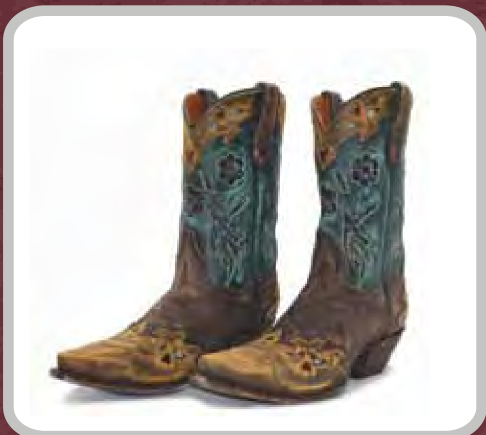
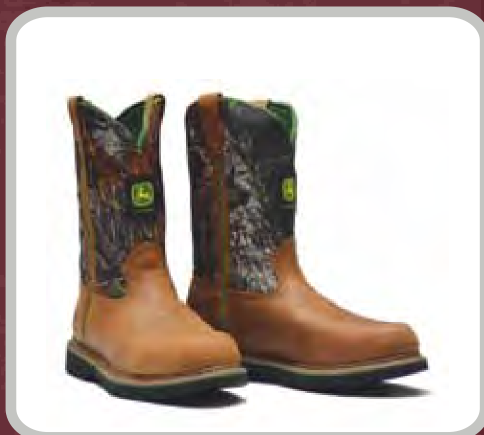
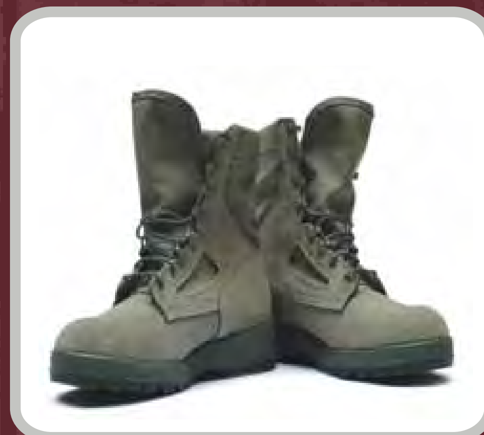
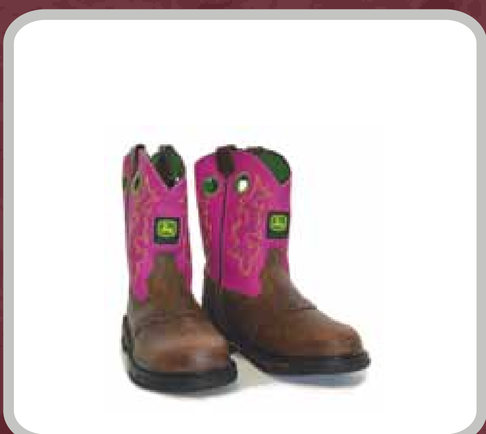
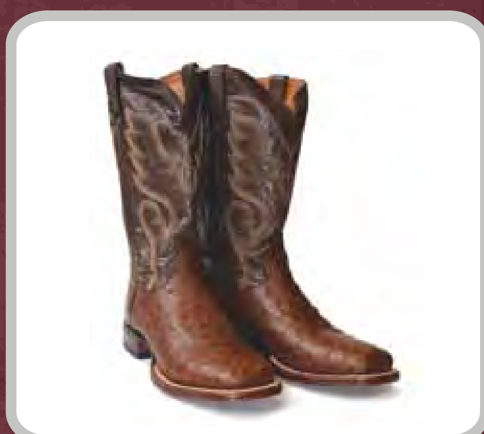
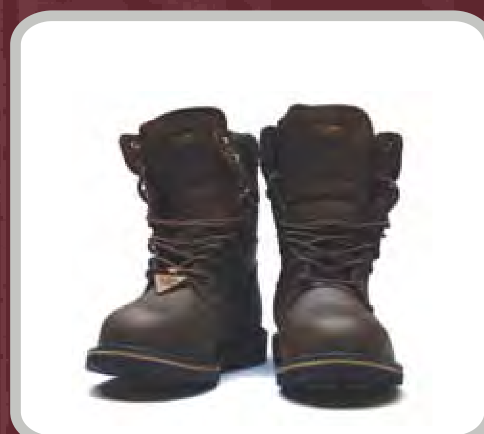
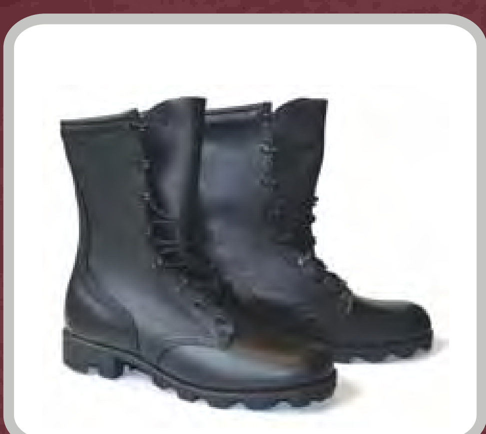
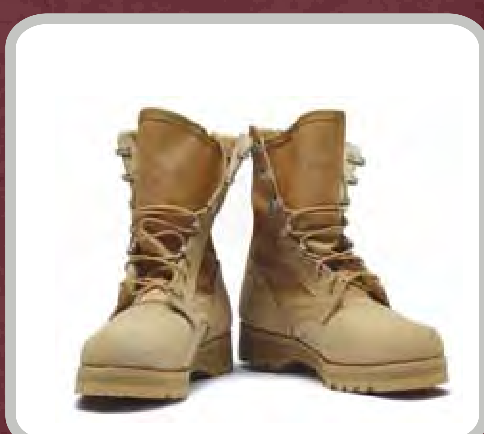
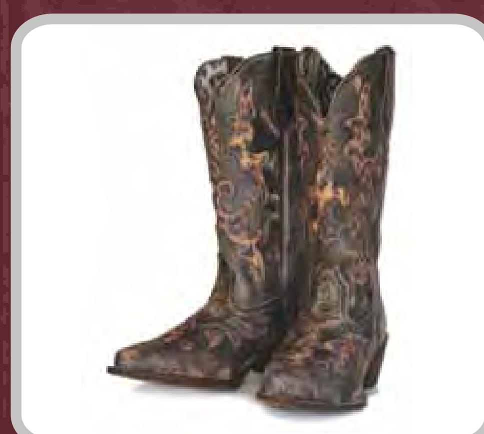
McRae Industries

2012 ANNUAL REPORT

Corporate Profile

McRae Industries, Inc. was founded in 1959 as a manufacturer and distributor of children's shoes.

Today, McRae Industries is involved in manufacturing, sales and distribution of high quality, reasonably priced boot products targeted to the western/lifestyle and work boot markets. In addition, we continue to take pride in manufacturing military combat boots for the U. S. Government. The company also operates other smaller businesses.

McRae Industries, Inc. corporate headquarters is located in Mount Gilead, North Carolina.

Selected Consolidated Financial Data

The following Selected Consolidated Financial Data of the Company presented below for each of the five years in the periods indicated has been derived from our audited and consolidated financial statements.

Fiscal Years Ended	7/28/12	7/30/11	7/31/10	8/1/09	8/2/08
(In thousands, except per share data)					
INCOME STATEMENT DATA:					
Net revenues	**$ 75,684**	$ 74,748	$ 62,571	$ 62,213	$ 80,021
Net earnings (loss)	**4,842**	3,829	2,952	(514)	5,041
Net earnings per common share					
Basic Earnings per share[a]:					
Class A	**2.73**	2.22	1.79	0.11	2.75
Class B	**0**	0	0	0	0
Diluted Earnings per share[b]:					
Class A	**2.27**	1.84	1.47	0.11	2.27
Class B	**NA**	NA	NA	NA	NA
BALANCE SHEET DATA:					
Total assets	**$ 58,459**	$ 53,811	$ 51,348	$ 49,763	$ 51,536
Long-term liabilities	**1,398**	1,334	1,134	2,139	698
Working capital	**40,278**	36,559	33,892	32,822	34,321
Shareholders' equity	**50,781**	47,029	44,154	42,318	43,783
Weighted average number of common shares outstanding:					
Class A	**2,038,902**	2,053,042	2,068,866	2,089,686	2,098,714
Class B	**414,853**	423,697	432,518	438,915	446,262
Weighted average number of common shares outstanding[c]:	**2,453,755**	2,476,739	2,501,384	2,528,601	2,544,976
Cash dividends declared per common share[d]:	**$ 0.36**	$ 0.36	$ 0.36	$ 0.36	$ 0.3525

(a) This calculation uses the two-class method under which all undistributed earnings are allocated to Class A Common Stock in the earnings per share calculation; thus, no earnings are allocated to the holders of Class B Common Stock. See Note 1 to the consolidated financial statements included in this report.

(b) This calculation uses the if-converted method which assumes all Class B Common Stock is converted into Class A Common Stock; thus, there are no holders of Class B Common Stock to participate in undistributed earnings. See Note 1 to the consolidated financial statements included in this report.

(c) Includes both Class A and Class B Common Stock

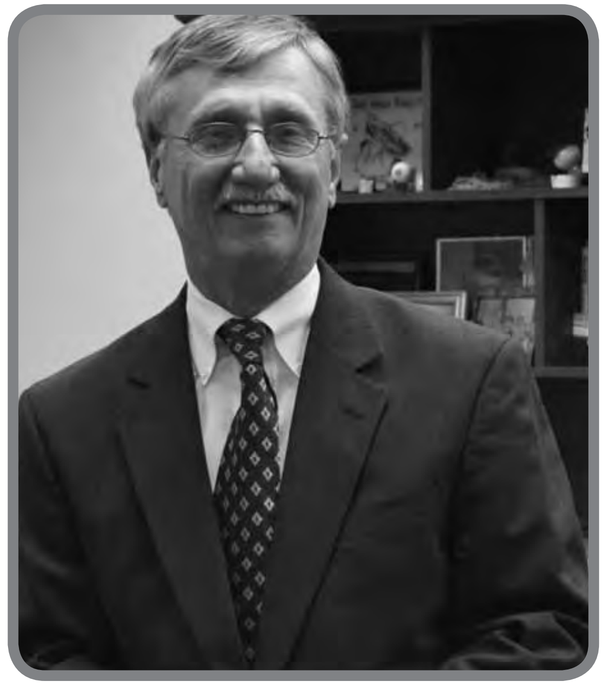
(d) Dividends were paid only on Class A Common Stock

Letter To Shareholders

Dear Friends and Shareholders,

I am very pleased to report that McRae Industries, Inc. had another successful year in fiscal 2012 as both net revenues and net earnings increased. Net revenues grew 1.3%, up from $74.7 million in fiscal 2011 to $75.7 million for fiscal 2012. Net earnings climbed to $4.8 million for fiscal 2012, up 26.3% from $3.8 million for fiscal 2011. These results were primarily attributable to a significant increase in the demand for our western/ lifestyle products.

Our western/lifestyle boot segment, which includes western wear, ladies fashion and children's footwear products, experienced a 21.5% growth in net revenues, up from $43.2 million for fiscal 2011 to $52.5 million for fiscal 2012 as demand for both men's and women's boots increased. In addition to the increased demand, especially for the higher priced Dan Post brand products, net revenue was positively impacted by a 1.9% improvement in gross profit margins. During fiscal 2012, our new products were embraced by the consumer and we plan to introduce an exciting array of new boots in all of our brands in January 2013. Hopefully, these products will have the same positive result.



D. Gary McRae, President

Net revenues for our work boot segment, which includes the Dan Post, Laredo, John Deere and McRae Industrial branded work boot products and our military boots, declined 26.3% as net revenues fell from $31.2 million for fiscal 2011 to $23.0 million for fiscal 2012. While our western and farm work boot business net revenues remained about the same year over year, our military boot business declined nearly 41%. This decrease in the military boot business resulted primarily from the government's overstock position and the completion of our contracts for both the hot weather Army combat boot and temperature weather Army combat boot. These products, which make up the majority of the footwear production of McRae Footwear, adversely impacted margins for the work boot segment. However, gross profit margin for the work boot segment increased slightly, from 14.8% for fiscal 2011 to 15.7% for fiscal 2012.

The Company continues to be financially strong. Our cash and cash equivalents totaled $12.9 million at July 28, 2012 as compared to $10.3 million at July 30, 2011. Working capital increased from $36.6 million at July 30, 2011 to $40.3 million at July 28, 2012. We continually look for ways to leverage our financial strength that will grow the company and make it more profitable. As such, we feel that the Company is well positioned for fiscal 2013.

Going forward into fiscal 2013, we are optimistic about the prospects for continued improvement in revenue and earnings in both the work boot and western/

lifestyle segments of our business. Over the past three years, we have experienced increasing demand for our western/lifestyle products and expect this demand to stay strong in fiscal 2013. The women's western boot business continues to lead the way with the percentage of its business at an all time high compared to our total western business. We are, however, well aware that this current cycle of western boot demand has lasted longer than previous cycles. As a result, we are continuing to develop new and exciting products to increase customer demand which, hopefully, will extend this western boot trend into future years.

The management of McRae Industries Inc., Dan Post Boot Company and McRae Footwear takes seriously our responsibility to grow our company profitably and to be good citizens in the communities in which we work.

We continue to develop new and innovative products for our work boot segment, not only for the farming and construction industries, but also for specific markets such as mining and manufacturing. Hopefully, a rebound in the economy will bring increased demand for these products. Our military business continues to be a challenge as a result of reduced foreign troop deployments, the U.S. Government's emphasis on cost reduction and their military boot overstock position. During the past year, we were the successful bidder on contracts for the hot weather Army combat boot and the temperate weather Army combat boot. Both of these contracts are for one year with four option years. While the annual estimated quantities forecasted by the Government are substantial, we need more boots to adequately cover our manufacturing costs efficiently. As a result, we continue to bid on other solicitations which, if we are the successful bidder, will increase the level of production of military boots. While we are having some success in our commercial military boot business, we do not expect this part of our business to contribute significantly to sales in fiscal 2013.

The management of McRae Industries Inc., Dan Post Boot Company and McRae Footwear takes seriously our responsibility to grow our company profitably and to be good citizens in the communities in which we work. We will face many challenges and opportunities in fiscal 2013 as we endeavor to meet these objectives.

We want to express our appreciation to all of our team members for their contributions toward our achievements during the past year. On behalf of the Board of Directors, we also thank you for your continued goodwill and support.

Sincerely,

D. Gary McRae
President

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Report of Independent Certified Public Accountants

To the Board of Directors and Shareholders of
McRae Industries, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of **McRae Industries, Inc.** (a Delaware corporation) and **Subsidiaries** as of July 28, 2012, and July 30, 2011, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended July 28, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of McRae Industries, Inc. and Subsidiaries as of July 28, 2012, and July 30, 2011, and the results of their operations and their cash flows for each of the three years in the period ended July 28, 2012, in conformity with accounting principles generally accepted in the United States of America.

Grant Thornton LLP

Charlotte, North Carolina
November 2, 2012

CONSOLIDATED BALANCE SHEETS

McRae Industries, Inc. and Subsidiaries

(In thousands, except share data)	July 28, 2012	July 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,874	$ 10,274
Accounts and notes receivable, less allowances of $1,170 and $989, respectively	11,782	10,981
Inventories, net	19,572	18,611
Income tax receivable	209	277
Prepaid expenses and other current assets	395	176
Deferred tax assets	1,726	1,688
Total current assets	46,558	42,007
Property and equipment, net	3,116	3,042
Other assets:		
Real estate held for investment	3,673	3,650
Amounts due from split-dollar life insurance	2,288	2,288
Trademarks	2,824	2,824
Total other assets	8,785	8,762
Total assets	$ 58,459	$ 53,811

The accompanying notes are an integral part of these consolidated financial statements

CONSOLIDATED BALANCE SHEETS
McRae Industries, Inc. and Subsidiaries

(In thousands, except share data)	**July 28, 2012**	**July 30, 2011**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,373	$ 2,755
Accrued employee benefits	1,158	851
Accrued payroll and payroll taxes	1,003	1,087
Other	746	755
Total current liabilities	6,280	5,448
Deferred tax liabilities	1,398	1,334
Total liabilities	7,678	6,782
Commitments and contingencies (Note 7)		
Shareholders' equity:		
Common Stock:		
Class A, $1 par value; authorized 5,000,000 shares issued and outstanding, 2,030,880 and 2,046,337 shares, respectively	2,031	2,046
Class B, $1 par value; authorized 2,500,000 Shares; issued and outstanding, 408,376 and 420,593 shares, respectively	408	421
Retained earnings	48,342	44,562
Total shareholders' equity	50,781	47,029
Total liabilities and shareholders' equity	$ 58,549	$ 53,811

The accompanying notes are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENTS OF OPERATIONS
McRae Industries, Inc. and Subsidiaries

(In thousands, except for share and per share data)

For Years Ended	**July 28, 2012**	**July 30, 2011**	**July 31, 2010**
Net revenues	$ 75,684	$ 74,748	$ 62,571
Cost of revenues	52,329	54,027	44,278
Gross profit	23,355	20,721	18,293
Selling, general and administrative expenses	15,671	14,626	13,705
Operating profit	7,684	6,095	4,588
Other income	249	202	206
Interest expense	(1)	(1)	(34)
Earnings before income taxes	7,932	6,296	4,760
Provision for income taxes	3,090	2,467	1,808
Net earnings	$ 4,842	$ 3,829	$ 2,952

Earnings per common share:			
Earnings per common share:			
Basic earnings per share:			
Class A	$ 2.73	$ 2.22	$ 1.79
Class B	0	0	0
Diluted earnings per share:			
Class A	2.27	1.84	1.47
Class B	NA	NA	NA
Weighted average number of common shares outstanding:			
Class A	2,038,902	2,053,042	2,068,866
Class B	414,853	423,697	432,518
Total	2,453,755	2,476,739	2,501,384

The accompanying notes are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

McRae Industries, Inc and Subsidiaries

(Dollars in thousands)

Common Stock, $1 par value

	Class A		Class B		
	Shares	**Amount**	**Shares**	**Amount**	**Retained Earnings**
Balance, August 1, 2009	2,083,854	$2,084	436,384	$436	$ 39,798
Purchase of ESOP distribution shares	(19,242)	(20)	(4,879)	(4)	(224)
Purchase of other shares	(12,856)	(13)			(110)
Conversion of Class B to Class A Stock	2,526	3	(2,526)	(3)	0
Cash Dividend ($.36 per Class A common stock)					(745)
Net earnings					2,952
Balance, July 31, 2010	2,054,282	$2,054	428,979	$429	$ 41,671
Purchase of ESOP distribution shares	(10,421)	(10)	(2,638)	(3)	(155)
Purchase of other shares	(3,272)	(3)			(44)
Conversion of Class B to Class A Stock	5,748	5	(5,748)	(5)	0
Cash Dividend ($.36 per Class A common stock)					(739)
Net earnings					3,829
Balance, July 30, 2011	2,046,337	$2,046	420,593	$421	$ 44,562
Purchase of ESOP distribution shares	(21,843)	(22)	(5,143)	(6)	(319)
Purchase of other shares	(488)		(200)		(9)
Conversion of Class B to Class A Stock	6,874	7	(6,874)	(7)	0
Cash Dividend ($.36 per Class A common stock)					(734)
Net earnings					4,842
Balance, July 28, 2012	2,030,880	$2,031	408,376	$408	$ 48,342

The accompanying notes are an integral part of these consolidated financial statements

CONSOLIDATED STATEMENTS OF CASH FLOWS
McRae Industries, Inc. and Subsidiaries

(In thousands)

For Years Ended	**July 28, 2012**	**July 30, 2011**	**July 31, 2010**
Cash Flows from Operating Activities:			
Net earnings	$ 4,842	$ 3,829	$ 2,952
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation	640	629	568
Loss on sale of assets	45	(83)	(25)
Deferred income taxes	26	161	60
Changes in operating assets and liabilities:			
Accounts receivable, net	(801)	(510)	(1,178)
Inventories	(961)	(1,436)	(4,320)
Prepaid expenses and other current assets	(219)	(11)	(44)
Accounts payable	618	(821)	203
Accrued employee benefits	307	177	514
Accrued payroll and payroll taxes	(84)	(24)	250
Income taxes	68	267	1,820
Other	(9)	56	(30)
Net cash provided by operating activities	**4,472**	**2,234**	**770**
Cash Flows from Investing Activities:			
Proceeds from sale of assets	8	126	157
Purchase of land for investment	(23)	(258)	(92)
Capital expenditures	(767)	(822)	(369)
Collections on notes receivable	0	0	598
Net cash (used in) provided by investing activities	**(782)**	**(954)**	**294**
Cash Flows from Financing Activities:			
Purchase of common stock	(356)	(215)	(371)
Principal repayments of bank note payable	0	0	(1,310)
Dividends paid	(734)	(739)	(745)
Net cash (used in) financing activities	**(1,090)**	**(954)**	**(2,426)**
Net Increase (Decrease) in Cash and Cash equivalents	2,600	326	(1,362)
Cash and Cash Equivalents at Beginning of Year	10,274	9,948	11,310
Cash and Cash Equivalents at End of Year	**$ 12,874**	**$ 10,274**	**$ 9,948**

The accompanying notes are an integral part of these consolidated financial statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

McRae Industries, Inc., (the "Company", which may be referred to as "we", "us" or "our"), is a Delaware corporation organized in 1983 and is the successor to a North Carolina corporation organized in 1959. Our principal lines of business are: manufacturing and selling military combat boots and importing and selling western and work boots.

On March 31, 2009, the Company sold substantially all of the assets of the bar code business for approximately $792,000, which did not result in a gain or loss. The assets sold included accounts receivables, various demonstration equipment, certain office furniture and fixtures, the Compsee trade name, domain names, and other registered trademarks. The buyer also assumed all of the accounts payable and specific accrued liabilities. The Company received $194,000 at closing and a promissory note for $598,000 due on September 30, 2009. For fiscal 2010, the Company operated under a supply agreement with the buyer to manufacture and exclusively sell a variety of our proprietary bar code products. The name of this business was changed and now operates under the name of McRae Technologies, Inc. On December 31, 2010, all significant operating activities of this business ceased. Currently, this business handles only repair and warranty work on products previously sold.

Principles of Consolidation

The consolidated financial statements include the accounts of all of the Company's wholly owned subsidiaries and other businesses over which we exercise significant control. All significant intercompany transactions and balances have been eliminated in consolidation.

Total assets and net revenues for each of our main business units are as follows:

	(In thousands)		
	2012	**2011**	**2010**
Total Assets:			
Western/Work Boots	$ 33,371	$ 30,593	$ 28,419
Military Boots	4,049	4,762	4,949
Bar Code	87	71	268

	(In thousands)		
	2012	**2011**	**2010**
Total Net Revenues:			
Western/Work Boots	$ 64,454	$ 55,624	$ 51,702
Military Boots	11,067	18,783	10,210
Bar Code	31	157	478
Other	132	184	182

Use of Estimates

The timely preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Actual results could differ from those estimates. The economic price adjustment related to our military combat boot contract is subject to certain price variations for leather.

Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits with banks and certificates of deposit purchased with an original maturity date of three months or less.

Accounts Receivable

Accounts receivable are stated at amounts expected to be collected from outstanding balances. Probable uncollectible accounts are reserved for by a charge to earnings and a credit to the allowance for doubtful accounts based on the assessment of the current status of individual accounts. Balances that are still outstanding after using reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. The Company performs on-going credit evaluations of its customers' financial condition and establishes an allowance for losses on trade receivables based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

Our western and work boot business records an allowance for sales returns. This is calculated applying historical return data to sales subject to potential returns. The allowance for sales returns totaled $470,000 and $389,000 for fiscal 2012 and fiscal 2011, respectively.

Inventories

Inventories are stated at the lower of cost or market value using the last-in, first-out (LIFO) method for military boots and using the first-in, first-out (FIFO) method for all other inventories. We regularly review our FIFO basis inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast and demand requirements for the next twelve months. Actual demand and market conditions may be different from those projected by our management primarily as a result of fashion cycles and trends and the overall financial condition of competitors in the western and work boot business. A one percentage point error in our inventory allowances would approximate $4,000 and $7,400 for the fiscal years ended July 28, 2012 and July 30, 2011, respectively.

Long-Lived Assets and Other Intangibles

The Company reviews long-lived assets with estimable useful lives for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

The Company tests identifiable intangible assets with an indefinite life for impairment annually. Furthermore, such assets are required to be tested for impairment on an interim basis if an event or circumstance indicates that it is more likely than not an impairment loss has been incurred. An impairment loss shall be recognized to the extent that the carrying amount of such assets exceeds its implied fair value. Impairment losses shall be recognized in operations. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. If these assumptions differ materially from future results, the Company may record impairment charges in the future. Based on its most recent analysis, the Company believes that no impairment exists as of July 28, 2012 and July 30, 2011, respectively.

Revenue Recognition

Sales of the Company are recognized as revenues when goods are shipped and title passes to the buyer. Our military boot sales to the U.S. Government under our current contract are recognized as revenues when the goods are received at their designated depot.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Federal and state income taxes are computed at current tax rates, less tax credits. Taxes are adjusted both for items that do not have tax consequences and for the cumulative effect of any changes in tax rates from those previously used to determine deferred tax assets or liabilities. Tax provisions include amounts that are currently payable, plus changes in deferred tax assets and liabilities that arise because of temporary differences between the time when items of income and expense are recognized for financial reporting and income tax purposes. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not such assets will be realized.

The Company's policy is to recognize interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense. The Company has recognized no interest or penalties since the adoption of the accounting guidance related to accounting for uncertainty in income taxes.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax in multiple state jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal income tax examinations for fiscal years ending before 2009. However, to the extent allowed by law, the tax authorities may have the right to examine prior periods where net operating losses were generated and carried forward, and make adjustments up to the amount of the net operating loss carryforward amount.

Earnings per Share

Under our Articles of Incorporation, we may pay dividends on our Class A Common Stock in excess of the dividends we pay on our Class B Common Stock. As a result, we have computed our earnings per share in compliance with Accounting Standards Codification (ASC) 260, "Earnings per Share". This guidance requires companies that have multiple classes of equity securities to use the "two class" or "if converted method" in computing earnings per share.

For our primary or basic earnings per share calculation, we use the two-class method, which implies a different dividend rate for our Class B Common Stock. Consequently, all undistributed earnings are allocated to Class A Common Stock in the earnings per share calculation. The result of this calculation allocates no earnings per share to the holders of Class B Common Stock.

For our diluted earnings per share calculation, we use the if-converted method. This calculation assumes that all Class B Common Stock is converted into Class A Common Stock. As a result, there are no holders of Class B Common Stock to participate in undistributed earnings.

While we have presented our earnings per share in accordance with (ASC) 260, we believe that the holders of Class A and Class B Common Stock have equal rights to the Company's undistributed earnings. Consequently, we believe that the calculation that best expresses economic reality is to calculate earnings per share using the total Class A and Class B Common Stock outstanding.

The Company had no common stock equivalents issued or outstanding for the three-year period ended July 28, 2012.

Advertising

The Company charges advertising costs when incurred as a component of SG&A expenses. Advertising expense amounted to $656,000, $627,000, and $621,000 for fiscal years 2012, 2011, and 2010, respectively.

Shipping and Handling

Shipping and handling costs that are charged to and reimbursed by the customer are recognized as revenues, while the related expenses, including buying, postage, external distribution and warehousing costs incurred by the Company are recorded as components of cost of goods sold in the consolidated statements of operations.

Split-Dollar Life Insurance

The Company is party to a split-dollar arrangement with respect to certain life insurance policies. We record an amount that is to be realized under the split dollar agreement. This amount is the actual premiums paid by the Company or the actual cash surrender value of the policy, whichever is less.

Real Estate Held for Investment

Real estate held for investment is land recorded at cost plus the cost of any improvements. Land is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

Reclassification

Certain amounts in the 2011 financial statements have been reclassified to conform to the 2012 presentation.

2. INVENTORIES

Current costs exceeded the LIFO value of inventories by approximately $800,000 and $780,000 at July 28, 2012 and July 30, 2011, respectively. Year-end inventories valued under the LIFO method were $1,761,000 and $1,898,000 at July 28, 2012 and July 30, 2011, respectively. For fiscal 2012 and 2011, higher FIFO pricing increased the LIFO reserve, which decreased net earnings by approximately $12,000 and $67,000, respectively.

Inventory reserves applicable to the FIFO inventories totaled $404,000 and $741,000 for fiscal 2012 and fiscal 2011, respectively.

The components of inventory, net of reserves, at each year-end are as follows:

	(In thousands) Fiscal Year Ended	
	2012	2011
Raw materials	$ 739	$ 1,110
Work-in-process	402	465
Finished goods	18,431	17,036
	$ 19,572	$ 18,611

3. PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost. Depreciation for financial reporting purposes is provided using the straight-line method over the estimated useful lives of the assets. Estimated useful lives range from three years for computer equipment to thirty-one and one-half years for buildings. Expenditures for routine maintenance and repairs are charged to expense as incurred.

Property and equipment at July 28, 2012 and July 30, 2011, consisted of the following:

	(In thousands) Fiscal Year Ended	
	2012	2011
Land and improvements	$ 393	$ 393
Buildings	4,085	4,067
Machinery and equipment	4,926	4,248
Furniture and fixtures	1,339	1,463
Construction in progress	99	270
	10,842	10,441
Less: Accumulated depreciation	(7,726)	(7,399)
	$ 3,116	$ 3,042

Depreciation expense for fiscal 2012, 2011, and 2010 was $640,000, $629,000, and $568,000, respectively.

4. NOTES PAYABLE AND LINES OF CREDIT

Notes Payable

The company had a note payable-bank that was paid in full in March 2010. Interest charges for this note totaled approximately $26,000 for fiscal 2010.

Lines of Credit

The Company has a $5,000,000 revolving line of credit with a bank. The Company had no outstanding borrowings under this line of credit as of July 28, 2012 and July 30, 2011. This line of credit provides for interest on outstanding balances to be paid monthly at the prime rate less 1.0%. This line of credit expires in January 2013 and is secured by the inventory and accounts receivable of the Company's western and work boot subsidiary.

The Company has an additional $1,750,000 line of credit with a bank. This line is restricted to 100% of the outstanding accounts receivable due from the U.S. Government. There were no outstanding borrowings under this line of credit as of July 28, 2012 and July 30, 2011. The line of credit expires in January 2013 and provides for interest on outstanding balances to be paid monthly at the prime rate.

Total aggregate interest charges for fiscal 2012, 2011, and 2010 were approximately $1,000, $1,000, and $34,000, respectively.

5. EMPLOYEE BENEFIT PLANS

The Company's employee benefit program consists of an employee stock ownership plan, a 401-K retirement plan, a cash bonus program, incentive awards, and other specified employee benefits as approved by the Board of Directors.

The employee stock ownership plan (ESOP) covers substantially all employees. Its principal investments include shares of Class A Common Stock and Class B Common Stock of the Company and collective funds consisting of short-term cash, fixed-income, and equity investments. There have been no contributions to the ESOP in fiscal years 2012, 2011 or 2010.

The Company has a 401-K retirement plan, which covers substantially all employees. Employees can contribute up to 25% of their annual salary to the plan. At its sole discretion, the Board of Directors determines the amount and timing of any Company matching contribution. The Company's contribution was $195,000, $211,000, and $143,000, for the fiscal years ended 2012, 2011, and 2010, respectively.

Employee benefit program expense amounted to $1,348,000, $1,059,000, and $819,000, in 2012, 2011 and 2010, respectively.

6. INCOME TAXES

Significant components of the provision for income taxes are as follows (in thousands):

	2012	2011	2010
Current expense			
Federal	$ 2,784	$ 2,077	$ 1,628
State	280	229	120
	3,064	2,306	1,748
Deferred expense			
Federal	22	137	51
State	4	24	9
	$ 3,090	$ 2,467	$ 1,808

The components of the provision (benefit) for deferred income taxes are as follows (in thousands):

	2012	2011	2010
Depreciation	$ 160	$ 128	$ 44
Accrued employee benefits	(117)	(68)	(195)
Allowances for doubtful accounts	(38)	(67)	29
Allowance for sales returns	(31)	(12)	(5)
Inventory	(182)	105	(21)
State net operating loss carry forward	(34)	9	(11)
Economic Price Adjustment Claim	60	(6)	(47)
ERP System write-off	0	0	195
Amortization	72	72	0
Prepaid Expenses	136	0	0
Other	0	0	71
Provision for deferred income taxes	$ 26	$ 161	$ 60

Deferred tax liabilities and assets at each year-end are as follows (in thousands):

	2012	2011
Noncurrent deferred assets (liabilities)		
Amortization	$ (600)	$ (529)
Gain on Like Kind Exchange	(391)	(391)
Depreciation	(575)	(414)
State net operating loss carry forward	168	134
Net noncurrent deferred tax liabilities	(1,398)	(1,200)
Current deferred tax assets (liabilities)		
Self Insurance	76	76
Accrued employee benefits	440	324
Allowances for doubtful accounts	266	228
Allowance for sales returns	179	148
Inventory	833	651
Economic Price Adjustment Claim	68	127
Prepaid Expenses	(136)	0
Net current deferred tax assets	1,726	1,554
Net deferred tax assets	$ 328	$ 354

State net operating loss carry forwards of $6 million will expire through fiscal 2024.

The reconciliation of income tax computed at the U.S. federal statutory tax rate to actual income tax expense are (in thousands):

	2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent
Tax at U.S. statutory rate	$2,697	34.0 %	$2,141	34.0 %	$1,638	34.0 %
State income taxes, net of federal tax benefit	188	2.4 %	167	2.6 %	303	6.3 %
Tax adjustments	143	1.8 %	126	2.0 %	102	2.1 %
Other – net	62	0.7%	33	0.5%	(235)	(4.9)%
	$3,090	38.9 %	$2,467	39.1 %	$1,808	37.5 %

The items included as "other-net" relate to book to tax deferrals, permanent differences, adjustment for non tax consolidated entities, and prior year tax provision to return adjustments.

Total income tax payments during fiscal years 2012, 2011 and 2010 were approximately $3,116,000, $2,095,000, and $1,812,000, respectively.

7. COMMITMENTS AND CONTINGENCIES

Lease Agreements

The Company leases certain offices and equipment under non-cancelable operating leases. Rental expenses on all operating leases were $597,000, $534,000, and $434,000, for fiscal 2012, 2011, and 2010, respectively. The future non-cancelable lease payments as of July 28, 2012 are as follows:

	2013	2014	2015	2016	2017
Lease Payments	$503,000	$499,000	$500,000	$502,000	$503,000

The Company leases approximately 34,000 square feet of office and warehouse space to Connected Office Products, Inc. The original lease covered a base year period and two one-year option periods. In July 2011, the lease was amended to cover a five-year period beginning on September 1, 2011. These lease and facility charge payments are reported as a component of "Other Income". The future minimum lease and facility charge payments are as follows:

	2013	2014	2015	2016
Lease Payments	$50,000	$50,000	$50,000	$50,000
Facility Charges	$64,550	$65,844	$67,162	$68,504

Concentrations

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash investments and receivables. The Company maintains substantially all of its cash and certificates of deposits with a financial institution in amounts that are in excess of the federally insured limits, which totaled approximately $13 million, $10 million, and $9 million, for fiscal 2012, 2011, and 2010, respectively. Management performs periodic evaluations of the relative credit standing of this financial institution.

Concentrations of credit risk with respect to receivables are minimal due to the large number of entities comprising the Company's customer base and their dispersion across many different industries. The Company does not require collateral on trade accounts receivable. As of July 28, 2012 and July 30, 2011, twenty-one customers accounted for 41% and 40% of accounts receivable, respectively.

Synthetic rubber used in our vulcanizing military boot operation is currently available and purchased from the only domestic supplier known to us. Synthetic rubber is available from foreign suppliers, however an exemption would be required from the Government to purchase synthetic rubber in the foreign market. The Vibram rubber specified outsoles is a registered product available only from Vibram USA and we are dependent on their ability to supply our needs. This supplier provided Vibram rubber outsoles for approximately $1.0 million and $2.3 million at July 28, 2012 and July 30, 2011, respectively.

Sales to the U.S. Government amounted to 13%, 24%, and 16%, of total consolidated net revenues for fiscal 2012, 2011, and 2010, respectively. Under the terms of sale to the U.S. Government, the negotiated contract prices of combat boots are subject to renegotiation if certain conditions are present. Management does not currently expect renegotiation, if any, to have a material adverse effect on the Company's consolidated financial position or results of operations.

8. SHAREHOLDERS' EQUITY

Common Stock

The Company's Bylaws provide for seven directors, two of whom are elected by the holders of the Class A Common Stock voting as a separate class, and five of whom are elected by the holders of the Class B Common Stock voting as a separate class. On all other matters (except matters required by law or the Company's Certificate of Incorporation or Bylaws to be approved by a different vote), the holders of Class A Common Stock and Class B Common Stock vote together as a single class with each share of Class A Common Stock entitled to one-tenth vote and each share of Class B Common Stock entitled to one vote. Each share of Class B Common Stock can be converted to Class A Common Stock on a share for share basis. All dividends paid on Class B Common Stock must also be paid on Class A Common Stock in an equal amount.

The Company has adopted the McRae Industries, Inc. 1998 Incentive Equity Plan (the Plan). Under the Plan, 100,000 shares of the Company's Class A Common Stock are reserved for issuance to certain key employees of the Company. At July 28, 2012, there were 100,000 shares available for future grants under the Plan.

The common stock is currently quoted in the Pink Sheets and stockholders are able to trade their shares in the over-the-counter markets or private transactions.

9. FAIR VALUE OF FINANCIAL INSTRUMENTS

Management used the following methods and assumptions to estimate the fair value of financial instruments:

The fair value of our cash and cash equivalents, accounts and notes receivable, accounts payable, and accrued liabilities approximate their carrying values due to their liquid nature.

The amount due from Split-Dollar Life Insurance policies represents the value of the Company's rights under split-dollar arrangements. Under these arrangements, the Company is entitled to be repaid cumulative premiums paid, or if less, the net cash surrender value of the policies.

10. RELATED PARTY TRANSACTIONS

The Company leases administrative and sales office space in Clarksville, Tennessee for the western boot business from the President of Dan Post Boot Company. The annual rent is approximately $112,000.

11. SUBSEQUENT EVENTS

On August 29, 2012, the Company declared a cash dividend of $.09 per share on its Class A Common Stock payable on September 28, 2012 to shareholders of record on September 14, 2012.

Subsequent events have been evaluated through November 2, 2012, which is the date the financial statements were available to be issued.

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Executive Officers & Directors

Front Row, Left - Right:
Victor A. Karam; D. Gary McRae; James W. McRae

Back Row, Left - Right:
Marvin G. Kiser, Sr.; William H. Swan; Hilton J. Cochran, Jr.; Brady W. Dickson

EXECUTIVE OFFICERS

D. Gary McRae
Chairman of the Board, President, Chief Executive Officer and Treasurer

James W. McRae
Vice-President and Secretary

Victor A. Karam
President, McRae Footwear

Marvin G. Kiser, Sr.
Vice-President of Finance

DIRECTORS

D. Gary McRae
Chairman of the Board, President, Chief Executive Officer and Treasurer

James W. McRae
Vice-President and Secretary

Victor A. Karam
President, McRae Footwear

Marvin G. Kiser, Sr.
Vice-President of Finance

Hilton J. Cochran, Jr.*
Executive Director,
Peacehaven Community Farm

Brady W. Dickson*
Consultant

William H. Swan*
Retired President,
Bob Swan Company

**Members of Audit and Compensation Committees*

Shareholder Information

SHAREHOLDERS
Requests for interim and annual reports or more information about the Company should be directed to:

Office of the Secretary
McRae Industries, Inc.
P. O. Box 1239
Mount Gilead, North Carolina 27306

STOCK
McRae's common stock is traded on the Pink Sheets (MRINA and MRINB).

TRANSFER AGENT, REGISTRAR, AND DIVIDEND DISBURSING AGENT
American Stock Transfer & Trust Company
10150 Mallard Creek Road, Suite 307 Charlotte, North Carolina 28262

ANNUAL MEETING
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