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WESCO FINANCIAL CORP

10-K

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CARD 1 DISCLOSURE INFORMATION GROUP BETHESDA MD 20816 FOR 12/31/86

Quick Reference Chart to Contents of SEC Filings

									Registration Statements						
									'34 Act		'33 Act				
REPORT CONTENTS	10-K	19-K 20-F	10-Q	8-K	10-C	6-K	Proxy Statement	Prospectus	F-10	8-A 8-B	"S" Type	ARS	Listing Application	N-1R	N-1Q
Auditor															
☐ Name	A	A	■				■	A	A		A	A	■	A	
☐ Opinion	A	A	■						A			A		A	
☐ Changes				A			■								
Compensation Plans															
☐ Equity	■		■				F	F	A		F		■	■	
☐ Monetary	■		■					F	A		F		■		
Company Information															
☐ Nature of Business	A	A				F		A	A		A	■	■		
☐ History	F	A						A			A	■	■		
☐ Organization and Change	F	F		A	■	F	■	A		F	A	■			
Debt Structure	A					F	■	A	A		A	A		A	
Depreciation & Other Schedules	A	A				F		A	A		A				
Dilution Factors	A	A		F		F		A	A		A	A			
Directors, Officers, Insiders															
☐ Identification	F	A				F	A	A	A		A	F			
☐ Background	■	A				F	F	A	■		A	■			
☐ Holdings	■	A		■			A	A	A		A				
☐ Compensation	■	A		■			A	A	A		A				
Earnings Per Share	A	A	A			F			A			A		A	
Financial Information															
☐ Annual Audited	A	A							A			A		A	
☐ Interim Audited		A					■	■			■				
☐ Interim Unaudited	■		A	■		F		F			F				
Foreign Operations	A						■	A	A		A	■	F		
Labor Contracts		■		■			■		F		F				
Legal Agreements	F	■		■					F		F				
Legal Counsel				■				A			A		■		
Loan Agreements	F		F	■			■		F		F			■	
Plants and Properties	A	F		■				F	A		F	■			
Portfolio Operations															
☐ Content (Listing of Securities)															A
☐ Management														A	
Product-Line Breakout	A							A			A	■			
Securities Structure	A	A			■			A	A		A				
Subsidiaries	A	A					■	A	A		A	■	■		
Underwriting				■				A	A		A				
Unregistered Securities	■			■			■	F			F				
Block Movements	■			F			■		A				■		

Legend **A** – *always included - included - if occured or significant* **F** – *frequently included* ■ *special circumstances only*

TENDER OFFER/ACQUISITION REPORTS	13D	13 G	14D-1	14D-9	13E-3	13E-4
Name of Issuer (Subject Company)	A	A	A	A	A	A
Filing Person (or Company)	A	A	A	A	A	A
Amount of Shares Owned	A	A				
Percent of Class Outstanding	A	A				
Financial Statements of Bidders			F		F	F
Purpose of Tender Offer			A	A	A	A
Source and Amount of Funds	A		A		A	
Identity and Background Information			A	A	A	
Persons Retained Employed or to be Compensated			A	A	A	A
Exhibits	F		F	F	F	F

5161 River Road ☐ Washington, D.C. 20016 ☐ 301/951-1300

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WESCO FINANCIAL CORPORATION

Annual Report 1986

Form 10-K Annual Report 1986

Headquarters building
of Wesco Financial Corporation
and Mutual Savings and Loan Assoc

BOARD OF DIRECTORS

Charles T. Munger
Chairman of the Board, Wesco Financial Corporation and Mutual Savings and Loan Association; President, Wesco Financial Corporation; Chairman of the Board, Blue Chip Stamps (trading stamps, parent of Wesco Financial Corporation); Vice Chairman of the Board, Berkshire Hathaway Inc. (insurance, candy, retailing, manufacturing, newspaper and encyclopedia publishing, parent of Blue Chip Stamps).

William T. Caspers*
Personal investments

Harold R. Dettmann
Vice President, Wesco Financial Corporation; President, Mutual Savings and Loan Association

James N. Gamble*
Investment counselling and trust administration

Elizabeth Caspers Peters
Personal investments

David K. Robinson*
Partner of Hahn & Hahn, attorneys at law

**Audit Committee member*

EXECUTIVE OFFICERS OF WESCO FINANCIAL CORPORATION AND MUTUAL SAVINGS AND LOAN ASSOCIATION

Charles T. Munger
Chairman of the Board and President, Wesco; Chairman of the Board, Mutual Savings

Harold R. Dettmann
Vice President, Wesco; President, Mutual Savings

John R. Armetta
Vice President, Wesco; Senior Vice President, Mutual Savings

Philip E. Lynn
Vice President, Wesco; Senior Vice President, Mutual Savings

Robert E. Sahm
Vice President, Wesco

Jeffrey L. Jacobson
Vice President and Chief Financial Officer, Wesco and Mutual Savings

Jeanne Leach
Treasurer, Wesco; Vice President and Controller, Mutual Savings

Dolores Henderson
Secretary, Wesco and Mutual Savings

Robert D. Aston
Vice President, Wesco; Senior Vice President, Mutual Savings

Dolly Russo
Senior Vice President and Branch Manager, Mutual Savings

LEGAL COUNSEL

Hahn & Hahn

LISTED ON

American Stock Exchange
Pacific Stock Exchange

TRANSFER AGENTS AND REGISTRARS

Security Pacific National Bank
P. O. Box 3546, Terminal Annex, Los Angeles, California 90051

Security Pacific National Bank
63 Wall Street, 13th Floor, New York, New York 10004

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1986 increased to $11,934,000 ($1.68 per share) from $8,347,000 ($1.17 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) decreased to $16,524,000 ($2.32 per share) from $51,541,000 ($7.24 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1986		December 31, 1985	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 2,159	$ .30	$ 3,342	$ .47
Precision Steel businesses	1,701	.24	2,010	.28
Wesco-Financial Insurance business—				
Underwriting	(1,469)	(.21)	(1,584)	(.22)
Investment activity	8,084	1.14	1,225	.17
	6,615	.93	(359)	(.05)
All other "normal" net operating income[2]	1,459	.21	3,354	.47
	11,934	1.68	8,347	1.17
Fluctuation in market value of GNMA futures contract	—	—	1,671	.24
Net gains on sales of securities[3]	4,590	.64	41,523	5.83
Wesco consolidated net income	$16,524	$2.32	$51,541	$7.24

(1) All figures are net of income taxes.

(2) After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

(3) The 1985 figure includes a $34,363,000 ($4.83 per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

Mutual Savings

Mutual Savings' "normal" net operating income of $2,159,000 in 1986 represented a decrease of 35% from the $3,342,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1985 and 1986 are set forth at the end of this annual report. They show (1) total savings accounts rising to $282 million from $269 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $79 million at the end of 1986, down 6% from the $83 million at the end of 1985, and (5) favorable effects of securities gains, which caused net worth to decline only $3 million in 1986 despite payment of a dividend of $7.5 million to the parent corporation.

The loan portfolio at the end of 1986, although containing almost no risk of loss from defaults, bore an average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and about equal to the average interest rate which now must be paid to hold savings accounts. This, of course, leaves no net interest margin to cover operating costs. However, the unrealized depreciation in the loan portfolio is now more than offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks. Such unrealized appreciation at December 31, 1986 was about $17 million.

As pointed out in footnote 14 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($54.8 million at December 31, 1986) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $54.8 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $54.8 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, in Mutual Savings, not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.6 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 11 years in the course of administration of land-use laws. But we are optimistic that delay will end in 1987 and that the Santa Barbara and Montecito communities will be very pleased with development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (32) and by the fact that only a minority of such houses (12) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens imposed by governmental bodies will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1987.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, continues to be a mediocre business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental-effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) as explained in last year's annual report, the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California continue to leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985-1986 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1987, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that at least 60% of assets be in housing-related loans. New direct loans aggregating $9 million were made in 1986, all adjustable rate mortgages with no cap on future interest rate changes but with an extremely low "spread" for the lender. In recent months the total of all loans on hand has risen as new loans made exceeded principal payoffs on old loans.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations and prevent recurrence of widespread insolvencies like those now bedevilling the industry.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,701,000 to "normal" net operating income in 1986, down 15% compared with $2,010,000 in 1985. The decrease in 1986 profit occurred in spite of increased revenues (up 2% to $52,304,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $10,172,000 to 1986 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $36.2 million was invested in January 1986.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 exceeded $67 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1986, are included on page 30 of this Annual Report, and show that Wes-FIC's net income for 1986 was $6,967,000 versus a small deficit ($359,000) for its first 4 months of operation in 1985. The 1986 net income figure included securities gains, net of income taxes, of $352,000.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

We very much like our association with Fireman's Fund, a real class operation, and with Jack Byrne, its CEO, who displayed great integrity, intelligence and vigor in returning GEICO Corporation to glory before he took his present position.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $1,459,000 in 1986 from $3,354,000 in 1985. Sources were (1) rents ($2,229,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level. The great decrease in interest and dividends received in this "other income" category was caused by the transfer of assets to Wes-FIC, where income is now classified as insurance income.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $4,590,000 in 1986 from $41,523,000 in 1985.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority-position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture-capital type investment for Wesco. In our judgment, the prospect for gain justified the risk of loss.

This investment continues to be carried at cost in Wesco's accompanying financial statements, and we continue in guarded optimism regarding our position.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1986 by about $13 million, up modestly from about $5 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $23 million. As earlier noted, about $17 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,940,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,091,000) in Wesco's balance sheet at December 31, 1986, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 96% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 19% in 1984-86, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1986. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1987, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (i) this virtual reprint of last year's letter or (ii) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were a year earlier.

The considerable, and higher than normal, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns a fair number of such high-return businesses.

On January 22, 1987, Wesco increased its regular quarterly dividend from 16½ cents per share to 17½ cents per share, payable March 12, 1987, to shareholders of record as of the close of business on February 20, 1987.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T. Munger

Charles T. Munger
Chairman of the Board

February 13, 1987

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1986 | Commission file number 1-4720

WESCO FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	95-2109453 (I.R.S. Employer Identification No.)
315 East Colorado Boulevard, Pasadena, California (Address of principal executive offices)	91101-1954 (Zip Code)

Registrant's telephone number, including area code (818) 449-2345

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

Title of each class	Name of each exchange on which registered
Capital Stock, $1 par value	American Stock Exchange and Pacific Stock Exchange
10⅛% Notes Due 1991	American Stock Exchange

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

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 twelve months and (2) has been subject to such filing requirements for the past 90 days. YES...X...No......

The aggregate market value of voting stock of the registrant held by non-affiliates of the registrant as of March 5, 1987 was: $50,888,250.

The number of shares outstanding of the registrant's Capital Stock as of March 5, 1987 was: 7,119,807.

DOCUMENTS INCORPORATED BY REFERENCE

Title of Document	Parts of Form 10-K
Proxy Statement for 1987 Annual Meeting of Stockholders	Part III, Items 10, 11, 12 and 13

PART I

Item 1. Business

GENERAL

Wesco Financial Corporation ("Wesco") was incorporated in Delaware on March 18, 1959. The principal businesses of Wesco, conducted by wholly owned subsidiaries, are the savings and loan business, through Mutual Savings and Loan Association ("Mutual Savings"), which was incorporated in California in 1925, the property and casualty insurance business, through Wesco-Financial Insurance Company ("Wes-FIC"), which was incorporated in Nebraska in 1985, and the steel service center business, through Precision Steel Warehouse, Inc. ("Precision Steel"), which was begun in 1940 and acquired by Wesco in 1979. Wesco also has investments in real estate and marketable securities and owns a small insurance agency.

From 1973 to July 1983, Wesco was controlled by a corporation named Blue Chip Stamps. In July 1983, that company transferred ownership of its 80.1% investment in Wesco to a newly formed, wholly owned company (the present Blue Chip Stamps) and was subsequently merged into Berkshire Hathaway Inc. ("Berkshire"). Thus, Wesco and its subsidiaries are controlled and 80.1%-owned directly by the present Blue Chip Stamps and indirectly by Berkshire.

Wesco's activities fall into three business segments—financial, insurance, and steel service. The financial segment includes (a) the savings and loan business, (b) operation of a business block in Pasadena, California, and (c) investments, principally in marketable common and preferred stocks. The insurance segment comprises the property and casualty insurance business. The steel service segment comprises mainly steel service center operations. The amounts of revenue, operating profit and identifiable assets attributable to each of these three business segments are included in the "Business Segment Data" note to Wesco's consolidated financial statements contained in Item 8, Financial Statements.

FINANCIAL SEGMENT

The earnings of Mutual Savings have been and are dependent on the interest rate spread between the yields earned on its long-term real estate loans and investments, and the costs of savings accounts.

The savings and loan business has been a difficult business since the late 1970s, as institutions with substantial amounts of long-term, low-yielding mortgage loans on their books, funded by short-term borrowings from depositors, have seen their cost of funds increase dramatically. The increase in cost of funds has been due both to prevailing interest rates at levels much higher than were once thought normal, and to fundamental changes that have occurred in the savings and loan industry. As a result of changes in federal regulations affecting savings and loan associations (and other depository institutions such as banks), regulations limiting rate competition for depositors' accounts were largely dismantled by 1985, and completely eliminated in 1986. Other regulations and regulatory attitudes have been modified to enable savings and loan associations and banks to compete more directly with each other and with other financial institutions in providing a wide variety of consumer financial services. This new environment thus far has not been very hospitable for the savings and loan business. In 1981 and 1982, most savings and loan associations suffered operating losses, and, although many have more recently earned profits, such profits have been earned principally as a result of the recent, and possibly short-term, moderation of interest rates.

Mutual Savings reacted to the changes in the savings and loan business by substantially reducing the size and scope of its business and altering the nature of its business activities while pondering a sound operating plan that would provide a socially constructive service while operating with acceptable profits accompanied by an acceptable level of risk. In 1979 Mutual Savings substantially curtailed its real estate loan originations because of the high cost of savings deposits, the reduction in net savings inflow, and uncertainty as to the future direction of loan interest rates.

In December 1980, Mutual Savings, which had operated at seventeen locations in Southern California and had ranked approximately 39th among California savings and loan associations in assets, sold all of its offices, except for its Pasadena headquarters office and a satellite office in a shopping mall across the street, to another association. Under terms of the sale, Mutual Savings transferred to the buyer approximately $307,000,000 of net branch savings accounts together with an equal book value of its highest-yielding mortgage loans and the physical assets of the branch offices, receiving approximately $8,000,000 in cash. Mutual Savings realized a gain on the sale of branch premises and equipment, after income taxes and expenses of sale, of approximately $2,900,000.

In 1982, Mutual Savings sold approximately $13,000,000 of real estate loans backed by GNMA certificates, realizing a loss after income tax benefit, of $2,425,000.

Mutual Savings, in 1986, re-entered real estate lending, offering a fully adjustable-rate mortgage loan, with no cap on future interest rate changes or on changes in borrower payments. These loans yield a "spread" of about 2% above the rate quoted on 1 year U.S. Treasury bills. Approximately $9 million was lent during 1986, yielding 7.7% as of yearend. Management is hopeful that Mutual Savings' portfolio of real estate loans eventually will grow substantially, with the target that at least 60% of assets will ultimately be in high-quality housing-related loans.

After the changes described above, the resulting savings and loan association is relatively small, ranking approximately 70th among California's savings and loan associations in assets at the end of 1986. Because it sold its highest-yielding mortgage loans in 1980, and it has begun to lend only recently, after interest rates have fallen from the higher levels which have generally prevailed since 1980, Mutual Savings' loan portfolio bears what may be the lowest average interest rate (7.5% per annum at the end of 1986) among all associations in the United States. The fixed-rate portion of the portfolio, carried on Mutual Savings' books at the end of 1986 at about $69 million, is worth somewhat less at current interest rates. This portfolio consists of rapidly repaying seasoned loans, all collateralized by properties in which the borrowers have large equity positions. Thus, they present almost no risk of loss to Mutual Savings. Based on a comparison with other associations, Mutual Savings is believed to have a higher ratio of shareholders' equity to total interest-bearing liabilities; a higher proportion of assets in short term, interest bearing cash equivalents; and a much higher proportion of assets in intermediate-term, tax-exempt bonds and common and preferred stocks. The short-term, interest-bearing cash equivalents currently produce a tax-equivalent yield sharply (about 4 percentage points) below that prevailing on the mortgage portfolio of the typical association, which operated more aggressively than Mutual Savings during former high-interest periods. The tax-exempt bonds and preferred stocks currently produce a tax-equivalent yield sharply (about 7 percentage points) higher than typical mortgage portfolios.

Effective in January 1984 the regulations of the California Savings and Loan Commissioner were amended to provide that a savings and loan association could invest up to 5% of its assets in any securities deemed prudent by management of the association. Mutual Savings invests in marketable equity securities from time to time. However, as of 1986 and 1985 yearends, it had no such investments.

Mutual Savings expects the savings and loan business to continue to be a difficult and competitive business. It intends to preserve its options by retaining financial strength and remaining very flexible with respect to expansion (including possible acquisition), or contraction. It may also consider revision of services designed to create more differentiation in the marketplace from standard financial services provided by others.

Effective in January 1983, the regulations of the California Savings and Loan Commissioner were amended to provide that a service corporation wholly owned by a savings and loan association could engage in any activity approved by the Commissioner. Mutual Savings' service subsidiary, Wes-Fin Service Corp. ("Wes-Fin"), accordingly obtained approval to purchase common and preferred stocks from time to time provided that, at the time of any purchase, the total amount invested would not exceed 7½% of the then total assets of Mutual Savings. As of December 31, 1985, Wes-Fin had invested the sum of $19,943,000 in common stocks under this authority. These securities were sold during 1986, and, at 1986 yearend, Wes-Fin had not yet reinvested in common stocks.

During 1986, Mutual Savings, excluding its service subsidiary, sustained a pre-tax operating loss before gains on sales of securities. However, the pre-tax loss was more than offset by income tax benefits available through application of Mutual Savings' pre-tax loss, as computed under income tax law, against pre-tax income of affiliates to be included in the same consolidated federal and state tax returns. In addition, the service subsidiary had a pre-tax operating profit before securities gains, which, when added to all securities gains and other income, caused 1986 net income of Mutual Savings to equal $4,684,000.

Wesco, as a savings and loan holding company, and Mutual Savings, as a savings and loan association, are subject to regulation by the Federal Savings and Loan Insurance Corporation ("FSLIC"), the Federal Home Loan Bank Board and the California Department of Savings and Loan. This regulatory framework encompasses reserve requirements, reporting requirements, periodic regulatory examinations, limitations on the types of loans and other investments that can be made, and regulations affecting the acquisition or disposition of certain types of businesses.

Issues currently of particular concern to the regulators and the industry are summarized below.

• The management of interest rate risk through the matching of interest-sensitive assets with liabilities of similar maturities.

• The increase in the level of net worth by the industry from 3% of liabilities (a level that many associations have not attained) to 6%, in steps, over several years beginning in 1987. Mutual Savings' net worth at 1986 yearend amounted to 19% of liabilities.

• Recapitalization of FSLIC, the assets of which have been substantially reduced as a result of its having rescued numerous associations that operated less conservatively than Mutual Savings during the past several years.

Wesco, while it seeks suitable businesses to acquire, and expansion of its existing operations, invests in marketable securities, including common stocks of unaffiliated companies. (See Note 3 to the accompanying consolidated financial statements for a summary of these investments and Schedule I accompanying such statements for further information.) Wesco owns a business block in Pasadena, California, which includes the nine-story office building in which its headquarters and the main office of Mutual Savings, Wes-Fin and WSC Insurance Agency (a small insurance agency wholly owned by Wesco) are located, and a multistory garage structure. These properties are nearly fully leased under agreements expiring at various dates to 1994.

Approximately 60 full-time employees are engaged in the savings and loan business and other financial segment activities.

THE INSURANCE SEGMENT

Wesco-Financial Insurance Company ("Wes-FIC"), a wholly owned subsidiary of Wesco, incorporated in Nebraska, was formed in August 1985 to engage in the property and casualty insurance and reinsurance business. Wesco contributed, as initial capital, $45,000,000 in cash and cash-equivalents to Wes-FIC in September 1985, and an additional $36,200,000 in cash in January 1986.

Wes-FIC, as its initial and sole insurance transaction through 1986 yearend, reinsured, through a Berkshire Hathaway insurance company subsidiary, National Indemnity Company ("NICO"), as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Insurance Companies. Wes-FIC thus assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in virtually the same position it would have been in if it, instead of Fireman's Fund, had directly written the business reinsured. Differences in results occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 exceeded $67,000,000.

Wes-FIC, as an insurance company, is subject to regulation by the Nebraska Department of Insurance. Regulations relate to, among other things, capital requirements, loss reserve requirements, reporting requirements, periodic regulatory examinations, and limitations on the types of investments that can be made.

In recent years, financial failures in the insurance industry have received considerable attention from news media, regulatory authorities and rating agencies. As one result, industry participants and the public have been made more aware of the benefits derived from dealing with insurers whose financial resources supported, with significant margins of safety against adversity, their promises. In this respect Wes-FIC is competitively well positioned, inasmuch as it possesses notable above-average financial strength.

Wes-FIC is operated by personnel employed by Berkshire and NICO; it has no employees of its own.

STEEL SERVICE SEGMENT

Precision Steel, acquired by Wesco in 1979 for approximately $15,000,000, operates a well-established steel service center business in two service center locations: one in Franklin Park, Illinois, near Chicago; the other, operated by a wholly owned subsidiary, in Charlotte, North Carolina. The service centers buy low carbon sheet and strip steel, coated metals, spring steels, stainless steel, brass, phosphor bronze, aluminum and other metals, cut these metals to order, and sell them to a wide variety of customers.

The service center business is highly competitive. For example, Precision Steel's annual sales volume of about $50 million compares with the steel service industry's annual volume of about $24 billion. Precision Steel competes not only with other service centers but also with mills which supply metal to the service centers. Competition exists in the areas of price, quality, availability of products and speed of delivery. Because it is willing to sell in relatively small quantities, Precision Steel has been able to compete in geographic areas distant from its service center facilities. Competitive pressure is intensified by imports and by a tendency of domestic manufacturers to substitute less costly components for parts traditionally made of steel.

Precision Brand Products, Inc. ("Precision Brand"), a wholly owned subsidiary of Precision Steel, manufactures shim stock and other tool room specialty items, as well as hose and muffler clamps, and distributes them under its own brand names nationwide, using both salesmen and manufacturers' representatives. This business is highly competitive.

Steel service raw materials are obtained principally from major domestic steel mills, and their availability is considered good. Precision Steel's service centers maintain extensive inventories in order to meet customer demand for prompt deliveries. Typically, an order is filled and the processed metals delivered to the customer within one week. Precision Brand normally maintains inventories adequate to allow for off-the-shelf service to customers.

The steel service businesses are subject to economic cycles in their area of the economy. These businesses are not dependent on a few large customers. Steel service backlog orders of $4,317,000 as of December 31, 1986 remained approximately unchanged from the $4,325,000 as of December 31, 1985.

Approximately 265 full-time employees are engaged in the steel service businesses, almost half of whom are members of unions. Management considers labor relations to be good.

Item 2. Properties

Wesco owns a business block in downtown Pasadena, California, which is improved with a nine-story office building that was constructed in 1964 and has approximately 125,000 square feet of net rentable area, as well as four commercial store buildings and a multistory garage with space for 425 automobiles. Approximately 22,000 square feet of this building are used by Wesco as its headquarters or leased to Mutual Savings for use as its main office, while the balance is leased to outside parties under agreements expiring at various dates to 1994. Mutual Savings leases its 1,700-square-foot satellite office in the Plaza Pasadena shopping center located across the street from its main office; this lease expires in 1990 and may be extended under two five-year options.

Wesco-Financial Insurance Company uses the headquarters office of NICO, a subsidiary of Berkshire Hathaway Inc., its ultimate parent, in Omaha, Nebraska, as its place of business.

Mutual Savings holds real estate which has been acquired by foreclosure. The most valuable parcel consists of 22 acres of vacant, largely oceanfront land near Santa Barbara, California, where residential development is presently intended. Such development is subject to various difficult-to-obtain regulatory approvals, but the property is expected eventually to provide a yield greatly in excess of its book cost. Other properties include several buildings in a shopping center in Upland, California, which are leased to various small businesses.

Precision Steel and its subsidiaries own three buildings housing their plant and office facilities having usable area approximately as follows: 138,000 square feet in Franklin Park, Illinois; 42,000 square feet in Charlotte, North Carolina; and 59,000 square feet in Downers Grove, Illinois.

Item 3. Legal Proceedings

Wesco and its subsidiaries are not involved in any legal proceedings which are expected to result in material loss.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of Wesco's shareholders subsequent to the annual meeting held in April 1986.

PART II

Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters

Wesco's common stock is traded on the American Stock Exchange and the Pacific Stock Exchange.

The following table sets forth the ranges of stock prices reported in the Wall Street Journal for Wesco's shares trading on the American Stock Exchange by quarter for 1986 and 1985, as well as cash dividends paid by Wesco on each outstanding share:

	1986		
	Sales Price		Dividends
Quarter Ended	High	Low	Paid
March 31	$50	$36	$0.165
June 30	51¾	40⅝	0.165
September 30	43½	39⅛	0.165
December 31	40½	37⅞	0.165
			$0.66

	1985		
	Sales Price		Dividends
Quarter Ended	High	Low	Paid
March 31	$29	$21⅜	$0.155
June 30	29¼	24⅞	0.155
September 30	29⅛	27⅜	0.155
December 31	41¼	29¼	0.155
			$0.62

There were approximately 1,250 shareholders of record of Wesco's common stock as of the close of business on February 27, 1987.

Item 6. Selected Financial Data

Set forth below and on the following pages are selected consolidated financial data for Wesco and its subsidiaries. For additional financial information, attention is directed to Wesco's audited 1986 consolidated financial statements appearing elsewhere in this report. (Dollar amounts are in thousands except for amounts per share.)

	Year Ended December 31,				
	1986	1985	1984	1983	1982
Income items—					
Interest on loans	$ 5,982	$ 6,794	$ 7,711	$ 8,567	$ 9,786
Insurance premiums earned	67,515	20,412	—	—	—
Steel service revenues	52,304	51,124	55,098	46,074	37,293
Interest and dividends on investments	32,227	31,595	24,935	18,319	17,273
Fluctuation in market value of GNMA futures contract	—	2,803	938	—	—
Gain on sales of marketable securities	8,282	62,895	19,360	3,025	9,998
Other	2,154	2,214	2,159	1,978	2,393
	168,464	177,837	110,201	77,963	76,743
Cost and expense items—					
Interest on savings accounts	22,275	25,191	20,940	16,870	15,985
Insurance losses and expenses	70,234	23,346	—	—	—
Cost of steel products sold	42,836	40,914	44,830	37,220	31,426
Selling, general and administrative	10,082	10,293	9,848	9,388	8,847
Interest on notes payable	3,114	3,035	3,103	4,673	6,199
Loss on sale of loans	—	—	—	—	4,761
	148,541	102,779	78,721	68,151	67,218
Income before income taxes	19,923	75,058	31,480	9,812	9,525
Income tax (provision) benefit	(3,399)	(23,517)	(7,824)	741	1,977
Net income	$ 16,524	$ 51,541	$ 23,656	$ 10,553	$ 11,502
Amounts per share:					
Net income	$2.32	$7.24	$3.32	$1.48	$1.62
Cash dividends	$ .66	$ .62	$ .58	$ .54	$ .50

	December 31,				
	1986	1985	1984	1983	1982
Assets—					
Cash, short-term investments, common and preferred stocks and state and municipal bonds	$475,735	$425,727	$289,540	$211,702	$177,421
Loans receivable	78,657	83,472	95,172	106,886	123,541
Total assets	611,199	561,957	417,003	355,031	332,766
Liabilities—					
Savings accounts	$282,358	$269,047	$227,087	$188,195	$152,489
Insurance losses and expenses	49,202	16,111	—	—	—
Notes payable	31,273	31,523	31,882	33,487	54,761
Total liabilities	408,608	371,156	273,364	230,919	215,363
Shareholders' equity	$202,591	$190,801	$143,639	$124,112	$117,403
Per share	$28.45	$26.80	$20.17	$17.43	$16.49

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

FINANCIAL CONDITION

Financial strength and liquidity have grown in recent years as Wesco's several business operations have provided a positive cash flow. Wesco and its subsidiaries maintain, as a matter of practice, liquidity beyond norms for the industries in which they operate. The amounts of cash, short-term investments and intermediate-term state and municipal bonds reflected in the consolidated balance sheet as of 1986 yearend was abnormally high, even for the operations of Wesco and its subsidiaries. Management has not recently found opportunities for more aggressive use of such capital.

The key component of a savings and loan association's earnings is net interest income. Its dependable generation not only requires the management of yields, costs and maturities of assets and liabilities, but also a limitation, consistent with the ratio of net worth to total interest-bearing liabilities, on the margin, or "gap," between interest-sensitive liabilities and interest-sensitive assets. Federal Home Loan Bank Board policies require that savings and loan associations monitor this gap and restructure maturities of assets and liabilities towards a reduction of interest rate risk. The table below sets forth the major balance sheet categories and dollar amounts of items for Mutual Savings and its consolidated subsidiary as of 1986 yearend which are rate sensitive, and the resulting net gaps as of the last three yearends:

Gap Analysis	Amounts (in Thousands) Subject to Repricing(*)					
Balance Sheet Category	Within 6 months	Within 1 year	Within 3 Years	Within 5 Years	Within 10 Years	Total
Rate-sensitive assets—						
Cash and short-term investments	$204,234	$204,234	$204,234	$204,234	$204,234	$204,234
State and municipal bonds	50	50	150	2,925	17,875	18,647
Common and preferred stocks	—	—	—	—	—	30,947
Loans receivable**	15,000	21,000	37,000	49,000	73,000	78,613
Total	219,284	225,284	241,384	256,159	295,109	332,441
Rate-sensitive liabilities—						
Savings accounts	179,805	221,067	273,594	282,212	282,441	282,441
Net gap at—						
December 31, 1986	$ 39,479	$ 4,217	$ (32,210)	$ (26,053)	$ 12,668	$ 50,000
December 31, 1985	$ (18,315)	$ (56,357)	$ (73,196)	$ (63,973)	$ (21,887)	$ 50,081
December 31, 1984	$ (72,887)	$ (90,679)	$ (91,132)	$ (76,114)	$ (30,745)	$ 56,386

*Amounts are *cumulative;* for example, loans that can be repriced in one year include loans which can be repriced in six months.

**Amounts subject to repricing in each period have been estimated inasmuch as they include prepayments as well as normal principal amortization.

The gap analysis demonstrates possibly temporary success in the ongoing restructuring of Mutual Savings' operations, begun in the late 1970s, in order to reduce exposure to interest rate risk and inflation (see Item 1, Business). As now restructured, Mutual Savings, and thus, Wesco's financial segment, are better poised to withstand, without significant financial impact, sharp increases or decreases in interest rates than in prior years. Mutual Savings re-entered the real estate lending market in 1986, offering adjustable rate first mortgage loans with low "spread" over cost of funds and no cap on future interest rate changes or borrower payments, on owner-occupied residential property. The volume of these loans approximated $9 million for the year. Management is hopeful that these new fully adjustable-rate loans will help Mutual Savings obtain a loan portfolio approximating 60% of its assets, with aggregate interest rate risk at an endurable level.

Mutual Savings is believed to have one of the lowest loan delinquency rates of any savings and loan association due to the seasoned nature of its loan portfolio. At 1986 yearend, monthly payments were past due over 60 days on $125,000 principal balance of such loans. See Item 1, Business, for further information on Mutual Savings' loan portfolio.

Wesco and each of its subsidiaries are believed to have adequate capital resources for all anticipated operational needs.

The Tax Reform Act of 1986 (the "Act") was enacted in October 1986. Its effect is expected to require an overall increase in the computation and payment of Federal income taxes. Management of Wesco does not expect the effect of the Act to materially affect the liquidity or net worth of Wesco or its subsidiaries.

As presently structured, Wesco's financial segment and insurance operations are not suffering significant detrimental effects from inflation. Their revenues generally have the same purchasing power as the dollars which represent their costs. Very few costs are stated in dollars which are other than current dollars. Very large unanticipated changes in the rate of inflation could, however, impact the insurance business, wherein premium rates are established well in advance of incurrence of the related costs. Management does not anticipate any significant effect in the unlikely event of such an occurrence.

The effects of inflation in the steel service businesses are discussed in the section entitled Steel Service Segment below. The inflationary pressures currently affecting the steel service businesses are not considered material to the consolidated operations of Wesco.

RESULTS OF OPERATIONS

The last several years have seen dramatic, sometimes adverse, changes in the savings and loan industry. In response, Wesco's savings and loan business has declined, both in size and its relative importance to Wesco's consolidated operations. At the same time, as funds have become available pending their use in expansion or acquisition, the portfolio of marketable securities has grown, and dividend and interest income and gains on securities transactions have increased in importance in Wesco's consolidated net income. Steel service operations were added in 1979, and property and casualty insurance operations were added in September 1985. (See Item 1, Business, for further discussion of the changes in the savings and loan industry and of Wesco's other operations.)

The following summary indicates the contribution to consolidated net income from each of Wesco's three business segments, and demonstrates the prevalence and effect on consolidated net income of large, unusual items in recent years (amounts are in thousands of dollars, all after income tax effect):

	1986	1985	1984	1983	1982
Financial segment:					
"Normal" net operating income (loss) of:					
Mutual Savings	$ 2,159	$ 3,342	$ 3,476	$ 3,046	$ 3,482
Other operations*	1,459	3,354	4,550	3,839	3,412
	3,618	6,696	8,026	6,885	6,894
Unusual items:					
Gain on sales of marketable securities	4,238	41,523	13,138	2,046	6,706
Fluctuation in market value of GNMA futures contract	—	1,671	458	—	—
Loss on sale of GNMA-backed real estate loans	—	—	—	—	(2,425)
	4,238	43,194	13,596	2,046	4,281
Net income—financial	7,856	49,890	21,622	8,931	11,175
Insurance segment:					
"Normal" net operating income (loss)	6,615	(359)	—	—	—
Gain on sales of marketable securities	352	—	—	—	—
Net income—insurance	6,967	(359)	—	—	—
Steel service segment:					
Net income—steel service	1,701	2,010	2,034	1,622	327
Net income—consolidated	$16,524	$51,541	$23,656	$10,553	$11,502

*Reflects net commercial real estate rental income, plus interest and dividend income from marketable securities held outside the savings and loan business, from the sum of which is deducted interest and other corporate expenses.

The foregoing summary contains consolidated *after-tax* earnings data. Reference is made to Wesco's consolidated financial statements, appearing in Item 8, Financial Statements, beginning on page 26, including Note 15, containing information as to operating profit *before taxes* for each of Wesco's business segments, for the past three years, and to the condensed consolidated balance sheet of Wesco's savings and loan subsidiary, Mutual Savings and Loan Association ("Mutual Savings") as of 1986 and 1985 yearends, appearing at the end of this annual report. The following discussion, by business segment, should be read in conjunction with these data.

Financial Segment

Mutual Savings' consolidated "normal" net operating income has resulted from income tax benefits available principally because of the presence of interest income on state and municipal bonds and dividend income on preferred and common stocks, taxed at very favorable corporate rates. Following is a summary of the components of Mutual Savings' consolidated "normal" net operating income (in thousands of dollars):

	1986	1985	1984	1983	1982
Revenues:					
Interest on loans and short-term investments and miscellaneous other revenues	$18,554	$20,172	$17,572	$14,225	$15,948
Dividends on common and preferred stocks	4,238	5,455	4,735	4,872	3,686
Interest on state and municipal bonds	2,348	3,220	3,643	3,643	3,604
	25,140	28,847	25,950	22,740	23,238
Expenses:					
Interest on savings accounts	22,396	25,265	22,012	20,025	19,753
Operating expenses	3,902	3,763	3,419	3,514	3,344
	26,298	29,028	25,431	23,539	23,097
Income (loss) before income tax benefit	(1,158)	(181)	519	(799)	141
Income tax benefit relating thereto	3,317	3,523	2,957	3,845	3,341
	$ 2,159	$ 3,342	$ 3,476	$ 3,046	$ 3,482

Mutual Savings' interest expense on savings accounts typically varies from year to year. The decrease in such cost for 1986 resulted from a decline in the overall interest rate; savings balances increased approximately $13 million during the year. Interest expense increased for 1985 almost entirely the result of the growth in savings balances. On an incremental-effects basis growth in savings accounts has been at a loss, because Mutual Savings has incurred in interest and other expenses more than it has received from employing proceeds in short-term interest-bearing investments far above regulatory requirements for liquidity. Only the interest on state and municipal bonds and dividends on preferred and common stocks, taxed at favorable rates, have enabled Mutual Savings to report a positive rate spread in recent years. Details are set forth in the following table.

	1986	1985	1984
Yield on loans	7.47%	7.60%	7.63%
Yield on investments*	9.76	12.26	14.44
Combined yield on loans and investments	9.19	10.94	11.78
Cost of savings	(8.24)	(9.81)	(10.30)
Rate spread**	0.95	1.13	1.48

*Interest on short-term investments, interest on state and municipal bonds and dividends on common and preferred stocks, all stated on a so-called tax-equivalent basis, i.e., on a pre-tax basis as if fully subject to income taxes at maximum corporate rates.

**The difference between the combined yield on loans and investments and the cost of savings.

Mutual Savings has little interest rate risk, but also, little rate spread. Such is not typical for many other savings and loan associations, who have continued their long-term lending practices and are currently reporting record earnings and widening rate spreads, resulting mainly from the recent decline in interest rates. Although Mutual Savings expects to continue to maintain a positive rate spread, the future of interest rates remains uncertain.

Normal net income from other financial operations (excluding savings and loan operations), summarized in a foregoing table, decreased to $1,459,000 in 1986 from $3,354,000 in 1985 and $4,550,000 in 1984. The decreases in this category of net income which occurred in each of the last two years resulted mainly from Wesco's contribution of funds to Wesco-Financial Insurance Company in September 1985 and January 1986. Related interest and dividend income is now classified as insurance income. In addition, yield on the investment portfolio declined in 1986 and 1985 due to changes in mix of securities held in each year and decreased yield on short-term investments.

Insurance Segment

Wesco entered into the property and casualty insurance business in September 1985. Its sole insurance business to date has been an arrangement under which it reinsures 2% of the property and casualty insurance business of Fireman's Fund Insurance Companies ("FFC"). (See Item 1, Business, for further information on Wesco-Financial Insurance Company—"Wes-FIC" and its separate financial statements, which are included in Note 2 to Wesco's consolidated financial statements, and pertinent to the following discussion.)

The "normal" net operating income or loss of Wes-FIC represents the combination of its underwriting results with the interest and dividend income from its investment activities.

A summary of Wes-FIC's underwriting results is presented below, on the basis of generally accepted accounting principles ("GAAP"), in thousands of dollars:

	Year Ended December 31, 1986		Four Months Ended December 31, 1985	
	Amount	**%**	**Amount**	**%**
Premiums written	$70,506		$46,738	
Premiums earned	$67,515	100.0	$20,412	100.0
Losses and loss expenses	48,454	71.8	16,606	81.4
Underwriting expenses	21,780	32.2	6,740	33.0
Total losses and expenses	70,234	104.0	23,346	114.4
Underwriting loss—pre-tax	(2,719)		(2,934)	
Applicable income tax credit	1,250		1,350	
After-tax loss	$ (1,469)		$ (1,584)	

The percentage figure shown in the above table representing the ratio of total losses and expenses (including policyholder dividends) to premiums earned (the "loss and expense ratio"), is comparable but not identical to the "combined ratio" that is computed for companies in the industry based on data assembled for statutory reporting purposes.

Wes-FIC's underwriting results were computed from summarized data reported by FFC. Underwriting results in the property and casualty insurance business have historically tended to be cyclical. Results were disastrous to many insurers for several years prior to 1986, as price competition, inflation and new judicial notions tended to extend insurance coverages beyond limits contemplated when policies were issued. Many large losses and several financial failures occurred in the industry. The result was a decrease in the industry's insuring capacity (basically a multiple of its reserves). This decreased capacity enabled insurers beginning sometime in 1985 to increase prices (premium rates) significantly as well as to become more selective in their underwriting. FFC attributes the improvement in its property and casualty underwriting results mainly to higher premium rates and use of tighter underwriting standards.

Insurance losses and loss expenses, and the related liabilities reflected on Wesco's consolidated balance sheet, are based in large part upon estimates and, therefore, are subject to estimation error. Any revisions of such estimates, which may be necessary in future periods, could significantly affect the results of operations reported for such future periods.

Wes-FIC's investment activities provided interest and dividend income, after income taxes, of $8,084,000 in 1986, versus $1,225,000 for 1985. These amounts were earned principally on the capital contributed to the insurance business by Wesco—$45 million in September 1985, and an additional $36.2 million in January 1986—and from investment of net reinsurance premium proceeds.

Wes-FIC also realized a securities gain of $352,000, after taxes, in 1986. Its realized securities gains and losses, if any, will likely fluctuate.

Wes-FIC's arrangement for the reinsurance of 2% of FFC's property and casualty insurance business continues to August 31, 1989. Wes-FIC maintains a strong capital position which provides it the opportunity to accept other insurance contracts, if obtainable at acceptable terms.

Steel Service Segment

Sales revenues increased approximately 2% in 1986 in spite of the sluggish level of manufacturing activity and steady competitive pressures in the marketplace. Steel revenues generally have followed economic cycles, with the increase in 1984 attributable mainly to the economic resurgence experienced after the 1981–1982 recession.

Cost of products sold, as a percentage of sales, amounted to 81.9%, 80.0%, 81.4% for 1986, 1985 and 1984. The increase in the cost percentage in 1986 resulted mainly from increased price competition and the resulting inability of Precision Steel to pass on cost increases due to continued customer sensitivity to price increases. The improvement in the percentage of cost of products sold in 1985 resulted mainly from the availability of more favorable quantity order prices on materials purchased than were available in 1984.

Steel service net income decreased approximately 15% in 1986 although sales revenues increased 2%. Steel service net income in 1985 was held to a decline of only 1% on a 7% decrease in sales revenues. The steel service business operates on a low gross margin. Any slight change in its cost of products sold as a percentage of revenues has a profound effect on its net income.

* * * * * *

The securities gains realized in 1985 by Wesco and its subsidiaries include an unusually large amount, $34,363,000 after income taxes, realized from sale of General Foods stock to Philip Morris Company in connection with the latter's tender offer at a large premium over the then-prevailing market price of General Foods' stock. Realized securities gains and other unusual items fluctuate from year to year, but management does not expect Wesco's annual gains in the foreseeable future to approach their unprecedented 1985 level.

Wesco's consolidated revenues include significant amounts of fully tax-exempt interest on state and municipal bonds, substantially exempt dividend income from common and preferred stocks, and gains and losses on sales of stock which are subject to favorable tax rates. Fluctuations in the amounts of and proportion that these investment income components bear to total consolidated pre-tax income have resulted in tax provisions and benefits expressed as percentages of pre-tax income, as follows: tax provisions of 17.1% in 1986, 31.3% in 1985 and 24.9% in 1984; tax benefits of 7.6% in 1983 and 20.8% in 1982. (See Note 8 to the accompanying consolidated financial statements for further information on income taxes.)

Consolidated revenues, expenses and earnings set forth in Item 6, Selected Financial Data, and in Wesco's consolidated statement of income are not necessarily indicative of future revenues, expenses and earnings in that they are subject to significant variations and timing of securities gains and losses, the occurrence of other unusual items and changes in the interest rate spread.

Item 8. Financial Statements

Following is an index to financial statements appearing in this report:

The data appearing on the financial statement schedules listed below should be read in conjunction with the consolidated financial statements and notes of Wesco Financial Corporation and the reports of independent accountants referred to above. Schedules not included with these financial statement schedules have been omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

Item 9. Disagreements on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information set forth in the section entitled "Election of Directors" appearing in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1987 annual meeting of shareholders, is incorporated herein by reference.

Item 11. Management Remuneration and Transactions

The information set forth in the section "Compensation of Directors and Executive Officers" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1987 annual meeting of shareholders, is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth in the section "Voting Securities and Principal Holders Thereof" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1987 annual meeting of shareholders, is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information set forth in the section "Transactions With Management and Others" in the definitive combined notice of annual meeting and proxy statement of Wesco Financial Corporation for its 1987 annual meeting of shareholders, is incorporated herein by reference.

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

The index to financial statements set forth in Item 8 of this report is incorporated herein by reference.

The following exhibits (listed by numbers corresponding to Table 1 of Item 601 of Regulation S-K) are incorporated herein by reference:

3a. Articles of Incorporation and By-Laws of Wesco Financial Corporation.

4. Form of Indenture (incorporated by reference to Exhibit 2 to Amendment No. 1 of Form S-7 Registration Statement of Wesco Financial Corporation filed June 20, 1979. File No. 2-64616).

22. Subsidiaries.

No reports on Form 8-K were filed during the quarter ended December 31, 1986.

SIGNATURES

Pursuant to the requirements of Section 13 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.

WESCO FINANCIAL CORPORATION

By: Charles T Munger
Charles T. Munger — March 26, 1987
Chairman of the Board and President
(principal executive officer)

By: Jeffrey L Jacobson
Jeffrey L. Jacobson — March 26, 1987
Vice President and Chief Financial Officer
(principal financial officer)

By: Jeanne Leach
Jeanne Leach — March 26, 1987
Treasurer
(principal accounting officer)

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

Charles T Munger
Charles T. Munger — March 26, 1987
Director

HR Dettmann
H. R. Dettmann — March 26, 1987
Director

William T. Caspers
William T. Caspers — March 26, 1987
Director

James N. Gamble
James N. Gamble — March 26, 1987
Director

REPORTS OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of
Wesco Financial Corporation

We have examined the consolidated balance sheets of Wesco Financial Corporation and subsidiaries as of December 31, 1986 and 1985, and the related statements of income and retained earnings, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Wesco Financial Corporation and subsidiaries as of December 31, 1986 and 1985, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Our examination also comprehended the schedules listed in the index at Item 8. In our opinion, such schedules, when considered in relation to the basic financial statements, present fairly, in all material respects, the information presented therein.

Touche Ross & Co
Touche Ross & Co.

Los Angeles, California
February 13, 1987

To the Board of Directors and Shareholders of
Wesco Financial Corporation

We have examined the consolidated statements of income and retained earnings and changes in financial position of Wesco Financial Corporation and subsidiaries for the year ended December 31, 1984. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In connection with our examination of the consolidated financial statements, we also examined financial statement schedule III for the year ended December 31, 1984, as listed in the accompanying index under Item 8.

In our opinion, the aforementioned consolidated financial statements present fairly the results of operations and the changes in financial position of Wesco Financial Corporation and subsidiaries for the year ended December 31, 1984, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Also, in our opinion, the related financial statement schedule III for the year ended December 31, 1984, 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.

Peat, Marwick, Mitchell & Co.
Peat, Marwick, Mitchell & Co.

Los Angeles, California
January 31, 1985

WESCO FINANCIAL CORPORATION
CONSOLIDATED BALANCE SHEET
(Dollar amounts in thousands)

	December 31,	
ASSETS	**1986**	**1985**
Cash	$ 4,601	$ 2,823
Investments (Note 3):		
Short-term investments	265,990	325,299
State and municipal bonds	165,177	26,398
Common and preferred stocks	30,947	62,187
Investment in Bowery Savings Bank	9,020	9,020
Total investments	471,134	422,904
Loans receivable (Note 4)	78,657	83,472
Accounts receivable from customers, agents and others	15,962	16,145
Inventories (Note 5)	8,449	8,213
Property, plant, premises and equipment (Note 6)	8,054	8,299
Deferred insurance policy acquisition costs (Note 2)	9,030	8,254
Other assets	15,312	11,847
	$611,199	$561,957
LIABILITIES AND SHAREHOLDERS' EQUITY		
Savings accounts (Note 7)	$282,358	$269,047
Losses and loss adjustment expenses (Note 2)	49,202	16,111
Unearned insurance premiums (Note 2)	29,317	26,326
Income taxes payable (Note 8)	11,520	23,130
Notes payable (Note 9)	31,273	31,523
Other liabilities	4,938	5,019
Total liabilities	408,608	371,156
Commitments and contingent liabilities (Notes 11 and 12)		
Shareholders' equity:		
Capital stock, $1 par value—authorized 7,500,000 shares; issued 7,119,807 shares	7,120	7,120
Capital surplus arising from stock dividends	23,319	23,319
Unrealized appreciation of marketable equity securities of insurance business (Note 3)	—	35
Retained earnings—partially restricted (Note 14)	172,152	160,327
Total shareholders' equity	202,591	190,801
	$611,199	$561,957

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS
(Dollar amounts in thousands except for amounts per share)

	Year Ended December 31,		
	1986	1985	1984
Income items:			
Interest on loans	$ 5,982	$ 6,794	$ 7,711
Insurance premiums earned (Note 2)	67,515	20,412	—
Steel service revenues	52,304	51,124	55,098
Interest and dividend income on investments	32,227	31,595	24,935
Fluctuation in market value of GNMA futures contract (Note 4)	—	2,803	938
Gain on sales of marketable securities (Note 10)	8,282	62,895	19,360
Rental income of $2,229, $2,219 and $2,078, less expense of $1,138, $1,123 and $1,032	1,091	1,096	1,046
Other income	1,063	1,118	1,113
	168,464	177,837	110,201
Cost and expense items:			
Interest expense on savings accounts	22,275	25,191	20,940
Insurance losses and loss adjustment expenses (Note 2)	48,454	16,606	—
Cost of steel products sold	42,836	40,914	44,830
Underwriting expenses (Note 2)	21,780	6,740	—
Selling, general and administrative expenses	10,082	10,293	9,848
Interest on notes payable	3,114	3,035	3,103
	148,541	102,779	78,721
Income before income taxes	19,923	75,058	31,480
Income tax provision (Note 8)	(3,399)	(23,517)	(7,824)
Net income	16,524	51,541	23,656
Retained earnings—beginning of year	160,327	113,200	93,673
Cash dividends declared and paid	(4,699)	(4,414)	(4,129)
Retained earnings—end of year	$172,152	$160,327	$113,200
Amounts per share based on 7,119,807 shares:			
Net income	$2.32	$7.24	$3.32
Cash dividends	$ .66	$ .62	$ .58

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
(Dollar amounts in thousands)

	Year Ended December 31,		
	1986	1985	1984
Sources (uses) of cash, including short-term investments, from operations—			
Net income	$ 16,524	$ 51,541	$ 23,656
Add (deduct):			
Depreciation and amortization, including amortization of bond premiums of $1,509, $300 and $421	2,504	1,289	1,371
Interest expense credited to savings accounts	18,705	20,845	18,061
Increase in unearned insurance premiums	2,991	26,326	—
Increase in insurance premiums receivable	(48)	(10,712)	—
Increase in deferred insurance policy acquisition costs	(776)	(8,254)	—
Increase in unpaid losses and loss adjustment expenses of insurance business	33,091	16,111	—
Increase (decrease) in income taxes payable	(11,610)	16,041	1,206
Other, net	(2,606)	115	1,021
Cash provided from operations	58,775	113,302	45,315
Other sources (uses) of cash—			
Principal collections on real estate loans	13,758	11,772	11,396
Real estate loans originated	(8,992)	—	—
Increase (decrease) in savings accounts, net	(5,394)	21,115	20,831
Decrease in common and preferred stocks	31,240	34,005	15,277
(Increase) decrease in state and municipal bonds	(137,270)	3,889	971
Investment in Bowery Savings Bank	—	(9,020)	—
Increase (decrease) in accounts payable from purchases of common stocks	(677)	(3,435)	4,012
Payment of cash dividends	(4,699)	(4,414)	(4,129)
Other, net	(4,272)	(2,453)	413
	(116,306)	51,459	48,771
Consolidated increase (decrease) in cash, including short-term investments	$ (57,531)	$164,761	$ 94,086

See accompanying notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollar amounts in thousands except for amounts per share)

Note 1. Presentation and Consolidation

The consolidated financial statements of Wesco Financial Corporation ("Wesco") include the accounts of Wesco and its subsidiaries. In prior years the statements were classified according to the two primary business segments: financial and steel service. Beginning in 1986, however, with the emergence of the insurance business as a third significant segment (see Note 2), the presentation in the statements has been simplified, and segment details are now presented in Note 15, classified as follows:

The financial segment includes the accounts of Wesco and its wholly owned subsidiaries, Mutual Savings and Loan Association ("Mutual Savings") and WSC Insurance Agency, together with Mutual Savings' wholly owned subsidiary, Wes-Fin Service Corp., as well as short-term investments and other investments of Precision Steel Warehouse, Inc. ("Precision Steel") and its subsidiaries, together with related interest and dividend income and gain or loss on related sales.

The insurance segment includes the accounts of Wesco-Financial Insurance Company ("Wes-FIC"), a wholly owned subsidiary of Wesco. (See Note 2.)

The steel service segment includes the operating accounts of Precision Steel and its wholly owned subsidiaries, Precision Brand Products, Inc., and Precision Steel Warehouse, Inc.—Charlotte Service Center.

All material intercompany balances and transactions have been eliminated.

Wesco is 80.1%-owned by Blue Chip Stamps, which in turn is wholly owned by Berkshire Hathaway Inc. ("Berkshire").

Note 2. Wesco-Financial Insurance Company

In August 1985 Wesco formed a wholly owned subsidiary, Wesco-Financial Insurance Company ("Wes-FIC"), to engage in the property and casualty insurance and reinsurance business. Wesco has contributed $81.2 million in cash and cash-equivalents to the capital of Wes-FIC: $45 million in September 1985 and $36.2 million in January 1986.

Wes-FIC, as its initial transaction, entered into a reinsurance agreement with National Indemnity Company ("NICO"), an insurance subsidiary of Berkshire, which acts in this transaction with Wes-FIC as an intermediary-without-profit. Under terms of the agreement, Wes-FIC participates proportionately (2%) in all premiums, losses and expenses of in-force business of Fireman's Fund Insurance Companies ("FFC") for a term of four years from September 1, 1985. No other insurance transactions have been entered into by Wes-FIC.

Wes-FIC's premiums written to date represent 2% of FFC's unearned premiums at September 1, 1985, plus 2% of FFC's premiums written in the months of September 1985 through December 1986. Likewise, Wes-FIC's costs, other than its nominal organizational expense and insignificant operating expenses allocated by NICO, represent 2% of FFC's costs relating to the risks with respect to which premiums were earned during the period Wes-FIC has operated. For insurance premiums written, commissions of $21,715 and $14,656 were paid through NICO to FFC in 1986 and 1985, representing a pro rata share of FFC's own acquisition costs. Of such amounts $9,030 and $8,254 are recorded in the accompanying consolidated balance sheet at December 31, 1986 and 1985 as deferred insurance policy acquisition costs. These deferred costs are deemed recoverable from premiums written but unearned at the respective yearends. In determining recoverability of such costs, Wes-FIC has taken into account investment income conservatively anticipated to be earned on funds held under the contract.

Summarized financial statements for Wes-FIC are presented on page 30.

Wesco-Financial Insurance Company
Condensed Balance Sheet

ASSETS	December 31, 1986	December 31, 1985
Cash and short-term investments	$ 6,677	$61,007
State and municipal bonds	140,407	3,784
Marketable equity securities, at market value	—	6,592
Premiums receivable	10,760	10,712
Deferred insurance policy acquisition costs	9,030	8,254
Other assets	5,146	728
	$172,020	$91,077
LIABILITIES AND SHAREHOLDER'S EQUITY		
Losses and loss adjustment expenses	$ 49,202	$16,111
Unearned premiums	29,317	26,326
Other liabilities	5,693	3,964
Total liabilities	84,212	46,401
Shareholder's equity:		
Capital stock and paid-in capital	81,200	45,000
Unrealized appreciation of marketable equity securities, net	—	35
Retained earnings (deficit)	6,608	(359)
Total shareholder's equity	87,808	44,676
	$172,020	$91,077

Wesco-Financial Insurance Company
Condensed Statement of Operations

	Year Ended December 31, 1986	Four Months Ended December 31, 1985
Insurance premiums written	$ 70,506	$46,738
Plus unearned premiums—beginning of period	26,326	—
Less unearned premiums—end of period	29,317	26,326
Insurance premiums earned	67,515	20,412
Interest and dividend income	9,685	2,219
	77,200	22,631
Losses and loss adjustment expenses	48,454	16,606
Amortization of deferred acquisition costs	20,939	6,402
Policyholder dividends	841	338
	70,234	23,346
Income (loss) before income taxes and securities gains	6,966	(715)
Income tax (provision) benefit thereon	(351)	356
Income (loss) before securities gains	6,615	(359)
Gain of $653 on sale of marketable securities, less income taxes	352	—
Net income (loss)	$ 6,967	$ (359)

Note 3. Investments

Short-term investments (mainly securities issued by the U.S. Government and obligations of the Federal Home Loan Bank or other U.S. Government Agencies) and state and municipal bonds, are stated at cost, adjusted for amortization of premium and accretion of discount.

Marketable equity securities are carried on the consolidated balance sheet at the lower of aggregate cost or market, except for those held in the insurance business, which are carried at market value. Any unrealized gain or loss resulting from such carrying values is added to or deducted from shareholders' equity on the consolidated balance sheet, net of deemed applicable income taxes, without effect on net income.

30 Dollar amounts in thousands except for amounts per share

Following is a summary of marketable securities at yearend:

	1986			1985		
	Cost	Market	Carrying Value	Cost	Market	Carrying Value
Short-term investments	$265,990	$265,887	$265,990	$325,299	$326,549	$325,299
State and municipal bonds	$166,624	$175,544	$165,177	$ 26,398	$ 29,747	$ 26,398
Marketable equity securities—						
Common stocks	$ —	$ —	$ —	$ 26,486	$ 26,763	$ 26,535
Preferred stocks	29,441	42,370	29,441	34,146	38,788	34,146
	29,441	42,370	29,441	60,632	65,551	60,681
Other preferred stocks	1,506	1,499	1,506	1,506	1,245	1,506
	$ 30,947	$ 43,869	$ 30,947	$ 62,138	$ 66,796	$ 62,187

At December 31, 1986, the consolidated portfolio of marketable equity securities contained aggregate unrealized gains of $12,929. There were no unrealized losses.

In addition to the investments in marketable securities summarized above, Wesco has an equity investment, at cost of $9,020, in approximately 9% of a New York-chartered savings bank, which was organized in 1985 and which took over the name, $5 billion in assets and liabilities of the insolvent Bowery Savings Bank in the city of New York at that time. The takeover was assisted by the Federal Deposit Insurance Corp. ("FDIC"), the federal agency, akin to FSLIC, which insures deposits in banks. Although terms of such FDIC assistance include future income-assistance payments, management of Wesco considers this investment to be essentially of the venture-capital type, with prospects for ultimate gain justifying the high risk of loss.

Note 4. Loans Receivable

Following is a summary of loans receivable by type of collateral at yearend:

	1986	1985
Residential property of one to four units	$ 67,972	$ 70,449
Residential property of more than four units	7,815	9,396
Commercial property and vacant land	2,384	3,107
Savings accounts	516	565
	78,687	83,517
Less unearned loan fees and unrealized profit on sales of real estate	(30)	(45)
	$ 78,657	$ 83,472
Average interest rate	7.48%	7.60%

Interest income on loans is recognized under the accrual method of accounting. Such accrued interest amounted to $279 and $310 at 1986 and 1985 yearends.

Mutual Savings entered into a financial futures contract in April 1984 for the purchase in March 1986 of $30 million principal amount of GNMA mortgage-backed pass-through certificates, at a cost of approximately $19 million to be paid in 1986. Generally accepted accounting principles require that earnings reflect fluctuations in market value of futures contracts. The unrealized gains for 1985 and 1984 of $2,803 and $938 before income taxes, are reflected on the accompanying consolidated statement of income in the category fluctuation in market value of GNMA futures contract. No additional gain or loss was realized on sale of the contract in 1985.

Dollar amounts in thousands except for amounts per share 31

Note 5. Inventories

Inventories are valued at the lower of last-in, first-out ("LIFO") cost or market. If the first-in, first-out ("FIFO") method of determining inventory cost had been used in lieu of the LIFO method, inventories would have been higher by $4,576 and $4,371 at yearend in 1986 and 1985.

The slight increase in difference between LIFO and FIFO valuation during 1986 resulted from a combination of factors, principally a slight increase in inventory quantities purchased at prices which differed from those prevailing in prior years, and a slight change in product mix. The effect of the aforementioned increase in the difference between LIFO and FIFO valuation resulted in an increase in cost of products sold and, thus, a decrease in net income of approximately $104 or $.01 per share.

Note 6. Property, Plant, Premises and Equipment

Following is a summary of property, plant, premises and equipment, stated at cost, at yearend:

	1986	1985
Land	$ 2,026	$ 2,026
Buildings and leasehold improvements	9,731	9,539
Machinery and equipment	5,385	5,137
Furniture and fixtures	1,092	898
	18,234	17,600
Less accumulated depreciation and amortization	10,180	9,301
	$ 8,054	$ 8,299

Land and buildings collateralize certain debt. See Note 9.

Property, plant, premises and equipment are depreciated under the straight-line method over the estimated useful lives of the assets.

Note 7. Savings Accounts

Following is a summary of accounts by type of account and interest rate at yearend:

Type of Account	Interest Rate [a]	1986	1985
Interest-bearing checking accounts[b]	5.25%	$ 3,154	$ 1,856
Passbook accounts[b]	5.50	14,308	13,286
Money market rate accounts[b]	5.71	71,935	65,988
Certificate accounts:			
7–31 days	6.60	333	456
32 days–6 months	6.39	30,867	27,305
7 months–1 year	6.88	25,328	14,478
13 months–2 years	7.75	38,030	47,363
25 months–4 years	9.95	52,661	59,199
Over 4 years	9.06	8,811	1,672
IRA/Keogh accounts, 18 months[c]	8.91	30,405	25,592
IRA/Keogh accounts, 4 years	9.81	2,956	321
Jumbo certificates of deposit	7.91	2,240	8,418
Other accounts	7.68	1,330	3,113
		$282,358	$269,047

[a] Weighted average interest rate at 1986 yearend.
[b] No stated maturity.
[c] Other IRA/Keogh accounts included in the various certificate accounts amounted to $2,394 and $879 at 1986 and 1985 yearends.

The weighted average interest rates on all accounts at 1986 and 1985 yearends were 7.46% and 9.07%. These rates are based upon stated interest rates without giving consideration to daily compounding of interest or forfeiture of interest due to premature withdrawals.

At yearend in 1986, certificate accounts mature as follows: 1987, $131,588; 1988, $45,183; 1989, $7,344; 1990, $8,543; 1991, $75; thereafter, $228.

32 Dollar amounts in thousands except for amounts per share

Note 8. Taxes on Income

The consolidated statement of income contains income tax charges (benefits) as follows:

	1986	1985	1984
Payable currently—			
Federal	$ 807	$15,097	$ 5,179
State	895	6,133	2,634
	1,702	21,230	7,813
Payable (recoverable) in the future—			
Federal	1,747	2,273	(9)
State	(50)	14	20
	1,697	2,287	11
	$ 3,399	$23,517	$ 7,824

Of the above taxes, the amounts currently payable are included in income taxes payable on the consolidated balance sheet, after deducting estimated payments. The amounts payable or recoverable in the future, deferred income taxes, are included in income taxes payable on the consolidated balance sheet, and result from the following timing differences in the recognition of revenue and expense items in the tax returns as compared to the financial statements:

	1986	1985	1984
Insurance policy acquisition costs deducted on cash basis for tax purposes vs. accrual basis on the books	$ 357	$ 3,797	$ —
Loan fees recognized under a different method for tax purposes	(403)	(339)	(316)
State income taxes deducted on cash basis for tax purposes vs. accrual basis on the books	1,903	(1,234)	(959)
Mutual Savings' income recognized on cash basis for tax purposes vs. accrual basis on the books	(207)	(411)	230
Other timing differences	47	474	1,056
Total taxes payable in the future	$ 1,697	$ 2,287	$ 11

The consolidated income tax provision of $3,399 for 1986 amounted to 17.1% of pre-tax income of $19,923; the provision of $23,517 for 1985 amounted to 31.3% of pre-tax income of $75,058, and the provision of $7,824 for 1984 amounted to 24.9% of pre-tax income of $31,480. Following is a summary of the differences between the federal statutory rate and these effective income tax rates:

	1986	1985	1984
Statutory federal income tax rate	46.0%	46.0%	46.0%
Increase (decrease) resulting from:			
85% exclusion from taxable income of dividends on common and preferred stocks	(8.9)	(5.2)	(11.1)
100% exclusion from taxable income of interest on state and municipal bonds	(19.2)	(1.8)	(4.7)
Use of lower rate on capital gains	(1.9)	(13.2)	(9.9)
State income taxes, net of federal income tax benefit	2.2	4.4	4.6
Other differences, net	(1.1)	1.1	—
Effective income tax rate	17.1%	31.3%	24.9%

Wesco and its subsidiaries are indirectly 80.1% owned by Berkshire Hathaway Inc. and are included in the latter's consolidated federal income tax returns. The provision (or benefit) for federal income tax is computed on the separate results of operations of Wesco as if it filed a separate consolidated return, and the amounts and timing of cash settlements between Wesco and Berkshire are made under the same assumption.

Federal income tax returns through 1980 have been examined by and settled with the Internal Revenue Service.

Dollar amounts in thousands except for amounts per share

Note 9. Notes Payable

Following is a list of notes payable at yearend:

	1986	1985
Notes due June 1991, currently redeemable at 103% of face value declining to 100% by 1989, bearing interest at 10⅛%, payable in semiannual installments	$25,000	$25,000
Notes payable, collateralized by land, buildings and assignment of leases, due in monthly installments through February 2007 of $45 including interest at 9¼%	4,940	5,023
Industrial revenue bonds, due in quarterly installments through December 1994 of $42 plus interest at 6½%	$ 1,333	$ 1,500
	$31,273	$31,523

Notes payable at yearend in 1986 mature as follows:

Year	
1987	$ 239
1988	245
1989	254
1990	262
1991	25,271
Thereafter	5,002
	$31,273

Agreements relating to the 10⅛% notes and the industrial revenue bonds contain covenants, among others, restricting funded debt, dividends and liens on property, plant and equipment. The obligors are in compliance with all of the covenants.

Note 10. Gain on Sales of Marketable Securities

Following is a summary of pre-tax gain on sales of marketable securities for each of the past three years:

	1986	1985	1984
Gain on sale of General Foods stock to Philip Morris Company under tender offer*	$ —	$50,539	$ —
Pre-tax gain realized on other sales of marketable securities	8,282	12,356	19,360
	$ 8,282	$62,895	$19,360

*Represents gain realized by Wesco and certain of its subsidiaries on the sale of their investment in General Foods Corporation common stock late in 1985 to Philip Morris Company in connection with the latter's tender offer at a large premium over the previously prevailing market price of General Foods' stock.

Note 11. Lease Commitments and Rental Expense

At yearend in 1986, Wesco and its subsidiaries have future minimum rental commitments as follows: 1987, $386; 1988, $219; 1989, $70; 1990, $29; thereafter, none. Rental expense amounted to $506, $469 and $456 in 1986, 1985 and 1984.

34 Dollar amounts in thousands except for amounts per share

Note 12. Pension and Profit Sharing Plans

Employees of Wesco and its subsidiaries who meet certain eligibility requirements are covered under either employer-sponsored noncontributory pension or profit sharing plans or union-sponsored pension plans. The employer-sponsored plans are funded annually at amounts sufficient to cover normal costs and to amortize prior service costs generally over 34 years. Costs of the employer-sponsored plans were $147, $197 and $209 in 1986, 1985 and 1984. Costs of the union-sponsored plans, which are paid monthly based on employee earnings, were $26, $17 and $14 in 1986, 1985 and 1984.

The latest actuarial evaluations of employer-sponsored pension plans were performed generally as of July 1, 1985 and June 1, 1986. In estimating present values of accumulated plan benefits, the actuaries assumed rates of return on investments ranging from 6% to 8%. Following is a comparison of accumulated benefits based on these evaluations with net assets available for payment of such benefits at evaluation dates:

Vested benefits	$ 2,183
Nonvested benefits	120
Total benefits	$ 2,303
Net assets available	$ 3,577

Wesco management estimates that since the dates of the above comparisons the overfunding of the plans has increased approximately $600.

The union-sponsored pension plans are multi-employer plans, and their trustees do not make available the relative financial positions of the various participating employers.

Note 13. Quarterly Financial Information

Unaudited quarterly financial information for 1986 and 1985 follows:

	Quarter Ended			
	December 31, 1986	September 30, 1986	June 30, 1986	March 31, 1986
Insurance premiums earned	$ 19,140	$ 17,286	$ 15,973	$ 15,116
Steel service revenues	12,822	12,679	13,508	13,493
Total revenues	46,040	39,880	42,480	40,064
Insurance losses and expenses	(20,208)	(17,443)	(16,393)	(16,190)
Cost of steel products sold	(10,395)	(10,419)	(10,980)	(11,042)
Interest expense—savings accounts	(5,360)	(5,504)	(5,583)	(5,828)
Net income	5,628	3,497	4,561	2,838
Per share	.79	.49	.64	.40
Gain on sales of marketable securities, net of income taxes, included in net income above	2,140	558	1,442	450
Per share	.29	.08	.21	.06
	December 31, 1985	September 30, 1985	June 30, 1985	March 31, 1985
Insurance premiums earned	$ 15,508	$ 4,904	$ —	$ —
Steel service revenues	12,505	12,630	12,605	13,565
Total revenues	90,073	34,290	29,950	23,524
Insurance losses and expenses	(17,602)	(5,744)	—	—
Cost of steel products sold	(9,455)	(10,284)	(10,095)	(11,080)
Interest expense—savings accounts	(6,298)	(6,497)	(6,334)	(6,062)
Net income	35,936	6,469	6,301	2,835
Per share	5.05	.91	.88	.40
Gain on sales of marketable securities, net of income taxes, included in net income above	34,284	4,182	2,964	93
Per share	4.81	.59	.42	.01

Dollar amounts in thousands except for amounts per share 35

Note 14. Retained Earnings

Retained earnings of Wesco include $47,314 of undistributed retained earnings of Mutual Savings, which were taken as special bad debt deductions for income tax purposes through 1968, after which such deductions were no longer available to Mutual Savings due to its having reached certain limitations. These deductions are not related to amounts of losses actually anticipated and have not been charged against book income. If, in the future, any portion of such retained earnings is used for any purpose other than to absorb loan losses, including payment of dividends to Wesco or distribution in liquidation, such withdrawal will necessitate accrual and payment of income taxes.

Because of the special bad debt deductions, and other differences in methods of reporting results of operations for tax return and financial statement purposes, Mutual Savings' ability to pay dividends to Wesco without being subject to tax is limited to approximately future earnings on a tax-return basis. (Dividends of $7,500 and $14,000 were paid in 1986 and 1985; none were paid in 1984.)

Note 15. Business Segment Data

The tables below reflect data for each of the three most recent years, broken down as to business segments.

	1986	1985	1984
Revenues:			
Financial	$ 38,109	$103,901	$ 54,896
Insurance	77,853	22,631	—
Steel service	52,502	51,305	55,305
	$168,464	$177,837	$110,201
Operating profit (loss) before taxes:			
Financial	$ 12,264	$ 75,235	$ 30,808
Insurance	7,619	(715)	—
Steel service	3,372	3,802	3,985
Corporate expenses	(218)	(229)	(210)
Interest expenses on notes payable	(3,114)	(3,035)	(3,103)
	$ 19,923	$ 75,058	$ 31,480

The above revenue and operating profit (loss) data include securities gains and gains relating to the fluctuation in market value of GNMA futures contracts, before taxes, as follows:

	1986	1985	1984
Financial	$ 7,629	$ 65,698	$ 20,298
Insurance	653	—	—
	$ 8,282	$ 65,698	$ 20,298

Additional business segment data follows:

	1986	1985	1984
Capital expenditures:			
Financial	$ 379	$ 486	$ 365
Insurance	—	—	—
Steel service	343	457	453
	$ 722	$ 943	$ 818
Depreciation and amortization of tangible assets:			
Financial	$ 297	$ 267	$ 457
Insurance	—	—	—
Steel	670	673	650
	$ 967	$ 940	$ 1,107
Identifiable assets at yearend:			
Financial	$420,877	$452,272	$398,822
Insurance	172,020	91,077	—
Steel service	18,302	18,608	18,181
	$611,199	$561,957	$417,003

36 Dollar amounts in thousands except for amounts per share

WESCO FINANCIAL CORPORATION
SCHEDULE I—MARKETABLE SECURITIES

DECEMBER 31, 1986
(Dollar amounts in thousands)

Name of Issuer and Title of Each Issue	Number of Shares of Stock or Principal Amount of Notes	Cost	Market Value	Balance Sheet Carrying Value
Securities held by the Consolidated group were as follows:				
Short-term investments—				
Securities of U.S. Government and obligations of the Federal Home Loan Bank and other U.S. Government Agencies	$254,933	$254,762	$254,647	$254,762
Other	11,228	11,228	11,228	11,228
Total short-term investments	$266,161	$265,990	$265,875	$265,990
State and municipal bonds	$151,770	$166,624	$175,544	$165,177
Preferred stocks—				
Various issues, primarily public utilities	798,565	$ 30,947	$ 43,869	$ 30,947

All of the securities listed above were held by Mutual Savings and Loan Association except as indicated below:

Name of Issuer and Title of Each Issue	Number of Shares of Stock or Principal Amount of Notes	Cost	Market Value	Balance Sheet Carrying Value
Held by Wesco Financial Corporation (registrant)—				
U.S. Government securities	$ 55,545	$ 55,043	$ 55,028	$ 55,043
Other short-term investments	364	364	365	364
	$ 55,909	$ 55,407	$ 55,393	$ 55,407
Held by Precision Steel Warehouse, Inc. (wholly owned subsidiary of Wesco Financial Corporation)—				
Other short-term investments	$ 4,129	$ 4,129	$ 4,129	$ 4,129
State and municipal bonds	5,820	6,123	6,399	6,298
	$ 9,949	$ 10,252	$ 10,528	$ 10,427
Held by Wesco-Financial Insurance Company (wholly owned subsidiary of Wesco Financial Corporation)—				
Other short-term investments	$ 6,675	$ 6,675	$ 6,675	$ 6,675
State and municipal bonds	127,540	141,853	146,600	140,407
	$134,215	$148,528	$153,275	$147,082
Held by Wes-Fin Service Corp. (wholly owned subsidiary of Mutual Savings and Loan Association)—				
U.S. Government securities	$ 32,140	$ 31,878	$ 31,868	$ 31,878

There were no individual issues with a cost or market value equal to or exceeding 2% of total assets at December 31, 1986.

Marketable equity securities held by the insurance subsidiary are carried at market value on the consolidated balance sheet; those held by the registrant and its other subsidiaries are carried at the lower of aggregate of cost or market.

WESCO FINANCIAL CORPORATION
SCHEDULE III—CONDENSED FINANCIAL INFORMATION OF REGISTRANT
BALANCE SHEET
(Dollar amounts in thousands)

	December 31, 1986	December 31, 1985
ASSETS		
Cash (including savings accounts at Mutual Savings of $13 and $224)	$ 44	$ 284
Short-term investments	55,407	59,181
Investment in Bowery Savings Bank	9,020	9,020
Investment in subsidiaries, at equity:		
Mutual Savings	54,763	57,579
Precision Steel	23,846	53,322
Wes-FIC	87,808	44,676
Others	137	120
	166,554	155,697
Premises and equipment, net	3,119	3,194
Other assets	569	4,767
	$234,713	$232,143
LIABILITIES AND SHAREHOLDERS' EQUITY		
Notes payable	$ 29,940	$ 30,023
Accounts payable and accrued expenses	426	500
Income taxes payable	1,756	10,819
Total liabilities	32,122	41,342
Shareholders' equity:		
Capital stock, $1 par value—authorized 7,500,000 shares; issued 7,119,807 shares	7,120	7,120
Capital surplus resulting from stock dividends	23,319	23,319
Retained earnings—partially restricted	172,152	160,327
Equity in unrealized appreciation of marketable equity securities of insurance subsidiary	—	35
Total shareholders' equity	202,591	190,801
	$234,713	$232,143

See notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
SUPPLEMENTARY INSURANCE INFORMATION
(Dollar amounts in thousands)
SCHEDULE V

Segment	Deferred Policy Acquisition Costs	Future Claim and Loss Expenses	Unearned Premiums	Earned Premiums	Net Investment Income	Loss and Loss Adjustment Expenses Incurred	Amortized Deferred Policy Acquisition Costs	Other Underwriting Expenses	Written Premiums
Property and casualty reinsurance—									
1986	$9,030	$49,202	$29,317	$67,515	$9,685	$48,454	$20,939	$ —	$70,506
1985	8,254	16,111	26,326	20,412	2,219	16,606	6,402	—	46,738

WESCO FINANCIAL CORPORATION
SCHEDULE III—CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENT OF INCOME AND RETAINED EARNINGS
(Dollar amounts in thousands)

	Year Ended December 31,		
	1986	1985	1984
Revenues—			
Dividends on preferred and common stocks	$ 179	$ 874	$ 2,208
Interest on short-term investments	3,077	4,908	3,138
Interest on savings accounts at Mutual Savings	117	66	1,048
Rental of office, store and garage premises, net	1,791	1,771	1,694
Dividends from subsidiaries	7,500	14,075	—
Gain on sales of marketable securities	3,165	35,995	10,635
Other	44	38	30
	15,873	57,727	18,753
Expenses—			
Interest	3,200	3,034	3,086
General and administrative	574	605	576
	3,774	3,639	3,662
Income before items shown below	12,099	54,088	15,091
Income tax provision	(2,267)	(14,086)	(4,907)
Equity in undistributed earnings of subsidiaries	6,692	11,539	13,472
Net income	16,524	51,541	23,656
Retained earnings—beginning of year	160,327	113,200	93,673
Cash dividends	(4,699)	(4,414)	(4,129)
Retained earnings—end of year	$172,152	$160,327	$113,200

See notes to consolidated financial statements.

WESCO FINANCIAL CORPORATION
SCHEDULE III—CONDENSED FINANCIAL INFORMATION OF REGISTRANT
STATEMENT OF CHANGES IN FINANCIAL POSITION
(Dollar amounts in thousands)

	Year Ended December 31,		
	1986	1985	1984
Sources (uses) of cash, including short-term investments, from operations—			
Net income	$16,524	$ 51,541	$ 23,656
Add (deduct):			
Depreciation and amortization	277	253	373
Equity in undistributed earnings of subsidiaries	(6,692)	(11,539)	(13,472)
Other, net	(75)	175	(124)
	10,034	40,430	10,433
Other sources (uses)			
Decrease in common and preferred stocks	—	12,613	33,576
Increase (decrease) in income taxes payable	(9,063)	10,363	542
Investment in subsidiaries, net	—	(45,100)	—
Investment in Bowery Savings Bank	—	(9,020)	—
Payment of cash dividends	(4,699)	(4,414)	(4,129)
Other, net	(286)	(541)	(349)
	(14,048)	(36,099)	29,640
Increase (decrease) in cash, including short-term investments	$ (4,014)	$ 4,331	$ 40,073

MUTUAL SAVINGS AND LOAN ASSOCIATION
(A Wholly Owned Subsidiary of Wesco Financial Corporation)
CONDENSED CONSOLIDATED BALANCE SHEET
(Dollar amounts in thousands)

	December 31, 1986	December 31, 1985
ASSETS		
Cash and short-term investments	$204,234	$157,766
State and municipal bonds, at cost (market $22,575 and $25,958)	18,647	22,608
Marketable equity securities, at lower of aggregate cost or market:		
Common stocks owned by service subsidiary (market $20,171 in 1985)	—	19,943
Preferred stocks owned by Mutual Savings (market $42,370 and $38,788)	29,441	34,146
Other marketable securities, at cost:		
Preferred stocks (market $1,499 and $1,245)	1,506	1,506
Loans receivable, principally real estate, yielding 7.48% and 7.60%	78,613	83,425
Income taxes receivable	—	1,450
Real estate held for sale	2,133	2,026
Investment in stock of Federal Home Loan Bank and prepayments to FSLIC secondary reserve	4,498	4,337
Other assets	3,128	4,390
	$342,200	$331,597
LIABILITIES AND SHAREHOLDER'S EQUITY		
Savings accounts	$282,441	$269,313
Accounts payable and accrued expenses	323	376
Income taxes payable, principally deferred	4,673	4,329
	287,437	274,018
Shareholder's equity:		
Guarantee stock and additional paid-in capital	100	100
Retained earnings—substantially restricted	54,663	57,479
Total shareholder's equity	54,763	57,579
	$342,200	$331,597
Cash dividends declared and paid	$ 7,500	$ 14,000

See notes to consolidated financial statements of Wesco Financial Corporation.