

STEWART & STEVENSON SERVICES INC

Form 10-Q

September 04, 2003

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 2, 2003

OR

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

For the transition period from to

Commission file number 0-8493

STEWART & STEVENSON SERVICES, INC.

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of
incorporation or organization)

74-1051605

(I.R.S. Employer
Identification No.)

2707 North Loop West, Houston, Texas

(Address of principal executive offices)

77008

(Zip Code)

(713) 868-7700

(Registrant's telephone number, including area code)

not applicable

(Former name, former address and former fiscal year,
if changed since last report)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, Without Par Value
(Class)

28,572,414 Shares
(Outstanding at August 15, 2003)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

The following information required by Rule 10-01 of Regulation S-X is provided herein for Stewart & Stevenson Services, Inc. and Subsidiaries (collectively, the Company):

Consolidated Condensed Balance Sheets August 2, 2003 and January 31, 2003.

Consolidated Condensed Statements of Earnings Three and Six Months Ended August 2, 2003 and August 3, 2002.

Consolidated Condensed Statements of Cash Flows Three and Six Months Ended August 2, 2003 and August 3, 2002.

Notes to Consolidated Condensed Financial Statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except share data)

	August 2, 2003 (Unaudited)	January 31, 2003 (Audited)
Assets		
Current Assets:		
Cash and cash equivalents	\$ 80,442	\$ 107,994
Accounts and notes receivable, net	151,285	151,839
Recoverable costs and accrued profits not yet billed	44,489	11,668
Inventories	237,660	244,416
Excess of current cost over LIFO values	(43,401)	(42,785)
Deferred income tax asset	16,004	16,126
Other current assets	8,423	3,967
Total assets of discontinued operations	8,861	14,404
Total Current Assets	503,763	507,629
Property, Plant and Equipment, net	118,781	118,964
Deferred Income Tax Asset	13,572	11,754
Intangibles and Other Assets, net	15,197	14,288
Total Assets	\$ 651,313	\$ 652,635
Liabilities and Shareholders' Equity		
Current Liabilities:		
Notes payable	\$ 2,546	\$ 1,454
Current portion of long-term debt	250	30,250
Accounts payable	74,121	60,159
Accrued payrolls and incentives	14,773	17,408
Billings in excess of incurred costs	71,611	62,568
Other current liabilities	34,412	29,537
Total liabilities of discontinued operations	3,021	4,092
Total Current Liabilities	200,734	205,468
Long-Term Debt, net	26,531	26,531
Accrued Postretirement Benefits and Pension	57,972	54,681
Other Long-Term Liabilities	4,042	3,947
Total Liabilities	289,279	290,627
Shareholders' Equity:		
Common stock, without par value, 100,000,000 shares authorized; 28,564,414 and 28,490,849 shares issued, respectively	56,085	54,843
Accumulated other comprehensive loss	(21,980)	(21,703)
Retained earnings	327,929	328,868
Total Shareholders' Equity	362,034	362,008
Total Liabilities and Shareholders' Equity	\$ 651,313	\$ 652,635

See accompanying notes to consolidated condensed financial statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF EARNINGS
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
	(Unaudited)		(Unaudited)	
Sales	\$ 312,851	\$ 285,035	\$ 602,623	\$ 584,705
Cost of sales	272,190	243,158	521,082	499,076
Gross profit	40,661	41,877	81,541	85,629
Selling and administrative expenses	36,515	35,063	71,824	70,487
Pension curtailment expense			2,400	
Interest expense	693	837	1,936	1,969
Interest and investment income	(559)	(374)	(1,059)	(712)
Other income, net	(564)	(492)	(476)	(513)
	36,085	35,034	74,625	71,231
Earnings from continuing operations before income taxes	4,576	6,843	6,916	14,398
Income tax provision	1,348	2,236	2,029	4,895
Net earnings from continuing operations before cumulative effect of change in accounting principle	3,228	4,607	4,887	9,503
Loss from discontinued operations, net of tax of \$(284), \$(2,649), \$(710) and \$(3,248)	(158)	(5,503)	(982)	(6,600)
Loss from disposal of discontinued operations, net of tax of \$(2,705)		(5,551)		(5,551)
Cumulative effect of change in accounting principle, net of tax of \$(1,798)				(3,682)
Net earnings (loss)	\$ 3,070	\$ (6,447)	\$ 3,905	\$ (6,330)
Weighted average shares outstanding:				
Basic	28,522	28,483	28,507	28,469
Diluted	28,967	28,754	28,804	28,761
Earnings (loss) per share:				
Basic:				
Continuing operations before cumulative effect	\$ 0.11	\$ 0.16	\$ 0.17	\$ 0.33
Loss from discontinued operations, net		(0.39)	(0.03)	(0.43)
Cumulative effect of change in accounting principle				(0.13)
Net earnings (loss) per share	\$ 0.11	\$ (0.23)	\$ 0.14	\$ (0.22)
Diluted:				
Continuing operations before cumulative effect	\$ 0.11	\$ 0.16	\$ 0.17	\$ 0.33

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Loss from discontinued operations, net			(0.38)		(0.03)		(0.42)
Cumulative effect of change in accounting principle							(0.13)
Net earnings (loss) per share	\$	0.11	\$	(0.22)	\$	0.14	\$ (0.22)
Cash dividends per share	\$	0.085	\$	0.085	\$	0.170	\$ 0.170

See accompanying notes to consolidated condensed financial statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
	(Unaudited)		(Unaudited)	
Operating Activities				
Net earnings (loss)	\$ 3,070	\$ (6,447)	\$ 3,905	\$ (6,330)
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:				
Net loss from discontinued operations	158	11,054	982	12,151
Cumulative effect of change in accounting principle				3,682
Depreciation and amortization	5,679	5,575	11,221	10,427
Change in operating assets and liabilities net of the effect of acquisitions and discontinued operations:				
Accounts and notes receivable, net	(3,887)	23,727	697	21,379
Recoverable costs and accrued profits not yet billed	(29,187)	(3,787)	(32,821)	(4,768)
Inventories	12,796	(7,545)	7,373	(12,698)
Other current and noncurrent assets	(5,245)	(3,165)	(6,879)	8,699
Accounts payable	16,988	2,610	13,962	(23,015)
Accrued payrolls and incentives	(4,806)	(3,420)	(2,289)	(4,229)
Billings in excess of incurred costs	7,413	23,209	9,043	28,113
Other current liabilities	1,465	1,117	4,944	8,491
Accrued postretirement benefits and pension	(539)	1,114	3,283	2,019
Other long-term liabilities	(290)	(553)	(241)	(749)
Net Cash Provided By Continuing Operations	3,615	43,489	13,180	43,172
Net Cash Provided By (Used In) Discontinued Operations	212	(2,372)	3,490	(4,583)
Net Cash Provided By Operating Activities	3,827	41,117	16,670	38,589
Investing Activities				
Expenditures for property, plant and equipment	(7,855)	(6,807)	(11,552)	(16,802)
Acquisition of businesses			(409)	
Disposal of property, plant and equipment, net	202	804	596	1,349
Net Cash Used In Investing Activities	(7,653)	(6,003)	(11,365)	(15,453)
Financing Activities				
Change in short-term notes payable	20	(985)	1,092	(1,033)
Payments on long-term borrowings	(30,000)		(30,000)	
Dividends paid	(2,423)	(2,417)	(4,845)	(4,835)
Proceeds from exercise of stock options	855	311	896	635
Net Cash Used In Financing Activities	(31,548)	(3,091)	(32,857)	(5,233)

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Increase (decrease) in cash and cash equivalents	(35,374)		32,023		(27,552)		17,903
Cash and cash equivalents, beginning of period	115,816		67,318		107,994		81,438
Cash and cash equivalents, end of period	\$ 80,442	\$	99,341	\$	80,442	\$	99,341

Cash Paid For:

Interest	\$ 2,257	\$	2,185	\$	2,425	\$	2,534
Income taxes (excluding refunds)	2,907		2,991		3,010		3,463

See accompanying notes to consolidated condensed financial statements.

**STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

Note 1 - Basis of Presentation

The accompanying consolidated condensed financial statements of Stewart & Stevenson Services, Inc. and Subsidiaries (collectively, the Company) have been prepared in accordance with Rule 10-01 of Regulation S-X for interim financial statements required to be filed with the Securities and Exchange Commission and do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. However, the information furnished herein reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results for the interim periods. The results of operations for the three and six months ended August 2, 2003 are not necessarily indicative of the results that will be realized for the fiscal year ending January 31, 2004.

The Company's fiscal year begins on February 1 of the year stated and ends on January 31 of the following year. For example, the Company's Fiscal 2003 commenced on February 1, 2003 and ends on January 31, 2004. The Company reports results on the fiscal quarter method with each quarter comprising approximately 13 weeks.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended January 31, 2003.

The accompanying consolidated condensed financial statements for Fiscal 2002 and related notes contain certain reclassifications to conform with the presentation used in Fiscal 2003.

Note 2 - Comprehensive Income

Total comprehensive income (loss) is as follows (*in thousands*):

	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
Net earnings (loss)	\$ 3,070	\$ (6,447)	\$ 3,905	\$ (6,330)
Unrealized gain (loss) on forward contracts, net of tax	(132)	397	(98)	284
Currency translation gain (loss), net of tax	(287)	(1,239)	(178)	(1,472)
Comprehensive income (loss)	\$ 2,651	\$ (7,289)	\$ 3,629	\$ (7,518)

Note 3 - Segment Information

The Company modified its internal organization structure in 2003. The modifications made were as follows:

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The Utilities Equipment business has been removed from the Airline Products segment and identified as a separate reporting segment. The Utilities Equipment business, which manufactures mobile railcar movers, snowblowers and off-road seismic vehicles, has been consolidated with Distributed Energy Solutions and Petroleum Equipment in the newly formed Engineered Products Division.

Certain business operations, which were exited in 2002, have been reclassified from Other Business Activities to the Power Products segment. This business operation consisted primarily of sales of gas compression equipment.

The marketing services and transportation/logistics business units were reclassified from the Power Products segment to Other Business Activities. These business units provide services to both internal customers and external unaffiliated customers.

Interest and investment income has been removed from segment operating profit (loss) measurements.

The corresponding segment information for Fiscal 2002 has been restated to conform to the new business segment presentation. Intercompany sales have been eliminated in all periods presented.

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Financial information relating to industry segments with a reconciliation to earnings from continuing operations before income taxes is as follows (*in thousands except percentages*):

	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
Sales				
Tactical Vehicle Systems	\$ 108,365	\$ 105,405	\$ 219,342	\$ 220,866
Power Products	126,825	133,522	251,175	282,798
Engineered Products:				
Petroleum Equipment	34,779	8,792	57,839	15,310
Distributed Energy Solutions	20,033	17,832	33,102	29,615
Utilities Equipment	3,436	1,803	6,024	3,387
Airline Products	18,352	15,353	32,596	28,070
Other Business Activities	1,061	2,328	2,545	4,659
Total Sales	\$ 312,851	\$ 285,035	\$ 602,623	\$ 584,705
Operating Profit (Loss)				
Tactical Vehicle Systems	\$ 17,283	\$ 15,577	\$ 35,066	\$ 30,491
Power Products	(5,196)	332	(8,047)	3,607
Engineered Products:				
Petroleum Equipment	1,625	(1,527)	2,233	(2,091)
Distributed Energy Solutions	(2,990)	(2,052)	(6,972)	(4,253)
Utilities Equipment	(923)	(569)	(1,815)	(1,488)
Airline Products	(712)	(993)	(2,704)	(3,207)
Other Business Activities	(527)	221	(1,048)	174
Total Operating Profit	8,560	10,989	16,713	23,233
Corporate expenses, net	(3,850)	(3,683)	(6,520)	(7,578)
Pension curtailment expense			(2,400)	
Interest and investment income	559	374	1,059	712
Interest expense	(693)	(837)	(1,936)	(1,969)
Earnings from continuing operations before income taxes	\$ 4,576	\$ 6,843	\$ 6,916	\$ 14,398
Operating Profit (Loss) Percentage				
Tactical Vehicle Systems	15.9%	14.8%	16.0%	13.8%
Power Products	(4.1)	0.2	(3.2)	1.3
Engineered Products:				
Petroleum Equipment	4.7	(17.4)	3.9	(13.7)
Distributed Energy Solutions	(14.9)	(11.5)	(21.1)	(14.4)
Utilities Equipment	(26.9)	(31.6)	(30.1)	(43.9)
Airline Products	(3.9)	(6.5)	(8.3)	(11.4)
Other Business Activities	(49.7)	9.5	(41.2)	3.7
Consolidated	2.7%	3.9%	2.8%	4.0%

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Selling and administrative expenses in Fiscal 2003 include costs associated with restructuring activities, primarily related to the consolidation of manufacturing operations in the Engineered Products Division and severance and other costs related to the elimination of certain positions in the Power Products and Corporate segments. A summary of restructuring costs incurred for the three and six months ended August 2, 2003 follows (*in thousands*):

	Three Months Ended August 2, 2003	Six Months Ended August 2, 2003
Power Products	\$	\$ 282
Engineered Products:		
Petroleum Equipment	194	367
Distributed Energy Solutions	442	967
Utilities Equipment	289	548
Corporate	1,325	1,737
Total restructuring costs incurred	\$ 2,250	\$ 3,901
Severance costs included in restructuring	\$ 1,300	\$ 2,000

As of August 2, 2003, \$1.8 million of restructuring costs were accrued and expected to be paid in future periods.

Note 4 Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standard Board (FASB) issued Statement Of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that the balance sheet valuation of goodwill and other intangible assets be evaluated for impairment at least annually. Further, it requires that amortization of goodwill cease beginning with the Company's Fiscal 2002. The Company implemented SFAS No. 142 effective February 1, 2002 and, accordingly, net goodwill balances as of such date were tested for impairment by comparing the fair value of each reporting unit to its carrying value. Fair value was determined using discounted estimated future cash flows and market multiples of earnings estimates. Significant estimates used in the methodologies included estimates of future earnings, future growth rates, weighted average cost of capital and market valuation multiples for each reporting unit. Based upon these impairment tests performed upon adoption of SFAS No. 142, the Company recognized, as a cumulative effect of a change in accounting principle in the first quarter of Fiscal 2002, a charge of \$3.7 million, or \$0.13 per diluted share, net of tax benefit of \$1.8 million. This impairment charge primarily related to the Airline Products segment.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which requires companies to recognize costs associated with plant closings or other exit or disposal activities when incurred. Previous guidance required recognition of such costs as a liability as of the date an entity commits to an exit plan. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. Adoption of the new standard impacts the timing of liability recognition related to future exit or disposal activities, but will not have a material effect on the ultimate costs associated with such activities.

In November 2002, the FASB issued Interpretation (FIN) No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, which requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligations undertaken in issuing the guarantee. FIN No. 45 also expands the disclosures required to be made by a guarantor about its obligation under certain guarantees that it has issued. The recognition provisions of FIN No. 45 do not apply to product warranties. Initial recognition and measurement provisions of FIN No. 45 are applicable on a prospective basis to guarantees issued after December 31, 2002. Adoption of the new standard did not have a material effect on the Company's consolidated financial statements.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities, which requires that a company that controls another entity through interests other than voting interests should consolidate such controlled entity. FIN No. 46 applies to variable interest entities created after January 31, 2003, and is effective for interim periods beginning after June 15, 2003 for existing variable interest entities. As the Company has no material exposures to special purpose entities or other off-balance sheet arrangements, the adoption of FIN No. 46 is not expected to have a material effect on the Company's consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation, by providing alternative methods of transition for a voluntary change to the fair value method of accounting for stock options and other stock-based employee compensation. As permitted under SFAS No. 123, the Company continues to use the intrinsic value method of accounting prescribed by APB No. 25, Accounting for Stock Issued to Employees, to account for its stock-based compensation programs. Accordingly, no compensation expense is recognized when the exercise price of an employee stock option is equal to or greater than the market price of the Company's common stock on the grant date.

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The following pro forma data are calculated as if compensation expense for the Company's stock option plans was determined based on the fair value at the grant date for awards under these plans, amortized to expense on a pro rata basis over the option vesting period, in accordance with the methodology prescribed by SFAS No. 123, Accounting for Stock-Based Compensation:

(In thousands, except per share data)	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
Net earnings (loss):				
As reported	\$ 3,070	\$ (6,447)	\$ 3,905	\$ (6,330)
Pro forma compensation expense, determined under fair value method, net of tax	(443)	(503)	(682)	(1,003)
Pro forma	\$ 2,627	\$ (6,950)	\$ 3,223	\$ (7,333)
Basic earnings (loss) per share:				
As reported	\$ 0.11	\$ (0.23)	\$ 0.14	\$ (0.22)
Pro forma	0.09	(0.24)	0.11	(0.26)
Diluted earnings (loss) per share:				
As reported	\$ 0.11	\$ (0.22)	\$ 0.14	\$ (0.22)
Pro forma	0.09	(0.24)	0.11	(0.25)

For purposes of the pro forma disclosures, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Note 5 - Commitments and Contingencies

As a custom packager of power systems, the Company issues bid and performance guarantees in the form of performance bonds or standby letters of credit. As of August 2, 2003 and January 31, 2003, performance type letters of credit totaled approximately \$9.4 million and \$5.7 million, respectively. In addition, the Company had contingent performance indemnities of approximately \$6.7 million as of August 2, 2003 and January 31, 2003.

The Company has provided certain guarantees in support of its customers' financing of purchases from the Company in the form of debt guarantees. Pursuant to such guarantees, once the customer has satisfied its debt obligation to the lender, the Company's guarantee is released. Should a customer fail to meet its obligation to the lender, the lender could require the Company to satisfy such obligation, in which case the Company would have some legal recourse against the customer. The amount of such guarantees is approximately \$0.6 million and \$0.9 million as of August 2, 2003 and January 31, 2003, respectively.

The Company leases certain facilities and equipment from third parties under operating lease arrangements of varying terms whose annual rentals are less than 1% of consolidated sales.

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The Company's government contract operations are subject to U.S. government investigations of business practices and cost classifications from which legal or administrative proceedings can result. Based on government procurement regulations, under certain circumstances a contractor can be fined, as well as suspended or debarred from government contracting. In that event, the Company would also be unable to sell equipment or services to customers that depend on loans or financial commitments from the Export Import Bank, Overseas Private Investment Corporation and similar government agencies during a suspension or debarment.

During Fiscal 1998, the U.S. Customs Service detained a medium tactical vehicle that was being shipped by the Company for display in a European trade show. The Company has been advised that the U.S. Customs Service and the Department of Justice are investigating potential violations by the Company of laws relating to the export of controlled military vehicles, weapons mounting systems and firearms. Such investigation could result in the filing of criminal, civil or administrative sanctions against the Company and/or individual employees and could result in a suspension or debarment of the Company from receiving new contracts or subcontracts with agencies of the U.S. government or the benefit of federal assistance payments.

The Company is a defendant in a suit brought under the *qui tam* provision of the False Claims Act, United States of America, *ex rel. Werner Stebner v. Stewart & Stevenson Services, Inc. and McLaughlin Body Co.*, Civil Action No. H-96-3363, in the United States District Court for the Southern District of Texas, Houston Division. The plaintiff's complaint seeks penalties and damages in an unspecified amount. The suit alleges that the Company made false statements and certifications in connection with claims for payment for Family of Medium Tactical Vehicles delivered to the U.S. Army starting in 1995, and the suit alleges that the vehicles were substandard because of corrosion problems. The suit was filed under seal in 1996, and following an investigation by the Justice Department, the United States declined to intervene in the suit, which was unsealed on August 29, 2000. The case is set for trial in

January 2004. The Company believes the claims in the suit are without merit and is vigorously defending the suit. Nevertheless, an unexpected outcome in the suit could have a material adverse impact on the Company's results of operations, consolidated financial position and liquidity.

The Company is a defendant in a suit brought by several subsidiaries of Diamond Offshore Drilling, Inc. (collectively, Diamond Offshore) on May 30, 2002, arising out of claims relating to a marine riser manufactured by the Company and purchased by Diamond Offshore for use on its Ocean Baroness semi-submersible drilling rig, Cause No. 2002-27831; *Diamond Offshore International Corporation, Diamond Offshore Company, Diamond Offshore Services Company, Diamond Offshore (USA), Inc., Diamond Offshore International Limited, and Diamond Offshore Drilling, Ltd. v. Stewart & Stevenson Services, Inc.*; in the District Court of Harris County, Texas 125th Judicial District Court (the Baroness Litigation). The suit was filed following a separation of the marine riser during deep water drilling operations and seeks to recover damages that are not specified in the complaint.

In a separate transaction on or about September 13, 2001, Diamond Offshore contracted with the Company for a marine riser for use on its Ocean Rover semi-submersible drilling rig. The Company was fulfilling this contract, when, on August 19, 2002, Diamond offshore amended its petition in the Baroness Litigation to seek a declaration that Diamond Offshore has no further contractual obligations to the Company. On August 21, 2002, before being served with Diamond Offshore's amended petition in the Baroness Litigation, the Company filed a separate lawsuit against Diamond Offshore seeking to recover damages, including attorneys' fees (the Rover Litigation). On August 30, 2002, the Court transferred the Rover Litigation to the 125th Judicial Court where the Baroness Litigation is pending. The two cases have been consolidated into one lawsuit in the 125th Judicial Court. The Company is vigorously prosecuting its claims against Diamond Offshore and defending the claims asserted against it by Diamond Offshore in this lawsuit.

It is presently impossible to determine the ultimate outcome of these matters or whether the resolution will have a material adverse effect on the Company's results of operations, consolidated financial position or liquidity, though the Company has recorded reserves that it believes are adequate for certain estimated legal fees associated with such matters as of the balance sheet date.

In 2001, the Company received from the United States Environmental Protection Agency (the EPA) a Request for Information under Section 104(e) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, for information pertaining to the R&H Oil Company Site in San Antonio, Texas (the Site). Information provided to the Company by the EPA indicates that the Company may have sent waste oils to the Site for recycling in the late 1980s, and that such waste oils may potentially account for between one and two percent of the volume of total wastes received by the oil recycler at the Site. Since the Company expects to receive a claim for cleanup and other costs related to this site, it has established additional reserves in Fiscal 2002, which it believes to be adequate at this time. As additional facts are developed and definitive remediation plans and necessary regulatory approvals for implementation of remediation are established, changes in these and other factors may result in actual costs exceeding the current environmental reserves. While uncertainties are inherent in the final outcome of these environmental matters, and it is presently impossible to determine the actual costs that ultimately may be incurred, management currently believes that the resolution of such uncertainties should not have a material adverse effect on the Company's results of operations, consolidated financial position or liquidity.

From time to time, the Company is subject to various environmental remediation requirements at certain of its facilities. The Company believes that the exposure associated with such requirements will not have a material adverse impact on the Company's results of operations, consolidated financial position or liquidity.

The Company is also a defendant in a number of lawsuits relating to contractual, product liability, personal injury and warranty matters normally incident to the Company's business. No individual case, or group of cases presenting substantially similar issues of law or fact, are expected to have a material effect on the manner in which the Company conducts its business or on its consolidated financial position or liquidity. The

Company maintains certain insurance policies that provide coverage for product liability and personal injury cases. The Company has established reserves that it believes to be adequate based on current evaluations. Nevertheless, an unexpected outcome in such cases could have a material adverse impact on the results of operations in the period it occurs. Moreover, future adverse developments in such cases could require material changes in the recorded reserve amounts.

Note 6 Government Contracting

The U.S. government is one of the Company's key customers. As such, decreased government spending or termination of significant government programs could adversely affect the Company's business. The Company's Tactical Vehicle Systems segment depends largely on U.S. government expenditures. In recent years, government contracts in this segment have accounted for substantial percentages of the Company's annual revenues and operating income. The Company is currently in the fifth production year of its second multi-year contract with the U.S. Department of the Army (U.S. Army) for production of the Family of Medium Tactical Vehicles (FMTV). In the fourth quarter of Fiscal 2002, the U.S. Army exercised an option to award a sixth program year to the current contract, which begins in October 2003 and is expected to be completed by September 2004. The funding of the FMTV contract is subject to the inherent uncertainties of Congressional appropriations. As is typical of multi-year defense contracts that may be canceled or adjusted by the government, the FMTV contract must be funded annually by the U.S. Army and may be terminated at

any time for the convenience of the government. If the FMTV contract is terminated, other than for the Company's default (in which event there could be serious adverse consequences and claims against the Company), it provides for termination charges that will reimburse the Company for certain allowable costs but not necessarily for all costs incurred.

In April 2003, the U.S. Army awarded the Company the FMTV A1 Competitive Rebuy (A1CR) production contract. The A1CR contract includes production of nearly 11,000 FMTV trucks and trailers over a five-year period, with an option for 12,000 additional vehicles. Production under the A1CR contract is expected to begin in October 2004, after completion of the current FMTV contract. The Company's profit margins on the A1CR contract are expected to be lower than historical margin levels for the current FMTV contract.

Major contracts for military systems are performed over extended periods of time and are subject to changes in scope of work and delivery schedules. Pricing negotiations on changes and settlement of claims often extend over prolonged periods of time. The Company's ultimate profitability on such contracts may depend on the eventual outcome of an equitable settlement of contractual issues with the U.S. government.

Note 7 - Discontinued Operations

During the fourth quarter of Fiscal 2001, the Company determined that the Petroleum Equipment segment's blowout preventer and controls, valve and drilling riser business was not strategically aligned with the Company's core competencies. The Company announced its intention to sell this business and, consequently, these activities were reclassified for reporting purposes for all periods shown as discontinued operations. These discontinued operations generated the following sales and operating losses in the three- and six-month periods ended August 2, 2003 and August 3, 2002:

(In thousands)	Three Months Ended		Six Months Ended	
	August 2, 2003	August 3, 2002	August 2, 2003	August 3, 2002
Sales	942	5,248	1,380	15,183
Operating loss	(442)	(8,152)	(1,692)	(9,848)
Operating loss, net of taxes	(158)	(5,503)	(982)	(6,600)

Additionally, the Company recognized a loss from the disposal of such discontinued operations in the second quarter of Fiscal 2002 of \$8.3 million (\$5.6 million, net of tax).

When the transaction consummated on September 13, 2002, the Company sold certain assets and retained certain contracts and related assets as well as the receivables and certain liabilities of the business, including warranty responsibility for products sold before closing as well as warranty responsibility for retained contracts to be completed. In some cases, the Company has agreements with customers on commitments to support its products, including retained warranties and contracts.

Note 8 - Inventories

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Summarized below are the components of inventories by segment excluding discontinued operations, net of customer deposits:

(In thousands)

August 2, 2003

January 31, 2003