LUFKIN INDUSTRIES, INC.

1985 ANNUAL REPORT


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J.B. HUNT
J.B. HUNT
TRANSPORT INC.
LOWELL, ARK.
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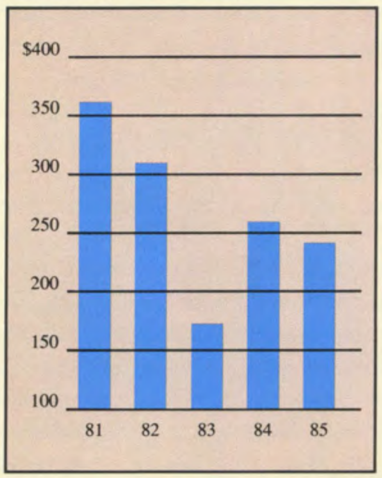
TRANSPORT INC.
LOWELL, ARK.

FINANCIAL HIGHLIGHTS

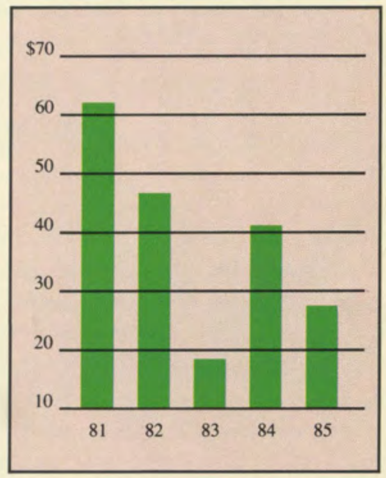
(In thousands of dollars, except per share data)

Years ended December 31	**1985**	1984	1983	1982	1981
Net sales	**$241,894**	$258,006	$170,406	$309,664	$364,443
Net earnings	**28,615**	40,973	19,573	46,957	62,697
Net earnings per share	**16.64**	23.83	11.38	27.12	36.02
Total assets	**292,471**	285,134	266,065	260,224	247,478
Cash dividends per share	**11.00**	10.00	9.00	10.00	9.00
Book value per share	**147.85**	142.21	128.38	125.99	109.88

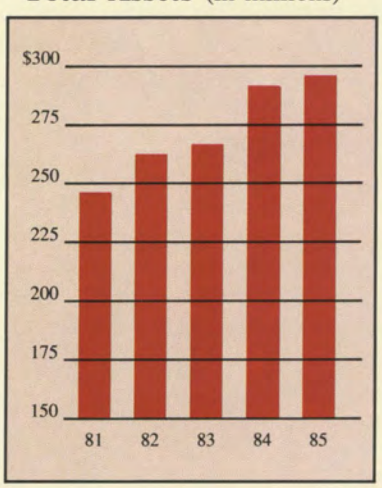
Sales (in millions)



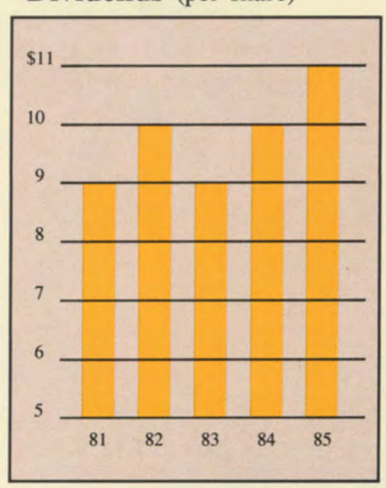
Earnings (in millions)



Total Assets (in millions)



Dividends (per share)



Cover: A LUFKIN crank-balanced unit works in the rolling hills near Konawa, Oklahoma
Opposite: J. B. Hunt Transport, Inc. is LUFKIN's largest trailer customer (Photos by Kurt Martin)

TO OUR SHAREHOLDERS

The year 1985 was a challenging but productive one for Lufkin Industries, Inc. The decline in business throughout the United States in general and in the oil industry in particular affected our sales and earnings.

At year end net sales for the company declined six percent from $258 million in 1984 to $241.9 million in 1985, and net earnings slipped 30 percent from $41 million in 1984 to $28.6 million in 1985. However, the Trailer Division had another exceedingly good sales year. Although trailer sales decreased one percent from $61.7 million in 1984 to $61.3 million 1985, this was still the second best sales year in the Division's history.

Total assets of your company were up to $292 million in 1985, from $285.1 million in 1984. Book value of our stock increased to $147.85 per share in 1985, compared to $142.21 per share in 1984. Dividends increased from $10 per share in 1984 to $11 per share in 1985.

When world-wide oil prices plummeted, the sales of pumping units were adversely affected. We responded to the challenge by intensifying our efforts to produce our products more economically and efficiently. During the past several years, we have had many projects that were aimed at increasing productivity and improving efficiency. Many of these projects came to fruition in 1985. In the Machinery Division, we engaged in productivity improvements which enabled us to reduce raw material, in-process and finished goods inventories and to reduce lead times drastically. This has resulted in giving our customers improved quality and better service.

Also in 1985, we launched a major productivity improvement program in the Trailer Division which has the same goals and uses the same techniques that we apply in other parts of the plant.

These productivity improvement programs are continuous in nature so that every day we strive to improve the way we produce our products and to improve service to our customers. We also have learned that productivity improvement not only is an opportunity for the manufacturing operations, but it applies to everything we do in every office operation and in every facet of our organization. We expect significant productivity improvements throughout our entire company in 1986.

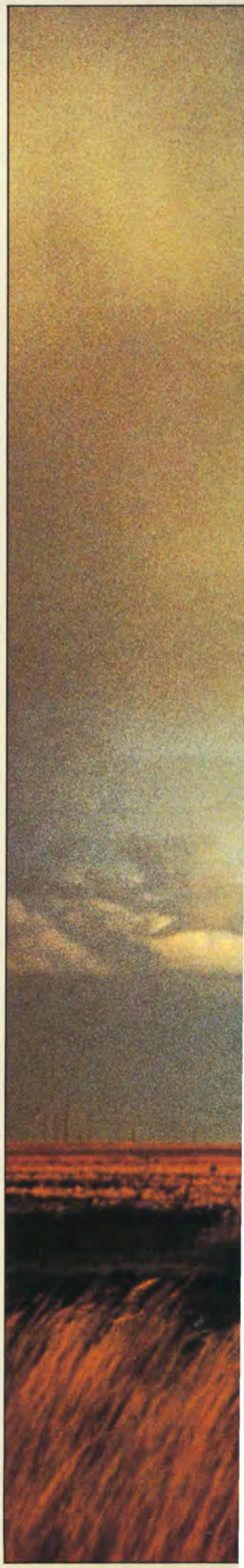
At the end of 1985, R. L. Poland retired as Chairman and Chief Executive Officer of the company. He had served 40 years of very distinguished service. Also retiring were Fred Griffin, Vice President, Engineering; Ben Queen, Vice President, Sales; and Bill Pennington, Vice President, Structural Plant. All served the company with distinction and their many contributions are noted with great appreciation. At the beginning of 1986, several new assignments were made within our management team. They are reflected in the list of corporate officers on page 24.

We look forward to the future with great anticipation. We have a strong foundation of past heritage on which to build, and we have the promise of a very bright future as we continue to improve our ability to be more competitive in every market that we serve and to be a worldwide producer of quality equipment.

F. B. Stevenson

F. B. Stevenson
President and Chief
Executive Officer

Opposite: A LUFKIN Mark II unit is highlighted by dissipating storm clouds and fading sunlight

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MACHINERY DIVISION

The Machinery Division of Lufkin Industries, Inc. is comprised of several component operations whose products are oilfield pumping units and industrial and marine gearing. These components include the foundry operations, machining and assembling operations, steel fabrication, final assembling and shipping operations, product design engineering, machinery sales and service, materials and information systems management, purchasing and many other support groups.

The Machinery Division accounted for 72 percent of the company's sales and 90 percent of its operating income in 1985.

The objectives of the Machinery Division during 1985 were to manufacture LUFKIN products quicker, better, less costly; that is, quicker to improve delivery; better to improve quality; and less costly to reduce manufacturing costs. All component operations contributed toward the achievement of these objectives.

Highlights of the foundry operations in 1985 could be characterized as innovations, education and ongoing capital improvements. These activities continued to place the foundry on the threshold of a new era of productivity.

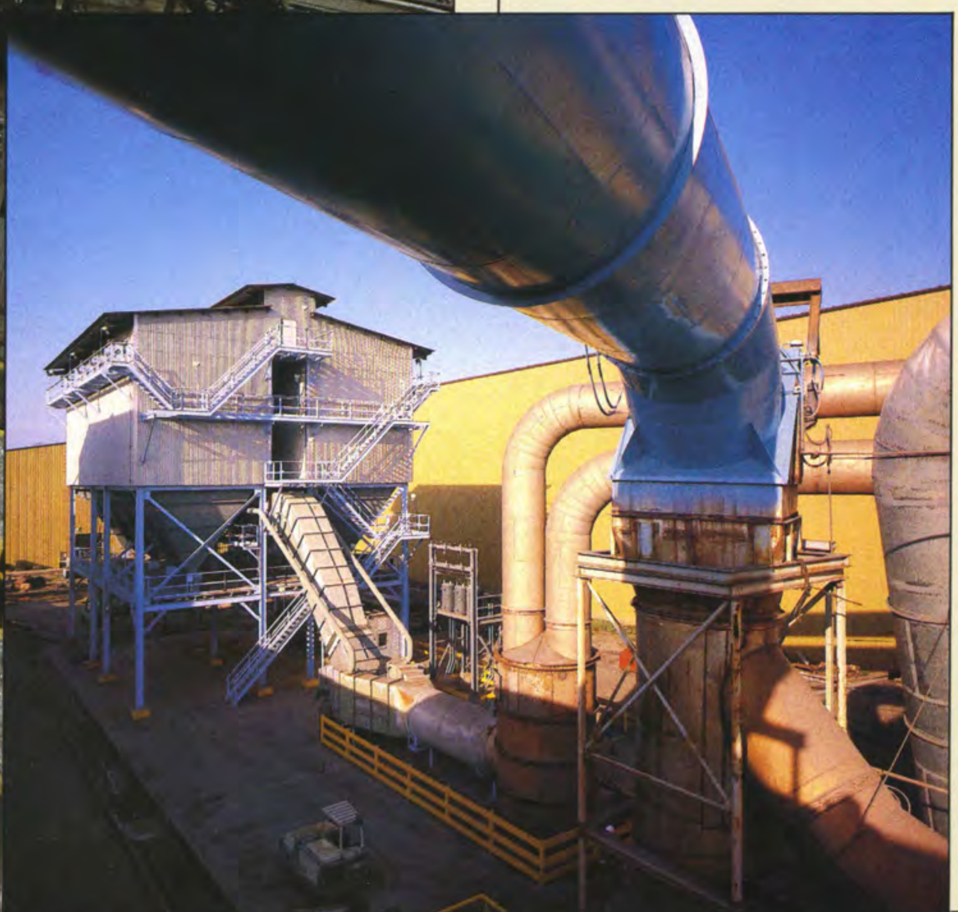
Innovative improvements in product design and foundry practices resulted in cost savings. Simplification of castings and the removal of cores reduced castings costs and eliminated many factors that contributed to scrap.

New technologies, facilities and management practices require foundry employees to sharpen existing skills and obtain new ones. Foundry principles, computer courses, electronics, supervision, English and writing are examples of ongoing training.

Significant progress occurred on several key capital projects during 1985. A new pollution control system for the foundry cupola went into operation during the third quarter. This system is one of the most modern designs available and more than satisfies regulatory requirements.

Construction was completed on the new ductile iron facility and limited production began during the fourth quarter. This automated facility is designed to produce castings of the highest quality and consistency. Although the facility uses proven processes, the level of automation achieved is unique within the industry.

Installation of a new small casting facility continued during 1985. The second phase of this work is scheduled for completion in mid-1986. The cornerstone of this facility is the new impact molding system. It will increase small casting capacity while significantly improving the foundry's capability to provide quality small castings at a lower cost.



Left: This high speed gear assembly cell is an example of machine cell manufacturing.
Above: A new pollution control system for the foundry cupola was put in operation in 1985

In the machining and assembling operations, the 1984 emphasis on methods to achieve cost reductions were continued during 1985. These consisted of improving the machining cell manufacturing, linking the cells to assembly operations, improving the "just in time" operations, exploring new technology and continuing personnel training.

A machining cell is basically a group of machines or equipment logically arranged to produce certain components or families of parts which require "like" operations on similar machines. It is a common sense approach in bringing machines together in linked fashion instead of having machines of like type in different departments.

The next step is linking the machining cells to the assembly operations. This means that parts are machined adjacent to the assembly areas. They are linked together by roller conveyor or other appropriate means of conveyance.

The "just in time" operation of the plant consists of producing only the parts needed as they are needed and passing them through linked cells to final point of use. Components purchased from outside sources are received and stored at "point of use" to insure effective operations.

Some $13 million was invested in new plant and equipment in 1985 in the continuing commitment to maintain modern "state of the art" machines for the company's factory operations. Such investments provide customers with quality products and improved deliveries.

In addition to new methods of production and the purchasing of new machines, particular attention was paid to the training of personnel during 1985. In an effort to enhance quality and product consistency, machine operators have been cross-trained to allow movement from machine cell to machine cell with equal competency. Supervisors are systematically rotated within the various shop areas to provide similar knowledge of manufacture of the products. All support people such as maintenance mechanics, electronics technicians, etc. have been trained in cell manufacturing and "just in time" principles.

During the past year, the Machinery Division engineering group was challenged by the need for more efficient designs to meet competition. Teams were formed to review all designs to better fit the manufacturing facility. The small pumping unit team completed the design and manufacture of the pilot model beam-balanced pumping unit, and began work on the small crank-balanced unit to gain competitive advantage in this market.

To assist in new pumping unit development, a test well facility is being designed which will duplicate field well conditions. This test facility will employ the latest technology to measure power consumption, torque loading, stresses and performance of pumping unit geometries and components.

The machinery sales and service department had to cope with declining oil prices in 1985, reducing exploration and drilling activities which caused a slump in the sale of sucker rod pumping units. Also, industrial and marine gear markets continued to be soft because of the slow worldwide economy.

Above: A new plasma arc burning machine is an integral part of the walking beam factory.
Right: Ductile iron gears are being poured in the new facility where production began in 1985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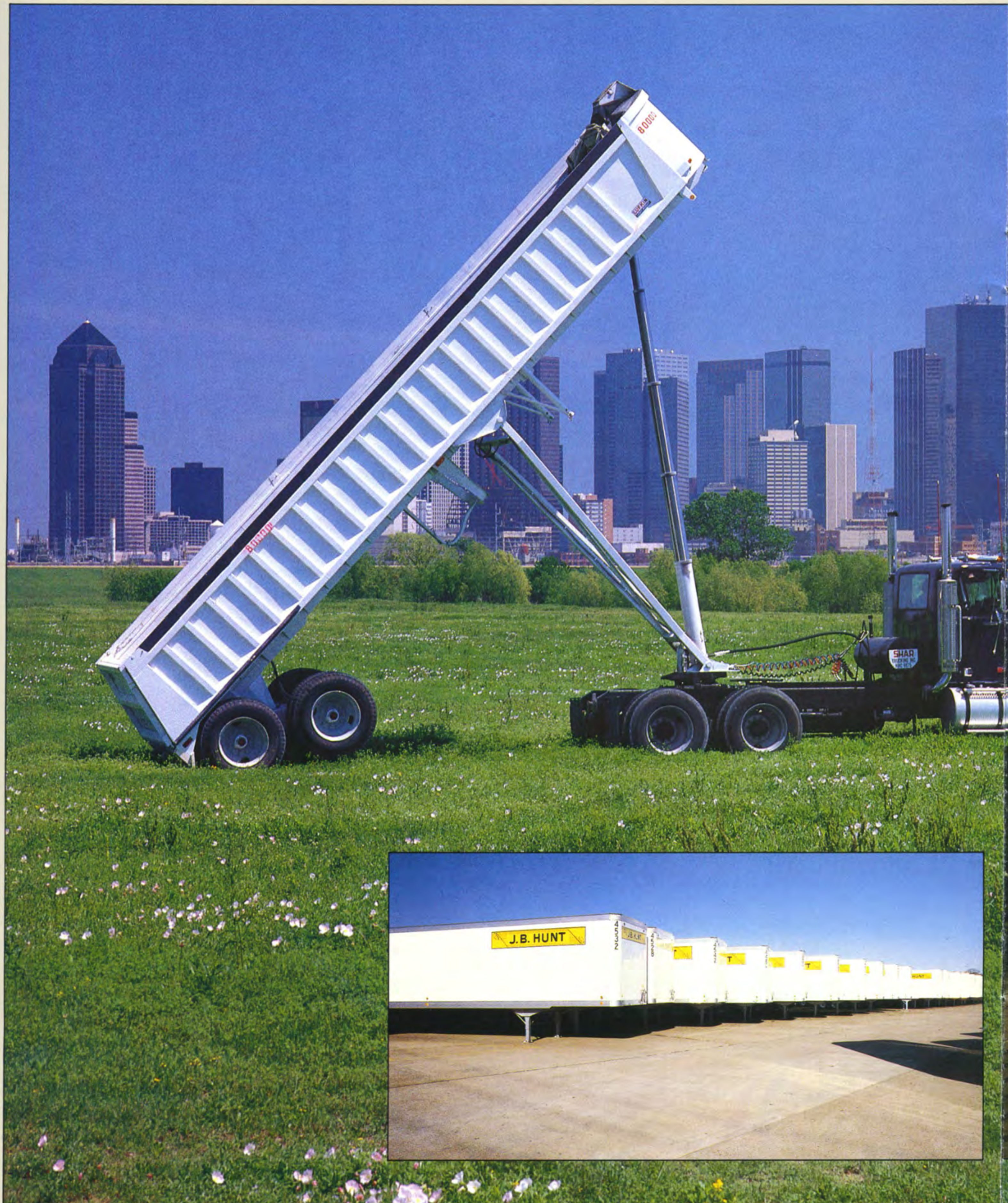
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TRAILER DIVISION

The Trailer Division had its second largest sales volume in 1985 of $61.3 million, which was down one percent from $61.7 million in 1984, which was the largest sales volume in the Division's history.

Industry-wide, sales of trailers were off approximately 20 percent in 1985 from that of 1984. The business was more competitive in 1985 than it was in the previous year. Consequently, more units were sold for approximately the same amount of dollars.

The largest number of vans ever built by this Division was produced in 1985. Of the 3,744 trailers manufactured, some 3,039 were vans. J. B. Hunt Transportation, Inc. was again the customer who placed the largest order with Lufkin Industries, as it was in 1984.

The dump trailer business in 1985 was almost a duplicate of that in 1984. It is expected that several states served by this Division will be upgrading their highways. That, in addition to new construction, may increase the dump trailer business in 1986.

At the end of 1985, this Division had a surplus of used trailers taken in as trades for new trailer sales.

The truck-trailer industry nationwide continued to upgrade their fleets during 1985 as a result of the passage of the federal Surface Transportation Act of late 1982 which allowed longer and wider trailers on interstate highways. Prior to the passage of this federal legislation, the trucking industry throughout the United States had been languishing. Following this legislation, fleet owners began replacing their smaller trailers with new, longer models.

The Trailer Division's engineering department had designed a new high cube van that would meet the specifications called for in the federal Act, and it was ready for production. When Congress passed the Act, the Trailer Division had what fleet owners needed. This high cube van is still a best seller.

In addition to the high cube van, the engineering group designed a new lightweight, high-strength flatbed trailer that has been accepted in the market. Sales of this trailer were fairly good in 1985, even though this market has been somewhat depressed throughout the country.

The industry-wide forecast for 1986 predicts trailer sales to be down 15 to 20 percent. However, LUFKIN's business appears good. The Division has a backlog of orders, with van production booked through May and with good orders on hand into July. Flatbeds and dumps continue to be soft and are expected to remain that way for awhile.

Some 50 sales, service and parts personnel are employed in the Trailer Division in its home and branch offices in nine locations. These are in Atlanta, Georgia; Memphis, Tennessee; Oklahoma City, Oklahoma; Shreveport, Louisiana; and in Dallas, Houston, Lubbock, San Antonio and Lufkin, Texas.

Left: The Dallas skyline is the backdrop for a LUFKIN dump trailer. Above: Van orders of all types constituted 81 percent of the trailers manufactured during 1985

INDUSTRIAL SUPPLIES DIVISION

Sales volume for the Industrial Supplies Division was down in 1985 to $6.7 million compared to $7.2 million in 1984. This drop in sales was attributed to increased competitive conditions in the supply business.

The Industrial Supplies Division is located in Lufkin and operates from one warehouse containing approximately 120,000 square feet. A portion of this space is used for administrative operations.

The Division is essentially a wholesale supplier of heavy hardware items, plumbing fixtures, pole line hardware and miscellaneous industrial items.

Sales of the Division are made at the Company's facilities in Lufkin through some six salesmen, two of whom handle sales to the Machinery Division and Trailer Division of the Company, while four salesmen call on the trade throughout the East Texas area.

The largest and most important accomplishment in 1985 was the installation of a distribution control system which is a computer software package designed specifically for supply houses.

The data base for the system was begun in March, 1985, and the installation was completed in September. Of special interest is the fact that all three major areas (inventory control, purchasing and billing) were converted simultaneously, an extremely aggressive approach.

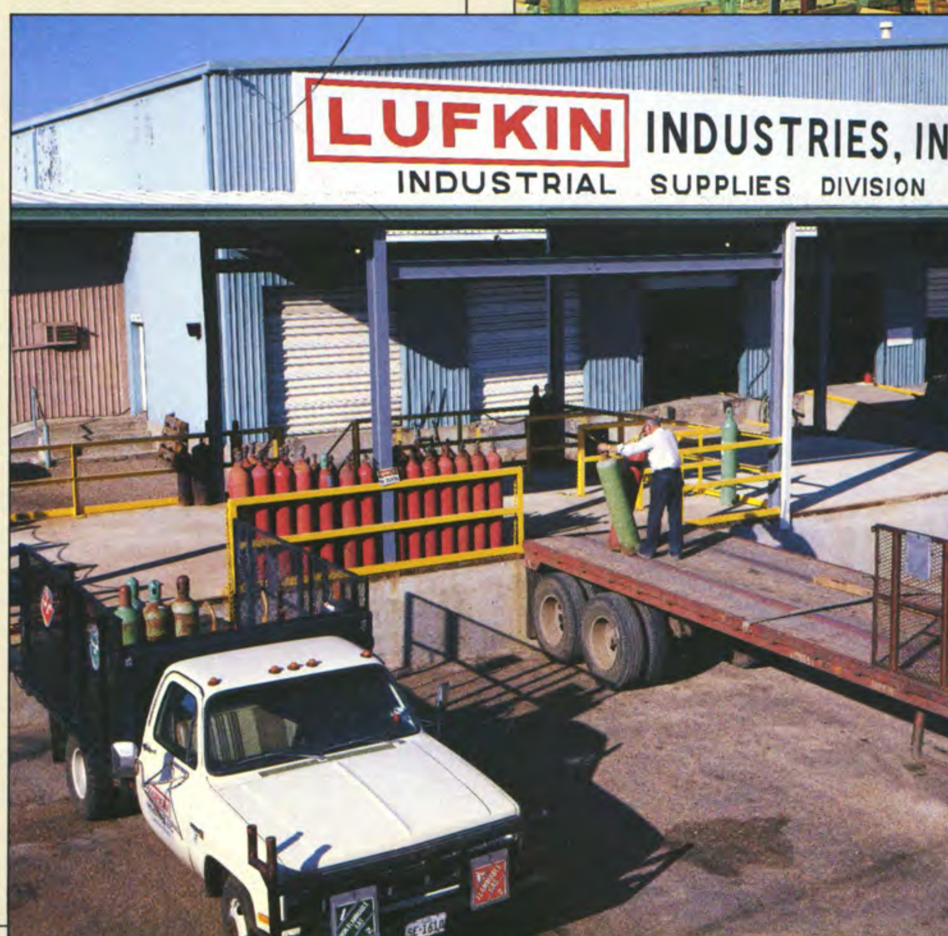
Results of this conversion have been significant. Already, product lines that need to be turned more often have been identified as well as specific items within product lines. The daily monitoring of invoices has allowed errors in markup to be corrected immediately. Invoicing has become more legible, accurate and price consistent. Also, the assignment of part numbers and warehouse location has decreased the amount of back orders and shipping errors, and the cycle count program has identified problem areas in the warehouse.

With the installation of the distribution control system, sales volume is expected to increase because current information on the turn ratio and gross margin can be ascertained daily and the proper balance between these two can be kept in proper perspective. It is hoped that overall inventory turning will increase in 1986.

Another improvement in the Division included a new gasses dock for the furnishing of oxygen, acetylene, etc. to other areas of the plant, resulting in cost savings to the company. It is planned to seek outside sales opportunities in 1986 to enhance the overall gas program.

A new plumbing showroom is scheduled for completion in 1986.

Cautious optimism is expressed by management of this Division concerning business in 1986. Should the lower interest rates spark a rebound in new housing starts, then the plumbing sales of the Division would be affected favorably, as would its pole line hardware and lumber related industrial sales.



**Above: A new gas dock was installed to furnish gasses to company manufacturing areas.
Right: Installation of a distribution control system enhanced operations in the warehouse**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FINANCIAL REVIEW & FINANCIAL STATEMENTS

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Opposite: A LUFKIN crank-balanced unit is a lone sentinel in the cold reaches of Wyoming

(Photo by David Freeze)


LUFKIN

Financial Review

Description of Business

The Company was incorporated under the laws of Texas on March 4, 1902 and has since that date maintained its principal office and manufacturing facilities in Lufkin, Texas. The Company's operations are divided into three divisions, the Machinery Division, Trailer Division and Industrial Supplies Division, which correspond to the Company's principal industry segments.

Machinery Division

The Company's Machinery Division designs, manufactures, sells, and services various types of oilfield pumping units as well as industrial and marine gears. Lufkin manufactures four basic types of pumping units: an air balanced unit; a beam balanced unit; a crank balanced unit; and a Mark II Unitorque unit. The basic differences between the four types relate to the counterbalancing system. The depth of a well and the desired fluid production determine the type of counterbalancing configuration that is required. There are numerous sizes and combinations of Lufkin oilfield pumping units within the four basic types. The Company's gears (speed increasers and reducers) are designed, manufactured, and sold primarily for use in marine propulsion units and for use in conjunction with machinery in heavy industries such as the steel, rubber, paper and sugar industries. The Company produces numerous sizes and combinations of gears.

The Company manufactures most of the component parts used in its products and purchases the raw materials and outside manufactured parts from a variety of suppliers on an order basis. The inventory of the Machinery Division consists primarily of raw materials and component parts which are generally assembled into finished products to fill specific customer orders. These finished products are sold by the division's own employees directly to the domestic petroleum, manufacturing and ship-building industries.

Oilfield pumping units are the Company's primary products sold in export. These sales, other than to Canada, are made principally through foreign sales representatives, licensees and distributors. During 1985, foreign sales accounted for approximately 16 percent of the Company's total net sales. While foreign sales are generally more profitable, they are subject to the risk of fluctuations in foreign import duties and taxes.

The domestic and international markets for the products of the Company's Machinery Division are highly competitive with price, quality and the speed of delivery being important factors. While the Company believes that it is one of the larger manufacturers of sucker rod pumping units in the United States, manufacturers of other types of units (submersibles and hydraulics) have a significant share of the total pumping unit market. The Company does not believe it is a significant factor in the gear market.

Trailer Division

The Company designs, manufactures, sells and services a variety of van, flatbed, and dump trailers, ranging in length from 24 to 50 feet and having capacities up to 75,000 pounds in flatbeds, 60,000 pounds in vans, and 30 cubic yards in dump trailers. Manufacturing operations are keyed mainly to specific customer orders.

The Trailer Division is also involved in repairing and selling used trailers which the Company receives in connection with the sale of its new trailers. The Company has trailer sales and service facilities in Atlanta, Georgia; Oklahoma City, Oklahoma; Memphis, Tennessee; and Lufkin, Dallas, San Antonio, Houston and Lubbock, Texas.

The Company uses a sales force of approximately 30 employees to distribute its trailers, primarily in the South. The Company also markets trailers through dealers. The Company's trailers are sold to a large number of customers, including trucking concerns operating nationally.

The truck trailer market is extremely competitive and the Company's products compete directly with those of other manufacturers, a number of which are larger and have greater resources than the Company. Price, quality, speed of delivery, and financing are primary competitive factors. The Company does not believe it is a significant factor in the market for truck trailers either in the South or nationally.

Industrial Supplies Division

The Industrial Supplies Division is essentially a wholesale supplier of heavy hardware items, plumbing fixtures, pole line hardware, and miscellaneous industrial items.

The division's sales are made at the Company's facilities in Lufkin and through five salesmen. Sales are primarily in the East Texas area and the division is not a substantial factor in the markets in which it competes.

General Information

Properties. The Company's major manufacturing facilities are located in and near Lufkin and are owned in fee.

Machinery Division—The Machinery Division is located on approximately 150 acres and includes a foundry, machine shop, structural shops, assembly shops and warehouses.

The Company also has a plant in Nisku, Canada which produces structural parts for pumping units. These parts are then assembled with parts shipped from Lufkin and are delivered to the Company's Canadian customers.

Trailer Division—The Company's trailer manufacturing facilities are located on a 60-acre portion of a 400-acre tract of land owned in fee by the Company and consist of one large building with a floor area of approximately eight acres. The plant operations are highly automated and consist principally of fabrication, welding and assembly activities.

Industrial Supplies Division—The Industrial Supplies Division has one warehouse which is located in Lufkin and contains approximately 120,000 square feet. A portion of this space is used for administrative operations.

Employees. The Company employs approximately 2,600 people, of whom approximately 1,800 are hourly paid. The Company has an open shop contract with three labor unions, all members of the AFL-CIO, which runs to September 30, 1986. The Company considers employee relations to be satisfactory.

Information on Voting Stock

There is no active market in the Company's common stock. As of February, 1986, the Company had approximately 1,200 record holders of its common stock.

Lufkin has paid cash dividends for 46 consecutive years. Total dividend payments were $18,911,000 in 1985 and $17,192,000 in 1984.

Quarterly Financial Data

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1985				
Net sales	$57.3	$61.4	$58.4	$64.8
Gross income	11.8	14.5	12.8	19.3**
Net earnings	5.3	6.1	5.8	11.4**
Earnings per share	3.11	3.54	3.39	6.60**
Dividends per share	2.75	2.75	2.75	2.75*
1984				
Net sales	$51.5	$61.0	$64.6	$80.9
Gross income	13.3	14.5	17.7	19.6
Net earnings	6.2	6.6	17.6***	10.6
Earnings per share	3.61	3.83	10.23***	6.16
Dividends per share	2.50	2.50	2.50	2.50

*Dividend distributed on January 2, 1986 to stockholders of record on December 1, 1985.

**A liquidation of LIFO inventories occurring during the fourth quarter of 1985 resulted in an increase in gross income during the quarter.

***Third quarter net earnings were increased by $8,397,000 as a result of a credit to income tax expense reflecting the change in the tax law (Tax Reform Act of 1984) which allowed the undistributed earnings of the Company's DISC subsidiary to be treated as previously taxed income, and therefore, escape tax permanently.

Additional Financial Information

Stockholders may obtain additional financial information for the year ended December 31, 1985 from the Company's Form 10-K Report filed with the Securities and Exchange Commission. A copy of this report may be obtained by written request to The Secretary, Lufkin Industries, Inc., P.O. Box 849, Lufkin, Texas 75901.

This report is presented for the general information of the stockholders and not in connection with the sale or offer to sell or solicitation of any offer to buy any securities nor is it intended as a representation by the Company of the value of any of its securities.

BUSINESS SEGMENT INFORMATION

(In thousands of dollars)	**1985**	1984	1983
Net sales:			
Machinery Division			
Pumping units	**$152,588**	$168,070	$108,577
Gears	**21,224**	21,043	18,213
Trailer Division	**61,349**	61,708	36,585
Industrial Supplies Division	**6,733**	7,185	7,031
Total net sales	**241,894**	258,006	170,406
Operating income:			
Machinery Division	**34,304**	42,154	25,376
Trailer Division	**4,051**	4,827	317
Industrial Supplies Division	**(408)**	61	333
Total operating income	**37,947**	47,042	26,026
Assets:			
Machinery Division	**131,342**	141,336	128,257
Trailer Division	**47,325**	45,340	33,776
Industrial Supplies Division	**5,093**	4,899	5,125
General corporate assets	**108,711**	93,559	98,907
Total assets	**292,471**	285,134	266,065
Capital expenditures:			
Machinery Division	**10,571**	9,349	4,836
Trailer Division	**742**	926	109
Industrial Supplies Division	**385**	40	49
General corporate	**1,626**	2,314	106
Total capital expenditures	**13,324**	12,629	5,100
Depreciation:			
Machinery Division	**8,144**	7,604	7,392
Trailer Division	**529**	462	420
Industrial Supplies Division	**112**	113	116
General corporate	**956**	699	644
Total depreciation	**9,741**	8,878	8,572
Net sales by geographic region:			
United States	**203,901**	213,058	138,774
Canada	**17,334**	22,339	15,132
Latin America	**10,258**	13,037	6,301
Other regions	**10,401**	9,572	10,199
Total net sales	**$241,894**	$258,006	$170,406

MANAGEMENT'S ANALYSIS OF OPERATING RESULTS AND FINANCIAL CONDITION

Operating Results

Net sales as well as earnings were down in 1985. Sales for 1985 were $241.9 million, compared to $258.0 million in 1984, a decrease of 6%. Sales for 1984 had increased 51% from 1983 sales totaling $170.4 million. Net earnings decreased 30% from $41.0 million in 1984 to $28.6 million in 1985. This followed a 109% increase in earnings in 1984. The decrease in sales in 1985 was primarily in the Machinery Division's pumping unit products.

The pumping unit sales decrease is primarily attributable to a reduced level in the number of active drilling rigs in the United States during 1985. In addition, the number of pumping units shipped during 1985 decreased 17% as compared to 1984. The decline in the number of units shipped was offset by the increase in the average unit size shipped during 1985 resulting in an overall decrease of 9% in pumping units sales in 1985 as compared to 1984.

Due to the uncertainty of oil prices and the supply/demand imbalance of oil, the Company is unsure of prospects for 1986 and beyond. Improvement in the Company's sales of pumping units is dependent on improved drilling activity which is conditional on continued recovery in demand for oil and stable oil prices.

The operating income of the Machinery Division decreased 19% in 1985 after increasing 66% in 1984. Operating income as a percent of net sales decreased in the Machinery Division from 22% in 1984 to 20% in 1985. The reduction resulted from the reduced sales volume of pumping units in 1985.

The Trailer Division's sales decreased 1% from $61.7 million in 1984 to $61.3 million in 1985. Trailer sales in 1984 were a record and increased 69% from 1983. This increase in demand of trailers for the past two years resulted primarily from improved economic conditions of the customers served as well as new regulations allowing larger trailers on Federal highways.

The Trailer Division's net operating income decreased 16% from $4.8 million in 1984 to $4.1 million in 1985. It had increased from $.3 million in 1983 as a result of the significant increase in sales volume in 1984. The decrease in net operating income in 1985 was caused by the increased competitive conditions in the trailer industry and the resulting price reductions.

Orders for trailers began to increase significantly in the last half of 1983 and a backlog of approximately six months in most trailer models existed at the beginning of 1986. The Company feels that trailer sales will continue to be strong throughout 1986.

While sales decreased in 1985, net earnings decreased 30% after increasing 109% in 1984. Part of the increase in 1984 earnings was attributable to a credit of $8,397,000 to tax expense as a result of a change in the tax law (The Tax Reform Act of 1984), which treated the undistributed earnings of the Company's DISC subsidiary as previously taxed income and therefore, they escaped tax permanently. Net earnings as a percent of net sales decreased to 11.8% in 1985 as compared to 15.9% in 1984 and 11.5% in 1983. This decrease was primarily attributable to the effect of the change in the tax law during 1984.

Liquidity and Capital Resources

At December 31, 1985, the Company had working capital of $126,999,000 as compared to $113,274,000 at December 31, 1984 and $94,745,000 at December 31, 1983.

The Company believes that existing working capital is sufficient to satisfy its 1986 requirements. In recent years, the expansion of the Company's facilities has been financed with internally generated funds and the Company plans financing any expansion and improvements of its facilities in this manner.

The impact of inflation on the Company is discussed in Note 7 of the Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEET

December 31, 1985 and 1984
(Thousands of dollars)

Assets	1985	1984
Current assets:		
Cash	**$ 3,539**	$ 3,808
Temporary investments	**57,013**	38,456
Accounts receivable, less allowance of $225,000	**33,863**	43,681
Installment notes and contracts receivable, less allowance of $75,000	**28,330**	24,175
Inventories	**22,111**	27,177
Total current assets	**144,856**	137,297
Property, plant and equipment:		
Land	**7,947**	7,483
Buildings	**48,546**	47,344
Machinery and equipment	**118,542**	107,596
	175,035	162,423
Less accumulated depreciation	**65,712**	56,683
Net property, plant and equipment	**109,323**	105,740
Investments in marketable securities	**37,987**	41,883
Other assets	**305**	214
	$292,471	$285,134

Liabilities and Stockholders' Equity

	1985	1984
Current liabilities:		
Accounts payable	**$ 8,080**	$ 12,036
Accrued liabilities:		
Payrolls	**1,544**	1,395
Contributions to pension plans	**1,869**	4,613
Taxes	**1,636**	1,681
Dividends declared	**4,728**	4,298
Total current liabilities	**17,857**	24,023
Deferred income taxes	**20,421**	16,622
Stockholders' equity:		
Common stock, par $1 per share; 4,000,000 shares authorized; 1,719,210 issued	**1,719**	1,719
Capital in excess of par	**15,555**	15,555
Retained earnings	**236,919**	227,215
Total stockholders' equity	**254,193**	244,489
	$292,471	$285,134

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF EARNINGS

Years ended December 31, 1985, 1984 and 1983
(Thousands of dollars)

	1985	1984	1983
Net sales	**$241,894**	$258,006	$170,406
Cost and expenses:			
Cost of sales	**183,511**	192,885	127,752
Selling, general and administrative expenses	**20,436**	18,078	16,629
Interest income	**(10,888)**	(11,275)	(9,714)
Interest expense	**236**	267	187
Other, net	**329**	16	224
	193,624	199,971	135,078
Earnings before income taxes	**48,270**	58,035	35,328
Income taxes	**19,655**	17,062	15,755
Net earnings	**$ 28,615**	$ 40,973	$ 19,573
Earnings per share	**$ 16.64**	$ 23.83	$ 11.38

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Years Ended December 31, 1985, 1984 and 1983
(Thousands of dollars)

	Common Stock		Capital In Excess	Retained
	Shares	Amount	of Par	Earnings
Balance December 31, 1982	1,719,210	$1,719	$15,555	$199,334
Net earnings				19,573
Cash dividends, $9.00 per share				(15,473)
Balance December 31, 1983	1,719,210	1,719	15,555	203,434
Net earnings				40,973
Cash dividends, $10.00 per share				(17,192)
Balance December 31, 1984	1,719,210	1,719	15,555	227,215
Net earnings				28,615
Cash dividends, $11.00 per share				(18,911)
Balance December 31, 1985	1,719,210	$1,719	$15,555	$236,919

See notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1985, 1984 and 1983
(Thousands of dollars)

	1985	1984	1983
Source of funds:			
From operations:			
Net earnings	**$ 28,615**	$ 40,973	$ 19,573
Expenses not currently requiring outlay of working capital:			
Depreciation	**9,741**	8,878	8,572
Deferred income taxes	**3,799**	(2,243)	5,062
Funds generated from operations	**42,155**	47,608	33,207
Decrease in marketable securities and other assets	**3,805**	2,742	—
Total funds provided	**45,960**	50,350	33,207
Use of funds:			
Net additions to property, plant and equipment	**13,324**	12,629	5,100
Dividends	**18,911**	17,192	15,473
Reduction in long-term debt	**—**	2,000	500
Increase in marketable securities and other assets	**—**	—	26,119
Total funds used	**32,235**	31,821	47,192
Increase (decrease) in working capital	**$ 13,725**	$ 18,529	$ (13,985)
Working capital increase (decrease) resulted from changes in:			
Cash	**$ (269)**	$ 339	$ 692
Temporary investments	**18,557**	(4,560)	(16,692)
Accounts receivable	**(9,818)**	13,461	(2,570)
Installment notes and contracts receivable	**4,155**	7,726	6,196
Inventories	**(5,066)**	1,094	(4,432)
Accounts payable	**3,956**	(5,249)	(1,717)
Accrued liabilities	**2,210**	5,718	4,538
Increase (decrease) in working capital	**$ 13,725**	$ 18,529	$ (13,985)

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of major accounting policies

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions. The Company has reclassified certain amounts as previously reported in the 1984 consolidated financial statements to conform to 1985 financial statement presentation.

Temporary investments and investments in marketable securities: In the accompanying balance sheet, temporary investments are carried at cost, which approximates market. The investment in marketable securities consisting of corporate and tax exempt bonds, government securities, common and preferred stock and guaranteed investment contracts is carried at cost and had a market value of $38,216,000 and $40,539,000 at December 31, 1985 and 1984, respectively. In management's opinion, there is no permanent impairment in value and there is no present intention to liquidate these securities at less than cost.

Installment notes and contracts receivable: A portion of the Company's sales is made on notes and conditional sales contracts which are payable on an installment basis over a period generally from three to five years. The profit from such sales is included in income at the time of sale for financial reporting purposes; however, for tax purposes such profit is recognized as installments are collected. The amounts due after one year ($18,813,000 at December 31, 1985 and $16,036,000 at December 31, 1984) are included in current assets in accordance with trade practice.

Inventories: The Company uses the last-in, first-out (LIFO) method of determining inventory cost, which does not exceed market, for substantially all inventories. Inventory costs include material, labor and factory overhead.

Property, plant and equipment: The Company records investments in these assets at cost. Improvements are capitalized, while repair and maintenance costs are charged to operations as incurred. Gains or losses realized on the sale or retirement of these assets are reflected in income.

The Company uses the straight-line depreciation method for financial reporting and accelerated methods for tax purposes.

Income taxes: The Company provides for United States taxes that may ultimately be payable on all undistributed foreign earnings. Provision is also made in the financial statements for the deferred taxes applicable to depreciation, income on installment notes and contracts receivable and other timing differences between financial and tax reporting methods. Current recognition is given in the statement of earnings to tax benefits resulting from investment tax credits using the flow-through method.

Earnings per share: Earnings per share amounts are based on the weighted average number of shares of common stock outstanding during the period.

(2) Retirement plans

The Company and its subsidiaries have retirement plans covering substantially all employees. The total unamortized prior service costs at January 1, 1985, the date of the latest actuarial valuation, was estimated to be $985,000. The total pension expense was $1,890,000 in 1985, $4,613,000 in 1984 and $5,541,000 in 1983, including amortization of prior service costs principally over a 10-year period. The amount provided each year for pension expense is paid into pension trust funds.

A comparison of accumulated plan benefits, calculated using an estimated rate of return of 7.0% in 1985 and 4.5% in 1984, and net assets for the plans are as follows:

	(In thousands) January 1	
	1985	1984
Actuarial present value of accumulated plan benefits		
Vested	**$36,521**	$38,814
Nonvested	**1,780**	3,089
	$38,301	$41,903
Net assets available for benefits	**$61,401**	$54,383

(3) Income taxes

The income tax provision for 1985, 1984 and 1983 consisted of the following:

	(Thousands of dollars)		
	1985	1984	1983
Amounts currently payable	**$15,856**	$19,305	$10,693
Amounts deferred	**3,799**	(2,243)	5,062
	$19,655	$17,062	$15,755

A reconciliation of the provision for income taxes to the United States tax rate of 46% of earnings before income taxes is as follows:

	(Thousands of dollars)		
	1985	1984	1983
Taxes computed at statutory rate	**$22,204**	$26,696	$16,250
Investment tax credits	**(959)**	(483)	(234)
Taxes previously provided on DISC*	—	(8,397)	—
Other, net	**(1,590)**	(754)	(261)
Actual provision	**$19,655**	$17,062	$15,755

The Company provides deferred taxes for timing differences between financial and taxable income as follows:

	(Thousands of dollars)		
	1985	1984	1983
Excess of tax depreciation over book depreciation	**$ 3,486**	$ 3,207	$ 3,156
DISC earnings not currently subject to tax	**(231)**	(6,087)	1,969
Income on installment notes	**544**	637	(63)
	$ 3,799	$(2,243)	$ 5,062

*In prior years, the Company provided deferred taxes on the undistributed earnings of its DISC subsidiary. The Tax Reform Act of 1984 treats these undistributed earnings as previously taxed income, and therefore, they escape tax permanently.

(4) Inventories

Inventories used in determining cost of sales were as follows:

	(Thousands of dollars)			
	1985	1984	1983	1982
Finished goods	**$ 5,865**	$ 5,670	$ 5,054	$ 5,906
Work in process	**9,085**	11,597	10,391	11,218
Raw material	**7,161**	9,910	10,638	13,391
	$22,111	$27,177	$26,083	$30,515

Had the FIFO method been used in determining inventory values, inventories would have been $28,424,000, $30,936,000, $29,693,000, and $36,996,000 higher at December 31, 1985, 1984, 1983 and 1982, respectively.

During 1985 and 1983, inventory quantities were reduced. These reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with the cost of 1985 and 1983 purchases. The effect of these liquidations increased net earnings by approximately $2,409,000 or $1.40 per share in 1985 and $4,350,000 or $2.53 per share in 1983.

(5) Supplementary income statement information

The following costs and expenses were charged to income during 1985, 1984, and 1983:

	(Thousands of dollars)		
	1985	1984	1983
Maintenance and repairs	**$5,816**	$5,047	$5,311
Depreciation	**9,741**	8,878	8,572

(6) Business segment information

Information concerning the Company's various business segments is included on Page 16 of this report.

(7) Supplemental information on the effects of inflation (Unaudited)

The following supplementary financial information discloses certain effects of inflation on the Company's historical cost financial statements. Current cost calculations involve a number of judgments as well as use of various estimating techniques and, therefore, may not accurately reflect the impact of inflation on the Company's business.

The supplemental data on a current cost dollar basis are expressed in year-end 1985 dollars and reflect adjustments to the historical financial statements for changes which have occurred in the purchasing power of the dollar and adjustments to reflect a current cost of inventories and property, plant and equipment of $47,119,000 and $162,772,000, respectively.

Current cost depreciation is based on the average current cost of properties held during the year. The depreciation methods and useful lives are the same as those used in preparing the primary financial statements.

Consolidated Statement of Earnings
Adjusted for Changing Prices
for the Year Ended December 31, 1985

(Thousands of dollars)	As Reported in Financial Statements	Adjusted for Changes in Specific Prices
Net sales	$241,894	$241,894
Cost of sales excluding depreciation	175,622	179,549
Depreciation	9,741	14,644
Other operating expenses	8,261	8,261
Income taxes	19,655	19,655
Net earnings	28,615	19,784
Loss from decline in purchasing power due to increase in net monetary assets		4,310
Decrease in specific prices of inventories and property and equipment, net		3,244
Effect of increase in general price level		1,755
Total of decrease in specific prices and increase in general price level		4,999

Five Year Comparison of Selected Supplementary
Financial Data Adjusted for Effects of Changing
Prices in Average 1985 Dollars

(Thousands of dollars, except per share amounts)	Years Ended December 31				
	1985	1984	1983	1982	1981
Net sales	**$241,894**	$258,006	$170,406	$309,664	$364,443
Net earnings	**19,784**	36,829	8,577	38,139	
Increase (decrease) in specific prices of inventories and property, plant and equipment, net of inflation	**(3,244)**	8,724	(9,816)	6,393	
Earnings per share	**11.51**	21.42	4.99	22.03	
Net assets at year end	**332,650**	326,338	298,724	302,065	
Other information: Purchasing power loss of net monetary items	**(4,310)**	(3,865)	(3,198)	(2,458)	
Dividends per share	**11.00**	10.00	9.00	10.00	9.00
Average consumer price index (1967=100)	**322.2**	311.1	298.4	289.1	272.3

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of Lufkin Industries, Inc.

We have examined the consolidated balance sheet of Lufkin Industries, Inc. (a Texas corporation), and subsidiaries as of December 31, 1985 and 1984 and the related consolidated statements of earnings, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. 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 accompanying consolidated financial statements present fairly the financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 1985 and 1984, and the results of their operations and the changes in their financial position for each of three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

ARTHUR ANDERSEN & CO.

Houston, Texas
February 14, 1986

DIRECTORS AND OFFICERS

Board of Directors

*S.W. Henderson, Jr.
S.W. Henderson, III
J.G. Kurth
*M.E. Kurth, Jr.
W.T. Little
*R.L. Poland
F.B. Stevenson
H.J. Trout, Jr.
*W.W. Trout, Jr.
*J.L. Wiener
J.L. Wiener, Jr.
Samson Wiener

*Member Executive Committee

Officers

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President, Chief Executive Officer

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C.J. Haley, Jr.
Secretary-Treasurer

R.E. Myers, Jr.
Assistant Secretary

J.B. Massingill
Assistant Treasurer

Opposite: This LUFKIN crank-balanced unit pumps among the flora of Central Texas near Caldwell
(Photo by David Freeze)


LUFKIN

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