased sales volumes of aluminum foil and sheet products, slag wool, furnace coke, window components and metal building products, combined with improved sales prices for furnace and foundry coke, window components and metal building and foundry products, were partially offset by lower sales volumes of foundry coke and lower sales prices for aluminum foil and sheet products. The group's operating income in 1997 was \$21.4 million, compared to an operating loss of \$10.4 million in 1996. The improved performance was the result of the overall sales increases and higher gross profit margins realized on furnace and foundry coke, slag wool, aluminum foil and sheet products, window components and metal building and foundry products. Results for 1996 were adversely impacted by a \$22.9 million write-off of goodwill, reflecting the Company's adoption of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("FASB 121") (see Note 5 of "Notes to Consolidated Financial Statements").

Water Transmission Products Group sales and revenues

declined slightly in 1997. The group's performance reflected lower sales volumes, but higher selling prices for ductile iron pressure pipe and fittings and higher selling prices and sales volumes for valves and hydrants. The order backlog at May 31, 1997 was 108,341 tons, which represents approximately three months shipments, compared with 121,734 tons at May 31, 1996. Operating income of \$14.0 million was \$3.5 million above the prior year. This increase was principally due to improved operating efficiencies and lower raw material costs, especially for scrap iron, the principal raw material used in the manufacture of ductile iron pressure pipe.

Natural Resources Group sales and revenues were \$17.9 million, or 4.9%, below the prior year. The decrease resulted from lower coal shipments due to reduced production levels, a \$3.7 million gain (in 1996) from the sale of gas royalty interests in certain mineral properties, lower gains realized from the sale of excess real estate in 1997 (\$2.5 million) versus 1996 (\$6.1 million) and lower coal and timber royalty income, partially offset by higher average selling prices for coal and methane gas and greater methane gas volume. A total of 6.95 million tons of coal was sold in 1997 versus 7.61 million tons in 1996, an 8.7% decrease reflecting lower shipments to certain export customers, partially offset by increased tonnage sold to Alabama Power Company ("Alabama Power"). The average price per ton of coal sold increased \$1.64 from \$42.85 in 1996 to \$44.49 in 1997 as a result of higher prices realized in the worldwide metallurgical market and a greater percentage of tonnage sold to Alabama Power at above-market contract prices. Methane gas sales volumes were 7.6 billion cubic feet in 1997 versus 6.8 billion cubic feet in 1996. The average selling price per thousand cubic feet, which included a monthly reservation fee of \$675,000, was \$3.75 in 1997 versus \$3.32 in 1996. The group's operating income in 1997 was \$27.6 million compared to an operating loss of \$105.9 million in 1996. Coal production costs of \$36.73 per ton in 1997 were slightly higher than 1996 costs of \$36.12 per ton. Operating income of \$27.6 million in 1997 includes settlement of a legal claim related to a theft of coal inventory from the Port of Mobile, Alabama, partially offset by a charge relating to a reduction in Jim Walter Resources' salaried workforce under a voluntary early retirement program. The operating loss of \$105.9 million in 1996 included a \$120.4 million FASB 121 write-down of fixed assets to estimated fair market values at two coal mines (see Note 5 of "Notes to Consolidated

Financial Statements") and firefighting and idle plant costs of \$16 million, principally associated with a fire at Blue Creek Mine No. 5 ("Mine No. 5") in November 1995. From December 1995 through March 1997, Mine No. 5 accelerated development of its eastern reserves. While in development, the mine's costs (\$40.7 million) were capitalized.

As a result of a previous fire that began in Mine No. 5 on November 17, 1993, the Company and Jim Walter Resources claimed compensable losses in the amount of \$25 million under their business interruption coverage. When the insurers refused to pay their pro rata portion of the claim, the Company and Jim Walter Resources commenced litigation seeking to enforce such insurance. The Company has entered into settlement with several insurers who, in the aggregate, have paid approximately \$12.4 million to date, reducing the contract claims to approximately \$12.6 million. The Company and Jim Walter Resources continue to pursue litigation against the remaining carriers, and a trial is tentatively scheduled for October 1997. (See Note 12 of "Notes to Consolidated Financial Statements").

Cost of sales, exclusive of depreciation, of \$980.2 million was 78.4% of net sales in 1997 versus \$987.4 million and 80.9% in 1996. Cost of sales in 1996 was adversely impacted by firefighting and idle plant costs associated with the Mine No. 5 fire. In addition, 1997 costs were favorably affected by decreases in the cost of scrap iron, the major raw material used in the manufacture of ductile iron pressure pipe.

Selling, general and administrative expenses of \$144.7 million were 9.6% of net sales and revenues in 1997 versus \$135.8 million and 9.1% in 1996. The increases principally reflect higher expenses at Jim Walter Homes and Jim Walter Resources as previously discussed.

Interest and amortization of debt expense was \$179.3 million in 1997 versus \$208.7 million in 1996, reflecting lower outstanding debt balances and reduced interest rates resulting from a debt refinancing completed on January 22, 1996. The average rate of interest in 1997 was 8.1% compared to 9.1% in 1996. The prime interest rate ranged from 8.25% to 8.5% in 1997 compared to a range of 8.25% to 9.0% in 1996.

The Company's effective tax rate in 1997 and 1996 differed from the statutory tax rate due to amortization of goodwill and the FASB 121 write-off of goodwill of \$22.9 million (in 1996), which are not deductible for tax purposes, and percentage depletion. Also, in the

fiscal 1996 fourth quarter, the Company recorded approximately \$27 million of non-recurring tax benefits resulting from utilization of a capital loss carry forward, the Company's election to carry its 1995 net operating loss forward rather than back to prior years (thereby avoiding the effect of a rate difference and loss of certain tax credits), and other miscellaneous tax adjustments. (See Note 9 of "Notes to Consolidated Financial Statements" for further discussion of income taxes.)

Net income for the year ended May 31, 1997 was \$37.1 million compared to a net loss of \$84.7 million in 1996, reflecting all of the previously mentioned factors as well as the impact of lower postretirement health benefits in 1997. The loss in fiscal 1996 includes an extraordinary loss of \$8.3 million (\$5.4 million net of income tax benefit) consisting of a redemption premium and write-off of deferred financing costs resulting from the debt refinancing completed in January 1996.

Years Ended May 31, 1996 and Pro Forma 1995

Net sales and revenues for the year ended May 31, 1996 were \$50.9 million, or 3.6%, ahead of the prior year with a 3.0% increase in pricing and/or product mix and a 0.6% increase in volume. This increase was the result of improved sales and revenues in all operating groups.

Homebuilding and Financing Group sales and revenues were \$5.9 million, or 1.5%, ahead of the prior year. This performance reflects a 5.2% increase in the average net selling price per home sold, from \$40,200 in 1995 to \$42,300 in 1996, partially offset by an 8.9% decrease in the number of homes sold, from 4,126 units in 1995 to 3,760 units in 1996. The higher average net selling price reflects a greater percentage of "90% complete" homes sold in the current year and a price increase instituted February 1, 1995 to compensate for higher building material costs. The decrease in unit sales resulted from extremely competitive conditions in virtually every Jim Walter Homes sales region. The relatively low mortgage interest rate environment and higher availability of mortgage financing for home buyers adversely affected Jim Walter Homes' sales volumes. In an effort to generate additional unit sales, Jim Walter Homes in December 1995 reduced its financing rate from 10% to 8.5% for its "90% complete" homes on a trial basis and, in March 1996, began formally advertising the lower rate. Jim Walter Homes'

backlog at May 31, 1996 was 1,957 units compared to 1,529 units at May 31, 1995, a 28% increase. Time charge income (revenues received from Mid-State Homes' instalment note portfolio) increased from \$222.2 million in 1995 to \$231.1 million in 1996 due to increased payoffs received in advance of maturity and an increase in the average balance per account, partially offset by a reduction in the total number of accounts. Operating income of \$63.4 million (net of interest expense) was \$18.4 million greater than the prior year. This performance reflected higher time charge income and improved homebuilding gross profit margins (resulting from a higher average net selling price per home sold and lower lumber costs) and lower interest expense in 1996 (\$128.2 million) as compared to that incurred in 1995 (\$131.6 million), partially offset by the lower number of homes sold.

Water Transmission Products Group sales and revenues were \$8.5 million, or 2.1%, ahead of the prior year. The increase was the result of higher sales prices, partially offset by reduced volumes for ductile iron pressure pipe, fittings and castings. Sales volumes were negatively impacted by severe winter weather conditions and delays in federal funding for planned water and sewer pipeline projects. The order backlog at May 31, 1996 was 121,734 tons compared with 121,548 tons at May 31, 1995. Operating income of \$10.5 million was \$2.4 million below the prior year. The lower performance resulted from the lower sales volumes and higher raw material costs, especially for scrap iron and alloys which are major raw material components, partially offset by higher sales prices.

Natural Resources Group sales and revenues exceeded the prior year by \$30.8 million, or 9.3%. The increase resulted from greater sales volumes for coal and methane gas, a higher average selling price for coal, higher outside gas and timber royalty income and a \$3.7 million gain (in 1996) from the sale of gas royalty interests in certain mineral properties. Gains from sales of certain excess real estate were \$6.1 million in each year. A total of 7.61 million tons of coal was sold in 1996 versus 7.20 million tons in 1995, a 5.7% increase resulting from greater shipments to certain export customers, partially offset by lower shipments to Alabama Power and Japanese steel mills. The average price per ton of coal sold increased \$1.51, from \$41.34 in 1995 to \$42.85 in 1996, due to higher prices realized in the worldwide metallurgical market and to Alabama Power. Mine No. 5 was shut down from November 17,

1993 through December 16, 1993 and from early April 1994 until May 16, 1994 as a result of a fire due to spontaneous combustion heatings. Representatives of Jim Walter Resources, the Mine Safety and Health Administration, Alabama State Mine Inspectors and the United Mine Workers of America agreed that the long-wall coal panel being mined in Mine No. 5 at the time the fire recurred in April 1994 would be abandoned and sealed off. Development mining for the two remaining longwall coal panels in this section of the mine resumed on May 16, 1994 and mining on the first longwall panel resumed on January 17, 1995.

Production was adversely impacted until such date. As a result of the fire, the Company and Jim Walter Resources claimed compensable losses in the amount of \$25 million under their business interruption insurance coverage. When the insurers refused to pay their pro rata portion of the claim, the Company commenced litigation seeking to enforce such insurance. The insurers issued policies insuring various percentages of the risk. The Company has entered into settlements with several insurers who, in the aggregate, paid approximately \$11.7 million through May 31, 1996, reducing the contract claims in the lawsuit to \$12.7 million. The Company and Jim Walter Resources continue to pursue litigation against the remaining carriers, and a trial is tentatively scheduled for October 1997. (See Note 12 of "Notes to Consolidated Financial Statements"). In November 1995, Mine No. 5 experienced another fire due to the unexpected recurrence of spontaneous combustion heatings and the mine was shut down. Efforts to contain and extinguish this fire were successful; however, conditions dictated that the mine be shut down for several weeks. The affected coal panels on the western side of the mine were then sealed off and development work on the eastern side of the Mine was ongoing from December 1995 through May 1996. Such development work was completed in March 1997. Jim Walter Resources' three other mines remained in full production during 1996 and 1995. The group incurred an operating loss of \$105.9 million in 1996 as compared to operating income of \$22.3 million in 1995. The lower performance reflects a \$120.4 million FASB 121 write-down of fixed assets to estimated fair market values at two coal mines (see Note 5 of "Notes to Consolidated Financial Statements") and firefighting and idle plant costs of \$16 million, principally associated with the fire at Mine No. 5. These factors were partially offset by increased sales volumes of coal and methane gas, a higher average sales price for coal,

higher gas and timber royalty income, the \$3.7 million gain (in 1996) from the sale of certain gas royalty interests and slightly lower costs per ton of coal produced (\$36.12 in 1996 versus \$37.13 in 1995).

Industrial Products Group sales and revenues were \$6.0 million, or 2.1%, greater than the prior year. Increased selling prices for furnace and foundry coke, aluminum foil products, window components and metal building and foundry products combined with greater sales volumes of furnace and foundry coke, resin-coated sand and patterns and tooling were partially offset by lower aluminum sheet products selling prices and volumes and reduced sales volumes of window components and metal building and foundry products. The group's operating loss in 1996 was \$10.4 million compared to operating income of \$6.6 million in 1995. This performance reflects a \$22.9 million FASB 121 write-off of excess of purchase price over net assets acquired (goodwill) (see Note 5 of "Notes to Consolidated Financial Statements") lower window components sales volume, higher raw material costs and reduced efficiencies due to prolonged start-up problems associated with the consolidation and relocation of JW Window Components' Hialeah, Florida and Columbus, Ohio operations to Elizabethton, Tennessee. These decreases were partially offset by increased margins realized on aluminum sheet and foil products, furnace coke and resin-coated sand.

Cost of sales, exclusive of depreciation, of \$987.4 million was 80.9% of net sales in 1996 versus \$951.4 million and 80.5% in 1995. The cost of sales increase was primarily the result of lower gross profit margins for pipe products, window components, patterns, tooling and metal building and foundry products, combined with firefighting and idle plant costs principally associated with the fire at Mine No. 5. These increases were partially offset by improved profit margins on home sales, aluminum foil and sheet products, furnace coke and resin-coated sand.

Selling, general and administrative expenses of \$135.8 million were 9.1% of net sales and revenues in 1996 versus \$130.6 million and 9.1% in 1995.

Interest and amortization of debt expense was \$208.7 million in 1996 versus \$223.2 million, on a pro forma basis in 1995, reflecting lower outstanding debt balances and reduced interest rates resulting from the debt refinancing completed on January 22, 1996. The average rate of interest in 1996 was 9.1% as compared

to 9.8%, on a pro forma basis in 1995. The prime interest rate ranged from 8.25% to 9.0% in 1996 compared to a range of 7.25% to 9.0% in 1995.

The Company's effective tax rate in 1996 and, on a pro forma basis, in 1995 differed from the statutory tax rate due to amortization of goodwill and the FASB 121 write-off of goodwill of \$22.9 million (in 1996) which are not deductible for tax purposes. In addition, in the fiscal 1996 fourth quarter, the Company recorded approximately \$27 million of non-recurring tax benefits resulting from utilization of a capital loss carry forward, the Company's election to carry forward its net operating loss (thereby avoiding the effect of a rate difference and loss of certain tax credits), and other miscellaneous tax adjustments (see Note 9 of "Notes to Consolidated Financial Statements" for further discussion of income taxes).

On January 22, 1996, the Company completed a \$550 million financing with a syndicate of banks led by NationsBank National Association (South). The financing consisted of a \$365 million revolving credit facility, a six-year \$125 million term loan and a \$60 million seven-year term loan (collectively, the "Credit Facilities"). Proceeds from the financing, together with \$75 million drawn under the Mid-State Trust V Variable Funding Loan Agreement, were used to redeem in full the \$490 million aggregate amount of 12.19% Series B Senior Notes due 2000 (the "Senior Notes") at a redemption price of 101% of the principal amount thereof plus accrued and unpaid interest thereon to the date of redemption and to replace an existing \$150 million bank credit facility, both of which were incurred as a result of the Company's emergence from bankruptcy in March 1995. The Company recorded an extraordinary loss of \$8.3 million (\$5.4 million net of income tax benefit) consisting of a redemption premium and write-off of unamortized debt expense related to the early repayment of the Senior Notes and the \$150 million bank credit facility (see Note 8 of "Notes to Consolidated Financial Statements").

The net loss for the year ended May 31, 1996 was \$84.7 million compared to a net loss of \$38.3 million, on a pro forma basis, in 1995 reflecting all of the previously mentioned factors as well as the impact of higher postretirement health benefits in 1996.

FINANCIAL CONDITION

On March 17, 1995, the Company and its subsidiaries emerged from bankruptcy pursuant to the Consensual Plan. Despite the confirmation and effectiveness of the Consensual Plan, the Bankruptcy Court continues to have jurisdiction over the resolution of disputed prepetition claims against the Company and other matters that may arise in connection with or related to the Consensual Plan.

A substantial controversy exists with regard to federal income taxes allegedly owed by the Company. Proofs of claim have been filed by the Internal Revenue Service for taxes, interest and penalties in the amount of \$110,560,883 with respect to fiscal years ended August 31, 1980 and August 31, 1983 through August 31, 1987; \$31,468,189 with respect to fiscal years ended May 31, 1988 (nine months) and May 31, 1989; and \$44,837,693 with respect to fiscal years ended May 31, 1990 and May 31, 1991. These proofs of claim represent total adjustments to taxable income of approximately \$360 million for all tax periods at issue.

Objections to the proofs of claim have been filed by the Company and the various issues are being litigated in the Bankruptcy Court. Included in the proofs of claim is an adjustment to taxable income disallowing a deduction of approximately \$51 million for hedging losses incurred during fiscal 1988. This issue was conceded by the Internal Revenue Service pursuant to a joint stipulation of parties approved by the Bankruptcy Court by an order dated January 3, 1997. The Company believes that the balance of such proofs of claim are substantially without merit and intends to vigorously defend such claims against the Company, but there can be no assurance as to the ultimate outcome.

Since May 31, 1996, total debt has decreased \$145.7 million resulting from early repayments on the Revolving Credit Facility (\$89.0 million), quarterly principal payments on Term Loan A and Term Loan B (\$16.0 million), scheduled payments of Mid-State Trust II Mortgage-Backed Notes (\$87.0 million), scheduled payments of Mid-State Trust III Asset-Backed Notes (\$30.7 million), scheduled payments of Mid-State Trust IV Asset-Backed Notes (\$61.1 million) and scheduled retirements of other long-term debt (\$0.9 million), partially offset by borrowings under the Mid-State Trust V Variable Funding Loan Agreement (\$139.0 million).

The Credit Facilities contain a \$365 million revolving credit facility which includes a sub-facility for trade and

other standby letters of credit up to \$75 million at any time outstanding and a sub-facility for swingline advances not to exceed/limited to \$15 million at any time outstanding. At May 31, 1997, \$40.0 million of letters of credit were outstanding under this facility.

The Credit Facilities contain a number of significant covenants that, among other things, restrict the ability of the Company and its subsidiaries to dispose of assets, incur additional indebtedness, pay dividends, create liens on assets, enter into leases, make investments or acquisitions, engage in mergers or consolidations or engage in certain transactions with subsidiaries and affiliates and otherwise restricts corporate activities (including change of control and asset sale transactions). In addition, under the Credit Facilities, the Company is required to maintain specified financial ratios and comply with certain financial tests, including interest coverage ratios, fixed charge coverage ratios and maximum leverage ratios, some of which become

more restrictive over time. The Company was in compliance with these covenants at May 31, 1997 and believes it will meet these financial tests over the remaining terms of these debt agreements.

The Trust V Variable Funding Loan Agreement's covenants, among other things, restrict the ability of Trust V to dispose of assets, create liens and engage in mergers or consolidations. The Company was in compliance with these covenants at May 31, 1997.

LIQUIDITY AND CAPITAL RESOURCES

At May 31, 1997, cash and cash equivalents, net of bank overdrafts, were approximately \$10.3 million. Operating cash flows for the year ended May 31, 1997, together with issuance of long-term debt under the Revolving Credit Facility and the Mid-State Trust V Variable Funding Loan Agreement, were primarily used for working capital requirements, retirement of long-term senior debt, interest payments and capital expenditures.

Working capital is required to fund adequate levels of inventories and accounts receivable. Commitments for capital expenditures at May 31, 1997 are not material; however, it is estimated that gross capital expenditures for the Company and its subsidiaries for the year ending May 31, 1998 will approximate \$105 million.

Because the Company's operating cash flow is significantly influenced by the general economy and, in particular, the level of construction, prior years' results should not necessarily be used to predict the Company's liquidity, capital expenditures, investment in instalment notes receivable or results of operations. The Company believes that the Mid-State Trust V Variable Funding Loan Agreement will provide Mid-State Homes with the funds needed to purchase the instalment notes and mortgages generated by Jim Walter Homes. On June 11, 1997, Mid-State purchased from Mid-State Trust V mortgage instalment notes having a gross amount of \$1,196.5 million and an economic balance of \$462.3 million and subsequently sold such mortgage instalment notes to Mid-State Trust VI ("Trust VI"), a business trust organized by Mid-State which owns all of the beneficial

interest in Trust VI. These sales were in exchange for the net proceeds from the public issuance by Trust VI of \$439.2 million of Trust VI Asset-Backed Notes. The notes were issued in four classes, bear interest at rates ranging from 7.34% to 7.79% and have a final maturity of July 1, 2035. Payments will be made quarterly on January 1, April 1, July 1, and October 1 based on collections on the underlying collateral less amounts paid for interest on the notes and Trust VI expenses. Net proceeds from the public offering were used primarily to pay down the Mid-State Trust V Variable Funding Loan Agreement indebtedness of \$384.0 million. It is anticipated that one or more permanent financings similar to Mid-State Trust VI will be required over the next several years to repay borrowings under the Mid-State Trust V Variable Funding Loan Agreement. The Company believes that, under present operating conditions, sufficient operating cash flow will be generated to make all required interest and principal payments, planned capital expenditures and meet substantially all operating needs. It is further expected that amounts available under the Credit Facilities will be sufficient to meet peak operating needs of the Company.

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

TO THE BOARD OF DIRECTORS
AND STOCKHOLDERS
WALTER INDUSTRIES, INC.

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations and of cash flows present fairly, in all material respects, the financial position of Walter Industries, Inc. and its subsidiaries at May 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended May 31, 1997 in conformity with generally accepted accounting principles. 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 of these statements in accordance with generally accepted auditing standards which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

Price Waterhouse LLP

Price Waterhouse LLP

Tampa, Florida

July 10, 1997

CONSOLIDATED BALANCE SHEET

	May 31,	
	1997	1996
	(in thousands)	
ASSETS		
Cash and cash equivalents (Notes 3 and 14)	\$ 35,782	\$ 32,543
Short-term investments, restricted (Notes 3 and 14)	195,371	175,432
Marketable securities (Notes 3 and 14)	41,222	49,338
Instalment notes receivable (Notes 4, 8 and 14)	4,256,845	4,208,252
Less - Provision for possible losses	(26,394)	(26,138)
Unearned time charges	(2,896,517)	(2,851,961)
Net	1,333,934	1,330,153
Trade receivables	170,236	178,847
Less - Provision for possible losses	(8,225)	(8,180)
Net	162,011	170,667
Other notes and accounts receivable	20,880	21,055
Inventories, at lower of cost (first in, first out or average) or market		
Finished goods	117,949	124,456
Goods in process	32,291	32,798
Raw materials and supplies	52,066	51,674
Houses held for resale	3,068	2,517
Total inventories	205,374	211,445
Prepaid expenses	11,862	11,937
Property, plant and equipment, at cost (Notes 5 and 6)	978,006	888,991
Less - Accumulated depreciation, depletion and amortization	(409,830)	(347,455)
Net	568,176	541,536
Investments	5,112	6,646
Deferred income taxes (Note 9)	109,023	155,171
Unamortized debt expense (Note 8)	22,793	29,548
Other assets (Note 13)	41,671	44,971
Excess of purchase price over net assets acquired (Notes 1, 5 and 7)	274,174	310,935
	<u>\$ 3,027,385</u>	<u>\$ 3,091,377</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Bank overdrafts (Note 3)	\$ 25,523	\$ 28,194
Accounts payable	86,418	74,330
Accrued expenses	131,768	120,477
Income taxes payable (Note 9)	58,884	56,238
Long-term senior debt (Notes 4, 8 and 14):		
Mortgage-backed/asset-backed notes	1,752,125	1,791,946
Other senior debt	313,450	419,350
Accrued interest	23,220	28,819
Accumulated postretirement health benefits obligation (Note 13)	268,959	247,827
Other long-term liabilities (Note 13)	47,626	47,502
Stockholders' equity (Notes 1, 10 and 11):		
Common stock, \$.01 par value per share:		
Authorized - 200,000,000 shares		
Issued - 55,063,412 shares and 54,868,335 shares	551	549
Capital in excess of par value	1,164,261	1,159,332
Retained earnings (deficit)	(840,744)	(877,861)
Excess of additional pension liability over unrecognized prior years service cost	(4,656)	(5,326)
Total stockholders' equity	319,412	276,694
	<u>\$ 3,027,385</u>	<u>\$ 3,091,377</u>

CONSOLIDATED STATEMENT OF OPERATIONS

	For the years ended May 31,		
	1997	1996	1995
	(in thousands except per share amounts)		
Sales and revenues:			
Net sales	\$ 1,251,022	\$ 1,220,397	\$ 1,181,635
Time charges (Note 4)	231,388	231,104	222,221
Miscellaneous	24,651	34,134	30,838
Interest income from Chapter 11 proceedings (Note 1)	—	—	7,628
	<u>1,507,061</u>	<u>1,485,635</u>	<u>1,442,322</u>
Cost and expenses:			
Cost of sales	980,235	987,354	951,381
Depreciation, depletion and amortization (Note 6)	71,814	74,341	72,037
Selling, general and administrative	144,703	135,840	130,616
Postretirement health benefits (Note 13)	22,710	27,129	25,961
Provision for possible losses	3,340	4,367	4,485
Chapter 11 costs (Note 1)	—	—	442,362
Interest and amortization of debt discount and expense (Notes 1 and 8)	179,291	208,690	304,548
Amortization of excess of purchase price over net assets acquired (Note 7)	34,870	39,096	40,027
Long-lived asset impairment (Note 5)	—	143,265	—
	<u>1,436,963</u>	<u>1,620,082</u>	<u>1,971,417</u>
	70,098	(134,447)	(529,095)
Income tax benefit (expense) (Note 9):			
Current	(8,244)	(621)	80,754
Deferred	(24,737)	55,776	89,696
Income (loss) before extraordinary item	<u>37,117</u>	<u>(79,292)</u>	<u>(358,645)</u>
Extraordinary item - loss on debt repayment (net of income tax benefit of \$2,910) (Note 8)	—	(5,404)	—
	<u>37,117</u>	<u>(84,696)</u>	<u>(358,645)</u>
Net income (loss)	<u>\$ 37,117</u>	<u>\$ (84,696)</u>	<u>\$ (358,645)</u>
Net income (loss) per share (Note 10):			
Income (loss) before extraordinary item	\$.67	\$ (1.56)	\$ (7.10)
Extraordinary item	—	(.10)	—
Net income (loss)	<u>\$.67</u>	<u>\$ (1.66)</u>	<u>\$ (7.10)</u>

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
OPERATIONS			
Income (loss) before extraordinary item	\$ 37,117	\$ (79,292)	\$ (358,645)
Charges to income not affecting cash:			
Settlement of Chapter 11 claims with debt and new common stock	—	—	444,752
Depreciation, depletion and amortization	71,814	74,341	72,037
Provision for deferred income taxes	24,737	(55,776)	(89,696)
Accumulated postretirement health benefits obligation (Note 13)	21,132	19,416	18,449
Provision for other long-term liabilities	1,336	(4,034)	294
Amortization of excess of purchase price over net assets acquired (Note 7)	34,870	39,096	40,027
Amortization of debt discount and expense	6,914	7,250	11,783
Long-lived asset impairment (Note 5)	—	143,265	—
	<u>197,920</u>	<u>144,266</u>	<u>139,001</u>
Decrease (increase) in:			
Short-term investments, restricted (Notes 3 and 14)	(19,939)	(47,430)	(20,450)
Marketable securities (Notes 3 and 14)	8,116	20,534	92,168
Instalment notes receivable, net (a)	(3,781)	30,875	(1,849)
Trade and other receivables, net	8,831	(8,900)	(44,009)
Federal income tax receivable	—	99,875	(99,875)
Inventories	6,071	(15,008)	(23,858)
Prepaid expenses	75	757	(1,359)
Deferred income taxes (Note 9)	21,411	(79,941)	—
Increase (decrease) in:			
Bank overdrafts (Note 3)	(2,671)	(5,552)	3,867
Accounts payable	14,850	(7,361)	28,925
Accrued expenses	11,937	7,054	28,242
Income taxes payable (Note 9)	2,646	2,977	(15,348)
Accrued interest	(5,599)	(9,033)	24,156
Cash flows from operations	<u>239,867</u>	<u>133,113</u>	<u>109,611</u>
FINANCING ACTIVITIES			
Issuance of long-term senior debt (Notes 4, 8 and 14)	159,000	680,000	974,450
Additions to unamortized debt expense	(159)	(6,045)	(17,153)
Extraordinary item-loss on debt repayment	—	(5,404)	—
Charge to income not affecting cash:			
Write off of unamortized debt expense	—	3,414	—
Provision for deferred income tax	—	(2,910)	—
Retirement of long-term senior debt (Notes 4, 8 and 14)	(304,721)	(689,074)	(120,250)
Disposition of liabilities subject to Chapter 11 proceedings	3,427	(63,932)	(604,044)(b)
Payment of accrued postpetition interest on Chapter 11 secured debt obligations	—	—	(244,334)
Fractional share payments	(13)	(8)	—
Cash flows used in financing activities	<u>(142,466)</u>	<u>(83,959)</u>	<u>(11,331)</u>
INVESTING ACTIVITIES			
Additions to property, plant and equipment, net of normal retirements	(98,454)	(73,485)	(76,966)
Decrease (increase) in investments and other assets	4,292	(1,261)	(4,442)
Cash flows used in investing activities	<u>(94,162)</u>	<u>(74,746)</u>	<u>(81,408)</u>
Net increase (decrease) in cash and cash equivalents	3,239	(25,592)	16,872
Cash and cash equivalents at beginning of year (Notes 3 and 14)	32,543	58,135	41,263
Cash and cash equivalents at end of year (Notes 3 and 14)	<u>\$ 35,782</u>	<u>\$ 32,543</u>	<u>\$ 58,135</u>

(a) Consists of sales and resales, net of repossessions and provision for possible losses, of \$173,418,000, \$148,749,000 and \$155,236,000 and cash collections on account and payouts in advance of maturity of \$169,637,000, \$179,624,000 and \$153,387,000, for the years ended May 31, 1997, 1996 and 1995, respectively.

(b) In addition, \$490 million of Series B Senior Notes and 44,050,974 shares of new common B stock were issued to satisfy a portion of the allowed claims of holders of secured and subordinated debt, settle a portion of the asbestos-related veil-piercing claims and 6,443,339 shares of new common stock were issued to the former shareholders in cancellation of their original holdings.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – RECENT HISTORY

Walter Industries, Inc. (the “Company”) was organized in 1987 for the purpose of acquiring Jim Walter Corporation (“Original Jim Walter”). The Company’s financial statements reflect the allocation of the purchase price of Original Jim Walter based upon the fair value of the assets acquired and the liabilities assumed. On December 27, 1989, the Company and most of its subsidiaries each filed a voluntary petition for reorganization under Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court for the Middle District of Florida, Tampa Division (the “Bankruptcy Court”). The Company emerged from

bankruptcy on March 17, 1995 (the “Effective Date”) pursuant to the Amended Joint Plan of Reorganization dated as of December 9, 1994, as modified on March 1, 1995 (as so modified the “Consensual Plan”). Despite the confirmation and effectiveness of the Consensual Plan, the Bankruptcy Court continues to have jurisdiction over, among other things, the resolution of disputed prepetition claims against the Company and other matters that may arise in connection with or relate to the Consensual Plan. The following unaudited pro forma consolidated statement of operations for fiscal 1995 was prepared to illustrate the estimated effects of the Consensual Plan and related financings as if they had occurred as of June 1, 1994.

PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

	For the year ended May 31, 1995		
	As Reported	Adjustments	Pro Forma
	(in thousands except per share amount)		
Sales and revenues:			
Net sales	\$ 1,181,635		\$ 1,181,635
Time charges	222,221		222,221
Miscellaneous	30,838		30,838
Interest income from Chapter 11 proceedings	7,628	\$ (7,628) ⁽¹⁾	—
	<u>1,442,322</u>	<u>(7,628)</u>	<u>1,434,694</u>
Cost and expenses:			
Cost of sales	951,381		951,381
Depreciation, depletion and amortization	72,037		72,037
Selling, general and administrative	130,616		130,616
Postretirement health benefits	25,961		25,961
Provision for possible losses	4,485		4,485
Chapter 11 costs	442,362	(442,362) ⁽²⁾	—
Interest and amortization of debt discount and expense	304,548	(81,364) ⁽³⁾	223,184
Amortization of excess of purchase price over net assets acquired	40,027		40,027
	<u>1,971,417</u>	<u>(523,726)</u>	<u>1,447,691</u>
	<u>(529,095)</u>	<u>516,098</u>	<u>(12,997)</u>
Income tax benefit (expense)	<u>170,450</u>	<u>(195,730)⁽⁴⁾</u>	<u>(25,280)</u>
Net income (loss)	<u>\$ (358,645)</u>	<u>\$ 320,368</u>	<u>\$ (38,277)</u>
Net loss per share			<u>\$ (.75)⁽⁵⁾</u>
Weighted average shares outstanding			50,988,626

Changes from the historical financial statement in the pro forma consolidated statement of operations consist of the following adjustments:

- (1) Interest income from Chapter 11 proceedings of \$7,628,000, which would not have been realized assuming the Consensual Plan became effective June 1, 1994, has been eliminated.
- (2) Chapter 11 costs of \$442,362,000, which would not have been incurred assuming the Consensual Plan became effective June 1, 1994, have been eliminated.
- (3) Interest and amortization of debt discount and expense has been reduced \$81,364,000 to give retroactive effect as if all indebtedness to be repaid pursuant to the Consensual Plan was so done as of June 1, 1994 and the \$490 million of Series B Senior Notes had been outstanding for the full year ended May 31, 1995. Borrowings under the Trust IV Asset-Backed Notes were assumed to increase during the period June 1, 1994 through November 30, 1994 proportionately with the comparable period increase in the outstanding economic balance of the instalment notes sold by Mid-State to Trust IV on March 16, 1995. Borrowings under the Trust V Variable Funding Loan Agreement were based on 78% of Jim Walter Homes' credit sales during the six-month period December 1, 1994 through May 31, 1995. This time period is subsequent to the Trust IV cut-off date for purchases of instalment notes from Mid-State. No working capital borrowings were assumed under the bank credit facility. Pro forma interest expense, however, includes letter of credit fees and unused working capital commitment fees.
- (4) The provision for income taxes has been adjusted at the applicable statutory rates to give effect to the pro forma adjustments described above.
- (5) Net loss per share has been computed based on the weighted average number of common shares outstanding (including 494,313 additional shares of common stock issued six months after the Effective Date of the Consensual Plan, but not including 3,880,140 additional shares which have been issued to an escrow account and would be anti-dilutive).

NOTE 2 - PRINCIPLES OF CONSOLIDATION

The Company, through its direct and indirect subsidiaries, currently offers a diversified line of products and services for homebuilding, water and waste water transmission, coal mining and related degasification, residential and non-residential construction, and industrial markets. The consolidated financial statements include the accounts of the Company and all of its subsidiaries. Preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Actual results could differ from those estimates. All significant intercompany balances have been eliminated. In addition, certain reclassifications have been made in the accompanying consolidated financial statements in order to conform with the fiscal 1997 presentation.

NOTE 3 - CASH AND CASH EQUIVALENTS, RESTRICTED SHORT-TERM INVESTMENTS AND MARKETABLE SECURITIES

Cash and cash equivalents include short-term deposits and highly liquid investments which have original maturities of three months or less and are stated at cost which approximates market. The Company's cash management system provides for the reimbursement of all major bank disbursement accounts on a daily basis. Checks issued but not yet presented to the banks for payment are classified as bank overdrafts.

Restricted short-term investments include (i) temporary investment of reserve funds and collections on instalment notes receivable owned by Mid-State Trusts II, III, IV and V (\$101,467,000) which are available only to pay expenses of the Trusts and principal and interest on indebtedness of the Trusts, (ii) certain funds held by Trust II that are in excess of the amount required to be paid for expenses, principal and interest on the Trust II Mortgage-Backed Notes but which are subject to retention (\$79,706,000) and (iii) miscellaneous other segregated accounts restricted to specific uses (\$14,198,000).

Investments with original maturities greater than three months are classified as marketable securities. In accordance with Statement of Financial Accounting Standards No. 115 - "Accounting for Certain Investments in Debt and Equity Securities," the Company's marketable securities are classified as avail-

able for sale and are carried at estimated fair values.

NOTE 4 – INSTALMENT NOTES RECEIVABLE

The instalment notes receivable arise from sales of partially finished homes to customers for time payments primarily over periods of twelve to thirty years and are secured by first mortgages or similar security instruments. The credit terms offered by Jim Walter Homes, Inc. (“Jim Walter Homes”) are usually for 100% of the purchase price of the home and the instalment notes receivable currently carry either an 8.5% or 10% annual percentage rate, without points or closing costs. Revenue and income from the sale of homes is included in income upon completion of construction and legal transfer to the customer. The buyer’s ownership of the land and the improvements necessary to complete the home constitute a significant equity investment to which the Company has access should the buyer default on payment of the instalment note obligation. Of the gross amount of \$4,256,845,000 an amount of \$3,967,340,000 is due after one year. Instalment payments estimated to be receivable within each of the five years from May 31, 1997 are \$289,505,000, \$284,802,000, \$277,990,000, \$270,327,000 and \$262,932,000, respectively, and \$2,871,289,000 after five years. Of the gross amount of instalment notes receivable of \$4,256,845,000, 19%, 12% and 11% are secured by homes located in the states of Texas, Mississippi and Florida, respectively. Time charges are included in equal parts in each monthly payment and are taken into income as collected. This method approximates the interest method since a much larger provision for loan losses and other expenses would be required if time charge income were accelerated. The aggregate amount of instalment notes receivable having at least one payment 90 or more days delinquent was 2.78% and 3.14% of total instalment notes receivable at May 31, 1997 and 1996, respectively.

Mid-State Homes, Inc. (“Mid-State”) purchases instalment notes from Jim Walter Homes on homes constructed and sold by Jim Walter Homes and services such instalment mortgage notes. Mid-State Trust II (“Trust II”), Mid-State Trust III (“Trust III”) and Mid-State Trust IV (“Trust IV”) are business trusts organized by Mid-State, which owns all of the beneficial interest in Trust III and Trust IV. Trust IV owns all of the beneficial interest in Trust II. The Trusts were organized for the purpose of purchasing instalment notes receivable from Mid-State with the net proceeds from the issuance

of the Trust II Mortgage-Backed Notes, the Trust III Asset-Backed Notes and the Trust IV Asset-Backed Notes. The assets of Trust II, Trust III and Trust IV, including the instalment notes receivable, are not available to satisfy claims of general creditors of the Company and its subsidiaries. The liabilities of Trusts II, III and IV for their publicly issued debt are to be satisfied solely from the proceeds of the underlying instalment notes and are non-recourse to the Company and its subsidiaries. The gross amount of instalment notes receivable at May 31, 1997 was \$4,256,845,000 and had an economic balance of \$2,019,581,000. The economic balance of an account is the present value of the future scheduled monthly payments due on the account. Such present value is calculated by discounting the remaining future scheduled monthly payments on an account by the effective financing rate. The effective financing rate is determined by calculating the discount rate which, when applied in a present value calculation, results in the present value of all originally scheduled monthly payments on such account being equal to the original amount financed. In effect, the economic balance of an account is the amount of principal that can be amortized by the instalment payments due over the remaining term of the account at the effective financing rate. Instalment notes receivable owned by Trust II had a gross book value of \$966,072,000 and an economic balance of \$609,227,000; receivables owned by Trust III had a gross book value of \$364,872,000 and an economic balance of \$195,535,000; and receivables owned by Trust IV had a gross book value of \$1,612,880,000 and an economic balance of \$704,532,000. Mid-State Trust V (“Trust V”), a business trust in which Mid-State holds all the beneficial interest, was organized to hold instalment notes receivable as collateral for borrowings to provide temporary financing to Mid-State for its current purchases of instalment notes and mortgages from Jim Walter Homes. At May 31, 1997, receivables owned by Trust V had a gross book value of \$1,310,206,000 and an economic balance of \$509,059,000 (see Note 8). Instalment notes receivable not pledged to the trusts had a gross book value of \$2,815,000 and an economic balance of \$1,228,000.

NOTE 5 – LONG-LIVED ASSET IMPAIRMENT

In March 1995, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 121 — “Accounting for the Impairment

of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of " ("FASB 121") which became effective for fiscal years beginning after December 15, 1995 (fiscal year 1997 for the Company). The Company elected to adopt FASB 121 during the third quarter of fiscal 1996 as a result of significant adverse changes in the results of operations during fiscal 1996, principally in the Natural Resources business segment. A fire which resulted from the unexpected recurrence of spontaneous combustion heatings at Jim Walter Resources' Mine No. 5 at the end of the fiscal second quarter, as well as various geological problems at the three other coal mines during portions of the year, led to the conclusion that there was an impairment of fixed assets within the Natural Resources segment.

After performing a review for asset impairment at each of the Company's business segments and applying the principles of measurement contained in FASB 121, the Company recorded a charge against earnings in 1996 of \$143,265,000 before tax (\$101,125,000 after tax). The charge included a \$120,400,000 pre-tax (\$78,260,000 after tax) write-down of fixed assets at two coal mines in the Natural Resources segment to their estimated fair market values. Fair market values were based principally on expected future discounted cash flows. In addition, a \$22,865,000 write-off of excess of purchase price over net assets acquired was recorded in the Industrial Products segment, substantially all of which was at JW Window Components, Inc. Adoption of this standard had no impact on cash flow.

NOTE 6 – PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are summarized as follows (see Note 5):

	May 31,	
	1997	1996
	(in thousands)	
Land and minerals	\$150,667	\$150,708
Land improvements	20,476	18,143
Buildings and leasehold improvements	106,004	98,452
Mine development costs	80,363	47,930
Machinery and equipment	597,357	548,562
Construction in progress	23,139	25,196
Total	<u>\$978,006</u>	<u>\$888,991</u>

The Company provides depreciation for financial reporting purposes principally on the straight line method over the useful lives of the assets. Assets (primarily mine development costs) extending for the full life of a coal mine are depreciated on the unit of production basis. For federal income tax purposes, accelerated methods are used for substantially all eligible properties. The depreciable property categories and the principal rates for depreciation used are as follows:

Land improvements	3.5% to 10%
Buildings	2% to 20%
Leasehold improvements	Over term of leases
Mine development costs	Over life of mines
Machinery and equipment	3.5% to 33.3%

Depletion of minerals is provided based on estimated recoverable quantities.

The Company has capitalized interest on qualifying properties in accordance with Statement of Financial Accounting Standards No. 34. Interest capitalized for the years ended May 31, 1997, 1996 and 1995 was immaterial.

Rental expense for all operating leases was \$12.0 million, \$11.0 million and \$10.0 million for the fiscal years ended May 31, 1997, 1996 and 1995, respectively. Future minimum payments under noncancelable operating leases at May 31, 1997 are: 1998, \$11.3 million; 1999, \$7.8 million; 2000, \$6.7 million; 2001, \$6.6 million; and 2002, \$5.4 million.

NOTE 7 – EXCESS OF PURCHASE PRICE OVER NET ASSETS ACQUIRED

The excess of purchase price over net assets acquired in connection with the acquisition of Original Jim Walter is being amortized over periods ranging up to twenty years. The Company evaluates, on a regular basis, whether events or circumstances have occurred that indicate the carrying amount of goodwill may warrant revision or may not be recoverable. The Company measures impairment of goodwill based upon estimated future undiscounted cash flows from operations of the related business unit (see Note 5). At May 31, 1997, the accumulated amortization of goodwill was approximately \$478.1 million. At May 31, 1997, the net unamortized balance of goodwill is not considered to be impaired.

NOTE 8 – DEBT

Long-term debt, in accordance with its contractual terms, consisted of the following at each year end:

	May 31,	
	1997	1996
	(in thousands)	
Senior debt:		
Walter Industries, Inc.		
Revolving Credit Facility	\$ 146,000	\$ 235,000
Term Loan A	106,250	121,250
Term Loan B	58,750	59,750
Other	2,450	3,350
	<u>313,450</u>	<u>419,350</u>
Mid-State Trusts		
Trust II Mortgage-Backed		
Notes	410,000	497,000
Trust III Asset-Backed Notes	116,934	147,669
Trust IV Asset-Backed Notes	841,191	902,277
Trust V Variable Funding		
Loan	384,000	245,000
	<u>1,752,125</u>	<u>1,791,946</u>
Total	<u>\$2,065,575</u>	<u>\$2,211,296</u>

Interest paid in cash for the years ended May 31, 1997, 1996 and 1995 was \$179,749,000, \$220,959,000 and \$437,357,000, respectively.

On January 22, 1996, the Company completed a \$550 million financing with a syndicate of banks led by NationsBank National Association (South). The financing consisted of a \$365 million revolving credit facility ("Revolving Credit Facility"), a \$125 million six-year term loan ("Term Loan A") and a \$60 million seven-year term loan ("Term Loan B") (collectively, the "Credit Facilities"). Proceeds from the financing, together with \$75 million drawn under the Trust V Variable Funding Loan Agreement, were used to redeem in full \$490 million aggregate amount of Series B Senior Notes Due 2000 (the "Senior Notes") at a redemption price of 101% of the principal amount thereof plus accrued and unpaid interest thereon to the date of redemption and to replace the existing \$150 million bank credit facility, both issued in connection with the Company's emergence from bankruptcy in March 1995. The Company recorded an extraordinary loss of \$8,314,000 (\$5,404,000 net of income tax benefit) consisting of a redemption premium and the write-off of unamortized debt expense related to the early repayment of the Senior Notes and the \$150 million bank credit facility.

The Credit Facilities are secured by a pledge of inter-company notes and stock of certain subsidiaries of the Company. Net cash proceeds from certain asset sales must be applied to permanently reduce the Credit Facilities and, beginning with fiscal year ending May 31, 1997, 50% of the excess cash flow (as defined in the Credit Facilities) must be used to permanently reduce Term Loan A and Term Loan B.

The Revolving Credit Facility is a six-year, non-amortizing facility which includes a sub-facility for trade and other standby letters of credit in an amount up to \$75 million at any time outstanding and a sub-facility for swingline advances in an amount not in excess of \$15 million at any time outstanding. Interest, at the option of the Company, is at (i) the greater of (a) the Prime Rate or (b) the Federal Funds Effective Rate plus .50%, or (ii) a LIBOR rate plus an Applicable Margin of .75% to 1.75% (based upon a leverage ratio pricing grid). At May 31, 1997, the weighted average interest rate was 7.73%. A commitment fee ranging from .25% to .50% per annum (based upon a leverage ratio pricing grid) is payable on the daily average unutilized commitment. The fee for outstanding letters of credit is priced at the Applicable Margin less .375%. At May 31, 1997, there were no swingline borrowings outstanding under this facility; however, letters of credit in the aggregate face amount of \$39,967,000 have been issued thereunder.

Term Loan A interest, at the option of the Company is at (i) the greater of (a) the Prime Rate or (b) the Federal Funds Effective Rate plus .50%, or (ii) a LIBOR rate plus .75% to 1.75% (based upon a leverage ratio pricing grid). Scheduled principal payments to be made in each of the five years from May 31, 1997 are \$16,250,000, \$21,250,000, \$25,000,000, \$25,000,000 and \$18,750,000, respectively. At May 31, 1997, the weighted average interest rate was 6.87%.

Term Loan B interest is at LIBOR plus 2% to 2.25% (based upon a leverage ratio pricing grid). At May 31, 1997, the interest rate was 7.88%. Scheduled principal payments in each of the five years from May 31, 1997 are \$1,000,000, \$1,000,000, \$1,000,000, \$1,000,000 and \$11,750,000, respectively.

The Trust II Mortgage-Backed Notes (see Note 4) were issued in five classes in varying principal amounts. Three of the classes have been fully repaid. The two remaining classes, A3 and A4, bear interest at the rates of 9.35% and 9.625%, respectively. Interest on each class of notes is payable quarterly on each January 1, April 1, July 1 and October 1 (each a "Payment Date").

On each Payment Date, regular scheduled principal payments will be made on the Class A3 and Class A4 Notes in order of maturity. Maturities of the balance of these Mortgage-Backed Notes range from April 1, 1998 for the Class A3 Notes to April 1, 2003 for the Class A4 Notes. The Class A3 and Class A4 Notes are subject to special principal payments and the Class A4 Notes may be subject to optional redemption under specified circumstances. The scheduled principal amount of notes maturing in each of the five years from May 31, 1997 is \$87,000,000, \$64,600,000, \$64,600,000, \$64,600,000 and \$64,600,000, respectively.

The Trust III Asset-Backed Notes (see Note 4) bear interest at 7.625%, constitute a single class and have a final maturity date of April 1, 2022. Payments are made quarterly on January 1, April 1, July 1 and October 1, based on collections on the underlying collateral less amounts paid for interest on the notes and Trust III expenses.

The Trust IV Asset-Backed Notes (see Note 4) bear interest at 8.33%, constitute a single class and have a final maturity of April 1, 2030. Payments are made quarterly on January 1, April 1, July 1 and October 1 based on collections on the underlying collateral and distributions from Trust II, less amounts paid for interest on the notes and Trust IV expenses.

On March 3, 1995, Trust V entered into the three-year \$500 million Variable Funding Loan Agreement with Enterprise Funding Corporation, an affiliate of NationsBank National Association, as lender, and NationsBank National Association (Carolinas) as Administrative Agent. It is contemplated that this facility will be an evergreen three-year facility with periodic paydowns from the proceeds of permanent financings similar to those done by Trusts II, III and IV. The facility currently matures on March 3, 2000. Accordingly, the \$384 million of borrowings outstanding at May 31, 1997 has been classified as long-term debt. Interest is based on the cost of A-1 and P-1 rated commercial paper plus .50%. The commitment fee on the unused portion of the facility is .20%

On June 11, 1997, Mid-State purchased from Mid-State Trust V mortgage instalment notes having a gross amount of \$1,196,479,000 and an economic balance of \$462,287,000 and subsequently sold such mortgage instalment notes to Mid-State Trust VI ("Trust VI"), a business trust organized by Mid-State which owns all of the beneficial interest in Trust VI. These sales were in

exchange for the net proceeds from the public issuance by Trust VI of \$439,150,000 of Trust VI Asset-Backed Notes. The notes were issued in four classes, bear interest at rates ranging from 7.34% to 7.79% and have a final maturity of July 1, 2035. Payments will be made quarterly on January 1, April 1, July 1 and October 1 based on collections on the underlying collateral, less amounts paid for interest on the notes and Trust VI expenses. Net proceeds from the public offering were used primarily to pay down the Trust V indebtedness of \$384,000,000.

The Company has traditionally used interest rate swaps as hedge instruments to manage interest rate risks. The Company has two types of interest rate risks: (i) current risk on interest rates related to debt which has floating rates and (ii) risk of interest and proceeds in refinancing from short-term to long-term certain indebtedness secured by the fixed rate instalment notes receivable generated by its homebuilding business. At May 31, 1997, Trust V had in place a swap agreement with a notional amount of \$360 million under which it pays a fixed interest rate of 5.25% and receives interest based on commercial paper rates. This swap was in effect until June 30, 1997, it accreted monthly and was designed to offset the interest rate risk of the Trust V Variable Funding Loan Agreement. Also at May 31, 1997, Trust V had in place forward swaps totaling \$150 million notional amount which were to start June 30, 1997 and run for 10 years at a blended monthly fixed rate of 7.25%. At that time, Trust V was to receive interest based on prevailing commercial paper rate levels. On May 15, 1997, in order to offset refinancing risk, Trust V entered into a rate swap agreement with a notional amount of \$250 million under which Trust V was to pay a fixed rate of 6.62%. This transaction had a termination date of June 13, 1997. With the creation of Trust VI on June 11, 1997, all swap agreements were terminated. Since interest rates have declined over the past year, Trust VI coupon levels were below those originally expected. This lower level of interest cost served to mitigate the losses incurred (\$8.6 million) on the swap agreements at termination. These losses will be deferred and amortized over the life of Trust VI.

The Credit Facilities contain a number of significant covenants that, among other things, restrict the ability of the Company and its subsidiaries to dispose of assets, incur additional indebtedness, pay dividends, create liens on assets, enter into leases, make investments or acquisitions, engage in mergers or consolidations, or

engage in certain transactions with subsidiaries and affiliates and otherwise restrict corporate activities (including change of control and asset sale transactions). In addition, under the Credit Facilities, the Company is required to maintain specified financial ratios and comply with certain financial tests, including interest coverage, fixed charge coverage ratios and maximum leverage ratios, some of which become more

restrictive over time. The Company was in compliance with these covenants at May 31, 1997.

The Trust V Variable Funding Loan Agreement's covenants, among other things, restricts the ability of Trust V to dispose of assets, create liens and engage in mergers or consolidations. The Company was in compliance with these covenants at May 31, 1997.

NOTE 9 – INCOME TAXES

Income tax expense (benefit) is made up of the following components:

	May 31, 1997		May 31, 1996		May 31, 1995	
	Current	Deferred	Current	Deferred	Current	Deferred
	(in thousands)					
United States	\$ 4,745	\$ 25,697	\$ (799)	\$ (54,846)	\$ (80,445)	\$ (88,815)
State and local	3,499	(960)	1,420	(930)	(309)	(881)
Total	<u>\$ 8,244</u>	<u>\$ 24,737</u>	<u>\$ 621</u>	<u>\$ (55,776)</u>	<u>\$ (80,754)</u>	<u>\$ (89,696)</u>

In fiscal 1997 and 1995, the Company paid federal income tax of approximately \$3.0 million and \$30.6 million, respectively. In fiscal 1997, the Company received a refund of federal income tax of \$21.4 million due to a net operating loss carryback. In fiscal 1996, the Company received a refund of federal income tax of \$22.2 million paid in a previous year as estimated payments. State income taxes paid in 1997 and 1995 were approximately \$2.6 million and \$4.0 million respectively, while state income taxes refunded in fiscal 1996 were approximately \$100,000.

The Company complies with Statement of Financial Accounting Standards No. 109 - "Accounting for Income Taxes" ("FASB 109"). FASB 109 is an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events which have been recognized in the Company's financial statements or tax returns. FASB 109 generally considers all expected future events other than changes in tax law or rates.

The income tax expense (benefit) before extraordinary item at the Company's effective tax rate differed from the statutory rate as follows:

	For the years ended May 31,		
	1997	1996	1995
Statutory tax rate	35.0%	(35.0)%	(35.0)%
Effect of:			
State and local income tax	2.3	.2	(.2)
Percentage depletion	(8.8)	(2.6)	(.5)
Amortization of excess of purchase price over net assets acquired and FASB 121 charge	17.5	16.2	2.7
Benefit of capital loss carryforward	—	(5.9)	(1.5)
Adjustment of prior years net operating loss carryforward	—	(5.0)	—
Effect of rate difference and avoidance of loss of credits on net operating loss due to carryforward election	.5	(9.1)	2.3
Other, net	.5	.2	—
Effective tax rate	<u>47.0%</u>	<u>(41.0)%</u>	<u>(32.2)%</u>

In fiscal 1996, the tax benefit related to the extraordinary item approximated the statutory rate and is deferred federal income tax.

Deferred tax liabilities (assets) are comprised of the following:

	May 31,	
	1997	1996
	(in thousands)	
Instalment sales method for instalment notes receivable in prior years	\$ 27,504	\$ 34,691
Depreciation	84,721	78,462
Difference in basis of assets under purchase accounting	18,536	20,424
Net operating loss carryforward	(91,230)	(155,283)
Accrued expenses	(46,101)	(39,034)
Postretirement benefits other than pensions	(102,453)	(94,431)
Total deferred tax (asset) liability	<u>\$ (109,023)</u>	<u>\$ (155,171)</u>

The Revenue Act of 1987 eliminated the instalment sales method of tax reporting for instalment sales after December 31, 1987.

As a result of the loss incurred in the 1996 fiscal year, the Company recorded a deferred tax asset of \$25.0 million. During fiscal 1997, the Company elected to carry the 1996 loss back to prior years rather than forward, resulting in a refund of federal income taxes of \$21.4 million, which was accordingly charged against the deferred tax asset. The election to carry back the net operating loss generated a tax charge of approximately \$400,000 in the fourth quarter of fiscal 1997 due to the effect of the rate difference and other miscellaneous tax adjustments.

During fiscal 1996, the Company elected to carry a 1995 loss forward rather than back to prior years, which generated a tax benefit of approximately \$19 million in the fourth quarter of fiscal 1996 due to the effect of the rate difference, avoidance of loss of credits and other miscellaneous tax adjustments. Also during the fourth quarter of fiscal 1996, the Company utilized its capital loss carryforward of approximately \$22.8 million. The Company's net operating loss carryforward at May 31, 1997 approximates \$242.1 million, which will expire in fiscal 2010. The Company's minimum tax credit carryforward at May 31, 1997 approximates \$6.5 million.

Under the Internal Revenue Code, if certain substantial changes in the Company's ownership occur, there are annual limitations on the amount of loss and credit carryforwards. The reorganization under the Consensual Plan created an ownership change in fiscal 1995; there-

fore, \$164.6 million of the remaining net operating loss carryforward is subject to the annual limitation.

However, the Company believes that the annual limitation will not affect the realization of the net operating loss carryforward, which is expected to be fully utilized by fiscal 1999.

The Company allocates federal income tax expense (benefit) to its subsidiaries based on their separate taxable income (loss).

A substantial controversy exists with regard to federal income taxes allegedly owed by the Company. Proofs of claim have been filed by the Internal Revenue Service for taxes, interest and penalties in the amounts of \$110,560,883 with respect to fiscal years ended August 31, 1980 and August 31, 1983 through August 31, 1987, \$31,468,189 with respect to fiscal years ended May 31, 1988 (nine months) and May 31, 1989 and \$44,837,693 with respect to fiscal years ended May 31, 1990 and May 31, 1991. These proofs of claim represent total adjustments to taxable income of approximately \$360 million for all tax periods at issue. Objections to the proofs of claim have been filed by the Company, and the various issues are being litigated in the Bankruptcy Court. Included in the proofs of claim is an adjustment to taxable income disallowing a deduction of approximately \$51 million for hedging losses incurred during fiscal year 1988. This issue was conceded by the Internal Revenue Service pursuant to a joint stipulation of parties approved by the Bankruptcy Court by an order dated January 3, 1997. The Company believes that the balance of such proofs of claim are substantially without merit and intends to defend vigorously such claims; however, there can be no assurance as to the ultimate outcome.

NOTE 10 – STOCKHOLDERS' EQUITY

The Company is authorized to issue 200,000,000 shares of common stock, \$.01 par value. As of May 31, 1997, 55,063,412 shares of common stock were outstanding. On June 24, 1997, the Company repurchased 1,387,092 shares of outstanding common stock and such shares are being held as treasury stock.

Pursuant to the Consensual Plan, 494,313 shares were issued on September 13, 1995 to all former stockholders as of the Effective Date of the Consensual Plan. Also on September 13, 1995, pursuant to the Consensual Plan, 3,880,140 shares of common stock were issued to an escrow account. To the extent that

certain federal income tax matters of the Company are resolved satisfactorily, up to a maximum 3,880,140 of the escrowed shares will be distributed to former stockholders of the Company as of the Effective Date. To the extent such matters are not resolved satisfactorily, the escrowed shares will be returned to the Company and canceled.

Pursuant to the Consensual Plan, a total of 54,868,766 shares of common stock were to be issued to creditors and former stockholders of the Company. The plan of reorganization originally proposed by certain creditors and committees (the "Creditors Plan") provided that subordinated bondholders could elect to receive "Qualified Securities" (cash and/or new senior notes) in lieu of common stock of the Company. The Consensual Plan confirmed by the Bankruptcy Court, which technically constituted a modification of the Creditors Plan kept in place the bondholders election. Certain subordinated bondholders, however, were unable to provide documentation evidencing their right to receive Qualified Securities within the two year time frame prescribed by the Consensual Plan. As a result, approxi-

mately 212,000 additional shares of common stock were issued in lieu of Qualified Securities in 1997. In addition, certain former stockholders did not tender their shares, which resulted in approximately 17,000 shares not being issued.

Primary net income per share in 1997 was computed by dividing net income by the monthly weighted average number of shares of common stock and common stock equivalents outstanding. Common stock equivalents include the number of shares issuable on the exercise of dilutive employee stock options less the number of shares of common stock which could have been purchased with the proceeds from the exercise of such options. These purchases were assumed to have been made at the average market price of the common stock during the year. Primary net loss per share in 1996 does not include 3,880,140 additional shares issued to an escrow account on September 13, 1995 pursuant to the Consensual Plan because such issuance would be anti-dilutive. Fully diluted net income (loss) per share is not materially different from primary net income (loss) per share.

Changes in stockholders' equity for the two years ended May 31, 1997 are summarized as follows:

	Common Stock		Capital in Excess	Retained Earnings (Deficit)	Excess of Additional Pension Liability
	Shares	Par Value			
(in thousands)					
Balance at May 31, 1995	50,494	\$ 505	\$ 1,159,384	\$ (793,165)	\$ (5,950)
Stock issued	4,374	44	(44)		
Fractional share payments			(8)		
Net loss				(84,696)	
Reverse excess of additional pension liability					624
Balance at May 31, 1996	54,868	549	1,159,332	(877,861)	(5,326)
Stock issued, net	195	2	4,942		
Fractional share payments			(13)		
Net income				37,117	
Reverse excess of additional pension liability					670
Balance at May 31, 1997	55,063	\$ 551	\$ 1,164,261	\$ (840,744)	\$ (4,656)

In management's opinion, information for fiscal 1995 is not relevant given the significant change in the Company's capital structure which occurred as a result of the Company's reorganization pursuant to the Consensual Plan (see Note 1).

In February 1997, Statement of Financial Accounting Standards No. 128 - "Earnings per Share" ("FASB 128"), was issued. FASB 128 will be effective for both interim and annual periods ending after December 15, 1997 and will require a restatement of previously reported earnings per share. Under FASB 128, "basic" earnings per share will replace the reporting of "primary" earnings per share. Basic earnings per share is calculated by dividing the income available to common stockholders by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. "Fully diluted" earnings per share will be replaced by "diluted" earnings per share under FASB 128. The calculation of diluted earnings per share is similar to that of fully diluted earnings per share under existing accounting pronouncements. Basic earnings per share and diluted earnings per share are not expected to be significantly different from primary net income per share and fully

diluted net income per share as calculated by the Company for the years ended May 31, 1997 or 1996.

NOTE 11 - STOCK OPTIONS

Under the Walter Industries, Inc. Long-Term Incentive Stock Plan approved by stockholders in October 1995, an aggregate of 3,000,000 shares of the Company's common stock have been reserved for the grant and issuance of incentive and non-qualified stock options, stock appreciation rights ("SARs") and stock awards. The maximum number of such shares with respect to which stock options or SARs may be granted to any employee during which the plan is in effect is 500,000 shares and the aggregate number of such shares that may be used in settlement of stock awards is 1,000,000 shares. An option becomes exercisable at such times and in such installments as set by the Compensation Committee of the Board, but no option will be exercisable after the tenth anniversary of the date on which it is granted. The option price per share may not be less than the fair market value of a share on the date the option is granted.

Information on stock options is summarized as follows:

	1997		1996	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	1,487,000	\$ 14.120	—	\$ —
Granted	1,219,000	12.313	1,500,000	14.120
Exercised	—	—	—	—
Canceled	(36,001)	13.571	(13,000)	14.125
Outstanding at end of year	<u>2,669,999</u>	13.301	<u>1,487,000</u>	14.120
Exercisable at end of year	<u>487,333</u>	14.118	<u>—</u>	—

Exercise Prices	Options Outstanding		Options Exercisable
	Number Outstanding at May 31, 1997	Weighted Average Remaining Contractual Life (years)	Number Exercisable at May 31, 1997
12.313	1,208,000	9.2	—
14.063	153,000	8.2	51,000
14.125	1,308,999	8.2	436,333
	<u>2,669,999</u>	8.7	<u>487,333</u>

Had compensation cost for the Company's option plans been determined based on the fair value at the grant dates as prescribed by Statement of Financial Accounting Standards No. 123 "Accounting for Stock Based Compensation" ("FASB 123"), the Company's net income and net income per share on a pro forma basis would have been (in thousands, except per share data):

	1997
Pro forma net income	\$ 35,314
Pro forma net income per share	\$.64

The preceding pro forma results were calculated with the use of the Black Scholes option-pricing model. The following assumptions were used for the year ended May 31, 1997: (1) risk free interest rate of 7.36%; (2) dividend yield of 0.0%; (3) expected life of 5.0 years; and (4) volatility of 29.3%.

The Walter Industries, Inc. Employee Stock Purchase Plan was adopted in January 1996. All full-time employees of the Company who have attained the age of majority in the state in which they reside are eligible to participate. The Company contributes a sum equal to 15% of each participant's actual payroll deduction as authorized, and remits such funds to a designated brokerage firm who purchases in the open market, as agent for the Company, as many shares of common stock as such funds will permit for the accounts of the participants. The amount of stock purchased depends upon the market prices of the common stock at the time the purchases are made. The total number of shares which may be purchased under the plan is 500,000. Total shares purchased under the plan in 1997 were approximately 200,000, and the Company's contribution was approximately \$400,000.

NOTE 12 – LITIGATION

Veil-Piercing Suits

Beginning in early 1989, the Company and certain of its officers, directors and shareholders were named as co-defendants in a number of lawsuits brought by persons ("Asbestos Claimants") claiming that the Company should be held liable for all asbestos-related liabilities of The Celotex Corporation ("Celotex") and its parent, Jim Walter Corporation ("JWC"). The stock of a predecessor of JWC ("Original Jim Walter") was acquired by a company known as Hillsborough Acquisition Corporation ("HAC"), a former subsidiary of the Company, pursuant to a 1988 leveraged buyout (the

"LBO"). Asserting a variety of theories of derivative liability, including piercing the corporate veil, the suits alleged, among other things, that Original Jim Walter was liable for all asbestos-related liabilities of Celotex and that the distribution by HAC of substantially all of its assets to the Company pursuant to the LBO was a fraudulent conveyance (the "Veil-Piercing Suits").

On December 27, 1989, the Company and certain of its subsidiaries filed for protection under Chapter 11 of Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Middle District of Florida, Tampa Division (the "Bankruptcy Court"), which stayed all Veil-Piercing Suits pursuant to the automatic stay. In January 1990, the Company filed a declaratory judgment action ("Adversary Proceeding") against all Asbestos Claimants who had filed Veil-Piercing Suits seeking a ruling that the Company could not be held liable for any asbestos-related liabilities of Celotex or JWC on any grounds, asserting that the corporate veil separating Original Jim Walter and Celotex was intact, and asserting that the LBO could not be deemed a fraudulent conveyance.

In April 1994, the Bankruptcy Court ruled in favor of the Company on all of the claims asserted in the Adversary Proceeding. The ruling was affirmed by the United States District Court for the Middle District of Florida (the "District Court") in October 1994. Thereafter, a settlement (the "Veil-Piercing Settlement") was entered into among the Company, certain of its creditors, Celotex, JWC and representatives of the Asbestos Claimants pursuant to which all the Veil-Piercing Suits would be dismissed and the Company and its officers, directors and relevant stockholders would be released from all liabilities relating to the LBO or associated with asbestos-related liabilities of Celotex or JWC. The Veil-Piercing Settlement is embodied in the Amended Joint Plan of Reorganization Dated as of December 9, 1994 as modified on March 1, 1995 (as so modified the "Consensual Plan") that was confirmed by the Bankruptcy Court pursuant to an order signed on March 2, 1995. The Consensual Plan binds all known and unknown claimants and enjoins such persons or entities from bringing any suits against the Company in the future for asbestos or LBO related claims. Dismissal of the Veil-Piercing Suits is in process and all of these suits will be dismissed in the near future pursuant to the terms of the Veil-Piercing Settlement and the Consensual Plan.

In March 1996, the Company, together with various

other parties, filed an adversary proceeding with the Bankruptcy Court, naming Celotex and JWC as defendants. In this proceeding the Company and the other named plaintiffs allege that Celotex and JWC breached the Veil-Piercing Settlement by failing to propose and use their best efforts to obtain confirmation of a Chapter 11 plan for Celotex that included an injunction issued pursuant to Section 524(g) of the Bankruptcy Code or other similar injunctive relief acceptable to each of the parties to the Veil-Piercing Settlement. Although all Veil-Piercing claims by Asbestos Claimants were resolved as part of the Consensual Plan, the Company believes that Section 524(g) affords additional statutory protection to the Company against the possibility of such claims in the future.

On May 28, 1996, the Bankruptcy Court issued an order granting in part the Company's motion for summary judgment and denying the motions for summary judgment filed by Celotex and JWC. The Bankruptcy Court found, among other things, that the plan of reorganization filed by Celotex in its Chapter 11 proceeding did not comply with the terms of the Veil-Piercing Settlement. The Bankruptcy Court's May 28, 1996 Order was appealed by Celotex and JWC.

In October 1996, Celotex and various other parties in the Celotex bankruptcy announced to the Court in the Celotex Bankruptcy (the "Celotex Bankruptcy Court") that an agreement had been reached between Celotex and each of its creditor groups pursuant to a Modified Joint Plan of Reorganization (the "Celotex Modified Plan") which, among other things, superseded and replaced all prior plans. The Celotex Modified Plan contains a provision for a Section 524(g) injunction as to all asbestos claimants. The Celotex Modified Plan was approved by a vote of the Celotex creditors and in December 1996 the Celotex Bankruptcy Court entered an Order confirming the Celotex Modified Plan. The Celotex Modified Plan became effective as of May 30, 1997. As a result of the Celotex Modified Plan containing a provision for a Section 524(g) injunction and such Plan having become effective, the Company believes that the appeal of Celotex and JWC of the Bankruptcy Court's May 28, 1996 Order is now moot and that the only issue which remains in that adversary proceeding is whether the Company and other plaintiffs are entitled to collect attorneys' fees and expenses from Celotex and JWC with respect to the prosecution of the adversary proceeding.

Suit by the Company and Jim Walter Resources, Inc. for Business Interruption Losses

On May 31, 1995, the Company and Jim Walter Resources, Inc. ("JWR") filed a lawsuit in the Circuit Court for Tuscaloosa County, Alabama (Civil Action No. CV-95-625) against certain insurers. The lawsuit arises out of a spontaneous combustion fire that began in JWR's underground coal mine No. 5 on November 17, 1993. Efforts to control the fire caused a blockage in the tunnels, corridors, and passageways necessary to conduct mining, so mining operations temporarily ceased. After JWR believed that the fire had been extinguished or brought under control, JWR resumed its mining operations. JWR subsequently detected that the intensity of the fire had increased substantially, making it necessary to seal off portions of the mine and to lose permanently certain corridors and passageways necessary to the continued mining of the longwall panel then being mined. JWR's longwall mining was interrupted until another longwall panel could be prepared. In addition to the mining of coal, JWR produces natural gas from wells drilled into the mine, and production of the gas from the area of the lost longwall panel was also lost. As a result of the fire, the Company and JWR claimed compensable losses in the amount of \$25 million under their business interruption insurance coverage. When the insurers refused to pay their pro rata portion of the claim, the lawsuit described above was commenced.

The complaint filed by the Company and JWR seeks payment of the amounts claimed to be due under the insurance policies in question and a declaratory judgment that the policies in question are not void or voidable due to any alleged failure to disclose or a lack of fortuity. Certain of the insurers have counterclaimed for rescission on the basis of nondisclosure and lack of fortuity. The Company and JWR also seek a declaratory judgment stating that each of the insurers is liable for its pro rata share of the business interruption loss. In addition, the Company and JWR have asserted a claim for bad faith refusal to pay against certain insurers.

The insurers issued policies insuring various percentages of the risk. The Company has entered into settlements with several insurers who, in the aggregate, have paid approximately \$12.4 million to date, reducing the contract claims in the lawsuit to approximately \$12.6 million. The Company and JWR continue to pursue the litigation against the remaining carriers, and a trial is tentatively scheduled for October 1997.

Litigation Related to Chapter 11 Distributions to Certain Holders of Subordinated Notes and/or Debentures

The plan of reorganization originally proposed by certain creditors and committees (the "Creditors' Plan") provided that subordinated bondholders could elect to receive "Qualified Securities" (cash and/or new senior notes) in lieu of shares of Common Stock of the Company. Such elections (the "Subordinated Note Claim Election") were to be made on the ballots used for voting on the Creditors' Plan. A balloting agent was retained to receive and separately tabulate ballots cast on the Creditors' Plan and the Debtors' Fifth Amended Joint Plan of Reorganization (the "Company's Plan"). Voting on the Company's Plan and the Creditors' Plan took place during the period August 12, 1994 through September 23, 1994.

Subsequent to September 23, 1994, the balloting agent filed with the bankruptcy Court two (2) separate voting certificates.

In preparing to make distributions to subordinated bondholders, it came to the attention of the Company that certain schedules associated with the certifications were inaccurate. As a result, the Company reviewed all ballots that the balloting agent claimed to be in its possession and determined that discrepancies existed between the schedules and certain of the ballots cast by subordinated bondholders.

The Company filed a motion with the Bankruptcy Court seeking to amend the schedules. In April 1995, an order was entered reflecting the Bankruptcy Court's decision to permit the amendment of the schedules in certain respects but not others (the "April Order").

Appeals from the April Order were filed with the District Court by various bondholders. In November 1996, the District Court entered an order granting the Company's motion to dismiss and dismissing as moot all appeals in this matter. No appeal of the District

Court's Order was taken and that Order is now final.

Income Tax Litigation

A substantial controversy exists with regard to federal income taxes allegedly owed by the Company. See Note 9 - Income Taxes for a more complete explanation.

Miscellaneous Litigation

The Company and its subsidiaries are parties to a number of other lawsuits arising in the ordinary course of their businesses. Most of these cases are in a preliminary stage and the Company is unable to predict a range of possible loss, if any. The Company provides for costs relating to these matters when a loss is probable and the amount is reasonably estimable. The effect of the outcome of these matters on the Company's future results of operations cannot be predicted because any such effect depends on future results of operations and the amount and timing of the resolution of such matters. While the results of litigation cannot be predicted with certainty, the Company believes that the final outcome of such other litigation will not have a materially adverse effect on the Company's consolidated financial condition.

NOTE 13 - PENSION AND OTHER EMPLOYEE BENEFITS

The Company has various pension and profit sharing plans covering substantially all employees. In addition to its own pension plans, the Company contributes to certain multi-employer plans. Total pension expense for the years ended May 31, 1997, 1996 and 1995, was \$7.6 million, \$11.8 million and \$8.2 million, respectively. The funding of retirement and employee benefit plans is in accordance with the requirements of the plans and, where applicable, in sufficient amounts to satisfy the "Minimum Funding Standards" of the Employee Retirement Income Security Act of 1974 ("ERISA"). The plans provide benefits based on years of service and compensation or at stated amounts for each year of service.

The net pension costs for Company administered plans are as follows:

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
Service cost-benefits earned during the period	\$ 6,644	\$ 6,072	\$ 5,817
Interest cost on projected benefit obligation	17,589	16,972	16,174
Actual loss (return) on assets	(28,532)	(35,347)	4,304
Net amortization and deferral	8,680	20,236	(21,377)
Net pension costs	<u>\$ 4,381</u>	<u>\$ 7,933</u>	<u>\$ 4,918</u>

The following table sets forth the funded status of Company administered plans:

	May 31, 1997		May 31, 1996	
	Assets exceed accumulated benefits	Accumulated benefits exceed assets	Assets exceed accumulated benefits	Accumulated benefits exceed assets
	Plans in which		Plans in which	
	(in thousands)			
Actuarial present value of accumulated benefit obligations:				
Vested benefits	\$ 166,103	\$ 46,853	\$ 149,542	\$ 50,941
Non-vested benefits	7,444	1,525	6,815	1,585
	<u>\$ 173,547</u>	<u>\$ 48,378</u>	<u>\$ 156,357</u>	<u>\$ 52,526</u>
Plan assets at fair value, primarily stocks and bonds	\$ 213,726	\$ 33,341	\$ 189,728	\$ 34,609
Projected benefit obligations	<u>207,610</u>	<u>48,430</u>	<u>188,422</u>	<u>54,008</u>
Plan assets in excess of (less than) projected benefit obligations	6,116	(15,089)	1,306	(19,399)
Unamortized portion of transition (asset) obligation at June 1, 1986	(7,524)	2,918	(9,185)	4,021
Unrecognized net loss from actual experience different from that assumed	6,743	4,758	13,191	6,124
Prior service cost not recognized	633	3,695	618	3,595
Contribution to plans after measurement date	<u>103</u>	<u>1,126</u>	<u>—</u>	<u>1,042</u>
Prepaid (accrued) pension cost	6,071	(2,592)	5,930	(4,617)
Additional liability	<u>—</u>	<u>(11,294)</u>	<u>—</u>	<u>(12,507)</u>
Prepaid pension cost (pension liability) recognized in the balance sheet	<u>\$ 6,071</u>	<u>\$ (13,886)</u>	<u>\$ 5,930</u>	<u>\$ (17,124)</u>

The projected benefit obligations were determined using an assumed discount rate of 7.50% in fiscal 1997 and 1996 and, where applicable, an assumed increase in future compensation levels of 4.50% in fiscal 1997 and 1996. The assumed long-term rate of return on plan assets was 9% and 8% in fiscal 1997 and 1996, respectively.

Under the labor contract with the United Mine Workers of America, Jim Walter Resources makes payments into multi-employer pension plan trusts established for union employees. Under ERISA, as amended by the Multiemployer Pension Plan Amendments Act of 1980, an employer is liable for a proportionate part of the plans' unfunded vested benefits liabilities. The Company estimates that its allocated portion of the unfunded vested benefits liabilities of these plans amounted to approximately \$34.7 million at May 31, 1997. However, although the net liability can be estimated, its components, the relative position of each employer with respect to actuarial present value of accumulated benefits and net assets available for bene-

fits, are not available to the Company.

The Company provides certain postretirement benefits other than pensions, primarily healthcare, to eligible retirees. The Company's postretirement benefit plans are not funded. Postretirement benefit costs were \$22.7 million in 1997, \$27.1 million in 1996 and \$26.0 million in 1995. Amounts paid for postretirement benefits were \$7.3 million in 1997, \$7.7 million in 1996 and \$7.5 million in 1995.

The net periodic postretirement benefit cost includes the following components:

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
Service cost	\$ 7,642	\$ 8,668	\$ 8,491
Interest cost	14,990	18,701	17,470
Net amortization and deferral	<u>78</u>	<u>(240)</u>	<u>—</u>
Net periodic postretirement benefit cost	<u>\$ 22,710</u>	<u>\$ 27,129</u>	<u>\$ 25,961</u>

The accumulated postretirement benefits obligation at May 31, 1997 and 1996 are as follows:

	May 31,	
	1997	1996
	(in thousands)	
Retirees	\$ 81,731	\$ 93,380
Fully eligible, active participants	37,189	32,896
Other active participants	106,493	132,026
Accumulated postretirement benefit obligation	225,413	258,302
Unrecognized net gain (loss)	43,546	(10,475)
Postretirement benefit liability recognized in the balance sheet	<u>\$ 268,959</u>	<u>\$ 247,827</u>

The principal assumptions used to measure the accumulated postretirement benefit obligation include a discount rate of 7.50% in fiscal 1997 and 1996 and a health care cost trend rate of 8.50% declining to 5.25% over a eight year period and remaining level thereafter in fiscal 1997 and a health care cost trend rate of 9.50% declining to 5.25% over a nine year period in fiscal 1996. A one percent increase in trend rates would increase the accumulated postretirement benefit obligation by 18% and increase net periodic postretirement benefit cost for 1997 by 21%.

Certain subsidiaries of the Company maintain profit sharing plans. The total cost of these plans for the years ended May 31, 1997, 1996 and 1995 was \$3.4 million, \$2.9 million and \$3.0 million, respectively

In February 1997, a reduction in the salaried workforce at Jim Walter Resources was completed under a voluntary early retirement program. The total cost of this program was \$6.2 million

NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107,

“Disclosures about Fair Value of Financial Instruments” (“FASB 107”) requires disclosure of estimated fair values for all financial instruments for which it is practicable to estimate fair value. Considerable judgment is necessary in developing estimates of fair value and a variety of valuation techniques are allowed under FASB 107. The derived fair value estimates resulting from the judgments and valuation techniques applied cannot be substantiated by comparison to independent materials or to disclosures by other companies with similar financial instruments. Furthermore, FASB 107 fair value disclosures do not purport to be the amount which could be attained in immediate settlement of the financial instrument. Fair value estimates are not necessarily more relevant than historical cost values and have limited usefulness in evaluating long-term assets and liabilities held in the ordinary course of business. Accordingly, management believes that the disclosures required by FASB 107 have limited relevance to the Company and its operations.

The following methods and assumptions were used to estimate fair value disclosures:

Cash and cash equivalents, restricted short term investments and marketable securities — The carrying amounts reported in the balance sheet approximate fair value.

Instalment notes receivable — The estimated fair value of instalment notes receivable at May 31, 1997 was in the range of \$2.0 billion to \$2.1 billion. The estimated fair value is based upon valuations prepared by an investment banking firm as of May 31, 1997. The value of mortgage-backed instruments such as instalment notes receivable are very sensitive to changes in interest rates.

Debt — The estimated fair value of long term debt at May 31, 1997 was \$2.142 billion based on current yields for comparable debt issues or prices for actual transactions.

NOTE 15 – SEGMENT INFORMATION

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
Sales and Revenues:			
Homebuilding and Financing	\$ 440,749	\$ 413,078	\$ 407,172
Water Transmission Products	419,813	419,984	411,442
Natural Resources (a)	345,011	362,948	332,151
Industrial Products	299,851	287,230	281,280
Corporate	1,637	2,395	10,277
Consolidated sales and revenues (b)(c)	<u>\$ 1,507,061</u>	<u>\$ 1,485,635</u>	<u>\$ 1,442,322</u>
Contributions to Operating Income (d)(e):			
Homebuilding and Financing (f)	\$ 81,731	\$ 63,390	\$ 44,954
Water Transmission Products	13,986	10,517	12,965
Natural Resources (g)	27,595	(105,929)	22,314
Industrial Products (g)	21,433	(10,406)	6,570
	<u>144,745</u>	<u>(42,428)</u>	<u>86,803</u>
Less-Unallocated corporate interest and other expense (h)	(74,647)	(92,019)	(615,898)
Income tax benefit (expense)	(32,981)	55,155	170,450
Income (loss) before extraordinary item	<u>\$ 37,117</u>	<u>\$ (79,292)</u>	<u>\$ (358,645)</u>
Depreciation, Depletion and Amortization:			
Homebuilding and Financing	\$ 3,311	\$ 3,279	\$ 3,336
Water Transmission Products	17,010	18,636	16,520
Natural Resources	38,107	38,652	41,434
Industrial Products	11,696	11,890	9,073
Corporate	1,690	1,884	1,674
Total	<u>\$ 71,814</u>	<u>\$ 74,341</u>	<u>\$ 72,037</u>
Gross Capital Expenditures:			
Homebuilding and Financing	\$ 5,617	\$ 3,735	\$ 4,192
Water Transmission Products	14,479	12,888	15,538
Natural Resources	54,999	53,576	46,214
Industrial Products	25,968	12,792	24,692
Corporate	692	532	681
Total	<u>\$ 101,755</u>	<u>\$ 83,523</u>	<u>\$ 91,317</u>
Identifiable Assets:			
Homebuilding and Financing	\$ 1,796,949	\$ 1,802,950	\$ 1,789,582
Water Transmission Products	452,963	480,209	480,617
Natural Resources	387,167	381,582	465,680
Industrial Products	192,688	177,668	213,836
Corporate (i)	197,618	248,968	295,438
Total	<u>\$ 3,027,385</u>	<u>\$ 3,091,377</u>	<u>\$ 3,245,153</u>

- (a) Includes sales of coal of \$309,308,000, \$325,495,000 and \$297,650,000 in 1997, 1996 and 1995, respectively. Jim Walter Resources' coal supply contract with Alabama Power Company that had been in effect since January 1, 1979, as amended, was superseded by a new contract executed May 10, 1994. The new contract is effective from

July 1, 1994 through August 31, 1999. Sales to Alabama Power Company in each of the years ended May 31, 1997, 1996 and 1995 were 13% of consolidated net sales and revenues.

- (b) Inter-segment sales (made primarily at prevailing market prices) are deducted from sales of the selling segment and are insignificant in amount with the exception of the sales of the Industrial Products Group to the Water Transmission Products Group of \$12,440,000, \$13,292,000 and \$13,373,000 and sales of the Natural Resources Group to the Industrial Products Group of \$4,172,000, \$4,774,000 and \$5,397,000 in 1997, 1996 and 1995, respectively.
- (c) Export sales, primarily coal, were \$134,733,000, \$171,446,000 and \$129,071,000 in 1997, 1996 and 1995, respectively. Export sales to any single geographic area do not exceed 10% of consolidated net sales and revenues.
- (d) Operating income amounts are after deducting amortization of excess of purchase price over net assets acquired (goodwill) of \$34,870,000 in 1997, \$39,096,000 in 1996 and \$40,027,000 in 1995. A breakdown by segment is as follows:

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
Homebuilding and financing	\$ 28,538	\$ 31,246	\$ 31,703
Water transmission products	12,212	12,247	12,214
Natural resources	(1,327)	(1,331)	(1,328)
Industrial products	638	2,135	2,627
Corporate	(5,191)	(5,201)	(5,189)
	<u>\$ 34,870</u>	<u>\$ 39,096</u>	<u>\$ 40,027</u>

- (e) Includes postretirement health benefits of \$22,710,000, \$27,129,000 and \$25,961,000 in 1997, 1996 and 1995. A breakdown by segment is as follows:

	For the years ended May 31,		
	1997	1996	1995
	(in thousands)		
Homebuilding and financing	\$ 1,888	\$ 1,636	\$ 2,295
Water transmission products	3,857	3,729	4,362
Natural resources	11,873	16,640	15,004
Industrial products	4,519	4,581	3,610
Corporate	573	543	690
	<u>\$ 22,710</u>	<u>\$ 27,129</u>	<u>\$ 25,961</u>

- (f) In July 1986, Waltsons, Inc., a corporation in which James W. Walter, Chairman Emeritus and a Director of the Company, has a twenty percent (20%) interest, acquired a fifty percent (50%) interest in the operations of Booker & Company, Inc. ("Booker"), a wholesale distributor of building supplies and materials. In December 1996, Waltsons, Inc. sold all of its interest in the operations of Booker. Booker has been a supplier of various building supplies and materials to Dixie Building Supplies, Inc., a wholly owned subsidiary of the Company. Booker's sales of building supplies and materials to such subsidiary totaled \$6,091,000, \$5,679,000 and \$5,434,000 in 1997, 1996 and 1995, respectively. The Company believes that the terms of the transactions between the Company and Booker are at least as favorable to the Company as those that could be obtained from unaffiliated third parties.
- (g) Includes FASB 121 write-down of fixed assets of \$120,400,000 at two coal mines in the Natural Resources Group and write-off of goodwill of \$22,865,000 in the Industrial Products Group in 1996.
- (h) Excludes interest expense incurred by the Homebuilding and Financing Group of \$118,959,000, \$128,215,000 and \$131,560,000 in 1997, 1996 and 1995, respectively. Such amounts are net of intercompany interest income of \$33,135,000 and \$28,127,000 in 1997 and 1996, and include intercompany interest expense of \$35,128,000 in 1995. The balance of unallocated expenses consisting primarily of unallocated interest, corporate expenses and Chapter 11 costs (in 1995) are attributable to all groups and cannot be reasonably allocated to specific groups.
- (i) Primarily cash and cash equivalents and corporate headquarters buildings and equipment.

REPORT OF MANAGEMENT

TO THE STOCKHOLDERS OF
WALTER INDUSTRIES, INC.

The management of Walter Industries, Inc. is responsible for the preparation, integrity and objectivity of the consolidated financial statements. The statements have been prepared in conformity with generally accepted accounting principles and, therefore, reflect estimates, where appropriate, based upon judgments of management. Financial information contained elsewhere in this annual report is consistent with that in the consolidated financial statements.

Walter Industries, Inc. and its subsidiaries maintain accounting systems and related internal controls that we believe are sufficient to provide reasonable assurance that financial records are reliable for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed benefits expected to be derived from the system. The system is augmented by written policies and guidelines, a strong program of internal audit, and the careful selection and training of qualified personnel.

Price Waterhouse LLP, independent certified public accountants, are engaged to examine the consolidated financial statements. Their examination is conducted in accordance with generally accepted auditing standards and provides an objective, independent review of management’s reporting of operating results and financial position. Their examination includes a review of internal controls and tests of transactions to establish a basis for reliance thereon in determining the nature, extent and timing of audit tests applied in the examination of the consolidated financial statements.

The Board of Directors, through the Audit Committee of the Board, is responsible for recommending to stockholders the independent certified public accountants to be engaged, and for ensuring that management fulfills its responsibilities in the preparation of the consolidated financial statements. The Audit Committee, composed solely of outside directors, meets periodically (separately and jointly) with the independent certified public accountants, representatives of management, and the internal auditors to ensure that each is properly discharging its financial control and reporting responsibili-

ties. The independent certified public accountants and internal auditors each have direct access to the Audit Committee, without management representatives present, to discuss the scope and results of their audit work, the adequacy of internal accounting controls, and the quality of financial reporting.

The management of your Company recognizes its responsibility to conduct the business of Walter Industries, Inc. in accordance with high ethical standards. This responsibility is reflected in key policy statements that, among other things, address potentially conflicting outside business interests of company employees, proper conduct of domestic and international business activities and compliance with federal and local laws. Ongoing communications and review programs are designed to help ensure compliance with these policies.



Kenneth E. Hyatt
Chairman, President and
Chief Executive Officer



Richard E. Almy
Executive Vice President and
Chief Operating Officer



Dean M. Fjelstul
Senior Vice President and
Chief Financial Officer



Frank A. Hult
Vice President, Controller and
Chief Accounting Officer



BOARD OF DIRECTORS

Left to right:

Perry Golkin, Member, Kohlberg Kravis Roberts & Co., LLC (1,6)

Howard L. Clark, Jr., Vice Chairman, Lehman Brothers, Inc. (2,3,5,6)

James B. Farley, Retired Chairman and Chief Executive Officer, Mutual of New York (1,2,3,4,5)

Richard E. Almy, Executive Vice President and Chief Operating Officer, Walter Industries, Inc.

Kenneth E. Hyatt, Chairman, President and Chief Executive Officer, Walter Industries, Inc.

James W. Walter, Chairman Emeritus and founder, Walter Industries, Inc. (2,6)

Michael T. Tokarz, Member, Kohlberg Kravis Roberts & Co., LLC (2,3,4)

James L. Johnson, Chairman Emeritus, GTE Corporation (1,3,4,5,6)

Eliot M. Fried, Managing Director, Lehman Brothers, Inc. (1,4)

(1) Audit Committee, (2) Finance Committee, (3) Compensation Committee

(4) Environmental, Health and Safety Committee, (5) Special Tax Oversight Committee

(6) Nominating Committee

CORPORATE DIRECTORY AND STOCKHOLDER INFORMATION

OFFICERS

Richard E. Almy

Executive Vice President and
Chief Operating Officer

Dean M. Fjelstul

Senior Vice President and
Chief Financial Officer

Frank A. Hult

Vice President, Controller and
Chief Accounting Officer

Kenneth E. Hyatt

Chairman, President and
Chief Executive Officer

Donald M. Kurucz

Vice President and Treasurer

Robert W. Michael

Senior Vice President and
Group Executive; President,
Jim Walter Homes, Inc.

Edward A. Porter

Vice President-General Counsel
and Secretary

William N. Temple

Senior Vice President and
Group Executive; President
United States Pipe and Foundry
Company, Inc.

David L. Townsend

Vice President-Administration

Cynthia B. Eisch

Assistant Controller; Tax Director

Stephen H. Foxworth

Assistant Treasurer

Kathy H. Love

Assistant Controller; Director of
Operations Audit

Kimberly A. Perez

Assistant Controller; Director of
Accounting and Strategic Planning

S. Louise Russell

Assistant Secretary

Mary C. Snow

Assistant General Counsel; Assistant
Secretary

Joseph W. Spransy

Assistant Secretary

COMMON STOCK

Trading

Nasdaq National Market
Trading Symbol: WLTR

Transfer Agent and Registrar

Harris Trust and Savings Bank
311 West Monroe
Chicago, Illinois 60690
(312) 461-3309

INDEPENDENT ACCOUNTANTS

Price Waterhouse LLP
400 North Ashley St., Suite 2800
Tampa, Florida 33601

ANNUAL MEETING

The Annual Meeting of Stockholders
of Walter Industries, Inc.
will be held on Tuesday, September
16, 1997, at 10 a.m. at the
Tampa Convention Center,
Ball Room Level, Meeting Room 6-7,
333 South Franklin Street,
Tampa, Florida.

QUARTERLY STOCK PRICE RANGE - FISCAL 1997

	1Q	2Q	3Q	4Q
High	14 ^{1/4}	14 ^{1/4}	15 ^{1/4}	15 ^{3/8}
Low	11 ^{7/8}	12 ^{5/8}	12 ^{5/8}	13 ^{1/4}

This Annual Report contains various forward-looking statements and includes assumptions concerning Walter Industries' operations, future results and prospects. These forward-looking statements are based on current expectations and are subject to risk and uncertainties. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, Walter Industries provides the following cautionary statement identifying important economic, political and technology factors which, among others, could cause the actual results or events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (i) changes in the current and future business environment, including interest rates and capital and consumer spending; (ii) competitive factors and competitor responses to Walter Industries' initiatives; (iii) successful development and market introductions of anticipated new products; (iv) changes in government law and regulations, including taxes; and (v) continuation of the favorable environment to make acquisitions, domestic and foreign, including regulatory requirements and market values of candidates.

INVESTOR/MEDIA INQUIRIES

For further information about
Walter Industries, Inc. and its
subsidiaries, please contact:

Public Relations Department
Walter Industries, Inc.
P.O. Box 31601
Tampa, Florida 33631-3601
Phone (813) 871-4448
Fax (813) 871-4430

FORM 10-K

A copy of the Company's annual
report to the Securities and
Exchange Commission on Form 10-K
for 1997 is available upon written
request to:

Walter Industries, Inc.
Public Relations Department
P.O. Box 31601
Tampa, Florida 33631-3601

CORPORATE OFFICES

Walter Industries, Inc.
1500 North Dale Mabry Highway
Tampa, Florida 33607
(813) 871-4811