

POTLATCH CORP
Form 10-K
February 20, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-K

(Mark One) ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2007
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____.
Commission File Number 1-32729

POTLATCH CORPORATION

(Exact name of registrant as specified in its charter)

Delaware 82-0156045
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)
601 West 1st Ave., Suite 1600
Spokane, Washington 99201
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (509) 835-1500

Securities registered pursuant to Section 12(b) of the Act:

| TITLE OF EACH CLASS | NAME OF EACH EXCHANGE ON WHICH REGISTERED |
|---------------------------------|---|
| Common Stock (\$1 par value) | New York Stock Exchange Chicago Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant at June 29, 2007, was approximately \$1,635.1 million, based on the closing price of \$43.05, as reported on the New York Stock Exchange Composite Transactions.

The number of shares of common stock outstanding as of January 31, 2008: 39,260,478 shares of Common Stock, par value of \$1 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be filed on or about March 26, 2008, with the Commission in connection with the 2008 annual meeting of stockholders are incorporated by reference in Part III hereof.

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Index to 2007 Form 10-K

| | PAGE NUMBER |
|---|------------------------|
| PART I | |
| ITEM 1. <u>Business</u> | 2 8 |
| ITEM 1A. <u>Risk Factors</u> | 8 10 |
| ITEM 1B. <u>Unresolved Staff Comments</u> | 10 |
| ITEM 2. <u>Properties</u> | 11 |
| ITEM 3. <u>Legal Proceedings</u> | 12 |
| ITEM 4. <u>Submission of Matters to a Vote of Security Holders</u> | 12 |
| <u>EXECUTIVE OFFICERS OF THE REGISTRANT</u> | 12 13 |
| PART II | |
| ITEM 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 14 |
| ITEM 6. <u>Selected Financial Data</u> | 15 |
| ITEM 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 15 |
| ITEM 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 15 |
| ITEM 8. <u>Financial Statements and Supplementary Data</u> | 15 |
| ITEM 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> | 15 |
| ITEM 9A. <u>Controls and Procedures</u> | 15 16 |
| ITEM 9B. <u>Other Information</u> | 16 |
| PART III | |
| ITEM 10. <u>Directors, Executive Officers and Corporate Governance</u> | 17 |
| ITEM 11. <u>Executive Compensation</u> | 17 |
| ITEM 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 18 |
| ITEM 13. <u>Certain Relationships and Related Transactions, and Director Independence</u> | 18 |
| ITEM 14. <u>Principal Accounting Fees and Services</u> | 18 |
| PART IV | |
| ITEM 15. <u>Exhibits and Financial Statement Schedules</u> | 19 |
| <u>SIGNATURES</u> | 20 |
| <u>INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SCHEDULES</u> | 21 |
| <u>EXHIBIT INDEX</u> | 84 87 |

Table of Contents

Part I

ITEM 1.

Business

GENERAL

Potlatch Corporation is a real estate investment trust, or REIT, with approximately 1.7 million acres of timberlands in Arkansas, Idaho, Minnesota, and Wisconsin. Through a wholly-owned taxable subsidiary, Potlatch Forest Products Corporation, which we refer to in this report as Potlatch TRS, we also operate 13 manufacturing facilities that produce lumber and panel products and bleached pulp products, including paperboard and tissue products. We also conduct a real estate sales and development business through Potlatch TRS. We completed our conversion to a REIT effective January 1, 2006.

The company, as it exists today, is the result of the restructuring of our operations effective January 1, 2006, to qualify for treatment as a REIT for federal income tax purposes. This restructuring primarily involved the creation of a new holding company that holds our timberlands and our manufacturing and other non-timberland assets through separate subsidiaries. Although the company as currently constituted was incorporated in September 2005, it is the successor to the business of Potlatch as originally structured, which was founded in 1903. For purposes of this report, any references to the company, us, we, and our include where the context requires both Potlatch Corporation and its predecessor, as it existed prior to the restructuring, together with their respective subsidiaries.

As a REIT, we expect to derive most of our income from investments in real estate, including the sale of standing timber. Also as a REIT, we generally will not be subject to federal corporate income taxes on our income and gain from investments in real estate that we distribute to our stockholders, including the income derived from the sale of timber, thereby reducing our corporate-level taxes and substantially eliminating the double taxation on income and gain that usually results in the case of a dividend distribution by a C corporation. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value at January 1, 2006 over tax basis on that date) on sales of real property (other than timber) held by the REIT during the first ten years following the REIT conversion. We will continue to be required to pay federal corporate income taxes on earnings from our non-real estate investments, principally our manufacturing operations, which are now held by Potlatch TRS.

Our businesses are organized into five reportable operating segments, as defined by Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 131, Disclosures About Segments of an Enterprise and Related Information: Resource; Real Estate; Wood Products; Pulp and Paperboard; and Consumer Products. Discussion of each of our segments is included on pages 3-6. Information relating to the amounts of revenues, operating income (loss) and identifiable assets attributable to each of our operating segments for 2005-2007 is included in Note 15 to the consolidated financial statements on pages 76-78 of this report.

Interested parties may access our periodic and current reports filed with the Securities and Exchange Commission, or SEC, at no charge, by visiting our website, www.potlatchcorp.com. In the menu select Investor Resources and Corporate Governance, then select SEC Filings. Information on our website is not part of this report.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This report contains, in addition to historical information, certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including without limitation, statements regarding future revenues, cash flows, distributions, compliance with REIT tax rules, costs, manufacturing output, capital expenditures, timber harvest levels, future land sales, like-kind exchanges and tax consequences, and other timber supply issues. Words such as anticipate, expect,

Table of Contents

will, intend, plan, target, project, believe, seek, schedule, estimate, could, can, may, and similar expressions such forward-looking statements. These forward-looking statements reflect management's current views regarding future events based on estimates and assumptions, and are therefore subject to known and unknown risks and uncertainties and are not guarantees of future performance. Our actual results of operations could differ materially from those expressed or implied by forward-looking statements contained in this report. Important factors that could cause or contribute to such differences include, but are not limited to:

changes in timber harvest levels on our lands

changes in timber prices

changes in timberland values

changes in policy regarding governmental timber sales

changes in the United States and international economies

changes in exchange rates between the U.S. dollar and other currencies

changes in the level of construction activity

changes in tariffs, quotas and trade agreements involving wood products

changes in worldwide demand for our products

changes in worldwide production and production capacity in the forest products industry

competitive pricing pressures for our products

unanticipated manufacturing disruptions

changes in general and industry-specific environmental laws and regulations

unforeseen environmental liabilities or expenditures

weather conditions

changes in raw material, energy and other costs

the ability to satisfy complex rules in order to remain qualified as a REIT

changes in tax laws that could reduce the benefits associated with REIT status.

Forward-looking statements contained in this report present management's views only as of the date of this report. Except as required under applicable law, we do not intend to issue updates concerning any future revisions of management's views to reflect events or circumstances occurring after the date of this report.

RESOURCE SEGMENT

The Resource segment manages approximately 1.7 million acres of timberlands we own in Arkansas, Idaho, Minnesota and Wisconsin. The timberlands include a wide diversity of softwood and hardwood species. In Arkansas we own approximately 468,000 acres of timberlands. Primary species on these lands include southern yellow pine, red oak, white oak and other hardwoods. We own approximately 842,000 acres of timberlands in the northern and central portions of the state of Idaho. Primary species on these lands include grand fir, inland red cedar, Douglas fir, ponderosa pine, western larch, Engelmann

Table of Contents

spruce and western white pine. We own approximately 312,000 acres of timberlands in Minnesota, comprised primarily of aspen and other mixed hardwoods and pine. Our Wisconsin timberlands, which were purchased in January 2007, consist of approximately 76,000 acres of pine and hardwoods. We are the largest private landowner in Idaho and Minnesota.

The primary business of the Resource segment is the management of our timberlands to optimize the value of all possible revenue producing opportunities while at the same time adhering to our strict stewardship standards. Management activities include, but are not limited to, planting trees, harvesting trees, building and maintaining roads, development of management plans and recreation lease management.

Activities of the segment are focused on three key areas: increasing harvest levels in ways that ensure long-term sustainability while maintaining high stewardship standards; increasing timber harvest levels in times of strong market demand and decreasing harvest levels in times of weak demand; and seeking acquisitions that complement our existing timberland base.

In 2007, the segment sold wood fiber at market prices to our manufacturing facilities. We believe the use of market prices as the internal transfer price maximizes our timber value and motivates management of our manufacturing segments to optimize operating efficiencies and identify profitable markets in which to compete. The amount of the segment's sales to our manufacturing facilities, which accounted for 58% of the Resource segment's total revenues in 2007, varied significantly among the segment's operations, ranging from approximately 43% of our Southern region revenues to approximately 62% of our Northern region revenues.

The segment also sold logs and pulpwood to a variety of forest products companies located near our timberlands using marketing methodologies that are designed to maximize the value of the products being sold. The segment's customers range in size from small operators to multinational corporations. The segment competes with owners of timberlands that operate in areas near our timberlands, ranging from private owners of small tracts of land to some of the largest timberland companies in the United States. The segment competes principally on the basis of log quality, distance to market, customer service and price.

The amount of timber harvested from company-owned lands is guided by our commitment to sustainable forest management. By continually improving silvicultural techniques, we have been able to increase the sustainable level of wood fiber produced per acre from our timberlands. We manage harvest levels on our timberlands in a manner that assures long-term sustainability. In 2007, all our timberlands were certified under the Forest Stewardship Council, or FSC, and International Standardization Organization, or ISO, programs, with the exception of the Idaho timberlands acquired late in the year. As a participant in these programs, we adhere to the collective principles of both of them. These principles include, but are not limited to: commitments to sustainable forestry, responsible practices, forest health and productivity, and protection of special sites.

These certifications aid us in marketing our products to customers who require that products they purchase for resale come from sustainably managed forests. In 2007 and 2006, our sales of FSC certified products increased significantly over the previous respective year. Most of these sales were at prices higher than average market prices.

REAL ESTATE SEGMENT

The activities of the Real Estate segment, formerly known as the Land Sales and Development segment, consist of the sale of selected non-strategic timberland real estate, including sales of land for higher and better use purposes, and the acquisition of timberlands. Sales of conservation easements are also included in this segment. Results for the segment depend on the timing of closing of transactions for those non-strategic property sales. The segment also engages in land development activities through Potlatch TRS, and plays an active role in negotiations for all timberland acquisitions.

Table of Contents

A main focus of this segment is to continually assess the use of each of our lands to manage them proactively for the highest value. In December 2006, we completed an initial stratification assessment of all of our land. The following tools were used in assessing our lands:

Electronic analysis, using geographic information systems

On-the-ground analysis and verification of modeling assumptions

Certain measured and ranked attributes, such as timber potential, recreational influences, accessibility, special features and population and demographic trends

As a result of the assessment of our lands, we identified 250,000 to 300,000 acres as having values that are potentially greater than timberland values. Sales of these lands are expected to occur over a 10 year period, with the goal of utilizing like-kind exchange transactions for tax efficiency, thus increasing cash flows. We sold 16,175 acres in 2007. As new lands are acquired, such as the Wisconsin and Idaho timberlands discussed below, we will complete similar stratification assessments on these lands.

In January 2007, we completed the acquisition of 76,000 acres of prime timberland in Wisconsin for \$64.5 million. This was our first significant purchase of timberland in more than a decade. The purchase of the Wisconsin timberlands was matched with sales of our own lands, primarily the hybrid poplar tree farm in Boardman, Oregon, for Internal Revenue Code section 1031 like-kind exchange purposes.

In September 2007, we entered into agreements to acquire approximately 179,000 acres of timberland in Idaho for approximately \$215 million. We completed the acquisition of the timberland in two separate transactions, with the first closing in September 2007 and the second closing in January 2008.

As discussed above, we expect to use Internal Revenue Code section 1031 like-kind exchanges whenever possible to match sales of our land having values greater than for timberland with acquisitions of land that has strategic benefits to us. For example, the Wisconsin timberland purchase allowed us to utilize a section 1031 like-kind exchange and not be subject to built-in-gains tax on an Arkansas conservation easement sale in December 2006 and the sale of our hybrid poplar tree farm in Boardman, Oregon in May 2007. The sale of the hybrid poplar tree farm is discussed in more detail under the heading, "Discontinued Operations," on page 7. We also matched a portion of the Idaho land purchase discussed above with sales of land in the fourth quarter of 2007 for section 1031 like-kind exchange purposes, and expect to use the Idaho land purchase for section 1031 like-kind exchanges of land we expect to sell in the first half of 2008.

WOOD PRODUCTS SEGMENT

The Wood Products segment manufactures and markets lumber, plywood and particleboard. These products are sold through our sales offices primarily to wholesalers for nationwide distribution.

To produce these wood products, we own and operate eight manufacturing facilities in Arkansas, Idaho, Michigan and Minnesota. A description of these facilities is included under Item 2 of this report.

Our share of the market for lumber, plywood and particleboard is not significant compared to the total United States market for these products. We believe that competitiveness in this industry is largely based on individual mill efficiency and on the availability of competitively priced resources on a facility-by-facility basis, rather than the number of mills operated. This is due to the fact that it is generally not economical to transfer wood between or among facilities, which would permit a greater degree of specialization and operating efficiencies. Instead, each facility must utilize the raw materials that are available to it in a relatively limited geographic area. For these reasons, we believe we are able to compete effectively with companies that have a larger number of mills. We compete based on product quality, customer service and price.

Table of Contents

PULP AND PAPERBOARD SEGMENT

The Pulp and Paperboard segment produces and markets bleached paperboard and bleached pulp. A description of the facilities used to produce these products is included under Item 2 of this report.

We are a significant producer of bleached paperboard in the United States, where we compete with at least five other domestic pulp and paperboard producers. We have approximately 12% of the available domestic bleached paperboard capacity. The business is capital intensive, which leads to high fixed costs. As a result, production generally continues as long as selling prices cover variable costs.

Bleached paperboard is a product used in the high-end segment of the packaging industry due to its strength, brightness and favorable printing and graphic surface features. Our bleached paperboard is processed by our customers into a variety of end products, including folding cartons for health and beauty aids, media and medical products, packaging for liquids and other food products, and paper cups and paper plates.

We also produce and sell bleached softwood market pulp, which is used as the basis for many paper products. We are not among the larger manufacturers of softwood market pulp in the United States. We sold 21% of our Idaho pulp production to our Consumer Products segment in 2007.

We utilize various methods for the sale and distribution of our paperboard and softwood pulp. In general, we sell paperboard to packaging converters domestically through sales offices located throughout the United States. The majority of our international paperboard sales are made in Japan, China, Taiwan, Australia and other Southeast Asian countries through sales representative offices. The majority of softwood market pulp sales are made through agents. Our principal methods of competing are product quality, customer service and price.

CONSUMER PRODUCTS SEGMENT

The Consumer Products segment produces and markets household tissue products. A description of the facilities used to produce these products is included under Item 2 of this report.

Our tissue products are manufactured on three machines at our facility in Lewiston, Idaho, as well as one machine at our facility in Las Vegas, Nevada. The tissue is then converted into packaged tissue products at three converting facilities in Lewiston, Las Vegas, and Elwood, Illinois. In 2007, approximately 50% of the pulp we used to make our tissue products was obtained from our Lewiston pulp mill. The remaining portion was purchased on the open market and consisted primarily of hardwood pulp, which enhances the quality of certain grades of tissue.

We are a significant producer of private label household tissue products in the United States. In 2007, we produced approximately 55% of the total private label tissue products sold in grocery stores in the United States. We compete with at least three companies that are much larger than us who sell national brand tissue products, as well as commercial, industrial and private label products. We also compete with other companies that sell regional brand products and commercial, industrial and private label products. Our household tissue products, comprised of facial and bathroom tissues, paper towels and napkins, are packaged to order for retail chains, wholesalers and cooperative buying organizations throughout the United States and, to a lesser extent, Canada. These products are sold to consumers under our customers' own brand names. We sell a majority of our tissue products to three national grocery store chains. We do not have long-term supply contracts with any of these national chains and the loss of one or more of these customers could have a material adverse effect upon the operating results of the Consumer Products segment.

We sell tissue products to major retail outlets, primarily through brokers. Our principal methods of competing are product quality, customer service and price.

Table of Contents**DISCONTINUED OPERATIONS**

In May 2007, we sold our hybrid poplar tree farm in Boardman, Oregon, for \$65 million in cash. We applied a large portion of the proceeds from this sale to our acquisition in the first quarter of 2007 of the Wisconsin timberlands through a tax-efficient section 1031 like-kind exchange. As a result of the sale, we recorded an after-tax charge of \$33.0 million in the first half of 2007. The charge represented estimated costs associated with the adjustment of the carrying value of the assets involved in the sale to fair market value, as well as approximately \$0.3 million in severance benefits and approximately \$0.2 million in transaction and other costs associated with the sale.

RAW MATERIALS

For our manufacturing operations, the principal raw material used is wood fiber, which is obtained from our Resource segment and purchased on the open market. Our Wood Products segment purchases a portion of its log needs from outside sources. Our Pulp and Paperboard segment purchases a substantial amount of wood chips and sawdust from third parties for use in the production of pulp. Our Consumer Products segment purchases several varieties of pulp from third parties, in addition to pulp provided by our Pulp and Paperboard segment, for use in manufacturing tissue products.

Information regarding 2007 fee harvests, purchases of wood fiber from third parties and sales of wood fiber to third parties are contained in the table below:

| | FEE TIMBER HARVESTED (TONS)* | PURCHASED FIBER (TONS) | TOTAL | TONS SOLD TO THIRD PARTIES |
|----------|---|-----------------------------------|--------------|---------------------------------------|
| Sawlogs | 2,726,000 | 1,487,000 | 4,213,000 | 1,370,000 |
| Pulpwood | 1,206,000 | 992,000 | 2,198,000 | 877,000 |
| Total | 3,932,000 | 2,479,000 | 6,411,000 | 2,247,000 |

* The term Fee Timber Harvested refers to timber harvested on properties owned by Potlatch, as distinguished from Purchased Fiber, which is purchased from third parties.

In 2007, we harvested fee timber in two regions of the United States: the Northern region, consisting of our Idaho, Minnesota and Wisconsin timberlands; and the Southern region, consisting of our Arkansas timberlands. The following table presents our total 2007 fee timber harvest by region:

| | FEE TIMBER HARVESTED (TONS) | | |
|-----------------|------------------------------------|-----------------|--------------|
| | SAWLOGS | PULPWOOD | TOTAL |
| Northern region | 1,818,000 | 576,000 | 2,394,000 |
| Southern region | 908,000 | 630,000 | 1,538,000 |
| Total | 2,726,000 | 1,206,000 | 3,932,000 |

In 2007, approximately 384,000 tons of the total 2,479,000 tons of purchased sawlogs and pulpwood were acquired directly from timberlands owned by federal, state and local governments. Wood fiber acquisitions from these sources occur in market transactions at current market prices. We generally do not maintain long-term supply contracts for a significant volume of timber.

Timber from our lands, together with outside purchases, is presently adequate to support our manufacturing operations. Beginning in the early 1990s and continuing to the present, the timber supply from federal lands has diminished, largely due to environmental pressures. The resultant reduction in supply has increased the demand for logs from private timberlands. Although the supply of timber available from federal lands has recently stabilized, the future available supply cannot be predicted, and thus the long-term effect on our earnings cannot be predicted.

Table of Contents

The volume and value of timber that can be harvested from our lands may be affected by natural disasters such as fire, insect infestation, disease, ice storms, wind storms, floods and other weather conditions and causes. We assume substantially all risk of loss to the standing timber we own from fire and other hazards, as do most owners of timber tracts in the United States, because insuring for such losses is not practicable.

SEASONALITY

Our Resource segment log and pulpwood production is typically lower in the first half of each year, as winter rains in the Southern region and spring thaws in the Northern region limit timber harvesting operations due to softened roadbeds and wet logging conditions, which restrict access to logging sites. Demand for our wood products typically decreases in the winter months when construction activity is slower, and increases in the spring, summer and fall when construction activity is generally higher. Our pulp, paperboard and tissue products are generally not affected by seasonal changes, although a number of our paperboard contracts are renewed at the beginning of each year.

ENVIRONMENTAL

Information regarding environmental matters is included under Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations on page 42 of this report.

EMPLOYEES

As of December 31, 2007, we had approximately 3,800 employees. The workforce consisted of approximately 800 salaried, 2,900 hourly and 100 temporary or part-time employees. As of December 31, 2007, approximately 52% of the workforce was covered under collective bargaining agreements.

Hourly union labor contracts expiring in 2008 are set forth below:

| | | | APPROXIMATE |
|-------------------|---|--|------------------|
| CONTRACT | | | NUMBER OF |
| EXPIRATION | | | HOURLY |
| DATE | LOCATION | UNION | EMPLOYEES |
| May 7 | Wood Products Division and Resource Division Warren, Arkansas | International Association of Machinists | 180 |
| May 31 | Wood Products Division Lewiston, Idaho | International Association of Machinists | 315 |
| May 31 | Pulp and Paperboard Division, Number 4 Power Boiler Lewiston, Idaho | International Association of Machinists | 45 |
| June 30 | Resource Division, Greenhouse | United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union | 15 |

Lewiston, Idaho

ITEM 1A.

Risk Factors

Investing in our common stock involves a significant degree of risk. In addition to the REIT-related risk factors discussed below, investors should carefully consider the risks and uncertainties presented under the following captions in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of Part II of this report: REIT Conversion and Factors Influencing Our Results of Operations and Cash Flows, all of which are incorporated herein by reference.

8 / POTLATCH CORPORATION

Table of Contents

REIT-RELATED RISK FACTORS

If we fail to remain qualified as a REIT, income from our timberlands will be subject to taxation at regular corporate rates and we will have reduced funds available for distribution to our stockholders.

Qualification as a REIT involves the application of highly technical and complex provisions of the Internal Revenue Code to our operations, including satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements, on a continuing basis. Given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations and the possibility of future changes in our circumstances, no assurance can be given that we will remain qualified as a REIT.

In addition, the rules dealing with federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Department of the Treasury. Changes to the tax laws affecting REITs, which may have retroactive application, could adversely affect our stockholders or us. We cannot predict how changes in the tax laws might affect our stockholders or us. Accordingly, we cannot assure you that new legislation, Treasury regulations, administrative interpretations or court decisions will not significantly affect our ability to remain qualified as a REIT or the federal income tax consequences of such qualification.

If in any taxable year we fail to remain qualified as a REIT,

we will not be allowed a deduction for distributions to stockholders in computing our taxable income; and

we will be subject to federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates.

Any such corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our stockholders, which in turn could have an adverse impact on the value of our common stock. In addition, we would be disqualified from treatment as a REIT for the four taxable years following the year during which the qualification was lost, unless we are entitled to relief under certain statutory provisions. As a result, net income and the funds available for distribution to our stockholders could be reduced for up to five years or longer, which would have an adverse impact on the value of our common stock.

There are uncertainties relating to the estimate of our special E&P distribution, which could result in our disqualification as a REIT.

In order to remain qualified as a REIT, we were required to distribute to our stockholders all of our accumulated non-REIT tax earnings and profits, or E&P, prior to the end of our first taxable year as a REIT, which was the taxable period ended December 31, 2006. In 2006, a special E&P distribution in the aggregate amount of approximately \$445 million was distributed to our stockholders. We believe that the amount of our special E&P distribution equaled or exceeded the amount required to be distributed in order to satisfy the requirements relating to the distribution of E&P. There are, however, substantial uncertainties relating to the determination of the amount of our pre-REIT E&P, including the possibility that the IRS could, in any audits for tax years through 2005, successfully assert that our taxable income should be increased, which would increase our pre-REIT E&P. Thus, we might fail to satisfy the requirement that we distributed all of our pre-REIT E&P by the close of our first taxable year as a REIT. Moreover, although there are procedures available to cure a failure to distribute all of our pre-REIT E&P, we cannot now determine whether we would be able to take advantage of them or the economic impact on us of doing so.

Table of Contents

Certain of our business activities are potentially subject to prohibited transactions tax on 100% of our net income, which would reduce our cash flow and impair our ability to make distributions.

REITs are generally intended to be passive entities and can thus only engage in those activities permitted by the Internal Revenue Code, which for us generally include: owning and managing a timberland portfolio; growing timber; and selling standing timber. Accordingly, the manufacture and sale by us of wood products, pulp and paperboard, tissue products, certain types of timberlands sales, and the harvest and sale of logs are conducted through Potlatch TRS because such activities generate non-qualifying REIT income and could constitute prohibited transactions if such activities were engaged in directly by the REIT. In general, prohibited transactions are defined by the Internal Revenue Code to be sales or other dispositions of property held primarily for sale to customers in the ordinary course of a trade or business.

By conducting our business in this manner, we believe we will satisfy the REIT requirements of the Internal Revenue Code and avoid the 100% tax that could be imposed if a REIT were to conduct a prohibited transaction. We may not always be successful, however, in limiting such activities to Potlatch TRS. Therefore, we could be subject to the 100% prohibited transactions tax if such instances were to occur, which would adversely affect our cash flow and impair our ability to make quarterly distributions.

ITEM 1B.

Unresolved Staff Comments

Not applicable.

10 / POTLATCH CORPORATION

Table of Contents

ITEM 2.

Properties

For information regarding our timberlands, see the discussion under the heading "Resource Segment" on pages 3-4 of this report. Our principal manufacturing facilities at December 31, 2007, which are all owned by us except as noted, together with their respective 2007 annual capacities and production, are as follows:

| | CAPACITY ^A | PRODUCTION ^A |
|-----------------------------------|-----------------------|-------------------------|
| WOOD PRODUCTS | | |
| Sawmills: | | |
| Prescott, Arkansas | 180,000 mbf | 170,000 mbf |
| Warren, Arkansas | 170,000 mbf | 154,000 mbf |
| Lewiston, Idaho | 205,000 mbf | 199,000 mbf |
| St. Maries, Idaho | 125,000 mbf | 120,000 mbf |
| Gwinn, Michigan | 180,000 mbf | 169,000 mbf |
| Bemidji, Minnesota | 105,000 mbf | 102,000 mbf |
| Plywood Mill ^B : | | |
| St. Maries, Idaho | 175,000 msf | 173,000 msf |
| Particleboard Mill ^C : | | |
| Post Falls, Idaho | 75,000 msf | 64,000 msf |
| PULP AND PAPERBOARD | | |
| Pulp Mills: | | |
| Cypress Bend, Arkansas | 300,000 tons | 296,000 tons |
| Lewiston, Idaho | 545,000 tons | 508,000 tons |
| Bleached Paperboard Mills: | | |
| Cypress Bend, Arkansas | 325,000 tons | 321,000 tons |
| Lewiston, Idaho | 430,000 tons | 424,000 tons |
| CONSUMER PRODUCTS | | |
| Tissue Mills: | | |
| Lewiston, Idaho | 180,000 tons | 179,000 tons |
| Las Vegas, Nevada | 35,000 tons | 34,000 tons |
| Tissue Converting Facilities: | | |
| Lewiston, Idaho | 100,000 tons | 95,000 tons |
| Elwood, Illinois ^D | 47,000 tons | 43,000 tons |
| Las Vegas, Nevada | 50,000 tons | 48,000 tons |

^A mbf stands for thousand board feet; msf stands for thousand square feet.

^B 3/8 inch panel thickness basis.

^C 3/4 inch panel thickness basis.

^D The building located at this facility is leased by Potlatch, while the operating equipment located within the building is owned by Potlatch.

Table of Contents

ITEM 3.

Legal Proceedings

Beginning in February 2006, a series of private antitrust lawsuits were filed against us and certain other manufacturers of oriented strand board (OSB) by plaintiffs who claim they purchased OSB at artificially high prices. The cases have been consolidated into two Consolidated Amended Class Action Complaints in the United States District Court for the Eastern District of Pennsylvania under the caption In Re OSB Antitrust Litigation, one on behalf of direct purchasers of OSB and the other on behalf of indirect purchasers. The complaints allege that the defendant OSB manufacturers violated federal and state antitrust laws by purportedly conspiring from mid-2002 to the present to drive up the price of OSB. The consolidated indirect purchaser complaint also alleges that defendants violated various states' unfair competition laws and common law. Each consolidated complaint seeks an unspecified amount of monetary damages to be trebled as provided under the antitrust laws and other relief. The court has ordered that the cases may proceed as class actions. It certified a nationwide class of direct purchasers who bought OSB structural panel products directly from one of the defendants during the period from June 1, 2002 to February 24, 2006. It also certified a nationwide class of indirect purchaser end users who purchased new OSB manufactured or sold by one of the defendants during the same time period; this class excludes persons who only bought OSB that was incorporated into a house or other structure. The claims of the nationwide indirect purchaser class are limited to injunctive relief. However, the court also certified a multistate class of indirect purchasers in 17 states whose members may recover compensation as allowed by state law. We believe we have meritorious defenses to these claims, and we are defending ourselves accordingly. We sold our OSB manufacturing facilities to Ainsworth Lumber Co. Ltd. in September 2004.

On September 28, 2005, Ainsworth notified us by letter of its claims under the indemnification provisions of the asset purchase agreement between us and Ainsworth whereby Ainsworth purchased our OSB facilities. The claims involve alleged breaches of representations and warranties regarding the condition of certain of the assets sold to Ainsworth. In July 2006, Ainsworth filed a complaint for breach of contract in the United States District Court for the Southern District of New York seeking an unspecified amount of monetary damages. The federal court case was subsequently dismissed voluntarily, and Ainsworth refiled its complaint in the Supreme Court of the State of New York for the County of New York on September 21, 2006. We believe we have meritorious defenses to the claim, and we are defending ourselves accordingly.

We believe there is no pending or threatened litigation that would have a material adverse effect on our financial position, operations or liquidity.

ITEM 4.

Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2007.

EXECUTIVE OFFICERS OF THE REGISTRANT

Information as of March 1, 2008, and for at least the past five years concerning the executive officers of the company is as follows:

Michael J. Covey (age 50), was elected President and Chief Executive Officer, and a director of the company, effective in February 2006, and has served as Chairman of the Board, President and Chief Executive Officer of the company since January 2007. Prior to February 2006, he was employed by Plum Creek Timber Company, Inc., for 23 years, serving as Executive Vice President from August 2001 until December 2005.

Table of Contents

Eric J. Cremers (age 44), has served as Vice President, Finance and Chief Financial Officer since July 2007. Prior to July 2006, he was employed by Albertsons, Inc. and served as Senior Vice President of Corporate Strategy and Business Development from July 2002 through June 2006.

William R. DeReu (age 41), has served as Vice President, Real Estate, since May 2006. Prior to May 2006, he was employed by Plum Creek Timber Company, Inc., and served as Director, National Land Asset Management Services from February 2006 through April 2006. From December 2002 through February 2006, he was Senior Land Asset Manager, Lake States Region, at Plum Creek.

Robert P. DeVleming (age 55), has served as Vice President, Consumer Products, since October 2004. From May 2003 through October 2004, he was Vice President, Sales, Consumer Products Division. From August 2002 through May 2003, he was Vice President, Tissue Expansion, Consumer Products Division. He has been with the company for 29 years.

Richard K. Kelly (age 60), has served as Vice President, Wood Products, since July 1999. He has been with the company for 32 years.

Pamela A. Mull (age 53), has served as Vice President and General Counsel since March 2006. From July 2006 to July 2007, she was also Corporate Secretary. Prior to March 2006, she served as Associate General Counsel. She has been with the company for 18 years.

Harry D. Seamans (age 54), has served as Vice President, Pulp and Paperboard, since January 2003. He has been with the company for 30 years.

Brent L. Stinnett (age 60), has served as Vice President, Resource Management, since August 2006. Prior to August 2006, he was employed by Plum Creek Timber Company, Inc., and served as Vice President and General Manager of the Gulf South region for Plum Creek from May 2002 through July 2006.

NOTE: The term of office of the officers of the company expires at the annual meeting of our board, and each officer holds office until the officer's successor is duly elected and qualified or until the earlier of the officer's death, resignation, retirement, removal by the board or as otherwise provided in our bylaws.

Table of Contents**Part II**

ITEM 5.

Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The company's common stock is traded on the New York and Chicago Stock Exchanges. The quarterly and yearly high and low sales price per share of our common stock, as reported in the New York Stock Exchange Composite Transactions for 2007 and 2006, as well as regular quarterly distribution payments per share for 2007 and 2006, were as follows:

| QUARTER | 2007 | | | 2006 | | |
|---------|----------|----------|---------------|----------|----------|---------------|
| | HIGH | LOW | DISTRIBUTIONS | HIGH | LOW | DISTRIBUTIONS |
| 1st | \$ 48.65 | \$ 43.32 | \$ 0.49 | \$ 54.26 | \$ 34.69 | \$ 15.80 |
| 2nd | 46.47 | 40.72 | 0.49 | 43.17 | 36.57 | 0.49 |
| 3rd | 47.00 | 38.99 | 0.49 | 39.16 | 33.65 | 0.49 |
| 4th | 49.98 | 41.14 | 0.51 | 44.94 | 36.67 | 0.49 |

The high share price for the first quarter of 2006 shown above was prior to the ex-dividend date for a \$15.15 per common share special earnings and profit, or E&P, distribution that was paid on March 31, 2006. On February 9, 2006, the date prior to the ex-dividend date with respect to the special E&P distribution, the closing share price of our common stock was \$50.35. On February 10, 2006, the ex-dividend date with respect to the special E&P distribution, the closing share price of our common stock was \$36.78. A full discussion of our special E&P distribution is included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of Part II of this report under the heading REIT Conversion.

There were approximately 1,180 stockholders of record at January 31, 2008.

The board of directors reviews and approves distributions by the company. The board considers a variety of factors in determining the distribution rate, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions, tax considerations and borrowing capacity. Consequently, the level of distributions to our stockholders may fluctuate and any reduction in the distribution rate may adversely affect our stock price.

Reference is made to the discussion in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, in Part II of this report, under the heading Liquidity and Capital Resources of (i) the covenants in our unsecured bank credit facility with which we must remain in compliance in order to make cash distributions and (ii) the REIT tax rules, which under certain circumstances may restrict our ability to receive dividends from Potlatch TRS, our taxable REIT subsidiary.

There are currently no authorized repurchase programs in effect under which the company may repurchase shares.

The table containing equity compensation plan information set forth in Item 12 of Part III of this report is incorporated herein by reference.

Table of Contents

ITEMS 6, 7, 7A and 8

The information called for by Items 6, 7, 7A and 8, inclusive, of Part II of this form is contained in the following sections of this report at the pages indicated below:

| | PAGE |
|---|---------------|
| | NUMBER |
| ITEM 6 <u>Selected Financial Data</u> | 22 |
| ITEM 7 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 23-43 |
| ITEM 7A <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 43-45 |
| ITEM 8 <u>Financial Statements and Supplementary Data</u> | 46-83 |
| ITEM 9. | |

Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

ITEM 9A.

Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of disclosure controls and procedures is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Subject to the limitations noted above, our management, with the participation of our CEO and CFO, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal year covered by this annual report on Form 10-K. Based on that evaluation, the CEO and CFO have concluded that, as of such date, our disclosure controls and procedures are effective to meet the objective for which they were designed and operate at the reasonable assurance level.

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes

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in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management, with the participation of the CEO and CFO, assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control-Integrated Framework*.

2007 FORM 10-K / 15

Table of Contents

Based on our assessment, management believes that, as of December 31, 2007, our internal control over financial reporting is effective based on those criteria.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes in our internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B.

Other Information

None.

16 / POTLATCH CORPORATION

Table of Contents

Part III

ITEM 10.

Directors, Executive Officers and Corporate Governance

Information regarding our directors is set forth under the heading "Board of Directors" in our definitive proxy statement, to be filed on or about March 26, 2008, for the 2008 annual meeting of stockholders, referred to in this report as the 2008 Proxy Statement, which information is incorporated herein by reference. Information concerning Executive Officers is included in Part I of this report following Item 4. Information regarding reporting compliance with Section 16(a) for directors, officers or other parties is set forth under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" in the 2008 Proxy Statement and is incorporated herein by reference.

We have adopted a Corporate Conduct and Ethics Code that applies to all directors and employees. You can find our Corporate Conduct and Ethics Code on our website by going to the following address: www.potlatchcorp.com, selecting "Investor Resources and Corporate Governance," and then selecting the link for "Corporate Conduct and Ethics Code." We will post any amendments, as well as any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, on our website. To date, no waivers of the Corporate Conduct and Ethics Code have been considered or granted.

Our board of directors has adopted corporate governance guidelines and charters for the board of directors "Audit Committee, Executive Compensation and Personnel Policies Committee, and Nominating and Corporate Governance Committee. You can find these documents on our website by going to the following address: www.potlatchcorp.com, selecting "Investor Resources and Corporate Governance," and then selecting the appropriate link.

You can also obtain a printed copy of any of the materials referred to above by contacting us at the following address:

Potlatch Corporation

Attention: Corporate Secretary

601 West 1st Ave., Suite 1600

Spokane, Washington 99201

Telephone: (509) 835-1500

The Audit Committee of our board of directors is an "audit committee" for purposes of Section 3(a)(58) of the Exchange Act. As of December 31, 2007, the members of that committee were Boh A. Dickey (Chair), Ruth Ann M. Gillis, Jerome C. Knoll, and Gregory L. Quesnel. The board of directors has determined that Mr. Dickey is an "audit committee financial expert" and that he and all of our Audit Committee members are "independent" as defined under the applicable rules and regulations of the SEC and the listing standards of the New York Stock Exchange.

ITEM 11.

Executive Compensation

Information set forth under the heading "Compensation Discussion and Analysis" in the 2008 Proxy Statement is incorporated herein by reference.

Table of Contents

ITEM 12.

Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information regarding any person or group known by us to be the beneficial owner of more than five percent of our common stock as well as the security ownership of management set forth under the heading "Stock Ownership" in the 2008 Proxy Statement is incorporated herein by reference.

The following table provides certain information as of December 31, 2007, with respect to our equity compensation plans:

| PLAN CATEGORY | NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS | WEIGHTED AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS | NUMBER OF SECURITIES REMAINING AVAILABLE FOR FUTURE ISSUANCE UNDER EQUITY COMPENSATION PLANS |
|--|---|---|---|
| Equity compensation plans approved by security holders | 1,180,330 | \$ 25.08 | 1,045,599 |
| Equity compensation plans not approved by security holders | | | |
| Total | 1,180,330 | \$ 25.08 | 1,045,599 |

¹ Includes 633,491 performance shares and 37,555 restricted stock units (RSUs), which are the maximum number of shares that could be awarded under the performance share and RSU programs, not including future dividend equivalents. Performance shares and RSUs are not included in the weighted average exercise price calculation.

ITEM 13.

Certain Relationships and Related Transactions, and Director Independence

There are no relationships or transactions that are required to be reported.

The information required by this item regarding director independence is included under the heading, "Board of Directors," in the 2008 Proxy Statement and is incorporated herein by reference.

ITEM 14.

Principal Accounting Fees and Services

Information set forth under the heading "Fees Paid to Independent Auditor in 2007 and 2006" in the 2008 Proxy Statement is incorporated herein by reference.

Table of Contents

PART IV

ITEM 15.

Exhibits and Financial Statement Schedules

CONSOLIDATED FINANCIAL STATEMENTS

Our consolidated financial statements are listed in the Index to Consolidated Financial Statements and Schedules on page 21 of this report.

FINANCIAL STATEMENT SCHEDULES

Our financial statement schedules are listed in the Index to Consolidated Financial Statements and Schedules on page 21 of this report.

EXHIBITS

Exhibits are listed in the Exhibit Index on pages 84-87 of this report.

2007 FORM 10-K / 19

Table of Contents

SIGNATURES

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

POTLATCH CORPORATION

(Registrant)

By /S/ MICHAEL J. COVEY
Michael J. Covey
Chairman of the Board, President

and Chief Executive Officer

Date: February 20, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on February 20, 2008, by the following persons on behalf of the registrant in the capacities indicated.

| | | |
|----|---|---|
| BY | /S/ MICHAEL J. COVEY Michael J. Covey | Director, Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer) |
| BY | /S/ ERIC J. CREMERS Eric J. Cremers | Vice President, Finance and Chief Financial Officer (Principal Financial Officer) |
| BY | /S/ TERRY L. CARTER Terry L. Carter | Controller (Principal Accounting Officer) |
| | * | Director |
| | Boh A. Dickey | |
| | * | Director |
| | William L. Driscoll | |
| | * | Director |
| | Ruth Ann M. Gillis | |
| | * | Director |
| | Jerome C. Knoll | |
| | * | Director |
| | John S. Moody | |
| | * | Director |
| | Lawrence S. Peiros | |
| | * | Director |
| | Gregory L. Quesnel | |
| | * | Director |
| | Michael T. Riordan | |
| | * | Director |

Judith M. Runstad

*

Dr. William T. Weyerhaeuser

Director

*By

/S/ **MICHAEL S. GADD**
Michael S. Gadd

(Attorney-in-fact)

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Index to Consolidated Financial Statements and Schedules

The following documents are filed as part of this report:

| | PAGE NUMBER |
|--|------------------------|
| <u>Selected Financial Data</u> | 22 |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 23 43 |
| Consolidated Financial Statements: | |
| <u>Consolidated Statements of Operations and Comprehensive Income for the years ended December 31, 2007, 2006 and 2005</u> | 46 |
| <u>Consolidated Balance Sheets at December 31, 2007 and 2006</u> | 47 |
| <u>Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005</u> | 48 |
| <u>Consolidated Statements of Stockholders' Equity for the years ended December 31, 2007, 2006 and 2005</u> | 49 |
| <u>Summary of Principal Accounting Policies</u> | 50 56 |
| <u>Notes to Consolidated Financial Statements</u> | 57 80 |
| <u>Reports of Independent Registered Public Accounting Firm</u> | 81 82 |
| Schedules: | |
| <u>II. Valuation and Qualifying Accounts</u> | 83 |
| All other schedules are omitted because they are not required, not applicable or the required information is given in the consolidated financial statements. | |

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Selected Financial Data

(Dollars in thousands except per-share amounts)

| | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|--------------|--------------|--------------|--------------|--------------|
| Revenues | \$ 1,654,021 | \$ 1,599,228 | \$ 1,495,930 | \$ 1,352,643 | \$ 1,191,455 |
| Earnings (loss) from continuing operations | 93,154 | 156,046 | 36,260 | 17,360 | (1,129) |
| Net earnings | 56,432 | 139,110 | 32,964 | 271,249 | 50,727 |
| Working capital | 49,252 | 160,255 | 255,256 | 254,409 | 305,627 |
| Current ratio | 1.2 to 1 | 1.8 to 1 | 2.7 to 1 | 2.7 to 1 | 2.8 to 1 |
| Long-term debt (including current portion) | \$ 321,510 | \$ 327,631 | \$ 335,454 | \$ 336,522 | \$ 618,785 |
| Stockholders' equity | 578,336 | 577,859 | 705,148 | 671,389 | 470,851 |
| Long-term debt to stockholders' equity ratio | 0.6 to 1 | 0.6 to 1 | 0.5 to 1 | 0.5 to 1 | 1.3 to 1 |
| Capital expenditures ¹ | \$ 90,072 | \$ 51,432 | \$ 95,083 | \$ 40,479 | \$ 67,715 |
| Total assets | 1,517,204 | 1,457,607 | 1,628,177 | 1,594,066 | 1,596,916 |
| Basic earnings (loss) from continuing operations per common share | \$ 2.38 | \$ 4.28 | \$ 1.25 | \$ 0.59 | \$ (0.04) |
| Basic net earnings per common share | 1.44 | 3.81 | 1.13 | 9.23 | 1.77 |
| Average common shares outstanding (in thousands) | 39,094 | 36,465 | 29,120 | 29,397 | 28,706 |
| Diluted earnings (loss) from continuing operations per common share | \$ 2.37 | \$ 4.26 | \$ 1.24 | \$ 0.59 | \$ (0.04) |
| Diluted net earnings per common share | 1.43 | 3.79 | 1.13 | 9.19 | 1.77 |
| Average common shares outstanding, assuming dilution (in thousands) | 39,384 | 36,672 | 29,252 | 29,515 | 28,718 |
| Distributions/Dividends per common share ² | \$ 1.98 | \$ 17.27 | \$ 0.60 | \$ 3.10 | \$ 0.60 |

¹ Included in capital expenditures for 2007 are \$14.5 million and \$35.3 million related to the acquisitions of approximately 76,000 acres of timberland in Wisconsin and 145,000 acres of timberland in Idaho, respectively. The remaining balance of cash expended in 2007 of approximately \$43.5 million for the Wisconsin timberlands and approximately \$118.8 million for the Idaho timberlands is included in Deposits on timberlands on our Consolidated Statements of Cash Flows and is not included in the capital expenditures balance above.

² Distributions for 2006 included a special E&P distribution of \$15.15 per common share, paid with a combination of cash and shares of the company's common stock. Dividends for 2004 included a special cash dividend of \$2.50 per common share. Certain amounts for 2003 through 2006 have been reclassified to conform to the 2007 presentation.

Table of Contents

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

OVERVIEW

Potlatch is a real estate investment trust, or REIT, that owns and manages approximately 1.7 million acres of timberlands located in Arkansas, Idaho, Minnesota, and Wisconsin. We are also engaged in the production of commodity wood products and bleached pulp products.

As of December 31, 2007, our business was organized into five segments:

The Resource segment consists of substantially all of our timberlands, as well as those assets necessary to manage these timberlands. The primary business of the segment is the management of our timberlands to optimize the value of all possible revenue producing opportunities while at the same time adhering to our strict stewardship standards. Management activities include, but are not limited to, planting trees, harvesting trees, building and maintaining roads, development of management plans and recreation lease management. In 2007, Resource segment revenues were \$296.8 million, representing approximately 16% of our net revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$170.8 million in 2007.

In January 2007, we completed the acquisition of 76,000 acres of prime timberland in Wisconsin for \$64.5 million. This was our first significant purchase of timberland in more than a decade. The purchase of the Wisconsin timberlands was matched with sales of our own lands, primarily the hybrid poplar tree farm in Boardman, Oregon, for Internal Revenue Code section 1031 like-kind exchange purposes.

In September 2007, we entered into agreements to acquire approximately 179,000 acres of timberland in Idaho for approximately \$215 million. We completed the acquisition of the timberland in two separate transactions, with the first closing in September 2007 and the second closing in January 2008.

The Real Estate segment, formerly known as the Land Sales and Development segment, consists of the sale of selected non-strategic timberland real estate, including sales of land for higher and better use purposes, and the acquisition of timberlands. Results for this segment depend on the timing of closing of transactions for those non-strategic property sales. This segment also engages in land development activities through Potlatch TRS. Real Estate segment net revenues for 2007 were \$24.1 million, which represented approximately 1% of our net revenues from continuing operations. The segment did not have intersegment revenues in 2007.

The Wood Products segment manufactures lumber, plywood and particleboard at eight mills located in Arkansas, Idaho, Michigan and Minnesota. The segment's products are largely commodity products, which are sold to wholesalers primarily for use in home building and other construction activity. Wood Products segment net revenues were \$464.6 million in 2007, representing approximately 25% of our revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$20.1 million in 2007.

The Pulp and Paperboard segment manufactures bleached paperboard used in packaging and bleached softwood market pulp. The Pulp and Paperboard segment operates two pulp and paperboard mills located in Arkansas and Idaho. Pulp and Paperboard segment net revenues were \$670.6 million in 2007, representing approximately 35% of our revenues from

continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$55.8 million in 2007.

Table of Contents

The Consumer Products segment manufactures tissue products primarily sold on a private label basis to major grocery store chains. The segment operates two tissue mills with related converting facilities in Idaho and Nevada, and one additional converting facility located in Illinois. Consumer Products segment net revenues were \$444.7 million in 2007, representing approximately 23% of our revenues from continuing operations, before elimination of intersegment revenues. Intersegment revenues were \$0.1 million in 2007.

In May 2007, we sold our hybrid poplar tree farm in Boardman, Oregon, for \$65 million in cash. We applied a large portion of the proceeds from this sale to our acquisition in the first quarter of 2007 of 76,000 acres of timberlands in Wisconsin through a tax-efficient Internal Revenue Code section 1031 like-kind exchange. Our consolidated financial statements and this discussion reflect the classification of the Boardman operation as discontinued operations for all periods presented.

REIT CONVERSION

Effective January 1, 2006, we restructured our operations to qualify for treatment as a real estate investment trust, or REIT, for federal income tax purposes. The REIT tax rules require that we derive most of our income, other than income generated by a taxable REIT subsidiary, from investments in real estate, which for us primarily consists of income from the sale of standing timber. Accordingly, prior to our REIT conversion we transferred to our wholly-owned taxable REIT subsidiary, Potlatch Forest Products Corporation, which we refer to in this report as Potlatch TRS, substantially all of our non-timberland assets, consisting primarily of our manufacturing facilities engaged in the manufacturing of wood products, pulp and paperboard and tissue products, assets previously used by us for the harvesting of timber and the sale of logs, and selected land parcels that we expect will be sold or developed for higher and better use purposes. Our use of Potlatch TRS, which is taxed as a C corporation, enables us to continue to engage in these non-REIT qualifying businesses without violating the REIT requirements. In connection with this restructuring, our subsidiary that holds our timberlands agreed to sell standing timber to Potlatch TRS at fair market prices.

As a REIT, generally we are not subject to federal corporate income taxes on ordinary taxable income and capital gains income from real estate investments that we distribute to our stockholders. We increased our regular quarterly distributions from an average of approximately \$4.4 million in 2005 to an average of approximately \$19.0 million in 2006 and approximately \$20.0 million in the fourth quarter of 2007. Distributions are determined and declared by the board of directors based on consideration of a number of factors, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions, tax considerations and borrowing capacity. Consequently, the level of future distributions to our stockholders may fluctuate, and any reduction in the distribution rate may adversely affect our stock price.

Under the REIT rules, to remain qualified as a REIT, a REIT must distribute, within a certain period after the end of each year, 90% of its ordinary taxable income for such year. We anticipate that our REIT income in the foreseeable future will consist primarily of net capital gains resulting from payments to be received under timber cutting contracts with Potlatch TRS and third parties, and not ordinary taxable income. Therefore, unlike most REITs, we may not be required to distribute material amounts of cash to remain qualified as a REIT. If, after giving effect to our distributions, we have not distributed an amount equal to 100% of our ordinary taxable income and net capital gains income, then we would be required to pay tax on the undistributed portion of such taxable income at regular corporate tax rates. In this case, our stockholders could be required to include their proportionate share of any undistributed capital gain in income and would receive a credit or refund for their share of the tax paid by us.

As a consequence of our conversion to a REIT, we were not permitted to retain earnings and profits accumulated during years when we were taxed as a C corporation. Therefore, in order to remain qualified as a REIT, we distributed these earnings and profits by making a one-time special distribution to stockholders, which we refer to as the special E&P distribution, on

Table of Contents

March 31, 2006. The special E&P distribution, with an aggregate value of approximately \$445 million, consisted of \$89 million in cash and approximately 9.1 million shares of Potlatch common stock valued at \$356 million.

Although as a REIT our taxes are significantly lower than those of a C corporation, if during the ten year period following the REIT conversion we sell any property not transferred to Potlatch TRS, other than through the utilization of an Internal Revenue Code section 1031 like-kind exchange or other than the sale of standing timber pursuant to a timber cutting contract, we will be subject to a corporate level federal income tax at the highest regular corporate rate on an amount equal to the excess of (i) the fair market value of the disposed property as of January 1, 2006, over (ii) our adjusted income tax basis in such property as of that date.

We will also continue to be required to pay federal corporate income taxes on income from our non-real estate investments, principally the operations of Potlatch TRS. Our use of Potlatch TRS enables us to continue to engage in non-REIT qualifying business activities. However, under the Internal Revenue Code, no more than 20% of the value of the assets of a REIT may be represented by securities of one or more taxable REIT subsidiaries. This limitation may affect our ability to make investments in our manufacturing operations or in other non-REIT qualifying operations.

As a REIT, our ability to receive dividends from Potlatch TRS will be limited by the rules with which we must comply to maintain REIT status. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to fund distributions to stockholders using cash flows from Potlatch TRS.

FACTORS INFLUENCING OUR RESULTS OF OPERATIONS AND CASH FLOWS

The operating results of our timberlands and manufacturing businesses have been and will continue to be influenced by a variety of factors, including the cyclical nature of the forest products industry, changes in timber prices and in harvest levels from our timberlands, competition, the efficiency and level of capacity utilization of our manufacturing operations, changes in our principal expenses, such as wood fiber and energy costs, and changes in the production capacity of our manufacturing operations as a result of major capital spending projects, asset dispositions or acquisitions and other factors.

Our results of operations and cash flows can be materially affected by the fluctuating nature of timber prices. A variety of factors affect prices for timber, including factors affecting demand, such as changes in economic conditions, construction activity levels, interest rates, population growth and weather conditions, as well as changes in timber supply and other factors. All of these factors can vary by region and by timber type, such as saw logs or pulpwood logs. In 2007, the overall price for our timber was up approximately 7% over 2006. In 2008, we expect overall pricing for our timber to decline by approximately 10%.

Our results of operations and cash flows are also affected by changes in timber availability at the local and national level. Increases in timber supply could adversely affect the prices that we receive for timber. Our timberland ownership is currently concentrated in Arkansas, Idaho, Minnesota and Wisconsin. In Arkansas and Minnesota, most timberlands are privately owned. Historically, increases in timber prices have often resulted in substantial increases in harvesting on private timberlands, including lands not previously made available for commercial timber operations, causing a short-term increase in supply that has tended to moderate price increases. In Idaho, where a greater proportion of timberland is publicly owned, any substantial increase in timber harvesting from these lands could significantly reduce timber prices, which could harm our results of operations. For more than twenty years, environmental concerns and other factors have limited timber sales by federal agencies, which historically had been major suppliers of timber to the United States forest products industry, particularly in the West. Any reversal of policy that substantially increases public timber sales could have a materially adverse effect on our results of operations and cash flows. On a local level, timber supplies can fluctuate depending upon factors such as changes in

Table of Contents

weather conditions and harvest strategies of local forest products industry participants, as well as occasionally high timber salvage efforts due to unusual pest infestations or fires.

Changes in harvest levels on our timberlands also may have a significant impact on our results of operations, due in part to the low cost basis of much of our timber from timberlands that we acquired many years ago. Over the long term, we manage our timberlands on a sustainable yield basis to achieve a balance between timber growth and timber harvests. From time to time, however, we may choose, consistent with our environmental commitments, to harvest timber at levels above or below our estimate of sustainability for various reasons. In 2007, the overall harvest from our timberlands was 3.9 million tons. Based on our current projections that take into consideration such factors as market conditions, the ages of our timber stands and recent timberland acquisitions and sales, we expect the overall timber harvest from our lands in 2008 to be between 4.2 million and 4.4 million tons, increasing to a range of 4.9 million to 5.3 million tons by 2010.

On a short-term basis, our timber harvest levels may be impacted by factors such as demand for timber and harvesting capacity. For example, in 2006 we deferred a portion of our planned timber harvest in our Southern region due to weak markets. In 2007, however, due to rebounding prices, we significantly increased the harvest from our Southern region timberlands, primarily to offset the 2006 deferred harvest. We also experience seasonally lower harvest activity during the winter and early spring due to weather conditions. Longer term, our timber harvest levels will be affected by acquisitions of additional timberlands, such as the Idaho timberlands discussed above and the Wisconsin timberlands purchased in early 2007, and sales of existing timberlands. In addition to timberland acquisitions and sales, future timber harvest levels may be affected by changes in estimates of long-term sustainable yield because of genetic improvements and other silvicultural advances, natural disasters, fires and other hazards, regulatory constraints and other factors beyond our control.

The operating results of our manufacturing operations generally reflect the cyclical pattern of the forest products industry. Historical prices for our manufactured products have been volatile, and we, like other manufacturers in the forest products industry, have limited direct influence over the timing and extent of price changes for our products. Product pricing is significantly affected by the relationship between supply and demand. Product supply is influenced primarily by fluctuations in available manufacturing capacity. Demand is affected by the state of the economy in general and a variety of other factors. The demand for our wood products is affected by the level of new residential construction activity and, to a lesser extent, home repair and remodeling activity, which are subject to fluctuations due to changes in economic conditions, interest rates, population growth, weather conditions and other factors. The demand for most of our pulp and paperboard products is primarily affected by the general state of the global economy, and the economies in North America and east Asia in particular. The demand for our tissue products is primarily affected by the state of the United States economy.

The markets for our products are highly competitive, and companies that have substantially greater financial resources than we do compete with us in each of our lines of business. Logs and other fiber from our timberlands, as well as our wood products, are subject to competition from timberland owners and wood products manufacturers in North America and to a lesser extent in South America, Europe, Australia and New Zealand. Our pulp-based products, other than tissue products, are globally traded commodity products. Because our competitors in these segments are located throughout the world, variations in exchange rates between the U.S. dollar and other currencies can significantly affect our competitive position compared to our international competitors. Since it is generally not profitable to sell tissue products overseas due to high transportation costs, and we do not sell a significant amount of tissue to Canada, currency exchange rates do not have a major effect on our ability to compete in our tissue business.

Our manufacturing businesses are capital intensive, which leads to high fixed costs and generally results in continued production as long as prices are sufficient to cover variable costs. These conditions have contributed to substantial price competition, particularly during periods of reduced demand. Some of our competitors may currently be lower-cost producers in

Table of Contents

some of the businesses in which we operate, and accordingly these competitors may be less adversely affected than we are by price decreases. In 2007, temporary downtime was taken due to an inability to cover variable costs at our Prescott and Warren, Arkansas, lumber mills, which both took approximately three weeks of downtime in the fourth quarter. Our Post Falls, Idaho, particleboard facility also took approximately two weeks of downtime during 2007 to reduce inventories. In 2006, temporary downtime was taken due to an inability to cover variable costs at our Prescott, Arkansas, lumber mill, which took approximately four weeks of downtime in the third quarter and our Warren, Arkansas, lumber mill, which took approximately three and six weeks of downtime in the third and fourth quarters, respectively. Following the 2006 downtime, both lumber mills began operating two shifts a day, compared to three shifts a day prior to the downtime. In addition to the Prescott and Warren downtime, our Gwinn, Michigan lumber mill and our Post Falls, Idaho particleboard facility took two weeks and one week of downtime, respectively, during 2006 to reduce inventories. No downtime was taken at any of our facilities in 2005 due to an inability to cover variable costs. However, downtime was taken during 2005 at our Gwinn, Michigan lumber facility and our Post Falls particleboard facility to reduce inventories. The profitability of our manufacturing segments depends largely on our ability to operate our manufacturing facilities efficiently and at or near full capacity. Our operating results can be adversely affected if market demand does not justify operating at these levels or if our operations are inefficient or suffer significant interruption for any reason.

Energy costs, which have become one of our most volatile operating expenses over the past several years, impact almost every aspect of our operations, from natural gas used at our manufacturing facilities to in-bound and out-bound transportation surcharges. In periods of high energy prices, market conditions may prevent us from passing higher energy costs on to our customers through price increases, and therefore such increased costs could adversely affect our operating results. For example, energy costs for the second half of 2005 were particularly high, exacerbated by petroleum and natural gas supply curtailments in the wake of the Gulf Coast hurricanes. We have taken steps through conservation and internal electrical production to reduce our exposure to both the volatile spot market for energy and to rate increases by regulated utilities. Our energy costs in future periods will depend principally on our ability to continue to produce a substantial portion of our electricity needs internally, on changes in market prices for natural gas and on reducing energy usage. To help mitigate the exposure to market risk for changes in natural gas commodity pricing, we occasionally use firm-price contracts to supply a portion of our natural gas requirements.

Another significant expense is the cost of wood fiber needed to supply our manufacturing facilities. The cost of various types of wood fiber that we purchase in the market has at times fluctuated greatly because of economic or industry conditions. Selling prices of our products have not always increased in response to wood fiber price increases, nor have wood fiber prices always decreased in conjunction with declining product prices. On occasion, our results of operations have been and may in the future be adversely affected if we are unable to pass cost increases through to our customers.

The disparity between the cost of wood fiber harvested from our timberlands and the cost of wood fiber purchased on the open market is due to the fact that the capitalized costs to establish most of our fee timber were expended many years ago. The initial stand establishment costs remain as a capitalized asset until the timber reaches maturity, which typically ranges from 30 to 60 years. Ongoing forest management costs include recurring items necessary to the ownership and administration of timber producing property and are expensed as incurred. The cost of purchased wood fiber is significantly higher due to the fact that the wood fiber being purchased from third parties is purchased at the current market price.

Changes in our timberland holdings and manufacturing capacity, primarily as a result of capital spending programs or asset purchases and dispositions, have affected our results of operations in recent periods. In May 2005, we purchased a lumber mill in Gwinn, Michigan. In January 2007, we purchased approximately 76,000 acres of timberlands in Wisconsin. In May 2007, we completed the sale of our hybrid poplar tree farm in Boardman, Oregon. In September 2007, we entered into agreements to

Table of Contents

acquire approximately 179,000 acres of timberland in Idaho. We completed the acquisition of the timberland in two separate transactions, with the first closing in September 2007 and the second closing in January 2008. These changes have affected or will affect our levels of net revenues and expenses, as well as the comparability of our operating results from period to period.

It is our practice to periodically review strategic and operational alternatives to improve our operating results and financial position. In this regard, we consider and plan to continue to consider, among other things, adjustments to our capital expenditures and overall spending, the expanding or restructuring of our operations to achieve efficiencies, and the disposition of assets that may have greater value to others. There can be no assurance that we will be successful in implementing any new strategic or operational initiatives or, if implemented, that they will have the effect of improving our operating results and financial position.

Among the reasons for our REIT conversion is that we will be better able to compete for acquisitions of timberlands against other entities that use tax-efficient structures. It is uncertain whether any timberland acquisitions we make will perform in accordance with our expectations. In addition, we anticipate financing acquisitions through Internal Revenue Code section 1031 like-kind exchanges, cash from operations, borrowings under our credit facility or proceeds from equity or debt offerings. Our inability to finance future acquisitions on favorable terms or the failure of any acquisition to perform as we expect could harm our results of operations.

CRITICAL ACCOUNTING POLICIES

Our principal accounting policies are discussed on pages 50-56 of this report. The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported financial position and operating results of the company. Management believes the accounting policies discussed below represent the most complex, difficult and subjective judgments it makes in this regard.

Long-lived assets. Due to the capital-intensive nature of our business, a significant portion of our total assets are invested in our timber and timberlands and our manufacturing facilities. Also, the cyclical patterns of our businesses cause cash flows to fluctuate by varying degrees from period to period. As a result, long-lived assets are a material component of our financial position with the potential for material change in valuation if assets are determined to be impaired. We account for impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, as measured by its undiscounted estimated future cash flows. We use our operational budgets to estimate future cash flows. Budgets are inherently uncertain estimates of future performance due to the fact that all inputs (revenues, costs and capital spending) are subject to frequent change for many different reasons, including the reasons previously described above under *Factors Influencing our Results of Operations and Cash Flows*. Because of the number of variables involved, the interrelationship between the variables and the long-term nature of the impairment measurement, sensitivity analysis of individual variables is not practical. Budget estimates are adjusted periodically to reflect changing business conditions, and operations are reviewed, as appropriate, for impairment using the most current data available. To date, this process has not resulted in an impairment charge for any of our assets associated with our continuing operations.

Timber and timberlands. Timber and timberlands are recorded at cost, net of depletion. Expenditures for reforestation, including all costs related to stand establishment, such as site preparation, costs of seeds or seedlings and tree planting, are capitalized. Expenditures for forest management, consisting of regularly recurring items necessary to the ownership and administration of our timber and timberlands, are accounted for as current operating expense. Our depletion is determined based on costs capitalized and the related current estimated recoverable timber volume. Recoverable volume does not include anticipated future growth, nor are anticipated future costs considered.

Table of Contents

There are currently no authoritative accounting rules relating to costs to be capitalized in the timber and timberlands category. We have used relevant portions of current accounting rules, industry practices and our judgment in determining costs to be capitalized or expensed. Alternate interpretations and judgments could significantly affect the amounts capitalized. Additionally, models and observations used to estimate the current recoverable timber volume on our lands are subject to judgments that could significantly affect volume estimates. Following are examples of factors that add to the complexity of the assumptions we make regarding capitalized or expensed costs:

harvest cycles can vary by geographic region and by species of timber;

weather patterns can affect annual harvest levels;

environmental regulations and restrictions may limit our ability to harvest certain timberlands;

changes in harvest plans may occur;

scientific advancement in seedlings and timber growing technology may affect future harvests;

land sales and acquisitions affect volumes available for harvest; and

major forest fire events or pest infestations can significantly affect future harvest levels.

Different assumptions for either the cost or volume estimates, or both, could have a significant effect upon amounts reported in our statements of operations and financial condition. Because of the number of variables involved and the interrelationship between the variables, sensitivity analysis of individual variables is not practical.

Restructuring charges and discontinued operations. In January 2007, we recorded a charge for a restructuring of our Resource segment. On March 30, 2007, we entered into a definitive agreement to sell our hybrid poplar tree farm in Boardman, Oregon. The sale was completed in the second quarter of 2007. These events required us to record estimates of liabilities for employee benefits and other costs at the time of the events. In making these judgments, we considered contractual obligations, legal liabilities and possible incremental costs incurred as a result of restructuring transactions to determine liability. Our estimated liabilities could differ materially from actual costs incurred, with resulting adjustments to future period earnings for any differences.

Environmental liabilities. We record accruals for estimated environmental liabilities that are not within the scope of SFAS No. 143, Accounting for Asset Retirement Obligations, and FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, in accordance with SFAS No. 5, Accounting for Commitments and Contingencies. These estimates reflect assumptions and judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities. In making these estimates, we consider, among other things, the activities we have conducted at any particular site, information obtained through consultation with applicable regulatory authorities and third parties, and our historical experience at other sites that are judged to be comparable. We must also consider the likelihood of changes in governmental regulations, advancements in environmental technologies, and changing legal standards regarding liability. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and changes in governmental regulations and environmental technologies, our accruals are subject to substantial uncertainties, and our actual costs could be materially more or less than the estimated amounts.

Pension and postretirement employee benefits. The determination of pension plan expense and the requirements for funding our pension plans are based on a number of actuarial assumptions. Two critical assumptions are the discount rate applied to pension plan obligations and the rate of return on plan assets. For other postretirement employee benefit, or OPEB, plans, which provide certain health care and life insurance benefits to qualified retired employees, critical assumptions in determining OPEB expense are the discount rate applied to benefit obligations and the assumed health care cost trend rates used in the calculation of benefit obligations.

Table of Contents

Note 12 to the consolidated financial statements on pages 65-71 includes information for the three years ended December 31, 2007, on the components of pension and OPEB expense and the underlying actuarial assumptions used to calculate periodic expense, as well as the funded status for our pension and OPEB plans as of December 31, 2007 and 2006.

The discount rate used in the determination of pension benefit obligations and pension expense is a weighted average benchmark rate based on high-quality fixed income investment interest rates, as well as the amount and timing of expected benefit payments. At December 31, 2007, we calculated obligations using a 6.40% discount rate. The discount rates used at December 31, 2006 and 2005 were 5.85% and 5.60%, respectively. To determine the expected long-term rate of return on pension assets, we employ a process that analyzes historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. The assumed long-term rates of return on pension plan assets used for the years ended December 31, 2007, 2006 and 2005 were 9.0%, 9.5% and 9.5%, respectively. Over the past 30 years, the period we have actively managed pension assets, our actual average annual return on pension plan assets has been approximately 11%.

Total periodic pension plan income in 2007 was \$8.3 million. An increase in the discount rate or the expected return on plan assets, all other assumptions remaining the same, would increase pension plan income, and conversely, a decrease in either of these measures would decrease plan income. As an indication of the sensitivity that pension income has to the discount rate assumption, a 25 basis point change in the discount rate would affect annual plan income by approximately \$1.4 million. A 25 basis point change in the assumption for expected return on plan assets would affect annual plan income by approximately \$1.7 million. The actual rates on plan assets may vary significantly from the assumption used because of unanticipated changes in financial markets.

No minimum contributions to our qualified pension plans are estimated for 2008 due to the funded status of those plans at December 31, 2007. However, we estimate contributions will total approximately \$1.7 million in 2008 to our non-qualified pension plan. We do not anticipate funding our postretirement employee benefit plans in 2008 except to pay benefit costs as incurred during the year by plan participants.

For our OPEB plans, expense for 2007 was \$19.3 million. The discount rate used to calculate OPEB obligations, which was determined using the same methodology we used for our pension plans, was 6.40% at December 31, 2007, and 5.85% and 5.60% at December 31, 2006 and 2005, respectively. The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2007 was a 10% increase over the previous year, with the rate of increase scheduled to decline one percent annually to a long-term ultimate rate increase assumption of 6% for 2011 and thereafter.

As an indication of the sensitivity that OPEB expense has to the discount rate assumption, a 25 basis point change in the discount rate would affect plan expense by approximately \$0.5 million. A 1% change in the assumption for health care cost trend rates would have affected 2007 plan expense by approximately \$1.6 - \$1.9 million and the total postretirement employee obligation by approximately \$21.4 - \$25.0 million, as reported in Note 12 on page 70. The actual rates of health care cost increases may vary significantly from the assumption used because of unanticipated changes in health care costs.

Periodic pension and OPEB expense are included in Materials, labor and other operating expenses and Selling, general and administrative expenses in the Consolidated Statements of Operations and Comprehensive Income. The expense is allocated to all business segments. In accordance with SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), long-term assets are recorded at December 31, 2007 and 2006, for overfunded plans and liabilities are recorded at December 31, 2007 and 2006, for underfunded plans. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. For underfunded plans, the estimated liability to be payable in the next twelve months is recorded as a current liability, with the remaining portion recorded as long-term. See Note 12 on pages 65-71 for further discussion.

Table of Contents**RESULTS OF OPERATIONS**

At December 31, 2007, our business was organized into five reporting segments: Resource, Real Estate, Wood Products, Pulp and Paperboard, and Consumer Products. Sales or transfers between segments are recorded as intersegment revenues based on prevailing market prices. Because of the role of the Resource segment in supplying our manufacturing segments with wood fiber, intersegment revenues represented a significant portion of the Resource segment's total revenues in 2007. Intersegment revenues represent a substantially smaller percentage of revenues for our other segments.

In the period-to-period discussion of our results of operations below, when we discuss our consolidated revenues, contributions by each of the segments to our revenues are reported after elimination of intersegment revenues. In the Discussion of Business Segments sections below, each segment's revenues are presented before elimination of intersegment revenues.

YEAR ENDED DECEMBER 31, 2007 COMPARED TO YEAR ENDED DECEMBER 31, 2006

The following table sets forth year-to-year changes in items included in our Consolidated Statements of Operations and Comprehensive Income for the years ended December 31, 2007 and 2006.

| (Dollars in thousands) | YEARS ENDED DECEMBER 31, | | |
|---|--------------------------|--------------|------------------------|
| | 2007 | 2006 | INCREASE (DECREASE) |
| Revenues | \$ 1,654,021 | \$ 1,599,228 | \$ 54,793 |
| Costs and expenses: | | | |
| Depreciation, depletion and amortization | 80,084 | 79,786 | 298 |
| Materials, labor and other operating expenses | 1,365,191 | 1,332,701 | 32,490 |
| Selling, general and administrative expenses | 90,488 | 90,529 | (41) |
| Restructuring charge | 2,653 | | 2,653 |
| Income from Canadian lumber settlement | | 39,320 | (39,320) |
| Earnings from continuing operations before interest and taxes | 115,605 | 135,532 | (19,927) |
| Interest expense | (30,710) | (29,120) | (1,590) |
| Debt retirement costs | | 53 | (53) |
| Interest income | 2,282 | 1,876 | 406 |
| Benefit for taxes | (5,977) | (47,705) | 41,728 |
| Earnings from continuing operations | 93,154 | 156,046 | (62,892) |
| Discontinued operations, net of tax | (36,722) | (16,936) | (19,786) |
| Net earnings | \$ 56,432 | \$ 139,110 | \$ (82,678) |
| Other comprehensive income, net of tax | 3,399 | | 3,399 |
| Comprehensive income | \$ 59,831 | \$ 139,110 | \$ (79,279) |

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

Revenues Total revenues from continuing operations of \$1.65 billion for the year ended December 31, 2007, were \$54.8 million higher than the \$1.60 billion recorded for the same period in 2006. Resource segment revenues were \$126.0 million for 2007, compared to \$105.7 million for 2006. The higher revenues were due to increased sales of logs to external customers for our Northern and Southern regions and higher log selling prices for our Southern region. Real Estate revenues were \$24.1 million in 2007, \$10.5 million higher than in 2006 due to increased sales in 2007 of properties identified as non-strategic through our stratification process. Revenues for Wood Products were \$444.5 million for 2007, compared to \$481.0 million for

Table of Contents

2006. The decrease was largely attributable to lower selling prices and decreased shipments of lumber, which were largely the result of the generally poor housing market in 2007. The decreased lumber shipments were primarily at our Prescott and Warren, Arkansas, sawmills, which reduced their daily operations from three shifts to two shifts beginning in the fourth quarter of 2006. Pulp and Paperboard revenues increased to \$614.8 million for 2007, compared to \$562.1 million for 2006, primarily due to higher pulp and paperboard selling prices and increased shipments of pulp to external customers. Consumer Products revenues were \$444.6 million in 2007, a slight increase compared to revenues of \$436.8 million in 2006 due to higher selling prices in 2007, which were mostly offset by decreased shipments of consumer tissue products.

Depreciation, depletion and amortization For the year ended December 31, 2007, depreciation, depletion and amortization expenses of \$80.1 million were relatively unchanged compared to \$79.8 million in 2006.

Materials, labor and other operating expenses Materials, labor and other operating expenses were \$1.37 billion for 2007, compared to \$1.33 billion recorded in 2006. The increase was due primarily to higher wood fiber costs for the Pulp and Paperboard segment, higher pulp costs for the Consumer Products segment, costs associated with increased plywood and pulp shipments, and additional expenses associated with increased fee timber harvests for our Resource segment. Decreased shipments of lumber and consumer tissue products, lower log costs for the Wood Products segment and fewer outside logs purchased by the Resource segment partially offset the unfavorable comparison.

Selling, general and administrative expenses For the year ended December 31, 2007, selling, general and administrative expenses were \$90.5 million, which was virtually unchanged from the amount recorded in 2006.

Restructuring charge In January 2007, we recorded a pre-tax charge of \$2.8 million associated with a restructuring within our Resource segment. A reduction to this charge of \$0.1 million was recorded in the third quarter of 2007. The charge represented estimated severance benefit costs for 35 employees. As of December 31, 2007, all amounts related to this charge had been paid.

Income from Canadian lumber settlement We received \$39.3 million in the fourth quarter of 2006 associated with the negotiated settlement of the softwood lumber trade dispute between the United States and Canada. The \$39.3 million represented our total pro rata share of \$500 million that was distributed to members of the Coalition for Fair Lumber Imports, of which we are a member.

Interest expense Interest expense totaled \$30.7 million for 2007, compared to \$29.1 million for 2006. The increase was due largely to interest expense in the fourth quarter of 2007 related to short-term borrowings under our unsecured bank credit facility revolving line of credit that were used to fund a portion of the purchase of 145,000 acres of Idaho timberlands for approximately \$163 million in September 2007.

Interest income For the year ended December 31, 2007, interest income was \$2.3 million, compared to \$1.9 million recorded for 2006. The increase was primarily due to a higher average cash and short-term investments balance for 2007.

Benefit for taxes For the year ended December 31, 2007, an income tax benefit of \$6.0 million related to continuing operations was recorded, compared to an income tax benefit of \$47.7 million recorded for 2006. The income tax benefit for 2007 included a \$3.9 million favorable adjustment for final determination of amounts owed to the IRS for the years 1995-2004, combined with a pre-tax operating loss for Potlatch TRS. Excluding this adjustment, our income tax benefit for 2007 was \$2.1 million, primarily due to the pre-tax loss for Potlatch TRS. The income tax benefit for 2006 was largely due to the reversal of \$56.5 million in timber-related deferred tax liabilities that were no longer necessary as a result of our REIT conversion. Excluding these tax benefits, we recorded an income tax provision of \$8.8 million in 2006, primarily due to pre-tax income for Potlatch TRS. Compared to 2007, the effective tax rate for 2006 was higher due primarily to \$39.3 million of pre-tax TRS income received in 2006 in association with the negotiated settlement of the softwood lumber trade dispute between the United States and Canada.

Table of Contents

Earnings from continuing operations In 2007, we recorded earnings from continuing operations of \$93.2 million, compared to \$156.0 million for 2006. The unfavorable comparison was due to the fact that 2006 results included the reversal of deferred tax liabilities and income from the Canadian lumber settlement, as discussed above, partially offset by higher earnings for our Pulp and Paperboard and Real Estate segments in 2007.

Discontinued operations For the year ended December 31, 2007, we recorded an after-tax loss of \$33.0 million related to sale of our Boardman, Oregon, hybrid poplar tree farm, which was completed during the second quarter. Excluding the loss on disposal, the Boardman operation recorded an after-tax operating loss of \$3.7 million for 2007, compared to a loss of \$16.9 million for 2006.

Other comprehensive income, net of tax Beginning in 2007, due to our adoption of SFAS No. 158, we are required to record comprehensive income or loss related to our defined benefit pension and other postretirement employee benefit plans for each reporting period when net gains or losses, or prior service costs or credits existing at the date of initial application of the Statement, are amortized as components of net periodic pension cost. In addition, we are required to record increases or decreases in other comprehensive income that result from the recognition of additional net gains or losses, or prior service costs or credits that arise during the year. As a result, we recorded other comprehensive income, net of tax, of \$3.4 million for 2007.

DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of \$81.8 million for the year ended December 31, 2007, compared to \$81.3 million for the year ended December 31, 2006. Segment revenues were \$296.8 million for 2007, compared to \$285.2 million for 2006. The higher revenues were due primarily to increased overall log sales volumes in our Northern region and higher log selling prices in our Southern region, partially offset by lower log selling prices in the Northern region and fewer logs sold to our manufacturing facilities. Expenses for the segment were \$215.0 million in 2007, compared to \$203.9 million in 2006. The higher expenses were primarily due to costs associated with a significant increase in fee timber harvested in our Southern region and a pre-tax restructuring charge of \$2.7 million recorded in 2007, partially offset by fewer outside logs purchased by the Southern region in 2007. Prior to 2007, the Resource segment purchased logs from third parties that were then sold to our Pulp and Paperboard segment and, to a lesser extent, our Wood Products segment. During 2007, these segments began directly purchasing logs from the outside, resulting in lower Resource segment revenues before elimination of intersegment revenues on a comparable basis with 2006, offset by a corresponding decrease in intersegment revenues, and lower outside log costs for the Resource segment.

The Real Estate segment reported operating income of \$17.3 million for 2007, compared to operating income of \$11.9 million for 2006. Revenues for the segment were \$24.1 million in 2007, compared to \$13.6 million in 2006. The higher revenues in 2007 for the segment were due to increased sales of properties identified as non-strategic through our stratification process. A total of 16,175 acres of land were sold in 2007 at an average price of \$1,491 per acre, compared to 3,159 acres of land and 17,572 acres of conservation easements sold in 2006 at average prices of \$1,832 and \$446 per acre, respectively. The higher price per acre for fee lands sold in 2006 was due to a larger percentage of higher-valued higher and better use-type lands sold versus a larger percentage of non-core lands sold in 2007. Results for the segment depend on the timing of closing of transactions for properties we identify as having higher and better use values. As a result of our assessment of our lands, which was completed in late 2006, we identified 250,000 to 300,000 acres of our land as having values that are potentially greater than for timberland. Sales of these lands are expected to occur within the next ten years, with the goal of utilizing like-kind exchange transactions for tax efficiency, thus maximizing cash flows. Therefore, we attempt to schedule closings of both sales and acquisitions, if possible, to occur at times when they would be most beneficial for tax efficiency. Real Estate segment expenses were \$6.8 million in 2007, compared to \$1.7 million for the same period in 2006. The increased expenses were due to costs associated with the additional sales of land in 2007, some of which were recently acquired lands with a higher cost basis.

Table of Contents

The Wood Products segment reported operating income of \$1.9 million for 2007, compared to \$39.5 million recorded for 2006, which included \$39.3 million of income associated with the negotiated settlement of the Canadian softwood lumber agreement. Revenues for the segment were \$464.6 million, compared to \$497.0 million for 2006. Lumber revenues were \$342.9 million in 2007, down from \$377.6 million for the same period in 2006. Revenues were lower due to lower overall selling prices and decreased shipments, which were largely the result of the generally poor housing market in 2007 and were partially offset by strong markets for our cedar lumber products. The decreased lumber shipments were primarily at our Prescott and Warren, Arkansas, lumber mills, which reduced their daily operations from three shifts to two shifts in the fourth quarter of 2006. Plywood revenues were \$55.3 million for 2007, relatively unchanged from \$55.1 million recorded for 2006 as increased shipments were offset by lower selling prices. Particleboard revenues were \$19.9 million for 2007, compared to \$20.4 million for 2006. The slightly lower particleboard revenues were due to decreased shipments. Other revenues for the segment, which consisted primarily of the sale of by-products such as chips, were \$46.5 million for 2007, compared to \$43.9 million for 2006. The increase was primarily due to increased chip sales from our St. Maries and Lewiston, Idaho lumber mills. Segment expenses were \$462.7 million in 2007, versus \$496.9 million in 2006. The decrease in expenses was primarily due to decreased lumber shipments and lower log costs.

The Pulp and Paperboard segment reported operating income of \$44.3 million for 2007, compared to \$23.6 million for 2006. Revenues for the segment were \$670.6 million for 2007, versus \$614.2 million for 2006. Paperboard revenues were \$567.8 million in 2007, compared to \$535.8 million in 2006. The increase was due to higher selling prices and a slight increase in shipments. Pulp revenues were \$101.8 million for 2007, \$24.5 million higher than the \$77.3 million recorded in 2006. The increase in pulp revenues was due to higher selling prices and increased shipments. Expenses for the segment were \$626.4 million for 2007, compared to \$590.6 million for 2006. The increased expenses were due primarily to significantly higher wood fiber costs and costs associated with increased pulp shipments. The higher wood fiber costs were largely attributable to very high chip and sawdust prices for our Lewiston, Idaho, pulp and paperboard operation in 2007 resulting mainly from sawmill curtailments in the West.

The Consumer Products segment reported operating income of \$19.2 million for 2007, versus \$27.3 million for 2006. Revenues for the segment were \$444.7 million in 2007, compared to \$436.9 million in 2006. The higher revenues for 2007 were due to selling a better mix of higher value finished goods and selling fewer unconverted, bulk parent rolls. Segment expenses were \$425.5 million for 2007, compared to \$409.6 million for 2006. Higher pulp costs were responsible for the increased segment expenses and were partially offset by decreased shipments.

Table of Contents**YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005**

The following table sets forth year-to-year changes in items included in our Consolidated Statements of Operations and Comprehensive Income for the years ended December 31, 2006 and 2005.

(Dollars in thousands)

| | YEARS ENDED DECEMBER 31, | | |
|---|--------------------------|--------------|------------------------|
| | 2006 | 2005 | INCREASE (DECREASE) |
| Revenues | \$ 1,599,228 | \$ 1,495,930 | \$ 103,298 |
| Costs and expenses: | | | |
| Depreciation, depletion and amortization | 79,786 | 78,342 | 1,444 |
| Materials, labor and other operating expenses | 1,332,701 | 1,253,002 | 79,699 |
| Selling, general and administrative expenses | 90,529 | 85,003 | 5,526 |
| Income from Canadian lumber settlement | 39,320 | | 39,320 |
| Earnings from continuing operations before interest and taxes | 135,532 | 79,583 | 55,949 |
| Interest expense | (29,120) | (29,045) | (75) |
| Debt retirement costs | 53 | | 53 |
| Interest income | 1,876 | 2,506 | (630) |
| Provision (benefit) for taxes | (47,705) | 16,784 | (64,489) |
| Earnings from continuing operations | 156,046 | 36,260 | 119,786 |
| Discontinued operations, net of taxes | (16,936) | (3,296) | (13,640) |
| Net earnings | \$ 139,110 | \$ 32,964 | \$ 106,146 |
| Other comprehensive loss, net of tax | | (720) | 720 |
| Comprehensive income | \$ 139,110 | \$ 32,244 | \$ 106,866 |

Certain amounts have been reclassified to conform to the 2007 presentation.

Revenues For the year ended December 31, 2006, revenues increased 7%, to \$1.60 billion, from \$1.50 billion for the year ended December 31, 2005. Resource revenues increased to \$105.7 million, compared to \$99.8 million for 2005. The increased revenues were due primarily to increased sales of logs from our Northern region to external customers. Real Estate revenues were \$13.6 million for 2006, \$12.9 million less than the \$26.5 million recorded for 2005 due to fewer strategic land sales. Wood Products revenues were \$481.0 million for 2006, compared to \$478.9 million for 2005. Pulp and Paperboard segment revenues were \$562.1 million for the year ended December 31, 2006, \$39.7 million more than 2005 revenues of \$522.4 million due to increased shipments of paperboard and higher selling prices for paperboard and pulp to external customers. Consumer Products segment revenues increased to \$436.8 million from \$368.3 million due to higher selling prices and increased shipments of consumer tissue products.

Depreciation, depletion and amortization For the year ended December 31, 2006, depreciation, depletion and amortization totaled \$79.8 million, compared to \$78.3 million recorded in 2005. The increase was primarily due to increased depletion expense in Idaho and a full year of depreciation related to the Gwinn, Michigan, lumber mill acquired in May 2005.

Materials, labor and other operating expenses Materials, labor and other operating expenses increased to \$1.33 billion for 2006, \$79.7 million higher than \$1.25 billion recorded for 2005. The higher costs were due primarily to increased lumber, plywood, paperboard and consumer tissue shipments, higher wood fiber, maintenance and freight costs for the Pulp and Paperboard segment, and higher pulp, freight and packaging costs for the Consumer Products segment.

Table of Contents

Selling, general and administrative expenses Selling, general and administrative expenses were \$90.5 million for 2006, compared to \$85.0 million for 2005. The increase was primarily due to higher compensation, bad debt and consulting expenses in 2006.

Income from Canadian lumber settlement As previously discussed, we received \$39.3 million in the fourth quarter of 2006 associated with the negotiated settlement of the softwood lumber trade dispute between the U.S. and Canada.

Interest expense Interest expense totaled \$29.1 million for the year ended December 31, 2006, compared to \$29.0 million for the year ended December 31, 2005.

Debt retirement costs During 2006, the remaining \$5.5 million balance of our 10% Senior Subordinated Notes was redeemed. In association with the redemption, we incurred pre-tax expenses of \$0.3 million for premium-related costs and \$0.1 million for deferred debt issuance costs. These expenses were more than offset by the recognition of previously deferred interest rate swap income associated with the notes.

Interest income For the year ended December 31, 2006, interest income was \$1.9 million, compared to \$2.5 million for 2005. The decrease was due to a lower average short-term investments balance during 2006 compared to 2005.

Provision (benefit) for taxes For the year ended December 31, 2006, we recorded an income tax benefit of \$47.7 million related to continuing operations. The tax benefit was largely due to the reversal of \$56.5 million in timber-related deferred tax liabilities that were no longer necessary as a result of our REIT conversion. Excluding these tax benefits, we recorded an income tax provision of \$8.8 million, primarily due to pre-tax income for Potlatch TRS. Our effective tax rate for Potlatch TRS in 2006 was 39.0%. For the year ended December 31, 2005, we recorded an income tax provision of \$16.8 million related to continuing operations.

Earnings from continuing operations We recorded earnings from continuing operations of \$156.0 million for the year ended December 31, 2006, compared to \$36.3 million for 2005. The tax benefit discussed above, better results for the Pulp and Paperboard, Consumer Products and Resource segments, and the income received in association with the Canadian lumber agreement were primarily responsible for the higher earnings in 2006.

Discontinued operations For 2006, we reported an after-tax operating loss of \$16.9 million from discontinued operations, which was all related to our former hybrid poplar tree farm. In 2005, the tree farm recorded an after-tax operating loss of \$3.3 million.

Other comprehensive loss, net of tax For the year ended December 31, 2005, we recorded an other comprehensive loss, net of tax, of \$0.7 million due to an increase in our minimum pension liability, which was due primarily to a change in the discount rate from 5.90% to 5.60%. There was no other comprehensive income recorded in 2006.

DISCUSSION OF BUSINESS SEGMENTS

The Resource segment reported operating income of \$81.3 million for 2006, compared to \$61.8 million for 2005. Segment revenues were \$285.2 million in 2006, compared to \$274.7 million in 2005. The higher revenues for 2006 were due to increased overall log sales volumes and higher log selling prices in our Northern region, partially offset by decreased log sales volumes and lower selling prices for logs in our Southern region. Resource segment expenses were \$203.9 million in 2006, compared to \$212.9 million in 2005. The decreased expenses primarily reflected lower costs associated with a decreased harvest of fee timber in our Southern region.

The Real Estate segment reported operating income of \$11.9 million for the year ended December 31, 2006, compared to \$22.4 million for the year ended December 31, 2005. Revenues for the segment were \$13.6 million for 2006, versus \$26.5 million for

Table of Contents

2005. The lower revenues for the segment were due to fewer strategic land sales in 2006, while the 2005 revenues consisted of larger acreage strategic land sales that included substantial timber value. Most of our land sales activity was on hold during 2006 pending the initial assessment of all our land for alternative values. This assessment was completed in late 2006. Expenses for the segment were \$1.7 million for 2006, compared to \$4.0 million for 2005. The decreased expenses were due to fewer sales of land in 2006.

The Wood Products segment reported operating income of \$39.5 million for the year ended December 31, 2006, compared to income of \$28.6 million recorded for the year ended December 31, 2005. The favorable comparison was due to the \$39.3 million received in 2006 in association with the Canadian softwood lumber agreement. Revenues for the segment were \$497.0 million in 2006, compared to \$493.5 million recorded in 2005. Lumber revenues were \$377.6 million in 2006, compared to \$384.6 million in 2005. The unfavorable comparison was primarily due to lower selling prices for lumber, which were partially offset by increased lumber shipments from our Gwinn, Michigan, lumber mill acquired in May 2005 and increased shipments from our Lewiston, Idaho, lumber mill. During 2006, our Prescott, Arkansas, lumber mill took approximately four weeks of downtime in the third quarter due to an inability to cover variable costs. Our Warren, Arkansas, lumber mill took approximately three and six weeks of downtime in the third and fourth quarters of 2006, respectively. Following the downtime, both the Prescott and Warren lumber mills began operating two shifts a day, compared to three shifts a day prior to the downtime. In addition to this downtime, our Gwinn, Michigan, lumber mill took two weeks of downtime in 2006 to reduce inventories. In 2005, our Warren, Arkansas, lumber mill took 4 days of downtime to install new equipment, and our Gwinn lumber mill took 14 days of downtime to reduce inventories. Plywood revenues increased to \$55.1 million for 2006, compared to \$52.5 million for 2005. The increased plywood revenues were due to increased shipments. Our plywood mill took 17 days of downtime during 2005 to install new equipment. Particleboard revenues were \$20.4 million in 2006, \$2.8 million higher than the \$17.6 million recorded in 2005, due primarily to higher selling prices. Our particleboard facility took approximately one week of downtime during 2006 to reduce inventories. During 2005, our particleboard mill took 22 days of downtime to reduce inventories, as well as an additional 4 days of downtime to install new equipment. Other revenues for the segment were \$43.9 million for 2006, \$5.1 million higher than the \$38.8 million recorded for 2005 due primarily to a full year of chip sales at our Gwinn lumber mill. Segment expenses were higher for 2006, totaling \$496.9 million, versus \$464.9 million for 2005. Costs associated with increased lumber and plywood shipments largely accounted for the increase over 2005.

The Pulp and Paperboard segment reported operating income of \$23.6 million for the year ended December 31, 2006, compared with a loss of \$1.6 million for the year ended December 31, 2005. Segment revenues were \$614.2 million for 2006, up from \$566.1 million for 2005. Paperboard revenues increased to \$535.8 million in 2006, compared to \$500.6 million in 2005. Higher selling prices and increased shipments were primarily responsible for the increased revenues. Pulp revenues were \$77.3 million in 2006, compared to \$64.6 million in 2005. The increase in pulp revenues for 2006 was due to higher selling prices. Segment expenses were higher for 2006, totaling \$590.6 million, compared to \$567.7 million in 2005. The increase reflected higher volumes of paperboard shipments for 2006 compared to 2005, combined with higher wood fiber, maintenance and freight costs.

The Consumer Products segment reported operating income of \$27.3 million for the year ended December 31, 2006, compared to \$10.6 million for the year ended December 31, 2005. Segment revenues were \$436.9 million for 2006, \$68.5 million higher than the \$368.4 million recorded for 2005. The increase in revenues was due to higher selling prices and increased shipments in 2006 compared to 2005. The higher selling prices in 2006 were attributable to a combination of price increases and sheet count reductions, and the increased shipments were primarily the result of our planned reduction in inventories in 2006. Segment expenses were higher for 2006, totaling \$409.6 million, versus \$357.8 million in 2005. Increased shipments and higher pulp, freight and packaging costs were primarily responsible for the higher segment expenses.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES**

At December 31, 2007, our financial position included long-term debt of \$321.5 million, including current installments on long-term debt of \$0.2 million. Long-term debt at December 31, 2007 (including current installments) decreased from the balance at December 31, 2006 of \$327.6 million due to normal repayments on maturing debt of \$6.1 million. Stockholders' equity at December 31, 2007, was \$578.3 million, relatively unchanged from the December 31, 2006, balance of \$577.9 million. Stockholders' equity in 2007 was favorably affected by net earnings of \$56.4 million, as well as the issuance of common stock related to the exercise of stock options. Distributions to common stockholders in 2007 totaled \$77.5 million. The ratio of long-term debt (including current installments) to stockholders' equity was .56 to 1 at December 31, 2007, compared to .57 to 1 at December 31, 2006.

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2007, are as follows:

(Dollars in thousands)

| | |
|------|---------|
| 2008 | \$ 209 |
| 2009 | 100,410 |
| 2010 | 11 |
| 2011 | 5,011 |
| 2012 | 21,656 |

Working capital totaled \$49.3 million at December 31, 2007, compared to \$160.3 million at December 31, 2006. The significant changes in the components of working capital are as follows:

Working capital at December 31, 2007, included a notes payable balance of \$110.3 million, compared to no balance at December 31, 2006. The balance at December 31, 2007, which consisted of short-term borrowings under our unsecured bank credit facility revolving line of credit, was the result of borrowings used to partially fund the purchase of approximately 145,000 acres of timberlands in Idaho in the third quarter of 2007.

Receivables decreased \$20.8 million due primarily to decreases in trade receivables associated with our Pulp and Paperboard and Wood Products segments, which were partially offset by an increase in income tax refunds receivable of \$9.8 million.

Accounts payable and accrued liabilities decreased \$16.6 million due largely to a decrease in accrued income taxes. Net cash provided by operating activities from continuing operations in 2007 totaled \$145.7 million, compared with \$189.2 million in 2006 and \$67.8 million in 2005. The unfavorable 2007 to 2006 comparison was largely due to \$0.9 million of cash used for working capital changes in 2007, versus \$39.5 million of cash provided by working capital changes in 2006, and lower earnings from continuing operations. The cash provided by working capital changes in 2006, compared to cash used for working capital changes in 2005 of \$54.0 million, combined with higher net earnings in 2006 compared to 2005, were largely responsible for the favorable 2006 to 2005 comparison.

Net cash used for investing activities from continuing operations was \$246.9 million in 2007, \$21.3 million in 2006 and \$47.6 million in 2005. In 2007, we used \$162.4 million for deposits on timberlands and \$90.1 million for capital expenditures. The deposits on timberlands included the portion of the Idaho timberlands purchased on our behalf by an Internal Revenue Code section 1031 like-kind exchange qualified intermediary, which are held by the intermediary until they are either matched with sales of company-owned properties through our like-kind exchange process or the end of a 180-day period, whichever comes first. In accordance with section 1031 rules, title to any portion of the Idaho timberlands held by the intermediary that is not matched with sales of company-owned properties within 180 days of the purchase of these timberlands will be transferred to

Table of Contents

us at the end of the 180-day period. Deposits on timberlands also included cash held by a like-kind exchange qualified intermediary for a portion of the Wisconsin timberlands purchased on our behalf by the intermediary, which was held until it was matched with the sale of the hybrid poplar tree farm to complete our like-kind exchange process for the purchase. Capital expenditures in 2007 included \$35.0 million and \$14.5 million in cash for the Idaho and Wisconsin timberland purchases, respectively. The balance of capital expenditures in 2007 was for forestland activities and various smaller projects designed to improve product quality and manufacturing efficiency. In 2006, a decrease in our short-term investments of \$36.1 million was more than offset by capital spending of \$51.4 million. A decrease in our short-term investments in 2005 provided \$54.3 million in cash, which was more than offset by capital spending of \$95.1 million.

At December 31, 2007, our authorized capital spending budget, including \$59.6 million carried over from prior years, totaled \$127.0 million. In September 2007, we entered into an agreement to acquire approximately 179,000 acres of timberland in Idaho for approximately \$215 million. We completed the acquisition of approximately 145,000 acres of the timberland in Idaho for approximately \$163 million in September 2007, with the acquisition of the remainder of the timberland completed in January 2008 for approximately \$51.4 million, which is included in the \$59.6 million carryover amount. Excluding this timberland acquisition, the remainder of spending in 2008 is expected to be focused primarily on various discretionary, high-return projects for our Wood Products, Pulp and Paperboard and Consumer Products segments, as well as various routine general replacement and forest resource projects. Net cash provided by financing totaled \$39.0 million in 2007, compared to cash used for financing of \$157.5 million in 2006 and \$11.2 million in 2005. The cash provided by financing in 2007 was due largely to an increase of \$110.3 million in notes payable and the issuance of \$10.0 million of common stock related to the exercise of stock options, partially offset by regular quarterly cash distributions to common stockholders totaling \$77.5 million. Cash used for financing activities in 2006 primarily consisted of distributions to common stockholders of \$165.1 million and the repayment of \$7.8 million of long-term debt, which were slightly offset by the issuance of \$8.5 million of common stock related to the exercise of stock options and a \$6.1 million increase in book overdrafts. The majority of cash used for financing in 2005 resulted from dividend payments of \$17.5 million and a \$6.5 million change in book overdrafts, which were partially offset by the issuance of treasury stock totaling \$16.1 million related to the exercise of stock options.

Cash provided by discontinued operations was \$63.4 million in 2007, compared to cash used for discontinued operations of \$8.7 million and \$11.6 million in 2006 and 2005, respectively. In 2007, cash provided by discontinued operations related to proceeds from the sale of the hybrid poplar tree farm in Boardman, Oregon. All of the cash used for discontinued operations in 2006 and 2005 related to operating losses from the hybrid poplar tree farm.

Our regular quarterly distributions increased from approximately \$19.0 million in 2006 to approximately \$20.0 million in the fourth quarter of 2007. Our 2006 and 2007 distributions were funded using cash flows from our REIT-qualifying timberland operations. Based on historical operating results and taking into account planned harvest activities, we also expect to fund a substantial majority of future annual distributions using the cash flows from our REIT-qualifying timberland operations. Any shortfall between cash available for distribution from REIT operations and anticipated future annual distributions to stockholders is expected to be funded through cash on hand, bank borrowings, Potlatch TRS distributions or a combination thereof. Our ability to fund distributions through bank borrowings is subject to our continued compliance with debt covenants, as well as the availability of borrowing capacity under our lending arrangements. If our operations do not generate sufficient cash flows and we are unable to borrow, we may be required to reduce our quarterly distributions. In addition, even if cash available for distribution from our REIT operations is sufficient on an annual basis to fund the entire distribution to stockholders, we anticipate that it may be necessary to utilize some short-term borrowing to fully fund distributions in the first half of each year as a result of the lower harvest activity during winter and early spring. Significant decreases in timber prices or other factors that have a materially adverse effect on the cash flows from our REIT operations could result in our inability to maintain our current distribution rate.

Table of Contents

In addition, the rules with which we must comply to maintain our status as a REIT limit our ability to use dividends from our manufacturing businesses for the payment of stockholder distributions. In particular, at least 75% of our gross income for each taxable year as a REIT must be derived from sales of our standing timber and other types of real estate income. No more than 25% of our gross income may consist of dividends from Potlatch TRS and other non-qualifying types of income. This requirement may limit our ability to receive dividends from Potlatch TRS and may impact our ability to fund distributions to stockholders using cash flows from Potlatch TRS. Our board of directors, in its sole discretion, will determine the actual amount of distributions to be made to stockholders based on consideration of a number of factors, including, but not limited to, our results of operations, cash flow and capital requirements, economic conditions, tax considerations and borrowing capacity.

Our current unsecured bank credit facility, which expires on December 22, 2008, provides for a revolving line of credit of up to \$250 million, including a \$35 million subfacility for letters of credit and a \$10 million subfacility for swing line loans. The aggregate principal amount available under this credit facility was increased by \$75 million in the third quarter of 2007. Usage under either or both subfacilities reduces availability under the revolving line of credit. As of December 31, 2007, there were \$110.3 million of borrowings outstanding under the revolving line of credit, and approximately \$10.3 million of the letter of credit subfacility was being used to support several outstanding letters of credit. The \$110.3 million in borrowings were used to fund a portion of the acquisition of 145,000 acres of timberland in Idaho for approximately \$163 million in September 2007. This purchase is part of the overall acquisition of approximately 179,000 acres of timberland in Idaho for approximately \$215 million. The acquisition of the remaining Idaho timberland for approximately \$51.4 million was completed in January 2008 using additional borrowings from our line of credit and available cash on hand. Loans under the credit facility bear interest at LIBOR plus between 0.625% and 1.625% for LIBOR loans, and a base rate effectively equal to the bank's prime rate plus up to 0.625% for other loans. As of December 31, 2007, the weighted average interest rate on the \$110.3 million of borrowings outstanding under the revolving line of credit was approximately 6.1%. As of the date of this report, we are eligible to borrow under the credit facility at LIBOR plus 1.125%.

The agreement governing our credit facility contains certain covenants that, among other things, limit to a certain degree our ability and that of our subsidiaries to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates or change the nature of our business. The credit facility also contains financial maintenance covenants establishing a maximum funded indebtedness to capitalization ratio, a minimum consolidated net worth requirement, and a minimum interest coverage ratio. We will be permitted to pay distributions under the terms of the credit facility so long as we remain in pro forma compliance with the financial covenants.

The table below sets forth the most restrictive covenants in the credit facility and our status with respect to these covenants as of December 31, 2007:

| | COVENANT REQUIREMENT | ACTUAL RATIO AT DECEMBER 31, 2007 |
|---|--|--|
| Maximum Funded Indebtedness To Capitalization Ratio | 55% | 38.9% |
| Minimum Net Worth | 80% of consolidated net worth at March 31, 2006 ¹ | 126.0% |
| Minimum Interest Coverage Ratio | 2.75 to 1.00 | 5.27 to 1.00 |

¹ The minimum requirement is 80% of consolidated net worth as of March 31, 2006, with an adjustment to the minimum requirement for the net cash proceeds, on a cumulative basis, of all equity issuances.

Table of Contents

Events of default under the credit facility include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events.

We and several of our subsidiaries are parties to the credit agreement and eligible to borrow thereunder, subject to the \$250 million aggregate credit limit and continued compliance with debt covenants. Any borrowings by one of these entities under the credit facility reduces the credit available for all the entities. As a result, borrowings by Potlatch TRS under the credit facility will, until repaid, reduce the amount of borrowings otherwise available to us for purposes such as the funding of quarterly distributions.

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

Since October 2005, Standard & Poor's Ratings Services, or S&P, has rated our senior unsecured debt at BB. Since the first quarter of 2003, Fitch, Inc. has rated our senior unsecured debt at BB+. Fitch affirmed its rating in January 2008, with a positive outlook. Moody's Investors Service Inc. has rated our senior unsecured debt at Ba1 and our senior secured subordinated debt at Ba2 since October 2004. Moody's affirmed its rating, with a stable outlook, in December 2007. The interest rate we pay on some of our debt is influenced by our credit ratings. See **Quantitative and Qualitative Disclosures About Market Risk** on pages 43-45 for additional information.

CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual obligations as of December 31, 2007. Portions of the amounts shown are reflected in our consolidated financial statements and accompanying notes, as required by generally accepted accounting principles. See the footnotes following the table for information regarding the amounts presented and for references to relevant consolidated financial statement notes that include a detailed discussion of the item.

| (DOLLARS IN THOUSANDS) | TOTAL | PAYMENTS DUE BY PERIOD | | | |
|-----------------------------------|--------------|------------------------|------------|------------|--------------|
| | | 1 YEAR | 2-3 YEARS | 4-5 YEARS | OVER 5 YEARS |
| Long-term debt ¹ | \$ 321,510 | \$ 209 | \$ 100,421 | \$ 26,667 | \$ 194,213 |
| Interest on long-term debt | 206,984 | 28,390 | 42,641 | 28,278 | 107,675 |
| Current notes payable | 110,300 | 110,300 | | | |
| Operating leases ² | 58,089 | 12,461 | 14,952 | 10,137 | 20,539 |
| Purchase obligations ³ | 107,391 | 68,153 | 31,113 | 6,538 | 1,587 |
| Other obligations ⁴ | 395,357 | 114,640 | 51,703 | 53,812 | 175,202 |
| Total | \$ 1,199,631 | \$ 334,153 | \$ 240,830 | \$ 125,432 | \$ 499,216 |

¹ See Note 8, **Debt**, in the notes to consolidated financial statements.

² See Note 13, **Commitments and Contingencies**, in the notes to consolidated financial statements.

³ Purchase obligations consist primarily of our purchase of the remaining portion of the Idaho timberlands, which closed in January 2008, accounts payable, the purchase of raw materials (primarily pulp), contracts for timber cutting and outside chipping, contracts with railroads and contracts with natural gas and electricity providers.

⁴ Included in other obligations are payments on qualified pensions and postretirement employee benefit plans. Payments on qualified pension plans are based on estimated minimum required contributions for years 1-5. Payments on postretirement employee benefit plans are based on expected future benefit payments as disclosed in Note 12, "Pension and Other Postretirement Employee Benefit Plans," to the consolidated financial statements for years 1-5.

Table of Contents

OFF-BALANCE SHEET ARRANGEMENTS

We currently are not a party to off-balance sheet arrangements that would require disclosure under this section.

ENVIRONMENTAL

We are subject to extensive federal and state environmental regulation of our operating facilities and timberlands, particularly with respect to air emissions, wastewater discharges, solid and hazardous waste management, site remediation, forestry operations, and threatened and endangered species. We endeavor to comply with all environmental regulations and regularly monitor our activities for such compliance. Compliance with environmental regulations is a significant factor in our business and requires capital expenditures as well as additional operating costs. Capital expenditures specifically designated for environmental compliance totaled approximately \$3.6 million during 2007 and are expected to be approximately \$3.1 million in 2008.

As previously discussed in Item I, Business, with the exception of the Idaho timberlands acquired in late 2007, our core timberlands in Idaho, Arkansas, Minnesota and Wisconsin were certified in 2007 by independent third parties to be in compliance with the FSC Program and the ISO 14001 standard for environmental management systems. We expect the recently acquired Idaho timberlands to be in compliance with these programs in 2008. Participation in the FSC and ISO programs is voluntary, and can require operating processes which are more stringent than existing federal or state requirements.

Our pulp mill in Lewiston, Idaho, discharges treated mill effluent into the nearby Snake River. Federal law requires that we comply with provisions of a National Pollution Discharge Elimination System, or NPDES, permit. In March 2005, the Environmental Protection Agency, or EPA, issued a new NPDES permit for the Lewiston pulp mill. The new NPDES permit requires, among other matters, a significant reduction in biochemical oxygen demand over the five-year period of the new permit and also requires a reduction in the temperature of the effluent during the months of July, August and September each year. We have completed physical modifications to the effluent system to meet the requirements of this permit.

The EPA has developed Maximum Achievable Control Technology, or MACT, standards for pulp and paper facilities, plywood and composite wood facilities and certain boiler units. We have studied the applicable MACT standards and estimate that capital expenditures necessary for compliance will be approximately \$1.9 million. The deadline for compliance is in 2008.

We believe that our facilities are currently in substantial compliance with applicable environmental laws and regulations. We cannot assure, however, that situations that may give rise to material environmental liabilities will not be discovered or that the enactment of new environmental laws or regulations or changes in existing laws or regulations will not require significant expenditures by us.

INCOME TAXES

Excluding the effect of a favorable adjustment of \$3.9 million due to the final determination of amounts owed to the Internal Revenue Service for the years 1995-2004, our effective tax rate related to continuing operations for 2007 was 2.3%. Excluding the reversal of \$56.5 million in timber-related deferred tax liabilities that were no longer necessary as a result of our REIT conversion, our effective tax rate related to continuing operations for 2006 was 8.1%. The effective tax rate related to continuing operations was 31.6% for 2005. Our effective rates for 2007 and 2006 were significantly lower than the rate for 2005 due to our REIT conversion in 2006. Compared to 2007, the effective tax rate for 2006 was higher due primarily to \$39.3 million of pre-tax TRS income received in 2006 in association with the negotiated settlement of the softwood lumber trade dispute between the United States and Canada.

Table of Contents

As a REIT, if we meet certain requirements, we generally will not be subject to federal corporate income taxes on our ordinary and capital gains income from our real estate investments that we distribute to our shareholders. However, we will be subject to corporate taxes on built-in gains (the excess of fair market value at January 1, 2006 over tax basis at that date) on sales of real property (other than timber) held by the REIT during the first ten years following our REIT conversion. The built-in gains tax can be eliminated if sale proceeds are reinvested in similar properties within specified time periods, through the utilization of Internal Revenue Code section 1031 like-kind exchanges. We will continue to be required to pay federal corporate income taxes on earnings from our non-real estate investments, principally our manufacturing operations, held by Potlatch TRS.

Due to the varying tax treatments of our activities, such as REIT operations, built-in gains, like-kind exchanges and TRS activities, our effective tax rate and amount of taxes paid may vary significantly from year to year. Quarterly estimates of taxes will likely also have greater variability than in prior years.

In association with our REIT conversion, we estimated an amount for deferred tax liabilities that were no longer necessary and reversed this amount, totaling \$56.5 million, as an income tax benefit in 2006. Also as a part of this analysis, we estimated the amount of REIT property that will be sold within the next ten years and retained a deferred tax liability at REIT conversion on the book-to-tax difference of approximately \$3 million. This estimate is periodically reviewed and adjusted as necessary.

The table below summarizes the historical tax characteristics of distributions to shareholders for the years ended December 31:

| (amounts per share) | 2007 | 2006 | 2005 |
|-----------------------------------|---------|----------|---------|
| Qualified distributions/dividends | \$ | \$ 15.15 | \$ 0.60 |
| Capital gain distributions | 1.98 | 2.12 | |
| Non-taxable return of capital | | | |
| Total distributions/dividends | \$ 1.98 | \$ 17.27 | \$ 0.60 |

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risks on financial instruments includes interest rate risk on our short-term investments and unsecured bank credit facility, and credit rate risk on our credit sensitive debentures.

Our short-term investments are invested in time or demand deposits, certificates of deposit and U.S. Treasury and U.S. government agency obligations, all of which have very short maturity periods, and they therefore earn an interest rate commensurate with low-risk instruments. We do not attempt to hedge our exposure to interest rate risk for our short-term investments. All short-term investments are made in compliance with the requirements of the Internal Revenue Code with respect to qualifying REIT investments.

As of December 31, 2007, there were \$110.3 million of borrowings outstanding under our unsecured bank credit facility. The interest rates applied to borrowings under the credit facility are adjusted often and therefore react quickly to any movement in the general trend of market interest rates. For example, a 1% increase or decrease in interest rates, based on our outstanding credit facility borrowings of \$110.3 million at December 31, 2007, would have a \$1.1 million annual effect on interest expense. We do not attempt to mitigate the effects of short-term interest rate fluctuations on our credit facility borrowings through the use of derivative financial instruments.

All of our long-term debt is fixed-rate and therefore changes in market interest rates do not expose us to interest rate risk for these financial instruments.

Table of Contents

We currently have \$100 million of credit sensitive debentures outstanding that pay interest to the debt holder based upon our credit ratings as established by S&P or Moody's. The following table denotes the interest rate applicable based on various credit ratings:

| MOODY S | RATINGS | S&P | APPLICABLE RATE (%) |
|-------------|---------|-------------|---------------------|
| Aaa | | AAA | 8.825 |
| Aa1 Aa3 | | AA+ AA- | 8.925 |
| A1 Baa2 | | A+ BBB | 9.125 |
| Baa3 | | BBB- | 9.425 |
| Ba1 | | BB+ | 12.500 |
| Ba2 | | BB | 13.000 |
| Ba3 | | BB- | 13.500 |
| B1 or lower | | B+ or lower | 14.000 |

In October 2005, S&P lowered our senior unsecured debt rating to BB stable from BB+. The rating downgrade caused the interest rate on our credit sensitive debentures to increase from 12.5% to 13.0%. Since October 2004, Moody's has rated our senior unsecured debt at Ba1. Moody's affirmed this rating, with a stable outlook, in December 2007.

We are exposed to market risk for changes in natural gas commodity pricing, which we partially mitigate through the use of firm price contracts for a portion of our natural gas requirements for our manufacturing facilities. The effects of these arrangements are not significant for any period presented.

Table of Contents**Quantitative Information about Market Risks**

(Dollars in thousands)

| | EXPECTED MATURITY DATE | | | | | | TOTAL |
|-------------------------------|------------------------|------------|-------|----------|-----------|------------|-------------------|
| | 2008 | 2009 | 2010 | 2011 | 2012 | THEREAFTER | |
| Long-term debt: | | | | | | | |
| Fixed rate | \$ 209 | \$ 100,410 | \$ 11 | \$ 5,011 | \$ 21,656 | \$ 194,213 | \$ 321,510 |
| Average interest rate | 6.9% | 13.0% | 6.5% | 8.6% | 5.7% | 6.8% | 8.7% |
| Fair value at 12/31/07 | | | | | | | \$ 338,524 |

2007 FORM 10-K / 45

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Comprehensive Income

(Dollars in thousands except per-share amounts)

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|--|---------------------------------|--------------|--------------|
| | 2007 | 2006 | 2005 |
| Revenues | \$ 1,654,021 | \$ 1,599,228 | \$ 1,495,930 |
| Costs and expenses: | | | |
| Depreciation, depletion and amortization | 80,084 | 79,786 | 78,342 |
| Materials, labor and other operating expenses | 1,365,191 | 1,332,701 | 1,253,002 |
| Selling, general and administrative expenses | 90,488 | 90,529 | 85,003 |
| Restructuring charge | 2,653 | | |
| | 1,538,416 | 1,503,016 | 1,416,347 |
| Income from Canadian lumber settlement | | 39,320 | |
| Earnings from continuing operations before interest and taxes | 115,605 | 135,532 | 79,583 |
| Interest expense | (30,710) | (29,120) | (29,045) |
| Debt retirement costs | | 53 | |
| Interest income | 2,282 | 1,876 | 2,506 |
| Earnings from continuing operations before taxes | 87,177 | 108,341 | 53,044 |
| Provision (benefit) for taxes | (5,977) | (47,705) | 16,784 |
| Earnings from continuing operations | 93,154 | 156,046 | 36,260 |
| Discontinued operations: | | | |
| Loss from discontinued operations (including loss on disposal of \$(35,774), \$ and \$) | (39,555) | (18,308) | (5,404) |
| Income tax benefit | (2,833) | (1,372) | (2,108) |
| | (36,722) | (16,936) | (3,296) |
| Net earnings | \$ 56,432 | \$ 139,110 | \$ 32,964 |
| Other comprehensive income (loss), net of tax: | | | |
| Defined benefit pension and other postretirement employee benefits: | | | |
| Net loss arising during the period, net of tax of \$(3,324), \$, and \$ | (5,200) | | |
| Prior service credit arising during the period, net of tax of \$2,001, \$ and \$ | 3,131 | | |
| Amortization of actuarial loss included in net periodic cost, net of tax of \$4,031, \$ and \$ | 6,305 | | |
| Amortization of prior service credit included in net periodic cost, net of tax of \$(536), \$ and \$ | (837) | | |
| Pre SFAS 158- Minimum pension liability adjustment, net of income tax benefit of \$, \$ and \$(441) | | | (720) |
| Other comprehensive income (loss), net of tax | 3,399 | | (720) |
| Comprehensive income | \$ 59,831 | \$ 139,110 | \$ 32,244 |
| Earnings per common share from continuing operations: | | | |
| Basic | \$ 2.38 | \$ 4.28 | \$ 1.25 |
| Diluted | 2.37 | 4.26 | 1.24 |
| Loss per common share from discontinued operations: | | | |
| Basic | (0.94) | (0.46) | (0.11) |
| Diluted | (0.93) | (0.46) | (0.11) |
| Net earnings per common share: | | | |
| Basic | 1.44 | 3.81 | 1.13 |

| | | | |
|--|------|------|------|
| Diluted | 1.43 | 3.79 | 1.13 |
| The accompanying notes and summary of principal accounting policies are an integral part of these consolidated financial statements. | | | |

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in thousands except per-share amounts)

| | AT DECEMBER 31 | |
|--|-----------------------|---------------------|
| | 2007 | 2006 |
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 9,047 | \$ 7,759 |
| Restricted cash | | 6,673 |
| Short-term investments | 22,289 | 21,564 |
| Receivables, net of allowance for doubtful accounts of \$1,205 (\$2,199 in 2006) | 114,260 | 135,105 |
| Inventories | 169,396 | 168,816 |
| Prepaid expenses | 18,967 | 16,602 |
| Total current assets | 333,959 | 356,519 |
| Land, other than timberlands | 8,549 | 8,554 |
| Plant and equipment, at cost less accumulated depreciation of \$1,335,868 (\$1,308,732 in 2006) | 510,776 | 562,387 |
| Timber, timberlands and related deposits, net | 534,513 | 391,577 |
| Pension assets | 108,435 | 118,355 |
| Other assets | 20,972 | 20,215 |
| | \$ 1,517,204 | \$ 1,457,607 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current installments on long-term debt | \$ 209 | \$ 6,157 |
| Current notes payable | 110,300 | |
| Current portion of liability for pensions and other postretirement employee benefits | 21,837 | 21,120 |
| Accounts payable and accrued liabilities | 152,361 | 168,987 |
| Total current liabilities | 284,707 | 196,264 |
| Long-term debt | 321,301 | 321,474 |
| Liability for pensions and other postretirement employee benefits | 261,956 | 289,791 |
| Other long-term obligations | 18,923 | 19,059 |
| Deferred taxes | 51,981 | 53,160 |
| Stockholders' equity: | | |
| Preferred stock, Authorized 4,000,000 shares, no shares issued | | |
| Common stock, \$1 par value, Authorized 100,000,000 shares, Issued 39,256,673 shares (38,824,427 shares in 2006) | 39,257 | 38,825 |
| Additional paid-in capital | 530,949 | 513,275 |
| Retained earnings | 123,783 | 144,811 |
| Accumulated other comprehensive loss, net of tax of \$73,943 (\$76,115 in 2006) | (115,653) | (119,052) |
| Total stockholders' equity | 578,336 | 577,859 |
| | \$ 1,517,204 | \$ 1,457,607 |

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

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows

(Dollars in thousands)

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|---|--|-------------|-------------|
| | 2007 | 2006 | 2005 |
| CASH FLOWS FROM CONTINUING OPERATIONS | | | |
| Net earnings | \$ 56,432 | \$ 139,110 | \$ 32,964 |
| Adjustments to reconcile net earnings to net operating cash flows from continuing operations: | | | |
| Loss from discontinued operations | 3,739 | 16,936 | 3,296 |
| Loss on disposal of discontinued operations | 32,983 | | |
| Depreciation, depletion, and amortization | 80,084 | 79,786 | 78,342 |
| Proceeds from land sales deposited with a like-kind exchange intermediary | (24,339) | (6,673) | |
| Non-cash cost of real estate sold | 3,552 | 277 | 838 |
| Cost of permit timber harvested | 866 | 3,343 | 6,176 |
| Debt retirement costs | | (53) | |
| Deferred taxes | (3,003) | (69,200) | 91 |
| Equity-based compensation expense | 5,804 | 4,096 | 2,257 |
| Employee benefit plans | (11,111) | (1,418) | (4,631) |
| Decrease (increase) in receivables | 20,241 | (20,394) | (10,910) |
| Decrease (increase) in inventories | (2,814) | 40,806 | (42,919) |
| Decrease (increase) in prepaid expenses | 81 | (463) | (123) |
| Increase (decrease) in accounts payable and accrued liabilities | (18,388) | 19,501 | (40) |
| Excess tax benefit from share-based payment arrangements | (2,734) | (890) | |
| Income tax benefit related to stock issued in conjunction with stock compensation plans | 4,313 | 2,556 | 2,491 |
| Funding of qualified pension plans | | (18,092) | |
| Net cash provided by operating activities from continuing operations | 145,706 | 189,228 | 67,832 |
| CASH FLOWS FROM INVESTING | | | |
| Decrease in short-term investments | 7,305 | 36,136 | 54,275 |
| Additions to plant and equipment, and to land other than timberlands | (32,353) | (43,811) | (88,847) |
| Additions to timber, timberlands and related logging facilities | (57,719) | (7,621) | (6,236) |
| Deposits on timberlands | (162,351) | | |
| Other, net | (1,752) | (6,016) | (6,769) |
| Net cash used for investing activities from continuing operations | (246,870) | (21,312) | (47,577) |
| CASH FLOWS FROM FINANCING | | | |
| Change in book overdrafts | 270 | 6,066 | (6,534) |
| Increase in notes payable | 110,300 | | |
| Issuance of common stock | 9,950 | 8,503 | |
| Retirement of long-term debt | (6,121) | (7,823) | (1,068) |
| Premiums and fees on debt retirement | | (275) | |
| Issuance of treasury stock | | 513 | 16,137 |
| Purchase of treasury stock | | | (1,868) |
| Distributions to common stockholders | (77,460) | (165,116) | (17,503) |
| Excess tax benefit from share-based payment arrangements | 2,734 | 890 | |
| Other, net | (655) | (299) | (360) |
| Net cash provided by (used for) financing activities from continuing operations | 39,018 | (157,541) | (11,196) |
| Cash from continuing operations | (62,146) | 10,375 | 9,059 |
| Cash flows of discontinued operations: | | | |
| Operating cash flows | 68 | (7,156) | (1,081) |
| Investing cash flows | 63,366 | (1,593) | (10,491) |
| Financing cash flows | | | |
| Increase (decrease) in cash | 1,288 | 1,626 | (2,513) |
| Balance at beginning of year | 7,759 | 6,133 | 8,646 |
| Balance at end of year | \$ 9,047 | \$ 7,759 | \$ 6,133 |

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Net interest paid (net of amounts capitalized) in 2007, 2006 and 2005 was \$30.6 million, \$29.4 million and \$29.0 million, respectively. Net income tax payments (refunds) in 2007, 2006 and 2005 were \$24.8 million, \$(2.3) million and \$17.0 million, respectively.

Not included in additions to timber, timberlands and related logging facilities for 2007 are non-cash transactions totaling \$66.5 million for the purchase of timberlands.

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

48 / POTLATCH CORPORATION

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Dollars in thousands except per-share amounts)

| | Common Stock Issued | | Additional Paid-In Capital | Accumulated Other Retained Comprehensive Earnings Loss | | Treasury Stock | | Total Stockholders Equity |
|---|---------------------|------------------|----------------------------|--|---------------------|------------------|---------------------|---------------------------|
| | Shares | Amount | | Shares | Amount | Shares | Amount | |
| Balance, December 31, 2004 | 32,721,980 | \$ 32,722 | \$ 147,851 | \$ 622,025 | \$ (1,403) | 3,802,004 | \$ (129,806) | \$ 671,389 |
| Exercise of stock options and stock awards | | | 855 | | | (447,617) | 15,282 | 16,137 |
| Accelerated stock repurchase | | | (1,868) | | | | | (1,868) |
| Income tax benefit resulting from the exercise of employee stock options | | | 2,491 | | | | | 2,491 |
| Performance share awards | | | 2,257 | | | | | 2,257 |
| Net earnings | | | | 32,964 | | | | 32,964 |
| Minimum pension liability adjustment, net of tax | | | | | (719) | | | (719) |
| Common dividends, \$0.60 per share | | | | (17,503) | | | | (17,503) |
| Balance, December 31, 2005 | 32,721,980 | \$ 32,722 | \$ 151,586 | \$ 637,486 | \$ (2,122) | 3,354,387 | \$ (114,524) | \$ 705,148 |
| Exercise of stock options and stock awards | 314,568 | 315 | 8,217 | | | (14,172) | 484 | 9,016 |
| Income tax benefit related to stock issued in conjunction with stock compensation plans | | | 2,556 | | | | | 2,556 |
| Performance share and restricted stock unit awards | | | 4,096 | | | | | 4,096 |
| Net earnings | | | | 139,110 | | | | 139,110 |
| Adjustment to initially apply SFAS No. 158, net of tax | | | | | (116,930) | | | (116,930) |
| Retirement of treasury stock | (3,340,627) | (3,341) | (20) | (110,700) | | (3,340,215) | 114,040 | (21) |
| Common distributions, \$17.27 per share* | 9,128,506 | 9,129 | 346,840 | (521,085) | | | | (165,116) |
| Balance, December 31, 2006 | 38,824,427 | \$ 38,825 | \$ 513,275 | \$ 144,811 | \$ (119,052) | | | \$ 577,859 |
| Exercise of stock options and stock awards | 360,653 | 361 | 9,589 | | | | | 9,950 |
| Income tax benefit related to stock issued in conjunction with stock compensation plans | | | 4,313 | | | | | 4,313 |
| Performance share and restricted stock unit awards | 71,593 | 71 | 3,772 | | | | | 3,843 |
| Net earnings | | | | 56,432 | | | | 56,432 |
| Pension and OPEB plans | | | | | 3,399 | | | 3,399 |
| Common distributions, \$1.98 per share | | | | (77,460) | | | | (77,460) |
| Balance, December 31, 2007 | 39,256,673 | \$ 39,257 | \$ 530,949 | \$ 123,783 | \$ (115,653) | | | \$ 578,336 |

* Includes regular quarterly distributions totaling \$2.12 per common share in the aggregate for 2006 and a special earnings and profit, or E&P, distribution paid in the first quarter of 2006 (see Note 1). The annualized rate of regular quarterly distributions for 2006, after adjusting for the issuance of approximately 9.1 million shares of common stock in association with the special E&P distribution, was \$1.96 per common share. The accompanying notes and summary of principal accounting policies are an integral part of these consolidated financial statements.

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Summary of Principal Accounting Policies**CONSOLIDATION**

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

We are primarily engaged in activities associated with timberland management, including the sale of timber, the management of our approximately 1.7 million acres of timberlands and the purchase and sale of timberlands. We are also engaged in the manufacture and sale of wood products and pulp and paper products. Our timberlands and all of our manufacturing facilities are located within the continental United States. The primary market for our products is the United States, although we sell a significant amount of paperboard to countries in the Pacific Rim. As discussed in Note 1 on page 57, the company converted to a Real Estate Investment Trust, or REIT, effective January 1, 2006.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, which we refer to in this report as U.S. GAAP, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

EARNINGS PER COMMON SHARE

Earnings per common share from continuing operations are computed by dividing earnings from continuing operations by the weighted average number of common shares outstanding in accordance with Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 128, Earnings Per Share. The following table reconciles the number of common shares used in calculating the basic and diluted earnings per share from continuing operations:

| | 2007 | 2006 | 2005 |
|--|------------|------------|------------|
| Basic average common shares outstanding | 39,093,573 | 36,464,619 | 29,119,581 |
| Incremental shares due to: | | | |
| Common stock options | 76,338 | 73,912 | 126,330 |
| Performance shares | 195,773 | 130,761 | |
| Restricted stock units | 18,494 | 3,206 | |
| Accelerated stock repurchase program | | | 5,940 |
| Diluted average common shares outstanding | 39,384,178 | 36,672,498 | 29,251,851 |
| Basic earnings per common share from continuing operations | \$ 2.38 | \$ 4.28 | \$ 1.25 |
| Diluted earnings per common share from continuing operations | \$ 2.37 | \$ 4.26 | \$ 1.24 |

Table of Contents

On March 31, 2006, we paid a special earnings and profit, or E&P, distribution, consisting of approximately 9.1 million shares of common stock and \$89 million in cash, in association with the REIT conversion. Reflected below are pro forma results giving effect to the common stock distribution for diluted earnings per common share from continuing operations, for the years ended December 31, 2006 and 2005, as if the common stock portion of the special E&P distribution had occurred at the beginning of each period:

(Dollars in thousands except per-share amounts)

| | Years Ended December 31, | |
|---|--------------------------|-----------|
| | 2006 | 2005 |
| Earnings from continuing operations | \$ 156,046 | \$ 36,260 |
| Diluted earnings per share from continuing operations | | |
| As reported | \$ 4.26 | \$ 1.24 |
| Pro forma | \$ 4.01 | \$ 0.95 |

For the year ended December 31, 2007, 7,400 performance shares, 1,500 restricted stock units and options to purchase 113,364 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. For the year ended December 31, 2006, 144,617 performance shares, 4,000 restricted stock units and options to purchase 243,838 shares of common stock were excluded from the computation of diluted earnings per share because their effect was anti-dilutive. Stock options to purchase 116,550 shares of common stock for 2005 were not included in the computation of diluted earnings per share because the exercise prices of the stock options were greater than the average market price of the common shares.

The computation of diluted average common shares outstanding for 2005 was affected by our accelerated stock repurchase program, which was completed during the third quarter of 2005, to the extent that the volume-weighted average price of the shares purchased by the counterparty under the program exceeded the price per share initially paid at the program's inception. Throughout the repurchase program, it was assumed that any additional amounts payable to the counterparty would be settled by shares of the company's stock, and thus any such differential that existed at the end of each reporting period was included in the computation of diluted average common shares outstanding. The reverse treasury stock method was used to calculate the additional number of shares included in the diluted share total. At the completion of the repurchase program, we elected to settle the differential due to the counterparty with a \$1.9 million cash payment rather than with shares of the company's stock.

EQUITY-BASED COMPENSATION

In December 2004, the FASB issued a revision of SFAS No. 123, Share-Based Payment, which we refer to in this report as SFAS No. 123R. We adopted the provisions of SFAS No. 123R on its effective date of January 1, 2006, using the modified prospective method.

At December 31, 2007, we had three stock incentive plans, the 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit grants were outstanding. All of these plans have received shareholder approval. We were originally authorized to issue up to 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At December 31, 2007, no shares were available for future use under the 1995 Stock Incentive Plan, while approximately 87,000 shares and 959,000 shares were authorized for future use under the 2000 and 2005 Stock Incentive Plans, respectively. All exercises of stock options or distributions of performance shares or restricted stock were made through issuance of new shares after January 31, 2006. Prior to that date, treasury shares were utilized.

Table of Contents

We recorded equity-based compensation expense of \$5.8 million in 2007, \$4.1 million in 2006 and \$2.3 million in 2005. For 2007 and 2006, respectively, \$5.2 million and \$3.7 million of the expense related to performance shares, and \$0.6 million and \$0.4 million related to restricted stock units. All equity-based compensation expense recorded in 2005 related to performance shares. All outstanding stock options were fully vested prior to January 1, 2006. The net income tax benefit recognized in the Consolidated Statements of Operations and Comprehensive Income for equity-based compensation totaled \$2.3 million, \$1.6 million and \$0.9 million in 2007, 2006 and 2005, respectively.

Directors of the company can each elect to defer compensation in the form of stock units. We record compensation expense or income during each reporting period based on the amount of compensation deferred during the period and the increase or decrease in the value of the company's common stock. We recorded director deferred expense totaling \$1.0 million in 2007 and \$1.8 million in 2006.

Prior to 2006, we applied the intrinsic value method under Accounting Principles Board, or APB, No. 25 and related Interpretations in accounting for our equity-based compensation. As a result, no compensation cost was recognized for stock options granted under the plans because the exercise price was equal to market value at the grant date. For performance share awards, which were first granted in December 2003, compensation expense was recorded ratably over the performance period based upon the market value of our stock and the likelihood that performance measurements would be met. No restricted stock units were outstanding prior to 2006.

See Note 14 on pages 73-76 for further discussion of, and the related impacts of adopting, SFAS No. 123R on our net earnings and net earnings per share.

INVENTORIES

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

PLANT AND EQUIPMENT

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

TIMBER, TIMBERLANDS AND RELATED DEPOSITS

Timber, timberlands and related deposits are valued at cost less depletion and amortization. For fee timber, the capitalized cost includes costs related to stand establishment, such as site preparation, including all costs of preparing the land for planting, cost of seeds or seedlings, whether purchased or company produced, tree planting, including labor, materials, depreciation of company-owned equipment and the cost of contract services. Upon completion of planting activities and field inspection to assure the planting operation was successful, a plantation will be considered established. Subsequent expenditures made to maintain the integrity or enhance the growth of an established plantation or stand are expensed. Post-establishment expenses include release spray treatments, pest control activities, thinning operations and fertilization. Expenditures for forest management consist of regularly recurring items necessary to ownership and administration of timber producing property such as fire protection, property taxes and insurance, silviculture costs incurred subsequent to stand establishment, cruising (physical inventory), property maintenance and salaries, supplies, travel, record-keeping and other normal recurring administrative personnel costs, and these expenditures are accounted for as current operating expenses. Timberland purchased on the open market is capitalized and the cost is allocated to the relative values of the component items as appraised, such as timberland, merchantable sawtimber, merchantable pulpwood, reproduction (young growth not merchantable), logging roads

Table of Contents

and other land improvements. The capitalized cost includes purchase price, title search and title recording, transfer taxes and fees, cruise of timber, appraisals and running of boundary lines.

The aggregate estimated volume of current standing timber inventory is updated at least annually to reflect increases in merchantable timber due to reclassification of young growth stands to merchantable timber stands, the annual growth rates of merchantable timber and the acquisition of additional merchantable timber, and to reflect decreases due to timber harvests and land sales. Reproduction accounts are reviewed annually, and dollars and volumes are transferred from reproduction accounts to merchantable timber accounts on a reasonable and consistent basis. Volumes and the related accumulated costs are tracked and, as the timber is harvested, the cost per ton is amortized to depletion. Total standing volume is estimated on an annual basis using inventory data and a forest growth projection model. Timber volumes are estimated from cruises of the timber tracts, which are completed on all of our timberlands on approximately a five to ten year cycle. Since the individual cruises collect field data at different times for specific sites, the growth-model projects standing inventory from the cruise date to a common reporting date. Average annual growth rates for the merchantable inventory have historically been in the range of 2%-5%.

Depletion represents the amount chargeable to cost for logs cut from fee timber. Generally, rates at which timber is depleted are calculated annually for each of our Resource regions by dividing the beginning of year balance of the timber accounts, including current year timber stand improvement costs, by the forest inventory volume, after inventory updates for growth projection adjustments, new timber cruises, land purchases in existing operating regions and sales and harvested volume. Separate depletion rates are established and calculated annually for timber purchased outside our existing operating regions, such as for the timber associated with land in Wisconsin and central Idaho purchased in 2007.

Logging roads and related facilities on our land are presumed to become a part of our road system unless it is known at the time of construction that the road will be abandoned. Therefore, the base cost of the road, such as the clearing, grading, and ditching, is not amortized and remains a capitalized item until abandonment or other disposition, while other portions of the initial cost, such as bridges, culverts and gravel surfacing are amortized over their useful lives, which range from 10 to 20 years. Costs associated with temporary logging roads that will not become part of our road system are expensed as incurred.

Since timber, timberlands and related deposits are generally considered to be long-term productive assets, we classify these expenditures as investing activities in our Consolidated Statements of Cash Flows. Depletion, amortization and cost of permit timber harvested associated with timber, timberlands and related deposits are non-cash adjustments to net earnings in the operating activities section of the Consolidated Statements of Cash Flows.

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

REAL ESTATE SALES

Sales of non-strategic real estate are considered to be part of our normal operations. We therefore recognize revenue and costs associated with real estate sold in our Consolidated Statements of Operations and Comprehensive Income. Certain cash receipts and payments associated with real estate have aspects of more than one class of cash flows. For example, cash generated from real estate sales is included as an operating activity in our Consolidated Statements of Cash Flows, and is adjusted for the non-cash cost of real estate sold. Acquisitions of timberlands, however, are reported as investing activities in our Consolidated Statements of Cash Flows.

Table of Contents

LIKE-KIND EXCHANGES AND RESTRICTED CASH

In order to acquire and sell assets, primarily timberlands, in a tax efficient manner, we enter into like-kind exchange, or LKE, tax-deferred transactions. There are two main types of LKE transactions: forward transactions, in which property is sold and the proceeds are reinvested by acquiring similar property; and reverse transactions, in which property is acquired and similar property is subsequently sold by us. Both forward and reverse transactions must be completed within prescribed time periods under Internal Revenue Code section 1031.

We use a qualified LKE intermediary to facilitate LKE transactions. Proceeds from forward LKE transactions are held by the intermediary and are classified as restricted cash because the funds must be reinvested in similar properties. If the acquisition of suitable LKE properties is not completed within 180 days of the sale of the company-owned property, the proceeds are distributed to us by the intermediary and are reclassified as available cash and applicable income taxes are determined. Proceeds from reverse LKE transactions are not restricted because the funds are not subject to risk, earn interest and are available upon demand; therefore, these proceeds are included in short-term investments. In the case of reverse transactions in which we have not yet completed LKE sales of company-owned land to match with property purchased on our behalf by the intermediary, the amount associated with the property purchased on our behalf but not yet matched with LKE sales is classified as a long-term asset and included in Timber, timberlands and related deposits, net in our Consolidated Balance Sheets and as Deposits on timberlands in the investing activities section of our Consolidated Statements of Cash Flows. Amounts deposited with a third party towards the potential future purchase of property that are not matched with LKE sales are also included in Timber, timberlands and related deposits, net in our Consolidated Balance Sheets and as Deposits on timberlands in our Consolidated Statements of Cash Flows.

At December 31, 2007, we had \$8.1 million of proceeds from land sales deposited with a LKE intermediary and classified as short-term investments in the Consolidated Balance Sheet. We had \$6.7 million of proceeds from land sales deposited with a LKE intermediary and classified as restricted cash at December 31, 2006 in the Consolidated Balance Sheet. These amounts are included as non-cash adjustments to net earnings from continuing operations in the Consolidated Statements of Cash Flows for 2007 and 2006.

LONG-LIVED ASSETS

We account for impairment of long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Assets to be disposed of are reported at the lower of carrying amount or fair value less cost to sell.

INCOME TAXES

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

ENVIRONMENTAL

As part of our corporate policy, we have an ongoing process to monitor, report on and comply with environmental requirements. Based on this ongoing process, accruals for environmental liabilities that are not within the scope of SFAS No. 143, Accounting for Asset Retirement Obligations, and FASB Interpretation, or FIN, No. 47, Accounting for Conditional Asset Retirement Obligations, are established in accordance with SFAS No. 5, Accounting for Contingencies. We estimate our environmental liabilities based on various assumptions and judgments, the specific nature of which varies in light of the particular facts and circumstances surrounding each environmental liability. These estimates typically reflect assumptions and

Table of Contents

judgments as to the probable nature, magnitude and timing of required investigation, remediation and monitoring activities and the probable cost of these activities, and in some cases reflect assumptions and judgments as to the obligation or willingness and ability of third parties to bear a proportionate or allocated share of the cost of these activities. Due to the numerous uncertainties and variables associated with these assumptions and judgments, and the effects of changes in governmental regulation and environmental technologies, both the precision and reliability of the resulting estimates of the related liabilities are subject to substantial uncertainties. We regularly monitor our estimated exposure to environmental liabilities and, as additional information becomes known, our estimates may change significantly. Our estimates of our environmental liabilities do not reflect potential future recoveries from insurance carriers except to the extent that recovery may from time to time be deemed probable as a result of a carrier's agreement to payment terms. In those instances in which our estimated exposure reflects actual or anticipated cost-sharing arrangements with third parties, we do not believe that we will be exposed to additional material liability as a result of non-performance by such third parties. We have accrued for specific environmental remediation costs that we have determined are probable and reasonably estimable, and currently we are not aware of any material environmental liabilities.

Fees for professional services associated with environmental and legal issues are expensed as incurred.

REVENUE RECOGNITION

We recognize revenue from the sale of timber when title and risk of loss transfers to the buyer. Revenue from the sale of real estate is recognized in accordance with SFAS No. 66, Accounting for Sales of Real Estate. We receive the entire consideration in cash at closing for substantially all of our real estate sales. Also at closing, all risks and rewards of ownership are transferred to the buyer, and we do not have a substantial continuing involvement in any of our properties after sales are consummated.

We recognize revenue from sales of our wood, pulp and paperboard and consumer tissue products when title and risk of loss pass to the customer. Revenues are recorded net of any sales taxes collected. Sales taxes, when collected, are recorded as a current liability and remitted to the appropriate governmental entities.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. SFAS No. 157 originally was to become effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. However, in November 2007, the effective date was partially deferred by the FASB for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair market value in the financial statements on a nonrecurring basis. We are currently reviewing this Statement to determine what effect, if any, it will have on our financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This Statement permits a company to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective as of the beginning of a company's first fiscal year that begins after November 15, 2007. We adopted this Statement effective January 1, 2008, which did not have a material effect on our financial condition and results of operations.

Table of Contents

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51. This Statement requires all companies to report noncontrolling or minority interests in subsidiaries as equity in the consolidated financial statements. The intention of SFAS No. 160 is to eliminate the diversity in practice regarding the accounting for transactions between a company and noncontrolling interests. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We are currently reviewing this Statement to determine what effect, if any, it will have on our financial condition and results of operations.

In December 2007, the FASB also issued SFAS No. 141 (Revised 2007), Business Combinations. This revised Statement, which we refer to as SFAS No. 141R, is intended to simplify existing guidance and converge rulemaking under U.S. GAAP with international accounting rules. SFAS No. 141R will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs and restructuring costs. Also under this Statement, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. SFAS No. 141R is effective for fiscal years beginning after December 15, 2008. Adoption of this Statement is not expected to have a material effect on our financial condition and results of operations.

RECLASSIFICATIONS

Certain 2006 and 2005 amounts have been reclassified to conform to the 2007 presentation.

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE 1.

REIT Conversion

Effective January 1, 2006, we restructured our operations to qualify for treatment as a real estate investment trust, or REIT, for federal income tax purposes. The REIT tax rules require that we derive most of our income, other than income generated by a taxable REIT subsidiary, from investments in real estate, which for us primarily includes income from the sale of standing timber. Accordingly, prior to our REIT conversion, we transferred to our wholly-owned taxable REIT subsidiary, Potlatch Forest Products Corporation, which we refer to in these notes as Potlatch TRS, substantially all of our non-timberland assets, consisting primarily of manufacturing facilities engaged in the manufacturing of wood products, pulp and paperboard and tissue products, assets used for the harvesting of timber and the sale of logs, and selected land parcels that we expect will be sold or developed for higher and better use purposes. Our use of Potlatch TRS, which is taxed as a C corporation, enables us to continue to engage in these non-REIT qualifying businesses without violating the REIT requirements. In connection with this restructuring, our subsidiary that holds our timberlands agreed to sell standing timber to Potlatch TRS at fair market prices.

As a consequence of our conversion to a REIT, we were not permitted to retain earnings and profits accumulated during years when we were taxed as a C corporation. Therefore, in order to remain qualified as a REIT, we distributed these earnings and profits by making a one-time special distribution to stockholders, which we refer to as the special E&P distribution, on March 31, 2006. The special E&P distribution, with an aggregate value of approximately \$445 million, consisted of \$89 million in cash and approximately 9.1 million shares of Potlatch common stock valued at \$356 million.

In addition, deferred tax liabilities of \$56.5 million, which related to REIT qualifying activities, were no longer required. The deferred tax balance was therefore reduced in 2006 by recording a benefit in our provision for income taxes.

NOTE 2.

Short-term Investments

Our short-term investments are invested in time or demand deposits, certificates of deposit and U.S. Treasury and U.S. government agency obligations, all of which have very short maturity periods, and they therefore earn an interest rate commensurate with low-risk instruments. We do not attempt to hedge our exposure to interest rate risk for our short-term investments. All short-term investments are made in compliance with the requirements of the Internal Revenue Code with respect to qualifying REIT investments.

Table of Contents

NOTE 3.

Inventories

(Dollars in thousands)

| | 2007 | 2006 |
|---|------------|------------|
| Logs, pulpwood, chips and sawdust | \$ 19,474 | \$ 23,518 |
| Lumber and other manufactured wood products | 23,307 | 22,931 |
| Pulp, paper and converted paper products | 80,572 | 78,164 |
| Materials and supplies | 46,043 | 44,203 |
| | \$ 169,396 | \$ 168,816 |
| Valued at lower of cost or market: | | |
| Last-in, first-out basis | \$ 36,750 | \$ 36,454 |
| Average cost basis | 132,646 | 132,362 |
| | \$ 169,396 | \$ 168,816 |

If the last-in, first-out inventory had been priced at lower of current average cost or market, the values would have been approximately \$23.3 million higher at December 31, 2007, and \$22.8 million higher at December 31, 2006. Reductions in quantities of LIFO inventories valued at lower costs prevailing in prior years had the effect of increasing earnings, net of income taxes, by less than \$0.1 million in 2007, 2006, and 2005.

NOTE 4.

Plant and Equipment

(Dollars in thousands)

| | 2007 | 2006 |
|--------------------------|--------------|--------------|
| Land improvements | \$ 59,997 | \$ 65,100 |
| Buildings and structures | 224,450 | 217,187 |
| Machinery and equipment | 1,542,063 | 1,568,980 |
| Construction in progress | 20,134 | 19,852 |
| | \$ 1,846,644 | \$ 1,871,119 |

Depreciation charged against income amounted to \$64.6 million in 2007 (\$68.4 million in 2006 and \$67.7 million in 2005).

At December 31, 2007, our authorized capital spending budget, including \$59.6 million carried over from prior years, totaled \$127.0 million.

NOTE 5.

Timber, Timberlands and Related Deposits

(Dollars in thousands)

| | 2007 | 2006 |
|----------------------------|-------------------|-------------------|
| Timber and timberlands | \$ 363,929 | \$ 341,427 |
| Deposits on timberlands | 118,830 | |
| Related logging facilities | 51,754 | 50,150 |
| | \$ 534,513 | \$ 391,577 |

Table of Contents

Depletion from company-owned lands amounted to \$12.4 million in 2007 (\$8.7 million in 2006 and \$7.8 million in 2005). Amortization of logging roads and related facilities amounted to \$2.4 million in 2007 (\$2.1 million in 2006 and \$2.2 million in 2005).

In 2007, we acquired approximately 76,000 acres of timberland in Wisconsin for approximately \$64.5 million. Also in 2007, we entered into agreements to acquire approximately 179,000 acres of timberland in Idaho for approximately \$215 million. We completed the acquisition of the Idaho timberland in two separate transactions, with the first closing in September 2007 and the second closing in January 2008. The deposits on timberlands balance of \$118.8 million at December 31, 2007, was related to amounts associated with the Idaho timberland property purchased on our behalf by a qualified LKE intermediary but not yet matched with LKE sales.

NOTE 6.

Other Assets

(Dollars in thousands)

| | 2007 | 2006 |
|------------------------|-----------|-----------|
| Noncurrent investments | \$ 17,411 | \$ 16,067 |
| Other | 3,561 | 4,148 |
| | \$ 20,972 | \$ 20,215 |

Noncurrent investments primarily consist of company-owned life insurance stated at cash surrender value.

NOTE 7.

Taxes on Income

As a REIT, if we meet certain requirements, we generally will not be subject to federal corporate income taxes on our ordinary and capital gains income from our real estate investments that we distribute to our shareholders. We will, however, be subject to corporate taxes on built-in gains (the excess of fair market value at January 1, 2006 over tax basis on that date) on sales of real property (other than timber) held by the REIT during the first ten years following the REIT conversion. The built-in gains tax can be eliminated if sale proceeds are reinvested in similar properties in accordance with the like-kind exchange provisions of the Internal Revenue Code. We will continue to be required to pay federal corporate income taxes on earnings from our non-real estate investments, principally our manufacturing operations, held by Potlatch TRS.

In association with our REIT conversion, we estimated an amount for deferred tax liabilities that were no longer necessary and reversed this amount, totaling \$56.5 million, as an income tax benefit in 2006. Also, as a part of this analysis, we estimated the amount of REIT property that may be sold within the next ten years and retained a deferred tax liability at REIT conversion on the book-to-tax difference of approximately \$3 million. This estimate is periodically reviewed and adjusted as necessary.

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

(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|--|------------|-----------|-----------|
| Current* | \$ (2,974) | \$ 21,495 | \$ 16,251 |
| Deferred | (5,836) | (14,038) | (1,575) |
| Deferred tax adjustment due to REIT conversion | | (56,534) | |

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| | | | |
|---|------------|-------------|-----------|
| Provision (benefit) for taxes on income | \$ (8,810) | \$ (49,077) | \$ 14,676 |
|---|------------|-------------|-----------|

* The estimated realized tax benefit related to stock issued in conjunction with our stock compensation plans that exceed any previously recognized deferred tax assets has been recorded as an increase to additional paid-in capital rather than a reduction to the provision for income taxes. The amount of this increase was \$4.3 million, \$2.6 million and \$2.5 million for the years ended December 31, 2007, 2006 and 2005, respectively.

2007 FORM 10-K / 59

Table of Contents

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

(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|---|------------|-------------|-----------|
| Computed expected tax expense | \$ 16,668 | \$ 31,511 | \$ 16,674 |
| REIT income not subject to federal income tax | (22,132) | (24,203) | |
| State and local taxes, net of federal income tax effects | (281) | 570 | 1,824 |
| Tax credits | (415) | (411) | (2,285) |
| Deferred tax adjustment due to REIT conversion | | (56,534) | |
| Federal audit settlement | (3,948) | | |
| Deferred state tax adjustments | | | (2,395) |
| Interest on audit settlement, net of federal income tax benefit | 957 | | |
| All other items | 341 | (10) | 858 |
| Provision (benefit) for taxes on income | \$ (8,810) | \$ (49,077) | \$ 14,676 |
| Effective tax rate | (18.5)% | (54.5)% | 30.8% |

Our effective tax rate for 2007 was (18.5)%, compared to (54.5)% for 2006 and 30.8% for 2005. The effective rate for 2007 was significantly different than the rate used for 2006 due largely to two events. First, in 2007, we recorded a favorable adjustment of \$3.9 million as a result of the final determination of amounts owed to the Internal Revenue Service, or IRS, regarding tax issues for the years 1995-2004. Second, in 2006 we reversed \$56.5 million of deferred taxes due to our REIT conversion. The effective rate for 2006 was significantly lower than the rate used for 2005 due to our REIT conversion and the resulting reversal of deferred taxes.

At December 31, 2007, our accounts receivable balance included \$9.8 million of anticipated federal and state tax refunds.

During 2007, we reached final agreement with the IRS on amounts owed for the tax years 1995 through 2004. Settlement of the tax issues for these years had been reached in 2006 and at December 31, 2006, our accrued tax liability included \$9.0 million as an estimate for future payment of federal and state taxes and interest. As a result of the agreement with the IRS, we paid \$5.2 million in 2007 to federal and state tax authorities and reversed \$3.9 million of the accrual to income. At December 31, 2007, the company had a net receivable of \$0.1 million related to refunds yet to be received from several state tax jurisdictions.

Table of Contents

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

(Dollars in thousands)

| | 2007 | 2006 |
|---|--------------|--------------|
| Deferred Tax Assets: | | |
| Employee benefits | \$ 9,999 | \$ 9,836 |
| Postretirement employee benefits | 102,131 | 114,341 |
| Incentive compensation | 5,017 | 3,938 |
| Tax credits | 6,403 | 6,346 |
| Other | 7,942 | 7,737 |
| Total deferred tax assets | 131,492 | 142,198 |
| Valuation allowance | (6,113) | (6,106) |
| Deferred tax assets, net of valuation allowance | \$ 125,379 | \$ 136,092 |
| Deferred Tax Liabilities: | | |
| Plant and equipment | \$ (127,597) | \$ (137,899) |
| Timber, timberlands and related deposits | (3,286) | (2,030) |
| Pensions | (31,694) | (37,025) |
| Total deferred tax liabilities | (162,577) | (176,954) |
| Net deferred tax liabilities | \$ (37,198) | \$ (40,862) |
| Net deferred tax liabilities consist of: | | |

(Dollars in thousands)

| | 2007 | 2006 |
|--|-------------|-------------|
| Current deferred tax assets ¹ | \$ 14,783 | \$ 12,298 |
| Noncurrent deferred tax assets | 111,496 | 123,794 |
| Noncurrent deferred tax liabilities | (163,477) | (176,954) |
| Net noncurrent deferred tax liabilities | (51,981) | (53,160) |
| Net deferred tax liabilities | \$ (37,198) | \$ (40,862) |

¹ Included in Prepaid expenses in the Consolidated Balance Sheets.

A valuation allowance has been recognized for certain state tax credit carryforwards due to uncertainty of sufficient taxable income prior to expiration of available carryover periods. The valuation allowance increased less than \$0.1 million during 2007 and 2006.

Tax years subject to examination by major taxing jurisdictions are as follows:

| Jurisdiction | Years | |
|--------------|-------|------|
| | | |
| Federal | 2005 | 2007 |
| Arkansas | 2004 | 2007 |
| California | 2004 | 2007 |
| Idaho | 2006 | 2007 |

Table of Contents

We adopted the provisions of FIN No. 48, Accounting for Uncertainty in Income Taxes, effective January 1, 2007. Adoption did not result in our recording a liability for unrecognized tax benefits on that date. A review of the company's tax positions at December 31, 2007, indicates that no uncertain tax positions had been taken during 2007 and no new information is available which would require derecognition of previously taken positions.

We reflect accrued interest related to tax obligations, as well as penalties, in our provision for income taxes. For the years ended December 31, 2007, 2006 and 2005, we recognized approximately \$0.1 million, \$0.4 million and \$(0.6) million in interest and penalties in our tax provision, respectively. At December 31, 2007 and 2006, we had approximately \$0.1 million and \$1.6 million accrued for the payment of interest, respectively.

NOTE 8.

Debt

(Dollars in thousands)

| | 2007 | 2006 |
|---|------------|------------|
| Revenue bonds, fixed-rate 5.9% to 7.75%, due 2008 through 2026 | \$ 150,213 | \$ 156,327 |
| Debentures, 6.95%, due 2015 | 22,481 | 22,479 |
| Credit sensitive debentures, 9.125%, due 2009 | 100,000 | 100,000 |
| Medium-term notes, fixed-rate 8.65% to 8.89%, due 2011 through 2022 | 48,750 | 48,750 |
| Other notes | 66 | 75 |
| | 321,510 | 327,631 |
| Less current installments on long-term debt | 209 | 6,157 |
| Long-term debt | \$ 321,301 | \$ 321,474 |

We repaid \$6.1 million and \$2.1 million of revenue bonds on their normal maturity dates in 2007 and 2006, respectively. In 2006, we also redeemed the remaining \$5.5 million balance of our outstanding \$250 million 10% Senior Subordinated Notes due 2011. The other \$244.5 million of these notes were redeemed in 2004.

The interest rate payable on our 9.125% credit sensitive debentures is subject to adjustment in accordance with the table below if certain changes in the debt rating of the debentures occur. In October 2005, S&P announced that it had lowered our senior unsecured debt rating to BB stable from BB+. The rating downgrade caused the interest rate on our credit sensitive debentures to increase from 12.5% to 13.0%. Since October 2004, Moody's has rated our senior unsecured debt at Ba1. Moody's affirmed this rating, with a stable outlook, in December 2007.

| MOODY S | RATINGS | S&P | APPLICABLE RATE (%) |
|-------------|---------|-------------|---------------------|
| Aaa | | AAA | 8.825 |
| Aa1 Aa3 | | AA+ AA- | 8.925 |
| A1 Baa2 | | A+ BBB | 9.125 |
| Baa3 | | BBB- | 9.425 |
| Ba1 | | BB+ | 12.500 |
| Ba2 | | BB | 13.000 |
| Ba3 | | BB- | 13.500 |
| B1 or lower | | B+ or lower | 14.000 |

Our current unsecured bank credit facility, which expires on December 22, 2008, provides for a revolving line of credit of up to \$250 million, including a \$35 million subfacility for letters of credit and a \$10 million subfacility for swing line loans. The

Table of Contents

aggregate principal amount available under this credit facility was increased by \$75 million in the third quarter of 2007. Usage under either or both subfacilities reduces availability under the revolving line of credit. As of December 31, 2007, there were \$110.3 million of borrowings outstanding under the revolving line of credit, and approximately \$10.3 million of the letter of credit subfacility was being used to support several outstanding letters of credit. The \$110.3 million of borrowings were used to fund a portion of the acquisition of 145,000 acres of timberland in Idaho for approximately \$163 million in September 2007. This purchase was part of the overall acquisition of approximately 179,000 acres of timberland in Idaho for approximately \$215 million. The acquisition of the remaining Idaho timberland for approximately \$51.4 million was completed in January 2008 using borrowings from our line of credit and available cash on hand. Loans under the credit facility bear interest at LIBOR plus between 0.625% and 1.625% for LIBOR loans, and a base rate effectively equal to the bank's prime rate plus up to 0.625% for other loans. As of December 31, 2007, the weighted average interest rate on the \$110.3 million of borrowings outstanding under the revolving line of credit was approximately 6.1%. As of the date of this report, we are eligible to borrow under the credit facility at LIBOR plus 1.125%.

The agreement governing our credit facility contains certain covenants that, among other things, limit to a certain degree our ability and that of our subsidiaries to create liens, merge or consolidate, dispose of assets, incur indebtedness and guarantees, repurchase or redeem capital stock and indebtedness, make certain investments or acquisitions, enter into certain transactions with affiliates or change the nature of our business. The credit facility also contains financial maintenance covenants establishing a maximum funded indebtedness to capitalization ratio, a minimum consolidated net worth requirement, and a minimum interest coverage ratio. We will be permitted to pay distributions under the terms of the credit facility so long as we remain in pro forma compliance with the financial covenants.

The table below sets forth the most restrictive covenants in the credit facility and our status with respect to these covenants as of December 31, 2007:

| | COVENANT REQUIREMENT | ACTUAL RATIO AT DECEMBER 31, 2007 |
|---|--|--|
| Maximum Funded Indebtedness To Capitalization Ratio | 55% | 38.9% |
| Minimum Net Worth | 80% of consolidated net worth at March 31, 2006 ¹ | 126.0% |
| Minimum Interest Coverage Ratio | 2.75 to 1.00 | 5.27 to 1.00 |

¹ The minimum requirement is 80% of consolidated net worth as of March 31, 2006, with an adjustment to the minimum requirement for the net cash proceeds, on a cumulative basis, of all equity issuances.

Events of default under the credit facility include, but are not limited to, payment defaults, covenant defaults, breaches of representations and warranties, cross defaults to certain other material agreements and indebtedness, bankruptcy and other insolvency events, material adverse judgments, actual or asserted invalidity of security interests or loan documentation, and certain change of control events.

We and several of our subsidiaries are parties to the credit agreement and eligible to borrow thereunder, subject to the \$250 million aggregate credit limit and continued compliance with debt covenants. Any borrowings by one of these entities under the credit facility reduces the credit available for all the entities. As a result, borrowings by Potlatch TRS under the credit facility would, until repaid, reduce the amount of borrowings otherwise available to us for purposes such as the funding of quarterly distributions.

Table of Contents

Scheduled payments due on long-term debt during each of the five years subsequent to December 31, 2007, are as follows:

(Dollars in thousands)

| | |
|---------|---------|
| 2008 | \$ 209 |
| 2009 | 100,410 |
| 2010 | 11 |
| 2011 | 5,011 |
| 2012 | 21,656 |
| NOTE 9. | |

Accounts Payable and Accrued Liabilities

(Dollars in thousands)

| | 2007 | 2006 |
|---|------------|------------|
| Trade accounts payable | \$ 48,836 | \$ 50,206 |
| Accrued wages, salaries and employee benefits | 40,148 | 39,611 |
| Accrued taxes on income | | 22,284 |
| Book overdrafts | 14,860 | 14,590 |
| Accrued taxes other than taxes on income | 10,235 | 9,999 |
| Accrued utilities | 5,196 | 4,311 |
| Accrued freight | 4,756 | 4,202 |
| Accrued interest | 4,301 | 3,848 |
| Other | 24,029 | 19,936 |
| | \$ 152,361 | \$ 168,987 |

NOTE 10.

Other Long-Term Obligations

(Dollars in thousands)

| | 2007 | 2006 |
|---|-----------|-----------|
| Employee benefits and related liabilities | \$ 12,021 | \$ 13,554 |
| Other | 6,902 | 5,505 |
| | \$ 18,923 | \$ 19,059 |

Table of Contents

NOTE 11.

Financial Instruments

Estimated fair values of our financial instruments are as follows:

(Dollars in thousands)

| | 2007 | | 2006 | |
|--|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Cash, restricted cash and short-term investments | \$ 31,336 | \$ 31,336 | \$ 35,996 | \$ 35,996 |
| Current notes payable | 110,300 | 110,300 | | |
| Long-term debt | 321,510 | 338,524 | 327,631 | 350,911 |

For short-term investments the carrying amount approximates fair value. Our current notes payable consist of borrowings under our unsecured bank credit facility revolving line of credit. Due to the short maturities of these borrowings, fair value is estimated to be the same as the carrying amount. The fair value of our long-term debt is estimated based upon the quoted market prices for the same or similar debt issues. For long-term debt for which there is no quoted market price, fair value is estimated based on average market prices for comparable liquid revenue bonds.

We use derivative financial instruments from time to time as a tool to help us manage our exposure to certain market risks. We enter into derivative financial instruments as hedges against our exposure to market risks only if we believe there is a high probability that changes in the value of the hedging instrument will offset corresponding changes in the underlying exposure. Relationships between hedging instruments and hedged items are formally documented, as well as our risk management objectives and strategies for entering into the transactions. Designated cash flow hedges are linked to forecasted transactions. We also periodically assess whether the derivative financial instruments are effective in offsetting changes in cash flows or the fair value of the hedged items. If a hedge ceases to be highly effective, hedge accounting will be discontinued and derivative instrument gains and losses will be recognized in earnings. We do not enter into derivative contracts for speculative purposes, whether or not we utilize hedge accounting treatment for a specific transaction.

We had no activity during 2007 or 2006 that required hedge or derivative accounting treatment. However, to partially mitigate our exposure to market risk for changes in utility commodity pricing, we entered into firm price contracts for a portion of the natural gas requirements for our manufacturing facilities. The effects of these arrangements were not significant.

NOTE 12.

Savings, Pension and Other Postretirement Employee Benefit Plans

Substantially all of our employees are eligible to participate in 401(k) savings plans and are covered by noncontributory defined benefit pension plans. These include both company-sponsored and multi-employer plans. In 2007, 2006 and 2005, we made matching 401(k) contributions on behalf of employees of \$6.0 million, \$5.4 million and \$5.1 million, respectively. We also provide benefits under company-sponsored defined benefit retiree health care and life insurance plans, which cover certain salaried and hourly employees. Most of the retiree health care plans require retiree contributions and contain other cost sharing features. The retiree life insurance plans are primarily noncontributory.

In September 2006, the FASB issued SFAS No. 158, which requires a company that is a business entity and sponsors one or more single-employer defined benefit plans to:

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Recognize the funded status of a benefit plan measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation in its statement of financial position. For a pension plan, the benefit obligation is

2007 FORM 10-K / 65

Table of Contents

the projected benefit obligation; for any other postretirement employee benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement employee benefit obligation.

Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS No. 87, Employers Accounting for Pensions, or SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income (loss), including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions).

Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

This Statement amends SFAS No. 87, SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, SFAS No. 106, SFAS No. 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, and other accounting literature. Upon initial application of this Statement and thereafter, a company should continue to apply the provisions in Statements 87, 88 and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

As required by SFAS No. 158, we recognized on our Consolidated Balance Sheets at December 31, 2007 and 2006, the funded status of our defined benefit pension and other postretirement employee benefit plans. Retrospective application of the provisions of Statement 158 was not permitted. The incremental effects of applying the Statement on individual line items in our Consolidated Balance Sheet at December 31, 2006, were as follows:

(Dollars in thousands)

| | Before Application of Statement 158 | Adjustments | After Application of Statement 158 |
|---|--|--------------------|---|
| Noncurrent pension assets | \$ 236,248 | \$ (117,893) | \$ 118,355 |
| Total assets | 1,575,500 | (117,893) | 1,457,607 |
| Current liability for pension and OPEB | (1,359) | (19,761) | (21,120) |
| Noncurrent liability for pension and OPEB | (235,770) | (54,021) | (289,791) |
| Net noncurrent deferred taxes | (127,913) | 74,753 | (53,160) |
| Total liabilities | (880,719) | 971 | (879,748) |
| Accumulated other comprehensive loss | 2,130 | 116,922 | 119,052 |
| Total stockholders' equity | (694,781) | 116,922 | (577,859) |

Table of Contents

We use a December 31 measurement date for our benefit plans, and as a result, the measurement date provisions of SFAS No. 158 had no effect on us. The change in benefit obligation, change in plan assets and funded status for company-sponsored benefit plans are as follows:

(Dollars in thousands)

| | PENSION BENEFIT PLANS | | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | |
|--|-----------------------|------------|--|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Benefit obligation at beginning of year | \$ 608,496 | \$ 616,551 | \$ 288,633 | \$ 333,400 |
| Service cost | 12,007 | 12,166 | 2,494 | 2,797 |
| Interest cost | 34,267 | 33,278 | 15,289 | 16,077 |
| Plan amendments | | 822 | (5,803) | |
| Actuarial gains | (1,092) | (13,085) | (17,687) | (46,720) |
| Special termination benefits | 487 | | | |
| Medicare Part D subsidies received | | | 1,487 | 1,277 |
| Benefits paid | (41,679) | (41,236) | (22,531) | (18,198) |
| Benefit obligation at end of year | 612,486 | 608,496 | 261,882 | 288,633 |
| Fair value of plan assets at beginning of year | 704,568 | 629,579 | 5 | 3 |
| Actual return on plan assets | 34,444 | 96,763 | 2 | 2 |
| Employer contribution | 1,670 | 19,462 | | |
| Benefits paid | (41,679) | (41,236) | | |
| Fair value of plan assets at end of year | 699,003 | 704,568 | 7 | 5 |
| Funded status at end of year | \$ 86,517 | \$ 96,072 | \$ (261,875) | \$ (288,628) |
| Amounts recognized in the consolidated balance sheets: | | | | |
| Noncurrent assets | \$ 108,435 | \$ 118,355 | \$ | \$ |
| Current liabilities | (1,744) | (1,725) | (20,093) | (19,395) |
| Noncurrent liabilities | (20,174) | (20,558) | (241,782) | (269,233) |
| Net amount recognized | \$ 86,517 | \$ 96,072 | \$ (261,875) | \$ (288,628) |

Amounts recognized (pre-tax) in Accumulated Other Comprehensive Loss consist of:

(Dollars in thousands)

| | PENSION BENEFIT PLANS | | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | |
|-----------------------------|-----------------------|------------|---|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Net loss | \$ 127,795 | \$ 106,127 | \$ 67,706 | \$ 91,186 |
| Prior service cost (credit) | 14,130 | 16,320 | (20,035) | (18,466) |
| Net amount recognized | \$ 141,925 | \$ 122,447 | \$ 47,671 | \$ 72,720 |

The accumulated benefit obligation for all defined benefit pension plans was \$589.7 million and \$583.3 million at December 31, 2007, and 2006, respectively.

Table of Contents

Information as of December 31 for certain pension plans included above with accumulated benefit obligations in excess of plan assets were as follows:

(Dollars in thousands)

| | 2007 | 2006 |
|--------------------------------|-----------|-----------|
| Projected benefit obligation | \$ 21,918 | \$ 22,283 |
| Accumulated benefit obligation | 21,198 | 21,221 |

Fair value of plan assets

Pre-tax components of Net Periodic Cost (Benefit) and other amounts recognized in Other Comprehensive Income were as follows:

Net Periodic Cost (Benefit):

(Dollars in thousands)

| | OTHER POSTRETIREMENT | | | | | |
|---|-----------------------|------------|-------------|------------------------|-----------|-----------|
| | PENSION BENEFIT PLANS | | | EMPLOYEE BENEFIT PLANS | | |
| | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 |
| Service cost | \$ 12,007 | \$ 12,166 | \$ 10,677 | \$ 2,494 | \$ 2,797 | \$ 2,778 |
| Interest cost | 34,267 | 33,278 | 33,421 | 15,289 | 16,077 | 18,211 |
| Expected return on plan assets | (62,419) | (61,295) | (61,669) | | | |
| Amortization of prior service cost (credit) | 2,190 | 2,068 | 2,100 | (3,563) | (2,576) | (2,576) |
| Amortization of actuarial loss | 5,216 | 5,675 | 1,350 | 5,120 | 7,913 | 11,233 |
| Special termination benefits | 487 | | | | | |
| Net periodic cost (benefit) | \$ (8,252) | \$ (8,108) | \$ (14,121) | \$ 19,340 | \$ 24,211 | \$ 29,646 |

Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income:

| | | | | | | |
|---|-----------|------------|-------------|-------------|-----------|-----------|
| Net loss (gain) | \$ 26,884 | \$ | \$ | \$ (18,360) | \$ | \$ |
| Prior service credit | | | | (5,132) | | |
| Amortization of prior service (cost) credit | (2,190) | | | 3,563 | | |
| Amortization of actuarial loss | (5,216) | | | (5,120) | | |
| Total recognized in other comprehensive loss (income) | 19,478 | | | (25,049) | | |
| Total recognized in net periodic cost (benefit) and other comprehensive loss (income) | \$ 11,226 | \$ (8,108) | \$ (14,121) | \$ (5,709) | \$ 24,211 | \$ 29,646 |

The estimated net loss and prior service cost for the defined benefit pension plans that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$4.1 million and \$2.1 million, respectively. The estimated net loss and prior service credit for the other postretirement employee plans that will be amortized from

Table of Contents

accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$4.2 million and \$(3.8) million, respectively.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003, or the Act, was signed into law. The Act, which went into effect on January 1, 2006, introduces a drug benefit under Medicare Part D and a federal subsidy to sponsors of retiree health care benefit plans that provide an equivalent benefit. Pursuant to FSP No. 106-2, we determined in 2004, with the assistance of consulting actuaries, that certain benefits provided under our plans were actuarially equivalent to the Medicare Part D standard plan and were eligible for the employer subsidy. We chose the prospective application option for adoption of the FSP as of July 1, 2004. At that time, the effects of the Act on the accumulated postretirement employee benefit obligation, or APBO, were measured and were determined to reduce the APBO by \$25.9 million. After receiving further guidance from the Centers for Medicare and Medicaid Services in 2005, our consulting actuaries determined that the effects of the Act would reduce the APBO by an additional \$21.5 million. The aggregate effect in 2005 of these two adjustments on service cost, interest cost and amortization of (gain)/loss was approximately \$7.3 million. This gain is reflected in the table presented above. During 2007 and 2006, we received subsidy payments totaling \$1.5 million and \$1.3 million, respectively.

Weighted average assumptions used to determine the benefit obligation as of December 31 were:

| | PENSION BENEFIT PLANS | | | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | | |
|--|-----------------------|-------|-------|---|-------|-------|
| | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 |
| Discount rate | 6.40% | 5.85% | 5.60% | 6.40% | 5.85% | 5.60% |
| Expected return on plan assets | 9.00 | 9.50 | 9.50 | 9.00 | 9.00 | 9.00 |
| Rate of salaried compensation increase | 4.00 | 4.00 | 4.00 | | | |

Weighted average assumptions used to determine the net periodic benefit (cost) for the years ended December 31 were:

| | PENSION BENEFIT PLANS | | | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | | |
|--|-----------------------|-------|-------|---|-------|-------|
| | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 |
| Discount rate | 5.85% | 5.60% | 5.90% | 5.85% | 5.60% | 5.90% |
| Expected return on plan assets | 9.50 | 9.50 | 9.50 | 9.00 | 9.00 | 9.00 |
| Rate of salaried compensation increase | 4.00 | 4.00 | 4.00 | | | |

The discount rate used in the determination of pension benefit obligations and pension expense is a weighted average benchmark rate based on high-quality fixed income investment interest rates, as well as the amount and timing of expected benefit payments. The discount rate used to calculate OPEB obligations was determined using the same methodology we used for our pension plans.

The expected return on plan assets assumption is based upon an analysis of historical long-term returns for various investment categories, as measured by appropriate indices. These indices are weighted based upon the extent to which plan assets are invested in the particular categories in arriving at our determination of a composite expected return. Over the past 30 years, the period we have actively managed pension assets, our actual average annual return on pension plan assets has been approximately 11%.

Table of Contents

The assumed health care cost trend rate used to calculate OPEB obligations and expense for 2007 was a 10% increase over the previous year, with the rate of increase scheduled to decline one percent annually to a long-term ultimate rate increase assumption of 6% for 2011 and thereafter. This assumption has a significant effect on the amounts reported. A one percentage point change in the health care cost trend rates would have the following effects:

(Dollars in thousands)

| | 1% INCREASE | 1% DECREASE |
|---|--------------------|--------------------|
| Effect on total of service and interest cost components | \$ 1,918 | \$ (1,609) |
| Effect on postretirement employee benefit obligation | 25,049 | (21,401) |

The weighted average asset allocations at December 31 by asset category are as follows:

| ASSET CATEGORY | PENSION BENEFIT PLANS | | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | |
|----------------------------|----------------------------------|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Domestic equity securities | 62% | 66% | % | % |
| Global equity securities | 10 | 10 | | |
| Debt securities | 26 | 22 | | |
| Other | 2 | 2 | 100 | 100 |
| Total | 100% | 100% | 100% | 100% |

We utilize formal investment policy guidelines for our company-sponsored pension plans. These guidelines are periodically reviewed by the board of directors. The board of directors has delegated its authority to management to insure that the investment policy and guidelines are adhered to and the investment objectives are met.

The general policy states that plan assets will be invested to seek the greatest return consistent with the fiduciary character of the pension funds and to allow the plans to meet the need for timely pension benefit payments. The specific investment guidelines stipulate that management will maintain adequate liquidity for meeting expected benefit payments by reviewing, on a timely basis, contribution and benefit payment levels and appropriately revise long-term and short-term asset allocations. Management takes reasonable and prudent steps to preserve the value of pension fund assets and to avoid the risk of large losses. Major steps taken to provide this protection include:

Assets are diversified among various asset classes, such as domestic equities, global equities, fixed income, convertible securities, venture capital and liquid reserves. The long-term asset allocation ranges are as follows:

| | |
|---|---------|
| Domestic and global equities | 50%-80% |
| Fixed income and convertible securities | 15%-40% |
| Venture capital | 00%-05% |
| Liquid reserves | 00%-10% |

The ranges are more heavily weighted toward equities since the liabilities of the pension plans are long-term in nature and equities historically have significantly outperformed other asset classes over long periods of time. Periodic reviews of allocations within these ranges are made to determine what adjustments should be made based on changing economic and market conditions and specific liquidity requirements.

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Assets are managed by professional investment managers and may be invested in separately managed accounts or commingled funds. Assets will be diversified by selecting different investment managers for each asset class and by limiting assets under each manager to no more than 25% of the total pension fund.

70 / POTLATCH CORPORATION

Table of Contents

Assets, other than venture capital, are not invested in securities rated below BBB- by S&P or Baa3 by Moody's.

Assets are not invested in Potlatch stock.

The investment guidelines also require that the individual investment managers are expected to achieve a reasonable rate of return over a market cycle. Emphasis will be placed on long-term performance versus short-term market aberrations. Factors to be considered in determining reasonable rates of return include performance achieved by a diverse cross section of other investment managers, performance of commonly used benchmarks (e.g., S&P 500 Index, Shearson Lehman Government/Corporate Intermediate Index, Morgan Stanley World Index, Merrill Lynch Investment Grade Convertibles Index, Russell Value Index), actuarial assumptions for return on plan investments and specific performance guidelines given to individual investment managers.

During 2007, eight active investment managers managed substantially all of the pension funds, each of whom had responsibility for managing a specific portion of these assets. Plan assets were diversified among the various asset classes within the allocation ranges approved by the board of directors.

No minimum contributions to our qualified pension plans are estimated for 2008 due to the funded status of those plans at December 31, 2007. However, we estimate contributions will total approximately \$1.7 million in 2008 for our non-qualified pension plan. We do not anticipate funding our postretirement employee benefit plans in 2008 except to pay benefit costs as incurred during the year by plan participants.

Estimated future benefit payments, which reflect expected future service and expected medicare prescription subsidy receipts, are as follows for the years indicated:

(Dollars in thousands)

| | PENSION BENEFIT PLANS | OTHER POSTRETIREMENT EMPLOYEE BENEFIT PLANS | EXPECTED MEDICARE SUBSIDY |
|-------------|------------------------------|--|--|
| 2008 | \$ 42,441 | \$ 21,800 | \$ 1,700 |
| 2009 | 42,276 | 22,500 | 1,900 |
| 2010 | 42,574 | 23,400 | 2,100 |
| 2011 | 43,074 | 24,200 | 2,200 |
| 2012 | 43,764 | 24,100 | 2,300 |
| 2013 - 2017 | 233,390 | 124,700 | 13,000 |

Hourly employees at two of our manufacturing facilities participate in multi-employer defined benefit pension plans: the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union Pension Fund; and the International Association of Machinist & Aerospace Workers National Pension Fund, to which we make contributions. We also make contributions to a trust fund established to provide retiree medical benefits for a portion of these employees, which is managed by the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union Pension Fund. Company contributions to these plans in 2007, 2006 and 2005 amounted to \$8.2 million, \$7.8 million and \$9.0 million, respectively.

NOTE 13.

Commitments and Contingencies

We have operating leases covering manufacturing, office, warehouse and distribution space, equipment and vehicles expiring at various dates through 2019. As leases expire, it can be expected that, in the normal course of business, certain leases will be renewed or replaced.

Table of Contents

As of December 31, 2007, the future minimum rental payments required under our operating leases are as follows:

(Dollars in thousands)

| | |
|----------------------|-----------|
| 2008 | \$ 12,461 |
| 2009 | 8,675 |
| 2010 | 6,277 |
| 2011 | 5,443 |
| 2012 | 4,694 |
| 2013 and later years | 20,539 |
| Total | \$ 58,089 |

Rent expense for continuing operations was \$13.7 million, \$14.2 million and \$13.5 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Beginning in February 2006, a series of private antitrust lawsuits were filed against us and certain other manufacturers of oriented strand board (OSB) by plaintiffs who claim they purchased OSB at artificially high prices. The cases have been consolidated into two Consolidated Amended Class Action Complaints in the United States District Court for the Eastern District of Pennsylvania under the caption In Re OSB Antitrust Litigation, one on behalf of direct purchasers of OSB and the other on behalf of indirect purchasers. The complaints allege that the defendant OSB manufacturers violated federal and state antitrust laws by purportedly conspiring from mid-2002 to the present to drive up the price of OSB. The consolidated indirect purchaser complaint also alleges that defendants violated various states' unfair competition laws and common law. Each consolidated complaint seeks an unspecified amount of monetary damages to be trebled as provided under the antitrust laws and other relief. The court has ordered that the cases may proceed as class actions. It certified a nationwide class of direct purchasers who bought OSB structural panel products directly from one of the defendants during the period from June 1, 2002 to February 24, 2006. It also certified a nationwide class of indirect purchaser end users who purchased new OSB manufactured or sold by one of the defendants during the same time period; this class excludes persons only who bought OSB that was incorporated into a house or other structure. The claims of the nationwide indirect purchaser class are limited to injunctive relief. However, the court also certified a multistate class of indirect purchasers in 17 states whose members may recover compensation as allowed by state law. We believe we have meritorious defenses to these claims, and we are defending ourselves accordingly. We sold our OSB manufacturing facilities to Ainsworth Lumber Co. Ltd. in September 2004.

On September 28, 2005, Ainsworth notified us by letter of its claims under the indemnification provisions of the asset purchase agreement between us and Ainsworth whereby Ainsworth purchased our OSB facilities. The claims involve alleged breaches of representations and warranties regarding the condition of certain of the assets sold to Ainsworth. In July 2006, Ainsworth filed a complaint for breach of contract in the United States District Court for the Southern District of New York seeking an unspecified amount of monetary damages. The federal court case was subsequently dismissed voluntarily, and Ainsworth refiled its complaint in the Supreme Court of the State of New York for the County of New York on September 21, 2006. We believe we have meritorious defenses to the claim, and we are defending ourselves accordingly.

We believe there is no pending or threatened litigation that would have a material adverse effect on our financial position, operations or liquidity.

During 2005, the FASB issued FIN No. 47, an Interpretation of SFAS No. 143. Under FIN No. 47, the company must recognize a liability and an asset equal to the fair value of its legal obligation to perform asset retirement activities that are conditional on a future event if the amount can be reasonably estimated. In accordance with the guidance of FIN No. 47, we undertook a

Table of Contents

review of our manufacturing facilities and other assets to determine, if possible, amounts that should be recognized as asset retirement obligations. The review resulted in our recording additional assets and corresponding liabilities, which were not material to our financial position or results of operations. We also identified situations that would have resulted in the recognition of additional asset retirement obligations, except for an inability to reasonably estimate the fair value of the liability at this time. Most of these situations relate to asbestos located within our manufacturing facilities where a settlement date or range of settlement dates cannot be specified, so that we are unable at this time to apply present value calculations to appropriately value an obligation. Any additional obligations recognized in the future as more information becomes available are not expected to have a material effect on our financial position or results of operations.

NOTE 14.

Equity-Based Compensation Plans

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). We adopted the provisions of SFAS No. 123R on its effective date of January 1, 2006, using the modified prospective method.

At December 31, 2007, we had three stock incentive plans, the 1995, 2000 and 2005 plans, under which stock option, performance share or restricted stock unit, or RSU, grants were outstanding. All of these plans have received shareholder approval. We were originally authorized to issue up to 1.7 million shares, 1.4 million shares and 1.6 million shares under our 1995 Stock Incentive Plan, 2000 Stock Incentive Plan and 2005 Stock Incentive Plan, respectively. At December 31, 2007, no shares were available for future use under the 1995 Stock Incentive Plan, while approximately 87,000 shares and 959,000 shares were authorized for future use under the 2000 and 2005 Stock Incentive Plans, respectively. All exercises of stock options or distributions of performance shares or restricted stock were made through the issuance of new shares after January 31, 2006. Prior to that date, treasury shares were utilized.

We recorded equity-based compensation expense of \$5.8 million in 2007, \$4.1 million in 2006 and \$2.3 million in 2005. Of these amounts, \$5.2 million and \$0.6 million related to performance shares and RSUs, respectively, in 2007, and \$3.7 million and \$0.4 million related to performance shares and RSUs, respectively, in 2006. All equity-based compensation expense recorded in 2005 related to performance shares. All outstanding stock options were fully vested prior to January 1, 2006. The net income tax benefit recognized in the Consolidated Statements of Operations and Comprehensive Income for equity-based compensation totaled \$2.3 million, \$1.6 million and \$0.9 million in 2007, 2006 and 2005, respectively.

Directors of the company can each elect to defer compensation in the form of stock units. We record compensation expense or income during each reporting period based on the amount of compensation deferred during the period and the increase or decrease in the value of the company's common stock. We recorded director deferred expense totaling \$1.0 million in 2007 and \$1.8 million in 2006.

Prior to 2006, we applied the intrinsic value method under APB No. 25 and related Interpretations in accounting for our equity-based compensation. As a result, no compensation cost was recognized for stock options granted under the plans because the exercise price was equal to market value at the grant date. For performance share awards, which were first granted in December 2003, compensation expense was recorded ratably over the performance period based upon the market value of our stock and the likelihood that performance measurements would be met. No restricted stock units were outstanding prior to 2006.

As required by SFAS No. 123R, \$2.7 million and \$0.9 million of cash flows for the years ended December 31, 2007 and 2006, respectively, representing the realized tax benefit related to the excess of the deductible amount over the compensation cost recognized, has been classified as a financing cash inflow in the Consolidated Statements of Cash Flows. Prior to the adoption of SFAS No. 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as cash flows from operating activities in the Consolidated Statements of Cash Flows.

Table of Contents

Had we adopted SFAS No. 123R in 2005, the effect of adoption would have approximated the pro forma disclosures made under SFAS No. 123 as of December 31, 2005, as follows:

(Dollars in thousands except per-share amounts)

| | |
|---|-------------|
| | 2005 |
| Net earnings, as reported | \$ 32,964 |
| Add: equity-based compensation expense recorded under APB No. 25, net of tax | 1,376 |
| Deduct: equity-based compensation expense determined under SFAS No. 123, net of tax | (2,091) |
| Pro forma net earnings | \$ 32,249 |
| Basic net earnings per share, as reported | \$ 1.13 |
| Diluted net earnings per share, as reported | 1.13 |
| Pro forma basic net earnings per share | 1.11 |
| Pro forma diluted net earnings per share | 1.11 |

STOCK OPTIONS

All outstanding stock options were granted with an exercise price equal to the market price on the date of grant, are fully exercisable after two years and expire not later than 10 years from the date of grant. In December 2005, the executive compensation and personnel policies committee of the board of directors, which we refer to as the committee, decided that no new stock options would be granted in 2005 and thus granted performance shares only, and no new stock options were granted in 2006 or 2007. The committee believes that performance shares provide a superior incentive to stock options for employees of a REIT. Additionally, the committee approved the accelerated vesting of all outstanding, unvested, stock options effective December 31, 2005. As a result, 58,275 options vested on that date instead of the normal vesting date of December 4, 2006. In accordance with APB No. 25 accounting rules, compensation expense related to the accelerated vesting, totaling less than one thousand dollars, was recorded on December 31, 2005.

The special E&P distribution of \$15.15 per common share paid in the first quarter of 2006 qualified as an equity restructuring event under our stock incentive plans. In order to maintain the same intrinsic value to option holders immediately before and after the special distribution was paid, the number of options granted and exercise prices of all outstanding stock options were adjusted after the record date for the special E&P distribution payment. The adjustment is reflected in the activity for 2006 presented in the table below.

A summary of the status of outstanding stock options as of December 31, 2007, 2006 and 2005 and changes during those years is presented below:

| | 2007 | | 2006 | | 2005 | |
|---|-----------|------------------------------|-----------|------------------------------|-----------|------------------------------|
| | SHARES | WEIGHTED AVG. EXERCISE PRICE | SHARES | WEIGHTED AVG. EXERCISE PRICE | SHARES | WEIGHTED AVG. EXERCISE PRICE |
| Outstanding at January 1 | 875,425 | \$ 26.16 | 849,960 | \$ 37.76 | 1,307,815 | \$ 37.23 |
| Adjustment as a result of special distribution/dividend | | | 360,435 | 26.40 | | |
| Shares exercised | (360,653) | 27.59 | (328,740) | 27.42 | (447,617) | 36.05 |
| Canceled or expired | (5,488) | 32.10 | (6,230) | 30.01 | (10,238) | 44.05 |
| Outstanding and exercisable at December 31 | 509,284 | 25.08 | 875,425 | 26.16 | 849,960 | 37.76 |
| | \$ 6,385 | | \$ 4,108 | | \$ 6,452 | |

Total intrinsic value of options
exercised during the year (in
thousands)

There were no unvested stock options outstanding during 2007 or 2006.

74 / POTLATCH CORPORATION

Table of Contents

The following table summarizes information about stock options outstanding at December 31, 2007:

| RANGE OF EXERCISE PRICES | NUMBER OUTSTANDING AT 12/31/07 | OPTIONS OUTSTANDING AND EXERCISABLE | | AGGREGATE INTRINSIC VALUE (IN THOUSANDS) |
|--------------------------|--------------------------------|--|------------------------------|--|
| | | WEIGHTED AVG. REMAINING CONTRACTUAL LIFE | WEIGHTED AVG. EXERCISE PRICE | |
| \$15.8849 to \$19.0779 | 97,495 | 4.55 years | \$ 17.43 | |
| \$21.3279 to \$25.1112 | 227,909 | 4.01 years | 22.45 | |
| \$27.5226 to \$35.4393 | 183,880 | 5.00 years | 32.40 | |
| \$15.8849 to \$35.4393 | 509,284 | 4.47 years | 25.08 | \$ 9,858 |

Cash received from stock option exercises for the years ended December 31, 2007, 2006 and 2005 was \$10.0 million, \$9.0 million and \$16.1 million, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled \$2.3 million, \$1.5 million and \$2.5 million for the years ended December 31, 2007, 2006 and 2005, respectively.

PERFORMANCE SHARES

Performance share awards granted under the stock incentive plans have a three-year performance period and shares are issued at the end of the period if the performance measure is met. The performance measure is a comparison of the percentile ranking of our total shareholder return compared to the total shareholder return performance of a selected peer group of forest products companies. The number of performance shares actually issued, as a percentage of the amounts initially granted, could range from 0% to 200%. Performance shares granted under the program may not be voted until issued. If performance share awards are paid out at the end of the three-year performance measurement period, the recipients will receive distribution equivalents at the time of payment equal to the distributions that would have been paid on the shares earned had the recipients owned the shares during the three-year period.

Due to the adoption of SFAS No. 123R, the fair value of all performance share awards after January 1, 2006, is estimated using a Monte Carlo simulation model. For the purpose of recognizing compensation expense, performance share awards granted prior to the adoption of SFAS No. 123R are valued at the market value of the company's stock at the date of grant.

A summary of the status of outstanding performance share awards as of December 31, 2007, 2006 and 2005, and changes during those years is presented below:

(Dollars in thousands except per-share amounts)

| | 2007 WEIGHTED AVG. GRANT DATE | | 2006 WEIGHTED AVG. GRANT DATE | | 2005 WEIGHTED AVG. GRANT DATE | |
|--|-------------------------------------|------------|-------------------------------------|------------|-------------------------------------|------------|
| | SHARES | FAIR VALUE | SHARES | FAIR VALUE | SHARES | FAIR VALUE |
| Unvested shares outstanding at January 1 | 329,358 | \$ 51.62 | 228,599 | \$ 47.38 | 127,161 | \$ 43.38 |
| Granted | 10,400 | 53.14 | 180,945 | 51.75 | 107,221 | 51.95 |
| Vested | (71,812) | 55.21 | (48,420) | 33.18 | | |
| Forfeited | (23,013) | 49.86 | (31,766) | 49.92 | (5,783) | 44.14 |
| Unvested shares outstanding at December 31 | 244,933 | 50.80 | 329,358 | 51.62 | 228,599 | 47.38 |

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| | | | |
|---|-----------|-----------|-----------|
| Total fair value of share awards vested during the year | \$ 3,964 | \$ 1,607 | \$ |
| Aggregate intrinsic value of unvested share awards at December 31 | \$ 10,027 | \$ 12,885 | \$ 11,654 |

2007 FORM 10-K / 75

Table of Contents

As of December 31, 2007, there was \$5.9 million of unrecognized compensation cost related to non-vested performance share awards. The cost is expected to be recognized over a weighted average period of 1.6 years. The estimated realized tax benefit that exceeds the previously recognized deferred tax asset for performance shares recognized as additional paid-in capital was \$2.0 million and \$1.1 million for the years ended December 31, 2007 and 2006, respectively. No performance shares were vested and thus no tax deductions were computed in 2005.

RESTRICTED STOCK UNITS

Our 2005 Stock Incentive Plan also allows for awards to be issued in the form of RSU grants. During 2007 and 2006, certain officers and other select employees of the company were granted RSU awards that will accrue distribution equivalents based on distributions paid during the RSU vesting period. The distribution equivalents will be converted into additional RSUs that will vest in the same manner as the underlying RSUs to which they relate. The terms of the awards generally state that 20% of the RSUs will vest on each of the first and second anniversaries of the awards, with the remaining 60% vesting on the third anniversary.

A summary of the status of outstanding RSU awards as of December 31, 2007 and 2006, and changes during these years is presented below:

| | 2007 | | 2006 | |
|--|-------------------------------------|--|-------------------------------------|--|
| | WEIGHTED AVG. GRANT DATE FAIR VALUE | AGGREGATE INTRINSIC VALUE (IN THOUSANDS) | WEIGHTED AVG. GRANT DATE FAIR VALUE | AGGREGATE INTRINSIC VALUE (IN THOUSANDS) |
| | SHARES | VALUE | SHARES | VALUE |
| Unvested shares outstanding at January 1 | 28,401 | \$ 50.32 | | \$ |
| Granted | 9,154 | 45.15 | 31,051 | 49.30 |
| Vested | (5,680) | 50.32 | | |
| Forfeited | | | (2,650) | 38.30 |
| Unvested shares outstanding at December 31 | 31,875 | 48.84 | 28,401 | 50.32 |
| | | \$ 1,417 | | \$ 1,245 |

For restricted stock awards granted during the period, the fair value of each share was estimated on the date of grant using the grant date market price. The total fair value of share awards vested during 2007 was \$0.3 million.

As of December 31, 2007, there was \$0.8 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is expected to be recognized over a weighted average period of 1.5 years.

NOTE 15.

Segment Information

As of December 31, 2007, our businesses were organized into five reportable operating segments, as defined by SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information: Resource; Real Estate; Wood Products; Pulp and Paperboard; and Consumer Products. The Resource segment consists of substantially all of our timberlands, as well as those assets that are necessary to manage these timberlands. The Real Estate segment consists of the sale of selected non-strategic timberland real estate, including sales for higher and better use purposes, and the acquisition of timberlands. The Wood Products segment produces lumber, plywood and particleboard. The Pulp and Paperboard segment produces paperboard and pulp. The Consumer Products segment produces consumer tissue products.

As a result of the sale of our Boardman, Oregon hybrid poplar tree farm in May 2007, the Resource segment information for the periods presented in the table below has been adjusted to reflect the Boardman operation as a discontinued operation.

Table of Contents

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

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

(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|--|--------------|--------------|--------------|
| Segment Revenues: | | | |
| Resource | \$ 296,821 | \$ 285,235 | \$ 274,729 |
| Real Estate | 24,116 | 13,617 | 26,466 |
| Wood Products: | | | |
| Lumber | 342,898 | 377,604 | 384,627 |
| Plywood | 55,309 | 55,102 | 52,477 |
| Particleboard | 19,922 | 20,419 | 17,646 |
| Other | 46,464 | 43,886 | 38,787 |
| | 464,593 | 497,011 | 493,537 |
| Pulp and Paperboard: | | | |
| Paperboard | 567,798 | 535,796 | 500,624 |
| Pulp | 101,754 | 77,291 | 64,569 |
| Other | 1,070 | 1,113 | 922 |
| | 670,622 | 614,200 | 566,115 |
| Consumer Products | 444,699 | 436,883 | 368,418 |
| | 1,900,851 | 1,846,946 | 1,729,265 |
| Elimination of intersegment revenues | (246,830) | (247,718) | (233,335) |
| Total consolidated revenues | \$ 1,654,021 | \$ 1,599,228 | \$ 1,495,930 |
| Intersegment Revenues or Transfers¹: | | | |
| Resource | \$ 170,825 | \$ 179,505 | \$ 174,903 |
| Wood Products | 20,059 | 16,023 | 14,599 |
| Pulp and Paperboard | 55,838 | 52,080 | 43,745 |
| Consumer Products | 108 | 110 | 88 |
| Total | \$ 246,830 | \$ 247,718 | \$ 233,335 |
| Operating Income (Loss): | | | |
| Resource | \$ 81,836 | \$ 81,344 | \$ 61,791 |
| Real Estate ² | 17,303 | 11,917 | 22,441 |
| Wood Products ³ | 1,901 | 39,465 | 28,594 |
| Pulp and Paperboard | 44,260 | 23,562 | (1,621) |
| Consumer Products | 19,194 | 27,269 | 10,628 |
| Eliminations and adjustments | (747) | (3,752) | (1,310) |
| | 163,747 | 179,805 | 120,523 |
| Corporate Items: | | | |
| Administration expense | (48,139) | (44,271) | (40,938) |
| Interest expense | (30,710) | (29,120) | (29,045) |
| Interest income | 2,279 | 1,874 | 2,504 |
| Debt retirement costs | | 53 | |
| Consolidated income before taxes on income | \$ 87,177 | \$ 108,341 | \$ 53,044 |
| Depreciation, depletion and amortization: | | | |
| Resource | \$ 15,365 | \$ 11,261 | \$ 10,551 |
| Wood Products | 14,446 | 15,790 | 14,741 |
| Pulp and Paperboard | 32,388 | 35,547 | 36,407 |
| Consumer Products | 16,268 | 15,800 | 15,587 |
| | 78,467 | 78,398 | 77,286 |
| Corporate | 1,617 | 1,388 | 1,056 |
| Total | \$ 80,084 | \$ 79,786 | \$ 78,342 |

Table of Contents

(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|---------------------------------------|--------------|--------------|--------------|
| Assets: | | | |
| Resource and Real Estate ⁴ | \$ 558,885 | \$ 453,240 | \$ 446,419 |
| Wood Products | 202,908 | 208,674 | 223,393 |
| Pulp and Paperboard | 361,611 | 386,794 | 406,086 |
| Consumer Products | 256,541 | 269,744 | 285,152 |
| | 1,379,945 | 1,318,452 | 1,361,050 |
| Corporate | 137,259 | 139,155 | 267,127 |
| Total consolidated assets | \$ 1,517,204 | \$ 1,457,607 | \$ 1,628,177 |
| Capital Expenditures: | | | |
| Resource and Real Estate ⁴ | \$ 58,955 | \$ 11,248 | \$ 6,733 |
| Wood Products | 10,837 | 13,085 | 52,204 |
| Pulp and Paperboard | 13,789 | 13,014 | 21,733 |
| Consumer Products | 5,531 | 12,773 | 13,402 |
| | 89,112 | 50,120 | 94,072 |
| Corporate | 960 | 1,312 | 1,011 |
| Total | \$ 90,072 | \$ 51,432 | \$ 95,083 |

¹ Intersegment revenues for 2005-2007, which were based on prevailing market prices, consisted primarily of logs, chips, pulp logs and other fiber sales by our Resource segment to the Wood Products and Pulp and Paperboard segments and pulp sold from our Pulp and Paperboard segment to our Consumer Products segment.

² Operating income for the Real Estate segment included non-cash costs for real estate sold of \$3.6 million, \$0.3 million and \$0.8 million in 2007, 2006 and 2005, respectively.

³ Operating income in 2006 for the Wood Products segment included \$39.3 million associated with the negotiated settlement of the softwood lumber trade dispute between the U.S. and Canada.

⁴ Assets and capital expenditures are shown on a combined basis for the Resource and Real Estate segments, as the company does not produce such internal information separately for those segments. Included in the Resource and Real Estate capital expenditures for 2007 are \$14.5 million and \$35.3 million related to the acquisitions of approximately 76,000 acres of timberland in Wisconsin and 145,000 acres of timberland in Idaho, respectively. The remaining balance of cash expended in 2007 of approximately \$43.5 million for the Wisconsin timberlands and approximately \$118.8 million for the Idaho timberlands is included in Deposits on timberlands on our Consolidated Statements of Cash Flows.

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

(Dollars in thousands)

| | 2007 | 2006 | 2005 |
|-----------------------------|--------------|--------------|--------------|
| United States | \$ 1,503,593 | \$ 1,480,791 | \$ 1,359,195 |
| Japan | 45,350 | 38,317 | 60,830 |
| China | 30,354 | 23,675 | 17,600 |
| Canada | 19,904 | 17,086 | 14,960 |
| Taiwan | 11,301 | 11,841 | 13,269 |
| Netherlands | 10,736 | 1,398 | |
| Australia | 4,835 | 6,278 | 8,694 |
| Vietnam | 4,420 | 22 | |
| Korea | 4,315 | 2,158 | 8,576 |
| Poland | 3,550 | 2,347 | |
| England | 3,383 | 3,224 | 3,145 |
| Mexico | 2,525 | 4,296 | 4,039 |
| Other foreign countries | 9,755 | 7,795 | 5,622 |
| Total consolidated revenues | \$ 1,654,021 | \$ 1,599,228 | \$ 1,495,930 |

Table of Contents

NOTE 16.

Restructuring Charge

The following is a description of the charge included in the Restructuring charge line in the Consolidated Statements of Operations and Comprehensive Income.

In January 2007, we recorded a pre-tax charge of \$2.8 million associated with a restructuring in our Resource segment. The charge represented estimated severance benefit costs for 35 employees. A reduction to this charge of \$0.1 million was recorded in the third quarter of 2007. As of December 31, 2007, all amounts related to this charge had been paid. There were no restructuring charges in 2006 or 2005.

NOTE 17.

Discontinued Operations

In May 2007, we sold our hybrid poplar tree farm in Boardman, Oregon, for \$65 million in cash. We applied a large portion of the proceeds from this sale to our acquisition in the first quarter of 2007 of 76,000 acres of timberlands in Wisconsin through a tax-efficient Internal Revenue Code section 1031 like-kind exchange.

As a result of the sale, we recorded an after-tax charge of \$33.0 million for the year ended December 31, 2007. The charge represented estimated costs associated with the adjustment of the carrying value of the assets involved in the sale to fair market value, as well as approximately \$0.3 million in severance benefits and approximately \$0.2 million in transaction and other costs associated with the sale. For the years ended December 31, 2007, 2006 and 2005, after-tax operating losses of \$3.7 million, \$16.9 million, and \$3.3 million, respectively, which were previously included in the operating results of our Resource segment, are classified as discontinued operations in the Consolidated Statement of Operations and Comprehensive Income, as required by SFAS No. 144. Revenues for the hybrid poplar tree farm, which were previously included in our Resource segment revenues, were \$2.5 million, \$8.6 million and \$6.0 million for the years ended December 31, 2007, 2006 and 2005, respectively.

In the Consolidated Statements of Cash Flows, we have separately disclosed the operating, investing and financing portions of the cash flows attributable to our discontinued operations.

2007 FORM 10-K / 79

Table of Contents

NOTE 18.

Financial Results by Quarter (Unaudited)

(Dollars in thousands except per-share amounts)

| | Three Months Ended | | | | | | | |
|--|--------------------|------------|------------|------------|--------------|------------|-------------|------------|
| | March 31 | | June 30 | | September 30 | | December 31 | |
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Revenues | \$ 386,206 | \$ 401,224 | \$ 414,714 | \$ 413,293 | \$ 436,066 | \$ 396,752 | \$ 417,035 | \$ 387,959 |
| Costs and expenses: | | | | | | | | |
| Depreciation, depletion, and amortization | 19,352 | 19,652 | 19,320 | 19,327 | 20,864 | 20,494 | 20,548 | 20,313 |
| Materials, labor and other operating expenses | 335,745 | 332,916 | 325,985 | 358,815 | 347,179 | 328,037 | 356,282 | 312,933 |
| Selling, general and administrative expenses | 20,891 | 23,322 | 20,987 | 21,673 | 23,244 | 22,990 | 25,366 | 22,544 |
| Restructuring charge | 2,797 | | 35 | | (141) | | (38) | |
| | 378,785 | 375,890 | 366,327 | 399,815 | 391,146 | 371,521 | 402,158 | 355,790 |
| Income from Canadian lumber settlement | | | | | | | | 39,320 |
| Earnings from continuing operations | 5,438 | 69,314 | 35,393 | 8,245 | 41,167 | 31,075 | 11,156 | 47,412 |
| Discontinued operations | (35,214) | (3,590) | (1,443) | (5,839) | (154) | (5,378) | 89 | (2,129) |
| Net earnings (loss) | \$ (29,776) | \$ 65,724 | \$ 33,950 | \$ 2,406 | \$ 41,013 | \$ 25,697 | \$ 11,245 | \$ 45,283 |
| Earnings per common share from continuing operations | | | | | | | | |
| Basic | \$ 0.14 | \$ 2.34 | \$ 0.91 | \$ 0.21 | \$ 1.05 | \$ 0.80 | \$ 0.28 | \$ 1.22 |
| Diluted | 0.14 | 2.33 | 0.90 | 0.21 | 1.04 | 0.80 | 0.28 | 1.22 |
| Loss per common share from discontinued operations | | | | | | | | |
| Basic | \$ (0.90) | \$ (0.12) | \$ (0.04) | \$ (0.15) | \$ | \$ (0.14) | \$ | \$ (0.05) |
| Diluted | (0.90) | (0.12) | (0.04) | (0.15) | | (0.14) | | (0.05) |
| Net earnings per common share | | | | | | | | |
| Basic | \$ (0.76) | \$ 2.22 | \$ 0.87 | \$ 0.06 | \$ 1.05 | \$ 0.66 | \$ 0.29 | \$ 1.17 |
| Diluted | (0.76) | 2.21 | 0.87 | 0.06 | 1.04 | 0.66 | 0.28 | 1.16 |

The above results for 2006 have been adjusted to reflect our adoption of FSP No. AUG AIR-1, Accounting for Planned Major Maintenance Activities, on January 1, 2007.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Potlatch Corporation:

We have audited the accompanying consolidated balance sheets of Potlatch Corporation and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations and comprehensive income, cash flows and stockholders equity for each of the years in the three-year period ended December 31, 2007. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in Item 15. These consolidated financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and the financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Potlatch Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

Effective December 31, 2006, Potlatch Corporation adopted Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*, as discussed in Note 12 in the accompanying consolidated financial statements. Also, effective January 1, 2006, Potlatch Corporation adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, as discussed in Note 14 in the accompanying consolidated financial statements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Potlatch Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 19, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP

Seattle, Washington

February 19, 2008

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Potlatch Corporation:

We have audited Potlatch Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Potlatch Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on internal control over financial reporting based on our audit.

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

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

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

In our opinion, Potlatch Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Potlatch Corporation and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations and comprehensive income, cash flows and stockholders' equity for each of the years in the three-year period ended December 31, 2007, and our report dated February 19, 2008 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Seattle, Washington

February 19, 2008

Table of Contents

Schedule II

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Valuation and Qualifying Accounts

FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Dollars in thousands)

| DESCRIPTION | BALANCE AT BEGINNING OF YEAR | AMOUNTS | | BALANCE AT END OF YEAR |
|---------------------------------------|------------------------------------|--|-------------------------|------------------------------|
| | | CHARGED (CREDITED) TO COSTS AND EXPENSES | DEDUCTIONS ¹ | |
| Reserve deducted from related assets: | | | | |
| Doubtful accounts | | | | |
| Accounts receivable | | | | |
| Year ended December 31, 2007 | \$ 2,199 | \$ 2,218 | \$ (3,212) | \$ 1,205 |
| Year ended December 31, 2006 | \$ 1,253 | \$ 1,245 | \$ (299) | \$ 2,199 |
| Year ended December 31, 2005 | \$ 1,226 | \$ (36) | \$ 63 | \$ 1,253 |

¹ Accounts written off, net of recoveries.

2007 FORM 10-K / 83

Table of Contents

POTLATCH CORPORATION AND CONSOLIDATED SUBSIDIARIES

Exhibit Index

| EXHIBIT NUMBER | DESCRIPTION |
|----------------|---|
| (2)(d)* | Asset Purchase Agreement, dated September 11, 2007, between Potlatch Forest Holdings, Inc., a Delaware corporation and wholly owned subsidiary of the Registrant, as Buyer, and Western Pacific Timber, LLC, as Seller, regarding property located in Adams, Boise, and Valley counties, State of Idaho, filed as Exhibit (2)(d) to the Quarterly Report on Form 10-Q filed by the Registrant on October 29, 2007. (The Registrant agrees to furnish supplementally to the Securities and Exchange Commission (the Commission) upon request a copy of any omitted schedule.) |
| (2)(e)* | Asset Purchase Agreement, dated September 11, 2007, between Potlatch Forest Holdings, Inc., a Delaware corporation and wholly owned subsidiary of the Registrant, as Buyer, and Western Pacific Timber, LLC, as Seller, regarding property located in Adams, Boise, Idaho, and Valley counties, State of Idaho, and the city of Cascade, Idaho, filed as Exhibit (2)(e) to the Quarterly Report on Form 10-Q filed by the Registrant on October 29, 2007. (The Registrant agrees to furnish supplementally to the Commission upon request a copy of any omitted schedule.) |
| (3)(a)* | Second Restated Certificate of Incorporation of the Registrant, effective February 3, 2006, filed as Exhibit 99.2 to the Current Report on Form 8-K filed by the Registrant on February 6, 2006. |
| (3)(b)* | Bylaws of the Registrant, as amended through December 1, 2006, filed as Exhibit (3)(b) to the Current Report on Form 8-K filed by the Registrant on December 7, 2006. |
| (4) | See Exhibits (3)(a) and (3)(b). The Registrant also undertakes to furnish to the Commission, upon request, any instrument defining the rights of holders of long-term debt. |
| (4)(a)* | Form of Indenture, dated as of November 27, 1990, filed as Exhibit (4)(a) to the Annual Report on Form 10-K filed by Potlatch Corporation, a Delaware corporation and the Registrant's former parent corporation (Original Potlatch) (on February 3, 2006, Original Potlatch merged with and into Potlatch Operating Company, a Delaware corporation and a wholly-owned subsidiary of the Registrant, the Registrant then changed its name to Potlatch Corporation and became the new, publicly traded parent corporation), for the fiscal year ended December 31, 2000 (2000 Form 10-K) (SEC File No. 1-5313). |
| (4)(a)(i)* | Officers' Certificate, dated January 24, 1991, filed as Exhibit (4)(a)(i) to the 2000 Form 10-K (SEC File No. 1-5313). |
| (4)(a)(ii)* | Officers' Certificate, dated December 12, 1991, filed as Exhibit (4)(a)(ii) to the Annual Report on Form 10-K filed by Original Potlatch for the fiscal year ended December 31, 2001 (2001 Form 10-K) (SEC File No. 1-5313). |
| (4)(a)(iii)* | First Supplemental Indenture, dated as of February 3, 2006, amending Exhibit (4)(a), filed as Exhibit (4)(a)(iii) to the Annual Report on Form 10-K filed by the Registrant for the fiscal year ended December 31, 2005 (2005 Form 10-K). |
| (10)(a)1* | Potlatch Corporation Management Performance Award Plan, as amended effective December 2, 2004, filed as Exhibit (10)(a) to the Annual Report on Form 10-K filed by Original Potlatch for the fiscal year ended December 31, 2004 (2004 Form 10-K). |
| (10)(b)(i)1* | Potlatch Forest Products Corporation Severance Program for Executive Employees, amended September 15, 2006 (successor to the Potlatch Severance Program for Executive Employees filed as Exhibit (10)(b) to the Quarterly Report on Form 10-Q for the quarter ended June 30, 2005), filed as Exhibit (10)(b) to the Current Report on Form 8-K by the Registrant on September 21, 2006, and as further amended April 4, 2007 and filed as Exhibit (10)(b) to the Current Report on Form 8-K filed by the Registrant on April 5, 2007. |

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(10)(c)^{1*}

Potlatch Corporation 2000 Stock Incentive Plan, adopted December 2, 1999, as amended effective December 29, 2005, filed as Exhibit (10)(c) to the Current Report on Form 8-K filed by Original Potlatch on January 5, 2006, and as amended September 16, 2006, filed as Exhibit (10)(c) to the Current Report on Form 8-K filed by the Registrant on September 21, 2006.

84 / POTLATCH CORPORATION

Table of Contents

| | |
|----------------------------|--|
| (10)(c)(ii) ^{1*} | Form of employee Stock Option agreement for the Potlatch Corporation 2000 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 2000, 2001, 2002, 2003 and 2004, filed as Exhibit (10)(c)(i) to the 2001 Form 10-K (SEC File No. 1-5313). |
| (10)(c)(iii) ^{1*} | Form of outside director Stock Option agreement for the Potlatch Corporation 2000 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 2000, 2001, 2002 and 2003, filed as Exhibit (10)(c)(ii) to the 2001 Form 10-K (SEC File No. 1-5313). |
| (10)(d) ^{1*} | Potlatch Corporation Salaried Employees Supplemental Benefit Plan, as amended and restated effective January 1, 1989, and as amended through May 24, 2005, filed as Exhibit (10)(d) to the Quarterly Report on Form 10-Q filed by Original Potlatch for the quarter ended June 30, 2005. |
| (10)(d)(i) ^{1*} | Amendment, effective as of January 1, 1998, to Plan described in Exhibit (10)(d), filed as Exhibit (10)(d)(i) to the Annual Report on Form 10-K filed by Original Potlatch for the fiscal year ended December 31, 2003 (2003 Form 10-K). |
| (10)(g) ^{1*} | Potlatch Corporation Deferred Compensation Plan for Directors, as amended through May 24, 2005, filed as Exhibit (10)(g) to the Quarterly Report on Form 10-Q filed by Original Potlatch for the quarter ended June 30, 2005. |
| (10)(h) ^{1*} | Potlatch Corporation Benefits Protection Trust Agreement, as amended and restated effective September 20, 2002, filed as Exhibit (10)(h) to the Quarterly Report on Form 10-Q filed by Original Potlatch for the quarter ended September 30, 2002; as further amended effective September 16, 2006 and filed as Exhibit (10)(h) to the Quarterly Report on Form 10-Q filed by the Registrant for the quarter ended September 30, 2006. |
| (10)(i)(i) ¹ | Compensation of Outside Directors, effective as of January 1, 2008. |
| (10)(j) ^{1*} | Form of Indemnification Agreement with each director of Potlatch Corporation as set forth on Schedule A, filed as Exhibit (10)(j) to the 2001 Form 10-K (SEC File No. 1-5313). |
| (10)(j)(iv) ¹ | Amendment No. 5 to Schedule A to Exhibit (10)(j). |
| (10)(k) ^{1*} | Form of Indemnification Agreement with certain officers of Potlatch Corporation as set forth on Schedule A, filed as Exhibit (10)(k) to the 2001 Form 10-K (SEC File No. 1-5313). |
| (10)(k)(iii) ¹ | Amendment No. 8 to Schedule A to Exhibit (10)(k). |
| (10)(m)(i) ^{1*} | Form of Amendments, dated January 12, 1999, to outstanding employee Stock Option Agreements, filed as Exhibit (10)(m)(i) to the 2003 Form 10-K. |
| (10)(m)(ii) ^{1*} | Form of Amendment, dated December 29, 1998, to outstanding outside director Stock Option Agreements, filed as Exhibit (10)(m)(ii) to the 2003 Form 10-K. |
| (10)(n) ^{1*} | Potlatch Corporation 1995 Stock Incentive Plan, adopted December 7, 1995, as amended effective December 29, 2005, filed as Exhibit (10)(n) to the Current Report on Form 8-K filed by Original Potlatch on January 5, 2006. |
| (10)(n)(iv) ^{1*} | Form of employee Stock Option Agreement for the Potlatch Corporation 1995 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 1998, filed as Exhibit (10)(n)(iv) to the 2003 Form 10-K. |
| (10)(n)(v) ^{1*} | Form of outside director Stock Option Agreement for the Potlatch Corporation 1995 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 1998, filed as Exhibit (10)(n)(v) to the 2003 Form 10-K. |
| (10)(n)(vi) ^{1*} | Form of employee Stock Option Agreement for the Potlatch Corporation 1995 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 1999, 2000, 2001 and 2002, filed as Exhibit (10)(n)(vi) to the 2004 Form 10-K. |
| (10)(n)(vii) ^{1*} | Form of outside director Stock Option Agreement for the Potlatch Corporation 1995 Stock Incentive Plan together with the Addendum thereto as used for options granted in December 1999 and 2000, filed as Exhibit (10)(n)(vii) to the 2004 Form 10-K. |

Table of Contents

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| (10)(o)* | Amended and Restated Credit Agreement, dated as of December 22, 2005, filed as Exhibit (10)(o) to the Current Report on Form 8-K filed by Original Potlatch on December 27, 2005. |
| (10)(o)(i)* | First Amendment dated February 20, 2007 to the Amended and Restated Credit Agreement dated as of December 22, 2005, filed as Exhibit (10)(o)(i) to the Quarterly Report on Form 10-Q filed by the Registrant on October 29, 2007. |
| (10)(o)(ii)* | Amended Schedule 2.01 effective August 1, 2007, to the Amended and Restated Credit Agreement dated as of December 22, 2005, filed as Exhibit (10)(o)(ii) to the Quarterly Report on Form 10-Q filed by the Registrant on October 29, 2007. |
| (10)(p) ^{1*} | Form of Performance Share Agreement for the Potlatch Corporation 2000 Stock Incentive Plan, together with the Addendum thereto as used for performance share awards granted in December 2003, 2004 and 2005, filed as Exhibit (10)(q) to the 2003 Form 10-K. |
| (10)(q) ^{1*} | Employment Agreement, effective February 6, 2006, between Original Potlatch, the Registrant and Michael J. Covey, filed as Exhibit 10(q) to the 2005 Form 10-K, and Addendum to Employment Agreement dated December 1, 2006, between Potlatch Corporation and Michael J. Covey, filed as Exhibit 10(q) to the Current Report on Form 8-K filed by the Registrant on December 7, 2006. |
| (10)(q)(i) ^{1*} | Restricted Stock Unit Agreement (2005 Stock Incentive Plan), together with the Addendum thereto, effective February 6, 2006, between the Registrant and Michael J. Covey, filed as Exhibit (10)(q)(1) to the 2005 Form 10-K. |
| (10)(q)(ii) ^{1*} | Performance Share Agreement (2005 Stock Incentive Plan), together with the Addendum thereto, effective February 6, 2006, between the Registrant and Michael J. Covey, filed as Exhibit (10)(q)(ii) to the 2005 Form 10-K. |
| (10)(r) ^{1*} | Potlatch Corporation 2005 Stock Incentive Plan, as amended and restated May 19, 2006, filed as Exhibit (10)(r) to the Quarterly Report on Form 10-Q filed by the Registrant for the quarter ended June 30, 2006, and as further amended and restated effective September 16, 2006, filed as Exhibit (10)(e) to the Current Report on Form 8-K filed by the Registrant on September 21, 2006. |
| (10)(r)(i) ^{1*} | Form of Restricted Stock Unit Agreement (2005 Stock Incentive Plan), as amended and restated May 19, 2006, to be used for restricted stock unit awards to be granted subsequent to May 19, 2006, filed as Exhibit (10)(r)(i) to the Quarterly Report on Form 10-Q filed by the Registrant for the quarter ended June 30, 2006. |
| (10)(r)(ii) ^{1*} | Form of Performance Share Agreement (2005 Stock Incentive Plan), as amended and restated May 19, 2006, to be used for performance share awards to be granted subsequent to May 19, 2006, filed as Exhibit (10)(r)(ii) to the Quarterly Report on Form 10-Q filed by the Registrant for the quarter ended June 30, 2006, and as further amended on January 17, 2007, to be used for performance share awards to be granted subsequent to May 19, 2006, filed as Exhibit (10)(r)(ii) to the Current Report on Form 8-K filed by the Registrant on January 19, 2007. |
| (10)(r)(iii) ^{1*} | Potlatch Corporation Management Performance Award Plan II, adopted September 16, 2006, filed as Exhibit (10)(r) to the Current Report on Form 8-K filed by the Registrant on September 21, 2006, and as amended April 4, 2007 and filed as Exhibit (10)(r) to the Current Report on Form 8-K filed by the Registrant on April 5, 2007. |
| (10)(s) ^{1*} | Potlatch Corporation Deferred Compensation Plan for Directors II, adopted September 16, 2006, filed as Exhibit (10)(s) to the Current Report on Form 8-K by the Registrant on September 21, 2006. |
| (10)(t) ^{1*} | Potlatch Forest Products Corporation Salaried Employees Supplemental Benefits Plan II, adopted September 15, 2006 (successor to the Potlatch Corporation Salaried Employees Supplemental Benefits Plan filed as Exhibit (10)(d) to the Quarterly Report on Form 10-Q filed by the Registrant for the quarter ended June 30, 2005), filed as Exhibit (10)(t) to the Current Report on Form 8-K by the Registrant on September 21, 2006, and as further amended April 4, 2007 and filed as Exhibit (10)(t) to the Current Report on Form 8-K filed by the Registrant on April 5, 2007. |

Table of Contents

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| (10)(u) ^{1*} | Retirement Agreement, dated June 4, 2007, between Potlatch Forest Products Corporation and Gerald L. Zuehlke, filed as Exhibit (10)(u) to the Quarterly Report on Form 10-Q filed by the Registrant on July 30, 2007. |
| (10)(v) ^{1*} | Offer Letter, dated May 21, 2007, between Potlatch Forest Products Corporation and Eric J. Cremers, filed as Exhibit (10)(v) to the Quarterly Report on Form 10-Q filed by the Registrant on July 30, 2007. |
| (12) | Computation of Ratio of Earnings to Fixed Charges. |
| (21) | Potlatch Corporation Subsidiaries. |
| (23) | Consent of Independent Registered Public Accounting Firm. |
| (24) | Powers of Attorney. |
| (31) | Rule 13a-14(a)/15d-14(a) Certifications. |
| (32) | Furnished statements of the Chief Executive Officer and Chief Financial Officer under 18 U.S.C. Section 1350. |

* Incorporated by reference.

¹ Management contract or compensatory plan, contract or arrangement.