STEWART & STEVENSON SERVICES INC
Form 10-K
April 13, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the fiscal year ended January 31, 2006 (Fiscal 2005) or

o **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	**77008**

(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (713) 868-7700

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

Common Stock, without par value	**New York Stock Exchange**
(Title of class)	(Name of exchange on which registered)

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

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

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

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 ý No o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer ý Non-accelerated filer o .

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

The aggregate market value of voting securities held by non-affiliates of the registrant as of July 30, 2005, the date of the registrant s most recently completed second fiscal quarter, was $639,225,087, based upon the closing price of the registrant s common stock on the New York Stock Exchange as of such date.

Number of shares outstanding of each of the registrant s classes of common stock, as of April 5, 2006:

Common Stock, Without Par Value: 29,495,398 Shares

PART I

FORWARD LOOKING STATEMENTS

Certain of the statements contained in this document, including those made under the captions Business, Legal Proceedings, and Management s Discussion and Analysis of Financial Condition and Results of Operations, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Other than statements of historical fact included herein, all statements herein, including in particular, but not limited to, statements regarding potential future products and markets, our future financial position or results of operations, business strategy, other plans and objectives for future operations, relating to trends, expressing our belief, referring to expectations, relating to future margins, referring to backlogs as to future product deliveries, relating to long-term contracts in progress or using the words should, could, may, and words of similar import and prospective focus, are forward-looking statements. We can give no assurance that any forward-looking statement of ours will prove to have been correct and such statements are not guarantees of future performance. They involve certain risks, uncertainties and assumptions that are difficult to predict, and actual outcomes and results may differ materially from what is expressed or forecasted or implied in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Specific important factors that could cause actual results, performance, or achievements to differ materially from our forward-looking statements, and that otherwise may affect our operations, are identified below. All written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by such factors.

Item 1. Business.

Stewart & Stevenson Services, Inc. (together with its wholly-owned subsidiaries, the Company or Stewart & Stevenson) was founded in Houston, Texas in 1902 and was incorporated under the laws of the State of Texas in 1947. Since its beginning, the Company has been primarily engaged in the custom fabrication of engine-driven products. At the beginning of Fiscal 2004, the Company operated in five business segments: the Tactical Vehicle Systems segment, the Power Products segment, the Engineered Products segment, the Airline Products segment, and the Distributed Energy Solutions segment. The Company announced its plan to exit the Distributed Energy Solutions business in September 2003 and, after substantial progress in the wind-down activities, the Company reported this segment as a discontinued operation in the fourth quarter of Fiscal 2004. The Company sold the Airlines Products business in January 2005 for $56 million, after adjustment, plus the assumption of certain liabilities. In January 2006, the Company completed the sale of substantially all the operating assets and business of the Power Products segment and the Engineered Products segment for cash consideration of approximately $283 million, after adjustment, and the assumption of certain liabilities, leaving the Company with the Tactical Vehicle Systems business described below.

On February 27, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Armor Holdings, Inc. (Armor Holdings) and one of its wholly-owned subsidiaries, pursuant to which Armor Holdings agreed to acquire all of the outstanding common stock of the Company for $35.00 per share in a cash merger transaction. Upon completion of the merger, the Company will be a subsidiary of Armor Holdings and there will be no further market for the Company s common stock. The transaction is subject to Company shareholder approval, the expiration or termination of the Hart-Scott-Rodino waiting period and other customary conditions. Under specified circumstances, if the Merger Agreement is terminated, the Company would be required to pay Armor Holdings a termination fee. In addition, the Merger Agreement contains conditions to Armor Holdings obligations to consummate the merger, including the absence of a material adverse change (as defined in the Merger Agreement) since the date of the Merger Agreement. The Company has scheduled a special meeting of shareholders for May 9, 2006 to consider and vote upon the proposed merger. The Company anticipates that the transaction will close during the second quarter of Fiscal 2006. See Legal Proceedings.

The Company s Tactical Vehicle Systems business assembles the Family of Medium Tactical Vehicles (FMTV) under contracts with the U.S. Army, and provides sustaining design engineering, service and support. The initial FMTV contract was awarded in 1991 and called for the production of approximately 11,200 2-1/2-ton and 5-ton trucks in several configurations, including troop carriers, wreckers, cargo trucks, vans and dump trucks. Production pursuant to the initial FMTV contract was completed as of January 31, 1999.

During October 1998, the Company received a second multi-year contract from the U.S. Army that provided for continued production of the FMTV through December 2004, including exercised option years. Production under the second contract, including all option years, totaled approximately 11,491 trucks and 2,292 trailers, with a total contract value of $2.05 billion.

In April 2003, the Company received a third multi-year contract from the U.S. Army that provided for continued production of the FMTV through September 2008. Base production under the third contract includes 7,063 trucks and 3,826 trailers at an initial contract value of approximately $1.2 billion. The U.S. Army also has the option to order up to an additional 10,889 units over the term of the contract, which could extend production beyond September 2008 depending on options exercised. Base

production under this contract has been funded by the U.S. government through September 2007, and as of March 31, 2006, the U.S. Army has exercised options for 3,382 trucks and 1,702 trailers under this contract.

During Fiscal 2004 and early Fiscal 2005, the Company received additional contract awards, which supplement the FMTV production under the U.S. Army contract. These awards included contracts for the production of 1,743 Low Signature Armored Cabs (LSAC) for use on the FMTV, which had a total contract value of approximately $153 million. Additionally, the Company received contract awards from the U.S. Army and Lear Siegler, Inc. to reset vehicles that have sustained damage in support of Operation Iraqi Freedom and Operation Enduring Freedom. Under these contracts, the Company has reset approximately 1,254 FMTVs which have been placed in service since 1992, along with 186 of the U.S. Army s Heavy Expanded Mobility Tactical Trucks (HEMTT) to their full operational standards. The total contract value under the reset contracts is approximately $76 million. The LSAC contracts and the reset contracts began in Fiscal 2004 and were substantially completed during Fiscal 2005.

The Company also received modifications to the FMTV contract from the U.S. Army in June 2005, valued at approximately $483 million. These modifications, which were funded by the 2005 U.S. Congress Supplemental Spending Bill, added 3,016 truck and trailer deliveries to the contract, including the exercise of options for 1,310 of the trucks and trailers described above. The Company is currently expanding the capacity of its Sealy, Texas production facility in order to meet these additional order deliveries, which are scheduled from June 2006 to September 2008. Total capital expenditures related to the expansion are expected to be approximately $25 million, approximately $13 million of which was incurred in Fiscal 2005. The expansion is expected to be completed by mid-2006.

In April 2005, the Company acquired all outstanding shares of Automotive Technik (Holdings) Limited (ATHL), the manufacturer of the Pinzgauer light tactical vehicle headquartered in the United Kingdom, for a total purchase price of approximately $48.2 million. The acquisition of ATHL broadens the Company s product offerings and provides additional marketing opportunities worldwide. ATHL currently has contracts to produce vehicles for the United Kingdom Ministry of Defence and the New Zealand Ministry of Defence, in addition to other programs worldwide.

The U.S. government is the Company s primary customer, accounting for over 85% of its sales from continuing operations. The FMTV contracts are subject to termination at the election of the customer and provide for termination charges that would reimburse the Company for allowable costs, but not necessarily all costs incurred. The loss of this customer would have a material adverse effect on the Company s future financial condition and results of operations.

The Company also sells the FMTV to other government contractors as a platform for installation of other equipment which is then resold to the U.S. Armed Forces. The Company also has sold vehicles to branches of the U.S. Armed Forces other than the U.S. Army, and believes there will be opportunities to sell additional vehicles to the U.S. Army, other branches of the U.S. Armed Forces and the armed forces of certain foreign countries.

The FMTV incorporates engines, transmissions, axles and a number of other components that are specified by the U.S. Army and are available only from the source or sources selected by the U.S. Army. In addition, the Company uses other suppliers for certain components of the FMTV, some of which are small businesses that are not well capitalized. Interruption in the supply of any of these components, for any reason, could have a material adverse effect on the results of operations of the Company. The Company believes that the U.S. Army would compensate the Company for any delays arising from the interruption in the supply of source-specified components under the FMTV contracts.

COMPETITION

The Company s primary competitor for U.S. sales is Oshkosh Truck Corporation. In addition to Oshkosh, the Company s primary competitors for international contracts for the sale of vehicles to foreign governments include DaimlerChrysler AG, Tatra, MAN and other companies that may have greater international recognition as vehicle manufacturers than the Company.

Competition involves pricing, delivery, quality, vehicle reliability and readiness, range of products and services, technology and other factors. Some of the Company s competitors have greater financial resources than the Company. The Company believes that its reputation for on-time delivery, quality engineering, vehicle reliability and readiness are important to the Company s market position.

INTERNATIONAL OPERATIONS

International operations are subject to risks caused by political and economic factors such as foreign governmental decrees, currency exchange rate volatility and inflation. The Company maintains operations in the United Kingdom, and historically had operations in other foreign jurisdictions, including Colombia, Venezuela and Argentina. The Company monitors the political and economic developments in those countries.

UNFILLED ORDERS

The Company s unfilled orders consist of written purchase orders and signed contracts. Historically, cancellations are rare; however, these unfilled orders are generally subject to cancellation or modification due to customer relationships or other conditions. Purchase options are not included in unfilled orders until exercised. Due to the inherent uncertainties of the Congressional appropriations process, the Company includes only the funded portions of awarded U.S. government contracts in unfilled orders. Unfilled orders relating to continuing operations increased to $957.8 million at January 31, 2006, from $456.6 million at January 31, 2005. Approximately $737 million of the unfilled orders at January 31, 2006 are expected to be recognized as sales in Fiscal 2006.

Unfilled orders at January 31, 2006 consisted primarily of vehicle production funded under the FMTV contract, production of Pinzgauer trucks in the U.K. operation and uncompleted reset contracts for vehicles ongoing in Sealy and Ft. Hood, Texas. During the first quarter of Fiscal 2005, the third program year of the FMTV contract was funded, extending production through September 2006 and increasing backlog by $316 million. During the second quarter of Fiscal 2005, we received contract modifications from the U.S. Army resulting from the 2005 U.S. Congress Supplemental Spending Bill, increasing backlog by $483 million. During the first quarter of Fiscal 2006, the fourth program year of the FMTV contract was funded, extending production through September 2007 and increasing backlog by approximately $344 million.

ENVIRONMENTAL MATTERS

The Company s operations are subject to numerous local, state and federal laws and regulations, including the regulations promulgated by the Occupational Safety and Health Administration, the U.S. Environmental Protection Agency and the U.S. Department of Transportation. The Company believes that it is in substantial compliance with these laws and regulations. In addition, the costs and expenditures related to compliance and remedial action under these laws and regulations were not material in Fiscal 2005, 2004 or 2003, and the Company currently expects that such costs and expenditures will not be material in Fiscal 2006.

Environmental laws, particularly those governing emissions standards, noise and disposal of hazardous wastes, have become more stringent in recent years. While the Company is not currently aware of any situation involving an environmental claim that would likely have a material adverse effect on its business, it is always possible that an environmental claim with respect to one or more of the Company s current or former product offerings or facilities could arise that could have a material adverse effect on the Company s financial condition, results of operations or cash flows.

EMPLOYEES

As of January 31, 2006, the Company employed approximately 1,245 full and part-time employees, none of which were represented by collective bargaining agreements. In the normal course of business, the Company utilizes the services of subcontractors. The Company believes that its employee relations are generally satisfactory.

AVAILABLE INFORMATION

The Company will make available its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, free of charge through our internet website at www.ssss.com as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (the Commission).

The information contained on the Company s website is not incorporated by reference into this Annual Report on Form 10-K and should not be considered to be a part of this Annual Report on Form 10-K.

Item 1A. Risk Factors.

Potential Sale of the Company: For additional information with respect to the potential merger with Armor Holdings, see the second paragraph of Item 1. Business.

Risks of Dependence on Government and Failure to Obtain New Government Contracts: Because the U.S. government is one of our key customers, decreased government spending or termination of significant government programs could adversely affect our business. U.S. government contracts account for a substantial portion of our annual revenues and operating income. In November 2004, we began full rate production under a third multi-year contract with the U.S. Army that provides for continued production of the FMTV through September 2008 at an initial contract value of $1.1 billion, excluding the exercise of any production options. Funding of the FMTV contract beyond September 2007 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 our default (in which event there could be serious adverse consequences and claims made against us), the contract includes a provision under which we will be reimbursed for certain allowable costs, but not necessarily for all costs incurred.

We have realized and expect to continue to realize lower margins under the third multi-year contract than under the FMTV contract completed in the fourth quarter of Fiscal 2004. There can be no assurance as to whether future governmental spending will adequately support our business in this area, and substantial decreases in government spending, the loss of the U.S. government as a customer or the cancellation of key significant government programs could materially and adversely affect our operations. Even if government spending in general continues at current levels, we are not assured that we can compete effectively as to the receipt of specific government orders and contract awards or as to the timing thereof. The U.S. Army is our primary customer, accounting for over 85% of our sales from continuing operations. The loss of this customer would have a material adverse effect on our consolidated financial condition and results of operations. In our forward-looking statements, we have assumed that we will continue to have satisfactory performance in our government contracting business.

Inherent Risks of Government Contracts: Government contracts present us with numerous special risks that are inherent in their nature and that could adversely affect our operations. Major contracts for military systems are often fixed-price contracts that 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. Our ultimate profitability on such contracts may depend on the eventual outcome of an equitable settlement of contractual issues with the U.S. government. Furthermore, there are significant risks in projecting actual costs on multi-year fixed-price government contracts because of unforeseen factors, including price and wage inflation and supply shortages. While we attempt to negotiate supply contracts with key suppliers that are synchronized with our long-term fixed-price obligations, we are not able to do that with a precision that eliminates risks that our actual costs of necessary items will not exceed the costs taken into account in the original contract pricing. Further, as to some suppliers and some items we do not have contracts that are synchronized at all with our long-term fixed-price obligations. As to such items, which include raw materials such as steel, as to which there have been recent substantial price increases, we are at continuous risk that we will have cost increases that were not taken into account in our contract pricing.

Our 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, we would also be prohibited from selling 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. In such events we might otherwise not be able to receive the benefits of federal assistance payments during a suspension or debarment. The U.S. Customs Service and the Department of Justice have conducted an investigation of potential violations by us of laws relating to the export of controlled military vehicles, weapons mounting systems and firearms. Such investigation could result in the filing of civil or administrative sanctions against us and/or individual employees, and could result in a suspension or debarment. In our forward-looking statements, we have assumed our reasonable management of risks inherent in our government contracting business, and that we will not experience a materially adverse outcome in any U.S. government investigations.

Risks of Supply Interruptions: The FMTV incorporates engines, transmissions, axles and a number of other components that are specified by the U.S. Army and are available only from the source or sources selected by the U.S. Army. Identifying additional or replacement suppliers approved by the U.S. Army for any of the numerous components used in the FMTV may not be accomplished quickly or on commercially reasonable terms, if at all. In addition to suppliers specified by the U.S. Army, we

use other suppliers for certain components of the FMTV, some of which are small businesses that are not well capitalized. In the event we were unable to mitigate the impact or find an alternate supplier in a timely manner, significant interruption in the supply of any of these components, for any reason, including insolvency of a supplier, work stoppages at suppliers and transportation interruptions, could involve significant additional costs and result in delays in production and product deliveries and could have a material adverse effect on our results of operations. In our forward-looking statements, we have assumed that we will not experience significant supply interruptions.

Risks Associated with Distributed Energy Solutions Business: In the third quarter of Fiscal 2003, we announced our plans to exit the turnkey engineering, procurement, and construction, or EPC, activities of the Distributed Energy Solutions segment. Since that time, we have incurred significant losses in the process of exiting this business related to the completion of remaining construction projects, costs to satisfy customer warranty obligations, valuation adjustments related to the liquidation of inventory and costs associated with the settlement of customer disputes. During the fourth quarter of Fiscal 2004, we reached the point in this wind down effort in which we are substantially complete with our construction activities, and as a result, the identified assets, liabilities and results of operations for that segment have been reported as discontinued operations. We continue to have substantial risk with respect to the performance on such contracts, including warranty, product performance and other contractual obligations, as well as certain claims and litigation that have arisen against us with respect to contracts entered into in past years. While we have recognized all known estimated losses on these uncompleted contracts, warranty obligations and other customer disputes, continued uncertainty remains related to the execution of the remaining obligations. These uncertainties may result in additional unexpected losses until all contractual issues are resolved and remaining obligations are completed. Additionally, we expect to continue to recognize some general and administrative costs required to support the remaining warranty and contract performance aspects of this business. We are also obligated to execute under certain fixed-price operation and/or maintenance contracts related to previously completed EPC projects, which have terms potentially extending up to five years. We have assumed in our forward-looking statements that we will be able to manage this circumstance in an overall satisfactory manner, having already taken significant charges with respect to these matters in prior years.

Risks of Fixed-Price Contracts: Many of our equipment sales contracts are fixed-price contracts as to which the original price may be set at an early stage of the process. The terms of these contracts require us to guarantee the price of products and services we provide and to assume the risk that the costs to provide such products and services will be greater than anticipated. The profitability of these contracts is therefore dependent on the ability to reasonably predict the costs associated with performing the contracts. These costs may be affected by a variety of factors, some of which are beyond our control. For example, U.S. manufacturers and distributors of steel products, which are used in many of our products, have in recent years experienced difficulties with the pricing and availability of steel. The volatility of steel prices and increase in steel demand worldwide has had and is expected to continue to have a negative effect on our expected costs under certain of our fixed-price contracts in the near future. Our failure to accurately estimate the resources required for a project, or our failure to complete our contractual obligations in a manner consistent with the project plan upon which our fixed-price contract was based, could adversely affect our profitability and could have a material adverse effect on our business, financial condition and results of operations. In recent years, as a result of incurring greater costs than were taken into account in original contract pricing, we have incurred significant losses on certain EPC projects in our discontinued Distributed Energy Solutions business. In our forward-looking statements, we have assumed that fixed-price contracts will have no further material adverse impact on our business, financial condition or results of operations.

Risks as to Rising Steel Prices: While noted above generally in connection with other risk factors, we specifically note that since early 2004, manufacturers and distributors of steel, which is used in many of our products, have experienced sharply increased prices and limited availability of steel and component parts containing steel. These increased steel prices have had and are expected to continue to have a negative impact on our margins in the near future, particularly on fixed-price contracts and other contracts for which we are unable to pass such cost increases on to our customers. If these steel price conditions continue, and if we are unable to raise our prices to keep pace with the material cost increases, our operating margins and results of operations could be adversely impacted in future periods.

Risks as to Cost Controls: As a manufacturing and service company operating within tight margins, with substantial facilities and inventories, our operations have been, and can be, adversely affected by our inability to control costs and to accurately estimate and plan our costs. We continuously endeavor to implement cost identification, estimation and savings measures in our operations. Our forward-looking statements assume that we will be able to contain our costs and expense increases at reasonable levels consistent with expected revenues.

Risks of Dependence on Third Party for Support Services: In connection with the disposition of the Engineered Products and Power Products businesses, including a significant portion of our information technology assets and personnel, we entered into

a transition services agreement with the buyer of those businesses pursuant to which the buyer is obligated to provide certain support services to us in the areas of information technology, telecommunications, accounting and payroll, record retention, tax compliance assistance and operational support for up to 18 months following the sale of those businesses, depending on the particular service. Because we no longer own the assets or employ the personnel necessary to perform those services, we are substantially dependent on the buyer to provide such support services. The buyer s failure to provide these services to us in a timely manner, or at all, could have material adverse effect on our business, operating results and financial condition.

Risk of a Decline in Defense Spending: Our government contracts are dependent upon the U.S. defense budget. Since the invasion of Iraq by the U.S. and other forces in March 2003, we have benefited from an upward trend in overall defense spending. Under the Bush Administration s fiscal 2007 budget, the defense budget is expected to continue to increase through fiscal year 2009. However, future defense spending could be negatively impacted by several factors, including, but not limited to, the U.S. government s budget deficits, a change in spending priorities and the costs of sustaining the U.S. military operations in Iraq and Afghanistan. A decrease in U.S. government defense spending or changes in spending allocation could result in a material decrease to our sales, earnings and cash flow.

Risks of General Economic Conditions: Our operations are to some extent dependent for success on the general economic well-being of the United States and certain international markets. A general economic downturn could adversely affect government military spending which could impact demand for our products and services. Although economic activity has improved in recent years, general economic conditions remain uncertain, particularly in light of the war in Iraq, other international tensions and related factors. If the U.S. or world economies decline or fail to further recover, the demand for our products and services could be adversely affected, thus adversely affecting our financial condition and results of operations. Further, other general market conditions such as increased inflation and higher interest rates could also adversely impact our results of operations. In our forward-looking statements, we have assumed that general market conditions will not worsen in Fiscal 2006 and that we are not entering a down-cycle in our markets or a period of significantly increasing inflation and interest rates.

Risk of Competition: Our international and domestic competitors may use their resources and product and service offerings to increase competition, both in terms of pricing and product and service offerings, thereby reducing our market shares and/or sales and profitability. Some of our existing and potential competitors have substantially greater marketing, financial and technical resources than we have, and these resources might be used in effective competition with us. We have assumed in our forward-looking statements that we will continue to be a reasonably effective competitor in our markets.

Risks Relating to Technology: Our business will suffer if we are unable to keep up with rapid technological change and product development. Our success will depend on our ability to anticipate changes in technology and industry requirements and to respond to technological developments on a timely basis, either internally or through strategic alliances. We will likely be constantly threatened by current competitors or new market entrants who may develop new technologies or products or establish new standards that could render our products less marketable or obsolete. Thus, we can offer no assurances that we will be successful in developing and marketing, on a timely and cost effective basis, products or product enhancements that respond to our competition, to technological developments, to changing industry standards and to marketplace acceptability. We have assumed in our forward-looking statements that we can reasonably keep pace with our competitors in technology changes and product development.

Risks Relating to Personnel: Labor shortages and our inability to recruit and retain key employees and workers could limit our operations and increase our labor costs and, in turn, adversely affect our results of operations. Our manufacturing operations are substantially dependent upon our ability to recruit and retain key managers and qualified machinists, welders, factory workers and other laborers. A strong labor market can adversely impact us by limiting our manufacturing capacity or resulting in significantly increased wages and other benefits to attract additional key employees and workers. We have assumed in our forward-looking statements that we will continue to be able to recruit and retain necessary personnel at overall costs that are comparable with our ability to produce revenues.

Risks of Claims and Litigation: Outcomes of pending litigation and governmental proceedings, as well as future unexpected litigation and legal disputes could have a material adverse impact on our operations. If we experience materially adverse outcomes or other unexpected results in our existing litigation and government proceedings, which in turn have a material adverse effect on our results of operations, the accuracy of our forward-looking statements would be affected. Similarly, if we experience in the future new, unexpected litigation or adverse results from new, unexpected litigation, there could also be a material adverse effect on our results, again affecting the accuracy of our forward-looking statements. Our forward-looking statements assume that there will be no materially adverse unexpected outcomes or results that we have not already adequately provided for.

Risks of Product Defects: Our customers often require demanding specifications for product performance and reliability. Because many of our products are complex and often use state-of-the-art components, processes, and techniques, undetected errors and design flaws may occur. Product defects result in higher product service, warranty and replacement costs and may cause damage to our customer relationships and industry reputation, all of which may negatively impact our results of operations. We have assumed in our forward-looking statements that we will not in the future incur material difficulties with respect to product defects and warranty claims.

Risks as to Foreign Sales and Global Trade Matters: Foreign sales are subject to special risks inherent in doing business outside of the United States, including the risk of war, terrorist activities, civil disturbances, embargoes, and government activities, all of which may disrupt markets. Foreign sales are also generally subject to the risk of compliance with additional laws, including tariff regulations and import and export restrictions. Sales in certain foreign countries require prior U.S. government approval in the form of an export license. We cannot assure you that we will not experience difficulties in connection with future foreign sales. Moreover, changes in global trade policies in our markets could impact our sales in these markets. We have assumed in our forward-looking statements that there will be no material changes in global trade policies, such as embargoes, new and large tariffs or other tax assessments and the like or other new and material restrictions on trade that apply in particular to our operations.

Risks as to Acquisitions and Restructuring Activities: Our success is dependent upon the integration of newly acquired businesses with our existing businesses. Our success is also dependent upon executing our restructuring plans in such a manner that we extricate value from facility closures and product offering and business exits, and that we structure continuing business activities in an efficient and tactical manner. This process involves some amount of realignment and reintegration of business processes. There can be no assurance as to the ultimate success of our integration and realignment efforts. Our forward-looking statements assume the successful integration of acquired businesses and realigned business activities and their future contribution to our operations.

Risks as to Currency Fluctuations: A material change in currency exchange rates in our markets could affect our future results as well as affect the carrying values of certain of our assets. World currencies have been subject to volatility in recent years. The U.S. dollar has continued to weaken somewhat against other key currencies (particularly the Euro and the British pound) in recent years. While a weakened U.S. dollar is not necessarily adverse to our business in general, it could be generally adverse for the U.S. economy in a number of ways, including putting upward pressure on interest rates. In addition, our U.K. manufacturing operation primarily conducts its business in British pounds sterling, but a portion of its costs are in Euros. Consequently, significant weakening of the U.K. pound in relation to the Euro would negatively impact the profitability of our U.K. operation. Significant weakening of the U.K. pound in relation to the U.S. dollar would reduce the carrying value of our U.K. assets, and would negatively impact the U.S. dollar-equivalent values of revenues and profits of our U.K. operation. Our forward-looking statements assume no material impact from future changes in currency exchange rates.

Risks as to Environmental and Safety Matters: Our operations and products, and the use thereof, are regulated under a number of federal, state, local and foreign environmental laws and regulations, which govern, among other things, the discharge of hazardous materials into the air and water as well as the handling, storage and disposal of hazardous materials. Compliance with these environmental laws is a major consideration in the manufacturing of our products

and in their servicing and distribution, as we use and generate hazardous substances and wastes in our manufacturing operations and as we may be subject to material financial liability for any investigation and clean-up of such hazardous materials. In addition, many of our current and former properties are or have been used for industrial purposes. Accordingly, we also may be subject to financial liabilities relating to the investigation and remediation of hazardous materials resulting from the action of previous owners or operators of industrial facilities on those sites. Liability in many instances may be imposed on us regardless of the legality of the original actions relating to hazardous or toxic substances or whether or not we knew of, or were responsible for, the presence of those substances. We are also subject to various federal, state, local and foreign laws and regulations relating to safety and health conditions in our manufacturing facilities and with respect to our products and the use thereof. Those laws and regulations may also subject us to material financial penalties or liabilities for any noncompliance, as well as potential business disruption if any portion of any of our facilities is required to be temporarily closed as a result of any violation of those laws and regulations. Any financial liability or business disruption from environmental, health or safety issues could have a material adverse effect on our financial condition and results of operations. Our forward-looking statements assume no material adverse impact from environmental and safety issues.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

The Company maintains its corporate executive and administrative offices at 2707 North Loop West, Houston, Texas, which occupy approximately 18,300 square feet of leased space.

The Company s Tactical Vehicle Systems business is headquartered in a 822,000 square foot Company-owned facility in Sealy, Texas, which includes the 202,000 square foot expansion of the facility in Fiscal 2005. The business also leases approximately 31,500 square feet within 7 facilities located in Virginia, North Carolina, Georgia, Tennessee, and Michigan, and approximately 59,000 square feet within two facilities in the United Kingdom, which includes the production facility and administrative offices for the ATHL business acquired in April 2005.

The Company also owns a 255,000 square foot manufacturing facility in Houston, Texas, which is being leased to the buyer of the Company s Engineered Products business, which was sold in January 2006. The lease of the Engineered Products facility expires in July 2008, and has a purchase option that expires in July 2007. In addition, the Company owns an approximately 29,430 square foot facility which is currently being marketed for sale, and leases approximately 237,000 square feet within 12 locations in the former Engineered Products and Power Products businesses, all of which are currently sub-leased to third parties.

The Company considers all property owned or leased by it to be well maintained, adequately insured and suitable for its purposes.

Item 3. Legal Proceedings.

U.S. Government Contingencies: During 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 U.S. Customs Service and the Department of Justice have conducted an investigation of 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 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. While they are possible, the Company does not believe that criminal sanctions will be sought. The Company believes that resolution of this matter will not have a material adverse effect on its consolidated results of operations, financial condition or liquidity and believes that the resolution of the matter that is possibly most adverse to the Company will involve the payment of a civil penalty that will not materially adversely affect the Company.

Klickitat Litigation: The Company and several of its subsidiaries in the Distributed Energy Solutions business are defendants in a suit filed by the Klickitat County Public Utility District No. 1 on December 11, 2003 arising out of claims relating to a landfill gas power generation facility in Roosevelt, Washington, Cause No. CY-03-3175-LRS; *Klickitat County Public Utility District No. 1 v. Stewart & Stevenson Services, Inc., Stewart & Stevenson Power, Inc., Sierra Detroit Diesel Allison, Inc., Pamco International, Inc. and Waukesha Engine Dresser, Inc.*; in the U.S. District Court for the Eastern District of Washington. The plaintiff has asserted claims with respect to equipment installed and

used since 1999 for breach of contract; promissory estoppel; violations of the Washington Products Liability Act; breach of warranties; intentional or negligent misrepresentation; and violations of the Washington Consumer Protection Act and seeks recovery of damages in excess of $15 million. The Company is vigorously defending this suit. In an order filed April 7, 2006, the court granted partial summary judgment dismissing all but two of plaintiff s nine causes of action with prejudice. As to the remaining claims, it is not yet possible for the Company to determine the ultimate outcome of the suit or whether its resolution will, in the future, have a material adverse effect on the Company s consolidated results of operations, financial position or liquidity. The Company is presently unable to determine whether a material liability has been incurred in this matter or to reasonably estimate the amount of any loss that may result from this matter. Consequently, the Company has recorded no accrual for any losses related to the ultimate outcome of this litigation. The Company has, however, recorded accruals that it believes are adequate for estimated legal fees that it expects to incur associated with this matter.

Antitrust Litigation: The Company, which was a distributor of Detroit Diesel parts through its Power Products business, is a co-defendant with Detroit Diesel Corporation and other Detroit Diesel distributors in two putative class action suits filed on February 9, 2005, Civil Action No. 05-616; *Cumberland Truck Equipment Co. et al. v. Detroit Diesel Corp., et al.* (the Cumberland Litigation), and Civil Action No. 05-625; *Diamond International Trucks, Inc. et al. v. Detroit Diesel Corp., et al.* (the DIT Litigation). The suits were initially filed in the U.S. District Court for the Eastern District of Pennsylvania. On November 14, 2005, the cases were transferred to the Eastern District of Michigan. In the Cumberland Litigation, plaintiffs

were dealers of Detroit Diesel parts whose agreements were terminated or not renewed on or after February 9, 2001. The plaintiffs are claiming antitrust violations arising out of the termination or non-renewal of their dealer agreements. In the DIT Litigation, plaintiffs are dealers of Detroit Diesel parts whose dealership classification was changed on or after February 9, 2001. The plaintiffs in the DIT Litigation are claiming antitrust violations arising out of changes to the classification of their dealerships. The plaintiffs in each suit have also alleged price fixing and group boycott in violation of Section 1 of the Sherman Act and have made claims for treble damages and injunctive and other relief. The Company is vigorously defending both suits. It is presently impossible for the Company to determine the ultimate outcome of either suit, but the Company currently believes that the resolution of these suits will not have a material adverse effect on the Company s consolidated results of operations, financial position or liquidity. The Company has recorded accruals that it currently believes are adequate for the estimated amount of costs and legal fees that it expects to incur associated with these matters.

Purported Class Action involving Merger: The Company and six of its directors are defendants in a purported class action lawsuit relating to the proposed merger transaction with Armor Holdings described above in Business . The lawsuit was filed on April 11, 2006, and alleges, among other things, that the defendants have breached their fiduciary duties to the shareholders of the Company by failing to maximize shareholder value when selling the Company, by favoring Armor Holdings in the proposed merger transaction and precluding superior offers for the Company and by failing to disclose material information or disclosing materially false information in its proxy materials relating to the shareholders meeting to be held on May 9, 2006. The lawsuit was filed in District Court in Harris County, Texas, by a purported shareholder of the Company on behalf of all other similarly situated shareholders. The lawsuit alleges that a class should be certified and the plaintiff named as representative of the purported class. No class has been certified at present and accordingly, we regard the action as a purported class action. Additional lawsuits could be filed in the future. The lawsuit seeks, among other things, a declaration that the merger agreement was entered into in breach of the fiduciary duties of the individual defendants and is therefore unlawful and unenforceable, an injunction against the Company proceeding with the transaction or consummating the transaction or any other business combination unless certain procedures are in place and damages, attorneys and experts fees, expenses and other relief. The Company believes that this lawsuit is wholly without merit and intends to vigorously defend it.

Environmental Contingencies: In 2001, the Company received from the U.S. 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 reserves 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 amounts accrued. 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 consolidated results of operations, financial position or liquidity. The Company believes that the most likely outcome in this environmental matter is the expenditure of an immaterial amount of consideration as a contribution to the remediation effort.

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, is expected to have a material effect on the manner in which the Company conducts its business or on its consolidated results of operations, 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 and its experience in these types of claim situations. Nevertheless, an unexpected outcome or adverse development in any such case could have a material adverse impact on the Company s consolidated results of operations in the period it occurs.

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

None.

PART II

Item 5. Market Price of and Dividends on the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

The Company s common stock is traded on the New York Stock Exchange under the symbol SVC . There were 492 shareholders of record as of April 5, 2006. The following table sets forth the high and low sales prices relating to the Company s common stock and the dividends declared by the Company in each quarterly period within the last two fiscal years.

Fiscal Year 2004	**High**	**Low**	**Dividend**
First Quarter	$ 17.20	$ 12.46	$ 0.085
Second Quarter	18.25	14.02	0.085
Third Quarter	18.14	14.55	0.085
Fourth Quarter	20.63	16.57	0.085
Fiscal Year 2005	**High**	**Low**	**Dividend**
First Quarter	$ 25.00	$ 19.74	$ 0.085
Second Quarter	25.24	20.86	0.085
Third Quarter	26.00	21.08	0.085
Fourth Quarter	26.37	20.00	0.085
Fiscal Year 2006 (through April 12, 2006)	**High**	**Low**	**Dividend**
First Quarter	$ 37.03	$ 24.60	$ 0.085

On December 7, 2005, the Board of Directors approved a dividend of $0.085 per share for shareholders of record on January 31, 2006, which dividends were paid on February 10, 2006. On April 6, the Board of Directors approved a dividend of $0.085 per share for shareholders of record on April 24, 2006, which dividends will be paid on May 8, 2006. Declaration and payment of dividends in the future is dependent upon the Company s earnings and liquidity position and limitations under the Company s revolving credit facility and senior notes agreement, among other factors. Based on the Company s financial condition at January 31, 2006, the restrictions imposed by the Company s senior notes and revolving credit facility do not currently restrict the Company s ability to declare and pay dividends at historical levels.

Item 6. Selected Financial Data.

The Selected Financial Data set forth below have been derived from the audited consolidated financial statements of the Company and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of the Company and notes thereto, included elsewhere herein.

			Year Ended January 31,		
(In thousands, except per share data)	**2006**	**2005**	**2004**	**2003**	**2002**
Income Statement Data:					
Sales	$ 726,352	$ 549,803	$ 445,686	$ 450,599	$ 424,818
Gross profit	43,760	73,798	78,992	88,790	75,660
Selling, administrative and other expenses	19,258	25,938	27,617	34,421	26,579
Recovery of costs incurred, net					(39,000)
Pension curtailment expense			2,400		
Other expense (income), net	(44)	407	(362)	(40)	(2,293)
Operating profit	24,546	47,453	49,337	54,409	90,374
Net earnings from continuing operations before cumulative effect of change in accounting	17,216	30,727	31,157	25,933	52,337
Net earnings (loss)	26,128	4,978	(53,203)	(7,201)	42,223
Per Share Data:					
Net earnings from continuing operations per share:					
Basic	$ 0.59	$ 1.07	$ 1.09	$ 0.91	$ 1.85
Diluted	0.58	1.06	1.08	0.90	1.81
Net earnings (loss) from discontinued operations per share:					
Basic	0.31	(0.90)	(2.95)	(1.16)	(0.36)
Diluted	0.30	(0.89)	(2.92)	(1.15)	(0.35)
Net earnings (loss) per share:					
Basic	0.90	0.17	(1.86)	(0.25)	1.49
Diluted	0.88	0.17	(1.84)	(0.25)	1.46
Weighted average shares outstanding:					
Basic	29,117	28,749	28,560	28,479	28,325
Diluted	29,593	28,984	28,887	28,690	28,865
Cash dividends declared per share	$ 0.34	$ 0.34	$ 0.34	$ 0.34	$ 0.34
Balance Sheet Data:					
Cash and cash equivalents	$ 333,171	$ 128,515	$ 52,186	$ 102,798	$ 81,438
Working capital	266,740	302,577	322,483	394,327	437,721
Total assets	577,711	613,342	602,663	652,635	649,055
Short-term debt	25,158			30,000	
Long-term debt	65	25,000	25,160	25,181	55,000
Shareholders equity	315,786	284,720	297,483	362,008	391,231

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

The following discussion and analysis, as well as the accompanying consolidated financial statements and the notes thereto, will aid in understanding our results of operations as well as our financial position, cash flows, indebtedness and other key financial information. The following discussion may contain forward-looking statements. In connection therewith, please see Risk Factors in Item 1A herein, which identify important factors that could cause actual results to differ materially from those predicted or implied in the forward-looking statements.

RESULTS OF OPERATIONS

Strategic Overview

In September 2003, we began a strategic review of all of our primary businesses in an effort to identify and implement necessary actions to enhance value for our shareholders. Since then, we exited the turnkey engineering, procurement and construction activities of the Distributed Energy Solutions segment and sold substantially all operating assets and businesses within the Airline Products, Power Products, and Engineered Products operating segments. The significant divestiture activities during Fiscal 2005 are described below.

In August 2005, we completed the sale of substantially all of the inventory, property, plant and equipment, distribution rights, and operations of four Power Products distribution locations in California for cash consideration of approximately $9.4 million. As a result of this sale, we recorded a $3.4 million pre-tax charge during Fiscal 2005, which included a $3.6 million estimated withdrawal liability from a union pension plan.

In January 2006, we completed the sale of substantially all remaining operating assets and business of the Power Products and Engineered Products segments for cash consideration of approximately $277 million and the assumption of certain liabilities. In March 2006, the cash consideration was adjusted upward by $6.4 million, based on the net asset value delivered at closing. As a result of the sale, we recognized a pre-tax gain of $9.7 million during Fiscal 2005.

As a result of these actions, we transformed our company into a single-focused manufacturer of tactical military vehicles and related products. During Fiscal 2005, we took significant actions in this business to continue to supplement our U.S. Army production contract.

In April 2005, we acquired all outstanding shares of Automotive Technik (Holdings) Limited (ATHL), the manufacturer of the Pinzgauer light tactical vehicle headquartered in the United Kingdom, for a total purchase price of approximately $48.2 million. The acquisition of ATHL broadens our product offerings and provides additional marketing opportunities worldwide. ATHL currently has contracts to produce vehicles for the United Kingdom Ministry of Defence and the New Zealand Ministry of Defence, in addition to other programs worldwide.

Additionally, we received contract modifications from the U.S. Army in June 2005, valued at approximately $483 million. These modifications, which are funded by the 2005 U.S. Congress Supplemental Spending Bill, added 3,016 truck and trailer deliveries to the current U.S. Army

production contract. Currently, we are expanding the capacity of our Sealy, Texas production facility in order to meet these additional order deliveries, which are scheduled from June 2006 to September 2008.

On February 27, 2006, we entered into a merger agreement with Armor Holdings, Inc. (Armor Holdings) and one of its wholly-owned subsidiaries, pursuant to which Armor Holdings agreed to acquire all of our outstanding common stock for $35.00 per share in a cash merger transaction. Upon completion of the merger, we will be a subsidiary of Armor Holdings and there will be no further market for our common stock. The transaction is subject to the approval of our shareholders, the expiration or termination of the Hart-Scott-Rodino waiting period and other customary conditions. Under specified circumstances, if the Merger Agreement is terminated, we would be required to pay Armor Holdings a termination fee. In addition, the Merger Agreement contains conditions to Armor Holdings obligations to consummate the merger, including the absence of a material adverse change (as defined in the Merger Agreement) since the date of the Merger Agreement. We have scheduled a special meeting of shareholders for May 9, 2006 to consider and vote upon the proposed merger. We anticipate that the transaction will close during the second quarter of Fiscal 2006.

Fiscal 2005 vs. Fiscal 2004

Continuing Operations

As a result of the divestitures of the Engineered Products and Power Products businesses in Fiscal 2005, continuing operations primarily consist of the Tactical Vehicle Systems business, which manufactures the Family of Medium Tactical Vehicles (FMTV) and related armoring under contracts with the U.S. Army and provides sustaining design engineering, service and support. With the ATHL acquisition described above, this business also manufactures Pinzgauer light tactical vehicles for the

United Kingdom Ministry of Defence, the New Zealand Ministry of Defence and other customers. Continuing operations also include certain corporate office expenses, including the facility-related costs of maintaining the corporate office, chief executive, legal, finance, internal audit, investor relations, human resources, tax and other similar costs.

Sales from continuing operations during Fiscal 2005 were $726.4 million, a $176.6 million (32%) increase from $549.8 million of sales recorded in Fiscal 2004. The sales increase is primarily attributable to production of Low Signature Armored Cabs (LSAC) in Fiscal 2005. A breakdown of unit deliveries follows:

	Year Ended January 31,	
	2006	**2005**
Trucks	2,953	2,804
Trailers	1,554	730
LSAC	1,765	270

We recorded $152.1 million of sales in Fiscal 2005 associated with the LSAC production, compared to $23.0 million recorded in Fiscal 2004. Additionally, we recorded $48.0 million of sales in Fiscal 2005 attributable to Pinzgauer truck sales from our U.K. manufacturing operation, which was acquired in April 2005. These sales increases were partially offset by declines in sales attributable to the U.S. Army FMTV production contracts. Equipment sales under the FMTV contracts declined $55.0 million (12%) from $443.8 million in Fiscal 2004 to $388.8 million in Fiscal 2005, primarily due to lower pricing under the current FMTV production contract compared to the contract completed in late 2004. Parts and service sales increased $54.8 million (66%) to $137.5 million in Fiscal 2005, compared to $82.7 million in Fiscal 2004. The increase in parts and service sales includes $36.5 million of sales in Fiscal 2005 related to vehicle reset programs awarded during Fiscal 2004, a $16.7 million increase from the $19.8 million of sales in Fiscal 2004, along with stronger spare parts requirements and sales generated by the ATHL operation acquired in April 2005.

Gross profit decreased to $43.8 million in Fiscal 2005 from $73.8 million in Fiscal 2004, reflecting a decline in gross profit margin from 13.4% to 6.0% on the higher revenue base. The decrease in gross profit margin for Fiscal 2005 is attributable to a number of factors, including the transition to the current multi-year FMTV production contract, which began in the fourth quarter of Fiscal 2004, higher cost for certain raw materials such as steel and an unfavorable product mix, which included a higher proportion of option trucks, trailers and reset work, all of which generate a relatively low gross profit margin compared to base FMTV trucks. Lower gross profit margins on the new FMTV production contract were partially offset by higher profit margins generated from the LSAC production.

Selling and administrative expenses, which include our corporate office expenses along with selling and product development expenses within the Tactical Vehicle Systems business, decreased to $19.3 million (2.7% of sales) in Fiscal 2005 from $25.9 million (4.7% of sales) in Fiscal 2004. These expenses include the costs associated with the corporate office, which declined to $13.4 million in Fiscal 2005 from $17.9 million in Fiscal 2004. This decline in corporate office spending is the result of cost control programs combined with lower compliance costs associated with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002. Selling and administrative expenses within the Tactical Vehicle Systems business declined to $5.8 million in Fiscal 2005 from $8.0 million in Fiscal 2004, primarily attributable to LSAC product development costs incurred in Fiscal 2004 which did not recur in Fiscal 2005.

Net interest income in Fiscal 2005 was $1.0 million, a $1.6 million improvement from net interest expense of $0.6 million incurred in Fiscal 2004. This improvement is driven primarily by a $1.5 million increase in interest income, resulting from higher invested cash balances and higher interest rates on invested cash.

The effective tax rate was 32.7% in Fiscal 2005 compared to 34.4% in Fiscal 2004. The decrease in Fiscal 2005 effective tax rate is primarily attributable to various permanent deductions, including the deduction for Qualified Production Activities created by the American Jobs Creation Act of 2004.

During the first quarter of Fiscal 2005, the third program year of the current FMTV contract valued at $316 million was funded, extending production through September 2006. Additionally, as described above, we received contract modifications from the U.S. Army in June 2005 valued at approximately $483 million. Consequently, total backlog for the Tactical Vehicle Systems business at January 31, 2006 was $958 million, compared to $457 million at January 31, 2005.

Projected deliveries for Fiscal 2006 currently include 5,566 trucks and 1,829 trailers. The current delivery schedule is subject to change at the request of the customer. The average operating margin on our existing backlog is expected to be higher than the operating margin achieved on Fiscal 2005 sales. However, expected operating margins on the components of backlog vary considerably among the numerous contracts and variants provided. This variability is attributable to a number of factors

including recent volatility in prices for steel and other commodities, base versus option versus supplemental production, the material content within each variant and other factors, many of which are not within our control. Consequently, depending on the mix of vehicles, LSACs, parts and services delivered in each quarter, the operating margin could vary significantly from one fiscal quarter to the next. Operating margins may also be impacted by additional contract awards and modifications, the level of engineering service and spare parts provided, and the timing and recognition of other costs and revenues during each period.

Discontinued Operations

As noted above, pursuant to sales of substantially all assets and operations of the Power Products and Engineered Products businesses, the assets and liabilities, along with the results of operations for these two operating segments have been re-classified to discontinued operations for all periods presented. In addition, discontinued operations include the results of our exited Distributed Energy Solutions and Airline Products businesses, as well as certain Power Products distribution locations in California which were sold in August 2005 and costs associated with retained obligations from our discontinued blowout preventer and controls, valve and drilling riser business, which was sold during Fiscal 2002.

Sales and operating profit (loss) from discontinued operations were as follows (*in thousands)*:

	Year Ended January 31,		
	2006	2005	2004
Sales			
Power Products	$ 535,122	$ 508,378	$ 509,981
Engineered Products	167,372	100,178	113,545
Airline Products		86,287	63,733
Distributed Energy Solutions	7,265	20,037	44,867
Total Sales	$ 709,759	$ 714,880	$ 732,126
Operating profit (loss)			
Power Products	$ 12,091	$ 13,352	$ (51,854)
Engineered Products	11,631	(11,574)	(15,358)
Airline Products		(5,752)	(12,594)
Distributed Energy Solutions	(8,125)	(42,188)	(53,475)
Total operating profit (loss)	15,597	(46,162)	(133,281)
Income tax expense (benefit)	6,325	(18,143)	(48,921)
Net earnings (loss) from discontinued operations	$ 9,272	$ (28,019)	$ (84,360)

In addition to the discontinued operating results above, we recorded a loss on sale of discontinued operations of $0.4 million (net of tax benefit of $0.2 million) in Fiscal 2005, and a gain on sale of discontinued operations of $2.3 million (net of tax expense of $1.3 million) in Fiscal 2004, related to the sale of the Airline Products, Power Products and Engineered Products businesses. The Fiscal 2005 loss on sale of discontinued operations included a $7.0 million pretax charge related to the settlement of a dispute arising from the Fiscal 2004 sale of the Airline Products business and a net pre-tax gain of $6.4 million resulting from sales of the Power Products and Engineered Products businesses. The Fiscal 2004 gain on sale of discontinued operations resulted from the sale of the Airline Products business.

Power Products: The Power Products business, which was responsible for marketing and aftermarket support of a wide range of industrial equipment, recorded sales of $535.1 million in Fiscal 2005, a $26.7 million (5%) increase from $508.4 million recorded in Fiscal 2004. The improved sales volume in Fiscal 2005 from the comparable periods of Fiscal 2004 is primarily attributable to improved pricing and sales execution, partially offset by a decline in sales

volume associated with the sale of four California locations in August 2005 and the remainder of the business in January 2006.

The Power Products business recorded an operating profit of $12.1 million in Fiscal 2005 compared to $13.4 million in Fiscal 2004. The decline in operating profit in Fiscal 2005 is primarily attributable to the inclusion in Fiscal 2004 of $2.3 million of gains on sales of assets and a $2.4 million LIFO inventory valuation reserve adjustment that did not recur in Fiscal 2005.

Engineered Products: The Engineered Products business included two primary product lines, petroleum equipment and utilities equipment. The petroleum equipment operation manufactured equipment primarily for the well stimulation segment of the oil service industry. The utilities equipment products included mobile railcar movers, snowblowers and off-road seismic vehicles. This business also includes certain retained obligations, which have substantially been completed, attributable to the blowout preventer and drilling riser business that was sold in Fiscal 2002. Engineered Products sales increased to $167.4 million in

Fiscal 2005 from $100.2 million in Fiscal 2004, representing an increase of $67.2 million (67%). The sales increase resulted from the increased worldwide demand for acidizing and fracturing equipment, as evidenced by several large petroleum equipment orders that were received during Fiscal 2004 and 2005.

Operating profit for Fiscal 2005 was $11.6 million, a $23.2 million improvement from the $11.6 million operating loss in Fiscal 2004. The improvement in operating profit is primarily attributable to the Fiscal 2004 settlement of outstanding litigation related to the exited blowout preventer and drilling riser business, which resulted in a $11.2 million pre-tax charge. The remaining improvement from Fiscal 2004 is primarily attributable to the increased sales volume along with margin improvements realized through pricing, manufacturing efficiencies and other cost reductions on the Fiscal 2005 equipment projects.

Airline Products: During the fourth quarter of Fiscal 2004, we sold substantially all of the assets and business of the Airline Products segment for proceeds of $60 million as well as the assumption of certain liabilities, subject to final adjustment based on the amount of working capital conveyed at closing. In November 2005, we reached an agreement with the buyer regarding certain contractual issues related to the sale, pursuant to which we agreed to refund $4.0 million of purchase price to the buyer. Primarily as a result of this dispute, we recorded pre-tax charges totaling $7.0 million to loss on sale of discontinued operations during Fiscal 2005, including the write-off of a $3.0 million receivable from the buyer.

Distributed Energy Solutions: During Fiscal 2003, we announced our decision to discontinue the turnkey engineering, procurement and construction activities of the Distributed Energy Solutions segment. The continued wind-down activities associated with retained warranty and other contractual obligations of this business are reflected in discontinued operations. The operating loss for Fiscal 2005 includes a $4.3 million pre-tax charge related to the settlement of a customer dispute and a $1.5 million pre-tax charge related to revised estimates of the cost of remaining customer warranty obligations. Remaining costs primarily represent general and administrative expenses to manage the completion of retained warranty and other contractual obligations.

Fiscal 2004 vs. Fiscal 2003

Continuing Operations

Sales from continuing operations during Fiscal 2004 were $549.8 million, a $104.1 million (23%) increase from $445.7 million of sales recorded in Fiscal 2003. The sales increase is primarily attributable to the increase in unit deliveries, as follows:

	Year Ended January 31,	
	2005	**2004**
Trucks	2,804	2,481
Trailers	730	509
LSAC	270	

The LSAC deliveries in Fiscal 2004 generated $23.0 million of additional sales and increases in truck and trailer deliveries generated an additional $51.8 million of sales. Also, parts and service sales increased by $29.3 million, primarily due to the reset contracts mentioned above, as well as the continued demand on replacement parts for vehicles deployed in Iraq.

Gross profit in Fiscal 2004 was $73.8 million (13.4% gross margin), down from $79.0 million (17.7% gross margin) in Fiscal 2003. This decline in gross profit is primarily attributable to the expected decline in margins associated with the transition to the current FMTV production contract, combined with $7.3 million of increased material costs associated with cost increases in steel components, partially offset by the impact of the higher sales volume.

Selling and administrative expenses decreased to $25.9 million (4.7% of sales) in Fiscal 2004 from $27.6 million (6.2% of sales) in Fiscal 2003. These expenses include the costs associated with the corporate office, which declined to $17.9 million in Fiscal 2004 from $20.4 million in Fiscal 2003. This decrease was largely attributable to $4.6 million of employee separation expenses incurred in Fiscal 2003. This cost decrease was partially offset by $1.8 million of costs incurred in Fiscal 2004 associated with the implementation of the internal control reporting requirements of the Sarbanes-Oxley Act of 2002, and changes in other operating expenses. Selling and administrative expenses within the Tactical Vehicle Systems business decreased to $8.0 million in Fiscal 2004 from $9.7 million in Fiscal 2003. This decrease is primarily attributable to lower bid and proposal costs associated with potential production contracts, partially offset by increased LSAC product development costs incurred in Fiscal 2004.

Net interest expense in Fiscal 2004 was $0.6 million, a $1.1 million decline from $1.7 million in Fiscal 2003. This reduction was primarily attributable to the scheduled payment of $30.0 million on long-term borrowings that was made in May 2003.

The effective tax rate was 34.4% in Fiscal 2004, relatively unchanged from the 34.6% in Fiscal 2003.

Discontinued Operations

Power Products: The Power Products business recorded sales of $508.4 million in Fiscal 2004, down slightly from the $510.0 million of sales recorded in Fiscal 2003. The slight reduction is primarily due to $46 million of sales declines associated with the exit of various product offerings and distribution locations throughout Fiscal 2003 and Fiscal 2004. These declines were nearly offset by sales growth attributable to improved sales execution and general economic improvements in the markets served by this business.

This business recorded an operating profit of $13.4 million in Fiscal 2004 compared to a $51.9 million operating loss in Fiscal 2003. The improvement in operating profit is partially attributable to $13.2 million of charges recorded in Fiscal 2003, including $4.5 million for the impairment of goodwill and other intangible assets, $4.5 million associated with the liquidation of slow-moving inventory, $2.5 million of legal defense and settlement costs and $1.7 million of employee separation costs. Additionally, Fiscal 2004 benefited from on-going cost reduction programs in this business. Workforce reductions resulted in an $18.1 million decrease in employee compensation costs and changes in employee benefit programs resulted in an additional $7.3 million decrease in operating expenses. This business also recognized $2.3 million of gains associated with the sale of assets and operations, a $2.4 million improvement in the LIFO inventory valuation reserve due to reductions in inventory levels, a $4.8 million reduction in bad debt expense and the $1.4 million of direct compensation from a parts and equipment supplier. Other cost reductions associated with product exits and branch closures, along with improved sales mix account for the remaining $15.8 million of operating profit improvement.

Engineered Products: Engineered Products sales decreased to $100.2 million in Fiscal 2004 from $113.5 million in Fiscal 2003, representing a decrease of $13.3 million (12%). Declines in petroleum equipment sales resulting from the completion of certain large equipment projects accounted for approximately $32 million of sales decline from Fiscal 2003. This decrease was partially offset by approximately $8 million of increased off-road seismic vehicle sales, $7 million of increased railcar mover sales, and other sales increases.

This business posted an operating loss of $11.6 million in Fiscal 2004, a $3.8 million improvement from the $15.4 million operating loss in Fiscal 2003. This change is partially attributable to $5.9 million of charges in Fiscal 2003, including $1.6 million associated with liquidation of slow-moving inventory, $1.8 million of costs associated with the consolidation of manufacturing operations, and a $2.5 million charge for the impairment of long-lived assets in accordance with SFAS No. 144. This business also recorded $0.7 million of improvement in the LIFO inventory valuation reserve in Fiscal 2004 due to reductions in inventory levels, along with an $8.3 million operating profit improvement attributable to higher margins on sales, which is due to improving order execution and cost controls, as well as general economic improvements in the markets that we serve. These improvements were offset by $11.2 million of charges associated with the settlement of two customer disputes in Fiscal 2004.

Airline Products: Airline Products sales increased to $86.3 million in Fiscal 2004, a $22.6 million (35%) increase over the $63.7 million of sales recorded in Fiscal 2003. Operating losses in this business were $5.8 million in Fiscal 2004, a $6.8 million improvement from the $12.6 million operating loss in Fiscal 2003. The reduction in operating loss was primarily attributable to a $3.1 million non-recurring charge in Fiscal 2003 related to inventory impairment, combined with the improvements resulting from the increased sales volumes.

Distributed Energy Solutions: Distributed Energy Solutions sales decreased to $20.0 million in Fiscal 2004 from $44.9 million of sales recorded in Fiscal 2003. Operating losses in this business were $42.2 million in Fiscal 2004 and $53.5 million in Fiscal 2003. The losses incurred in this business were the result of actions taken to liquidate the assets of the business, satisfy remaining customer obligations, and settle outstanding disputes following the announcement the exit this business in September 2003.

LIQUIDITY AND CAPITAL RESOURCES

The January 2006 sales of the Power Products and Engineered Products businesses for $277 million in cash provided substantial liquidity. Our sources of cash liquidity include cash and cash equivalents, short-term investments, amounts available under credit facilities and cash from operations. We believe that these sources will provide sufficient capital to fund our working capital requirements, capital expenditure needs, foreseeable acquisition activity, dividends and other financial commitments.

We have a $100 million unsecured revolving credit facility which expires in January 2009. To date, no borrowings have been made under this facility. The revolving credit facility has a $25 million sub-facility which may be used for letters of credit. Approximately $7.0 million in letters of credit under the revolving credit facility were outstanding at January 31, 2006 and $93.0 million was available for borrowing.

This revolving credit facility was issued pursuant to agreements containing covenants that restrict indebtedness, guarantees, sales of assets and other items, and require us to maintain a minimum fixed charge coverage ratio and maximum leverage ratio. Based on our financial condition as of January 31, 2006, the restrictions imposed by our revolving credit facility do not restrict our ability to meet our obligations or to declare and pay dividends at historical levels.

We have $25.0 million in unsecured senior notes outstanding, which bear interest at a rate of 7.38% and are due and payable in May 2006. The senior notes agreement limits sales of assets and other items and contains a maximum debt-to-total capitalization covenant. Based on our financial condition as of January 31, 2006, the restrictions imposed by our senior notes do not restrict our ability to meet our obligations or to declare and pay dividends at historical levels.

For additional information related to the revolving credit facility and senior notes, see Note 7 to the consolidated financial statements.

Selected Statements of Cash Flows Data

(In thousands)	**Fiscal 2005**	**Fiscal 2004**	**Fiscal 2003**
Net cash provided by (used in):			
Operating activities of continuing operations	$ 37,874	$ 24,122	$ 18,071
Operating activities of discontinued operations	(67,883)	11,716	(12,734)
Investing activities	238,857	48,534	(18,112)
Financing activities	(3,666)	(8,043)	(37,837)
Effect of exchange rate changes on cash	(526)		
Increase (decrease) in cash and cash equivalents	$ 204,656	$ 76,329	$ (50,612)

Selected Balance Sheet Data

(In thousands)	**Fiscal 2005**	**Fiscal 2004**	**Fiscal 2003**
Cash, cash equivalents, and short-term investments	$ 336,971	$ 130,995	$ 59,931
Working capital	266,740	302,577	327,464
Total debt	25,223	25,000	25,160

Fiscal 2005 vs. Fiscal 2004

Net cash provided by operating activities of continuing operations increased by $13.8 million (57%) from $24.1 million in Fiscal 2004 to $37.9 million in Fiscal 2005. This increase is primarily attributable to a $10.2 million reduction of working capital, while net earnings adjusted for non-cash items provided a $3.6 million improvement. Cash flows from discontinued operations, on the other hand, decreased from $11.7 million of cash provided in Fiscal 2004 to a $67.9 million use of cash in Fiscal 2005, primarily resulting from increases in working capital to support the growth in the Power Products and Engineered Products businesses prior to their sale in January 2006.

Net cash provided by investing activities improved to $238.9 million in Fiscal 2005 from $48.5 million in Fiscal 2004. This improvement is primarily attributable to proceeds from sales of businesses, which generated $301.7 million in Fiscal 2005 compared to $51.6 million in Fiscal 2004. The higher sales proceeds were partially offset by $44.6 million of cash used to acquire the ATHL business in April 2005, combined with an $8.0 million increase in capital expenditures, primarily relating the to the expansion of the Sealy, Texas manufacturing facility. We expect to incur approximately $12 million of capital expenditures during Fiscal 2006 to complete the facility expansion.

Net cash used in financing activities decreased by $4.4 million to $3.7 million in Fiscal 2005 compared to $8.0 million in Fiscal 2004. This decrease is primarily attributable to higher proceeds from the exercise of stock options.

Fiscal 2004 vs. Fiscal 2003

Net cash provided by operating activities of continuing operations was $24.1 million in Fiscal 2004, a $6.0 million improvement from the $18.1 million in Fiscal 2003. Net earnings from continuing operations adjusted for non-cash items generated a $3.7 million decline in operating cash flow, while changes in working capital balances generated a $9.7 million increase to cash provided by operating activities. Discontinued operations provided $11.7 million of cash in Fiscal 2004, a $24.4 million improvement from the $12.7 million of cash used in Fiscal 2003. The improved cash flow from discontinued operations is primarily the result of reduced operating losses in Fiscal 2004, as compared to Fiscal 2003.

Net cash from investing activities improved to $48.5 million of cash provided in Fiscal 2004 from $18.1 million of cash used in Fiscal 2003. This improvement is primarily attributable to $51.6 million of proceeds from the sale of the Airline Products business combined with a $13.0 million improvement resulting from changes in short-term investments.

Net cash used in financing activities decreased by $29.8 million to $8.0 million in Fiscal 2004 compared to Fiscal 2003. This decrease is primarily attributable to the scheduled repayment of $30.0 million in senior notes in May 2003.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

We occasionally enter into certain financing arrangements in the ordinary course of business, including non-cancelable operating leases, letters of credit and debt guarantees.

We enter into operating leases for some of our facility and equipment needs. Such lease arrangements enable us to conserve cash by paying monthly lease rental fees for the applicable assets rather than purchasing them. At the end of the lease period, we have no further obligation to the lessor. If we decide to cancel or terminate a lease prior to the end of its term, we are typically obligated to pay the remaining lease payments over the term of the lease, and in certain cases may be allowed to sublet the asset to another party.

We are occasionally required to issue performance indemnities or to post letters of credit, generally issued by a bank, to collateralize certain insurance programs, to secure credit facilities or to ensure performance under contracts. A letter of credit commits the issuer to remit specified amounts to the holder, if the holder demonstrates that we have failed to meet our obligations under the letter of credit. If this were to occur, we would be obligated to reimburse the issuer for any payments the issuer was required to remit to the holder of the letter of credit. Generally, a letter of credit is released when we have satisfied the obligations that the letter of credit is securing.

Our contractual obligations at January 31, 2006, excluding interest on debt balances, are summarized as follows (*in thousands*):

	Less than one year	Fiscal 2007	Fiscal 2008	Fiscal 2009	Fiscal 2010	Thereafter	Total
Debt obligations	$ 25,158	$ 51	$ 14	$	$	$	$ 25,223
Operating leases	1,384	1,311	1,220	1,187	772	2,564	8,438

Total contractual cash obligations	$ 26,542	$ 1,362	$ 1,234	$ 1,187	$ 772	$ 2,564	$ 33,661

In addition, our other commercial commitments expire as follows (*in thousands*):

	Less than one year	**Fiscal 2007**	**Fiscal 2008**	**Fiscal 2009**	**Fiscal 2010**	**Thereafter**	**Total**
Letters of credit	$ 9,100	$ 2,515	$ 1,958	$	$	$ 368	$ 13,941
Contingent performance indemnities		2,230					2,230
	$ 9,100	$ 4,745	$ 1,958	$	$	$ 368	$ 16,171

In addition to the above, we have frozen noncontributory defined benefit pension plans that covered substantially all of our full-time employees. Effective July 1, 2003, we froze the benefits earned under these plans, with the exception of a small transition group. We do not anticipate making any contributions to these plans in Fiscal 2006.

EMPLOYEE DEFINED BENEFIT PLANS

We have a frozen noncontributory defined benefit pension plan that covered substantially all of our full-time employees and an unfunded defined benefit supplemental executive retirement plan covering certain highly compensated employees. The pension benefits were based on years of service, limited to 45 years, and the employee s highest consecutive five-year average compensation out of the last 10 years of employment. We fund pension costs in conformity with the funding requirements of applicable government regulations. In an effort to reduce ongoing operating costs and improve our competitive position, we froze the benefits earned under such plans effective July 1, 2003, with the exception of a small transition group.

Since our accumulated benefit obligation exceeds the fair value of our plan assets, we are required to reflect on our balance sheet a minimum pension liability for the difference totaling $45.9 million as of January 31, 2006. Minimum pension liability adjustments are non-cash adjustments that are reflected as an increase in pension liability with an offsetting charge to shareholders equity (net of income tax) through other comprehensive income (rather than net income).

The calculations of liability and expense associated with our pension plans are dependent on key assumptions, including the discount rate, the expected long-term rate of return on plan assets, and the assumed rate of compensation increases. For purposes of calculating our benefit obligations as of January 31, 2006, we increased the assumed discount rate used for this calculation from 5.5% at January 31, 2005 to 5.6%, based on the change in the Moody s Aa long-term corporate bond yield from January 31, 2005 to January 31, 2006.

We assumed our expected long-term rate of return on plan assets to be 8.5%, which is consistent with Fiscal 2004. In determining the expected long-term rate of return on plan assets, we considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of risk premiums associated with other asset classes and the expectations of future returns over a 20-year time horizon on each asset class, based on the views of leading financial advisors and economists. The expected return for each asset class was then weighted based on the plan s target asset allocation. We also gave consideration to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment using capital market projections, an estimated long-term asset allocation strategy based on the plan s statement of investment policy, objectives and guidelines and an estimate of annual administrative, investment management and trading expenses.

Consistent with the prior year, we used 4.1% in Fiscal 2005 as the assumed rate of compensation increase for our employee population, based on historical trends and the expectation that long-term rates of compensation increase should approximate growth in overall gross domestic product.

We continuously review all assumptions used in the pension calculations and may revise them in the future. If we were to decrease the expected long-term rate of return on plan assets assumption by 100 basis points, the pension expense we recognized in Fiscal 2005 would have increased by $1.1 million. If we were to decrease the discount rate by 100 basis points, the pension expense we recognized in Fiscal 2005 would have increased by approximately $1.6 million.

During Fiscal 2005, 2004 and 2003 we recognized $2.5 million, $1.6 million and $5.9 million, respectively, of expense associated with our defined benefit pension plans. We made funding contributions of $0.4 million, $10.9 million and $13.1 million in Fiscal 2005, Fiscal 2004 and Fiscal 2003, respectively. Based on the best available information we have at this time, we expect that in Fiscal 2006 we will recognize approximately $3.5 million of pension expense and will contribute less than $1.0 million to our defined benefit pension plans. These estimates for Fiscal 2006 include a discount rate of 5.6%, an expected long-term rate of return on plan assets of 8.0% and a 4.1% rate of compensation increase. Increases in future pension funding requirements could occur if the actual return on plan assets in future periods does not approximate

the long-term rate of return assumed by us, and the amount of such increases could be material.

In addition to our defined benefit pension plans, we have a defined benefit postretirement medical plan, which provides for the payment of medical costs of eligible employees and dependents upon retirement. The plan is currently not funded. We expect to continue paying postretirement medical costs as covered claims are incurred. Effective July 1, 2003, we decided that postretirement medical benefits will not be provided to future retirees, with the exception of a small transition group. In addition, plan participants pay a higher portion of total plan costs in subsequent years.

Like the pension plans discussed above, the defined benefit postretirement medical plan is dependent on key assumptions, including the discount rate and future healthcare cost trend rates. For this actuarial calculation, we used a discount rate of 5.6% and assumed an annual rate of increase of approximately 10% for pre-age 65 covered health care benefits, eventually and

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gradually decreasing to 5% by 2016 and remaining at that level thereafter. A one percentage point increase in the healthcare cost trend rate assumption in each future year would impact the postretirement benefit obligation by approximately $0.1 million and would impact the total service and interest cost by approximately $0.1 million.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law. The Act introduced a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The defined benefit postretirement medical plan has been amended such that, effective January 1, 2006, prescription medication coverage was discontinued for all participants who were both eligible for prescription drug benefits under Medicare and for whom Medicare is the primary payor. This plan change has reduced the plan s net periodic benefit cost beginning in Fiscal 2005.

CRITICAL ACCOUNTING POLICIES

Preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts and related disclosures during the period. We evaluate our estimates on an ongoing basis, based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. If actual market conditions are less favorable than those projected by us, additional adjustments to reserve items might be required. We consider the following policies to be the most critical and pervasive accounting policies we use, and the areas most sensitive to material change from external factors.

Revenue Recognition: The majority of our sales are derived from fixed price contracts to provide equipment. Revenue on equipment and parts sales is recognized when contract terms are met, collectibility is reasonably assured and a product is shipped or risk of ownership has been transferred to and accepted by the customer. Revenue from service agreements is recognized as earned, when services have been rendered. With respect to cost-plus-fixed-fee contracts, we recognize the fee ratably as the actual costs are incurred, based upon the total fee amounts expected to be realized upon completion of the contracts. Amounts collected in advance of being earned are reflected on the balance sheet as unearned revenue. Bid and proposal costs are expensed as incurred.

Warranty Costs: Based on historical experience and contract terms, we provide for the estimated cost of product and service warranties at the time of sale or, in some cases, when specific warranty problems are identified. Accrued warranty costs are adjusted periodically to reflect actual experience. Certain warranty and other related claims involve matters of dispute that ultimately are resolved by negotiation, arbitration or litigation. Occasionally, a material warranty issue can arise that is beyond our historical experience. We provide for any such warranty issues as they become known and estimable. Should actual product failure rates or repair costs differ from our current estimates, revisions to the estimated warranty liability would be required.

Inventories: Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out (FIFO) basis, and market determined on the basis of estimated realizable values. Production cost includes material, labor and manufacturing overhead. When circumstances dictate, we write inventory down to its estimated realizable value based upon assumptions about future demand, technological innovations, market conditions, plans for disposal and the

physical condition of products. If circumstances change, causing us to reduce our estimate of realizable value for specific inventory items or categories, additional provisions to cost of sales may be required.

Asset Impairment: We assess the valuation of components of our property, plant and equipment and other long-lived assets whenever events or circumstances dictate that the carrying value might not be recoverable. We base our evaluation on indicators such as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements and other external market conditions or factors that may be present. If such factors indicate that the carrying amount of an asset or asset group may not be recoverable, we determine whether impairment has occurred by analyzing an estimate of undiscounted future cash flows at the lowest level for which identifiable cash flows exist. If our estimate of undiscounted future cash flows during the estimated useful life of the asset is less than the carrying value of the asset, we recognize a loss for the difference between the carrying value of the asset and its estimated fair value, measured by the present value of estimated future cash flows or other means, as appropriate under the circumstances.

Deferred Income Tax Assets: We record deferred tax assets and liabilities for differences between the book basis and tax basis of our net assets. We record a valuation allowance, when appropriate, to adjust deferred tax asset balances to the amount we expect to realize. We consider, as applicable, the amount of taxable income available in carryback years, future taxable income and potential tax planning strategies in assessing the potential need for a valuation allowance. We will require future taxable

income in order to fully realize our net deferred tax assets. Should we determine that we will not likely realize all or part of our net deferred income tax assets in the future, an adjustment to the deferred tax asset balance would be charged to the income tax provision in the period such determination is made.

Stock-Based Compensation: As permitted under SFAS No. 123, we use the intrinsic value method of accounting to account for our employee stock options and other 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 our common stock on the grant date and all other provisions of the award are fixed. Had we used the fair value method of accounting for stock-based compensation prescribed by SFAS No. 123, net earnings would have been negatively impacted by $2.5 million, $1.4 million and $1.1 million for Fiscal 2005, 2004 and 2003, respectively.

In connection with the sale of our Power Products and Engineered Products businesses in January 2006, we entered into termination and release agreements with three former executives. Pursuant to such agreements, the Company accelerated the vesting of all stock option agreements held by the three executives, and extended their exercise term from 30 days after the date of termination to December 31, 2006. As a result of these modifications of terms, the Company recorded non-cash compensation expense totaling $3.3 million in Fiscal 2005, which was charged to gain (loss) on sale of discontinued operations in the consolidated statement of operations.

Insurance: We maintain a variety of insurance for our operations that we believe to be customary and reasonable. Although we believe we currently maintain insurance coverage that is adequate for the risks involved, there is always a risk that our insurance may not be sufficient to cover any particular loss or that our insurance may not cover all losses. For example, it is possible that an adverse product liability claim could arise in excess of our coverage. In addition, insurance rates and availability are subject to wide fluctuation, and changes in our coverage and the insurance industry could result in increases in our insurance cost and higher deductibles and retentions.

We are self-insured up to certain levels in the form of deductibles and retentions for general liability, vehicle liability, group medical and workers compensation claims. Other than normal business and contractual risks that are not insurable, our risk is commonly insured against and the effect of a loss occurrence is not expected to be significant. We accrue for estimated self-insurance costs and uninsured exposures based on estimated development of claims filed and an estimate of claims incurred but not reported. We regularly review estimates of reported and unreported claims and provide for losses accordingly. Although we believe that adequate reserves have been provided for expected liabilities arising from our self-insured obligations, uninsured claims and exposures, our estimates of these liabilities may change as claims develop, and adjustments to reserves may be required.

Pensions and Other Postretirement Benefits: We account for our defined benefit pension plan and our defined benefit postretirement medical plan in accordance with SFAS No. 87, Employers Accounting for Pensions and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions, respectively. These standards require that amounts recognized in the financial statements be determined on an actuarial basis. Significant assumptions involved in determining our pension and other postretirement benefit expense include the expected return on plan assets, expected healthcare cost trend rates and expected compensation increases, and the discount rate for calculating future liability. See Employee Defined Benefit Plans for further discussion.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, which requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statements of operations based on their fair values. SFAS No. 123R is effective in the first quarter of Fiscal 2006. Pursuant to the provisions of the Company s stock option plans, as a result of the Board of Directors approving the Armor Holdings merger, substantially all outstanding stock options became fully vested and exercisable on February 26, 2006, subject to certain restrictions. As a result of this event, we expect that the adoption of the provisions of SFAS No. 123R will result in a pre-tax charge to compensation expense in the first quarter of Fiscal 2006 totaling approximately $7.0 million. See Note 1 and Note 2 to our consolidated financial statements included elsewhere herein for further discussion.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB 43, Chapter 4, which clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges and requires the allocation of fixed production overheads to inventory based on the normal utilization of capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred by us beginning in Fiscal 2006. We do not believe the implementation of SFAS No. 151 will have a material impact on our consolidated financial statements.

Item 7a. Quantitative and Qualitative Disclosures about Market Risk.

Foreign Currency Risk: In April 2005, we acquired all outstanding shares of ATHL, a light tactical vehicle manufacturer headquartered in the United Kingdom, for a total purchase price, denominated in British pounds, of approximately $48.2 million. The functional currency for ATHL is the British pound. In connection with the acquisition, we established a British pound-denominated intercompany note in the amount of £12.5 million (approximately $22.1 million at January 31, 2006), which is to be repaid in annual installments through December 2009. Subsequently, we advanced ATHL an additional £4.2 million (approximately $7.4 million at January 31, 2006), under intercompany notes which are due to be repaid in Fiscal 2006. In order to mitigate the exposure related to the intercompany notes receivable denominated in British pounds we entered into a series of forward foreign exchange contracts.

Substantially all of the sales of ATHL are denominated in British pounds. Purchases of materials and component parts are also substantially denominated in British pounds; however, some component purchases are denominated in Euros and other foreign currencies. As a result, the earnings from ATHL are affected by fluctuation in the value of the British pound against the Euro, the U.S. dollar and other currencies.

Fluctuations in currency exchange rates may also impact our shareholders equity. Amounts invested in non-U.S. subsidiaries are translated into U.S. dollars at the exchange rates in effect at the balance sheet date. The resulting translation adjustments are recorded in shareholders equity as cumulative translation adjustments. With regard to the ATHL acquisition, the intercompany note and hedging program described above are intended to mitigate the exposure related to £12.5 million, or $23.5 million of the original purchase price. The remaining portion of the initial investment is impacted by fluctuations in the U.S. dollar equivalent to the British pound.

In addition, certain suppliers of our U.S. operations bill in foreign currencies, particularly the Euro. We occasionally enter into foreign exchange forward contracts with maturities of up to 12 months to hedge these specific purchase commitments and anticipated transactions but not for speculative or trading purposes.

Interest Rate Risk: We have $25.1 million in fixed rate debt, of which $0.1 million is denominated in foreign currency.

The table below provides information about our market sensitive financial instruments, all of which are due in Fiscal 2006 and none of which was entered into for trading purposes. This table constitutes a forward-looking statement *(in thousands, except interest rate data)*.

	Book Value at January 31, 2006	Fair Value at January 31, 2006
Notes Payable, denominated in foreign currency	$ 50	$ 50
Average interest rate	2.00%	
Long-term debt	$ 25,000	$ 25,136
Average interest rate	7.38%	

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Item 8. Financial Statements and Supplementary Data.

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Management s Report on Internal Control Over Financial Reporting

Report of Independent Registered Public Accounting Firm

Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

Consolidated Balance Sheets as of January 31, 2006 and 2005

Consolidated Statements of Operations for the Years ended January 31, 2006, 2005 and 2004

Consolidated Statements of Shareholders Equity for the Years ended January 31, 2006, 2005 and 2004

Consolidated Statements of Comprehensive Income for the Years ended January 31, 2006, 2005 and 2004

Consolidated Statements of Cash Flows for the Years ended January 31, 2006, 2005 and 2004

Notes to Consolidated Financial Statements

MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in the Securities Exchange Act of 1934 Rule 13a-15(f). The Company s internal controls were designed to provide reasonable assurance as to the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

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

Management assessed the effectiveness of the Company s internal control over financial reporting as of January 31, 2006, excluding the operations of Automotive Technik (Holdings) Limited and its subsidiaries. These businesses were acquired in April 2005 and represent approximately 4% of the Company s total assets as of January 31, 2006 and 7% of total revenues for the year then ended. Automotive Technik (Holdings) Limited s net loss constituted approximately 13% of the Company s consolidated net income for the year ended January 31, 2006. In making its assessment, management has utilized the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control Integrated Framework.

Based on this assessment, management concluded that, as of January 31, 2006, the Company s internal control over financial reporting was effective.

Our assessment of the effectiveness of the Company s internal control over financial reporting has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report, which is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Stewart & Stevenson Services, Inc.

We have audited the accompanying consolidated balance sheets of Stewart & Stevenson Services, Inc. and subsidiaries as of January 31, 2006 and 2005 and the related consolidated statements of operations, shareholders equity, comprehensive income and cash flows for each of the three years in the period ended January 31, 2006. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Stewart & Stevenson Services, Inc. and subsidiaries as of January 31, 2006 and 2005 and the consolidated results of their operations and their cash flows for each of the three years in the period ended January 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Stewart & Stevenson Services, Inc. s internal control over financial reporting as of January 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 11, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

April 11, 2006
Houston, Texas

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Shareholders

Stewart & Stevenson Services, Inc.

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Stewart & Stevenson Services, Inc. and subsidiaries maintained effective internal control over financial reporting as of January 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Stewart & Stevenson Services, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

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

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

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

As indicated in the accompanying Management s Report on Internal Control over Financial Reporting, management s assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Automotive Technick (Holdings) Limited and its subsidiaries, which are included in the Fiscal 2005 consolidated financial statements of Stewart & Stevenson Services, Inc. and constituted 4% of total assets as of January 31, 2006 and 7% of total consolidated revenues for the year then ended. Automotive Technick (Holdings) Limited s net loss constituted 13% of Stewart & Stevenson Services, Inc. s consolidated net income for the year ended January 31, 2006. Our audit of internal control over financial reporting of Stewart & Stevenson Services, Inc. also did not include an evaluation of the internal control over financial reporting of Automotive Technick (Holdings) Limited.

In our opinion, management s assessment that Stewart & Stevenson Services, Inc. and subsidiaries maintained effective internal control over financial reporting as of January 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Stewart & Stevenson Services, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of January 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of January 31, 2006 and 2005 and the related consolidated statements of operations, shareholders equity, comprehensive income and cash flows for each of the three years in the period ended January 31, 2006 of Stewart & Stevenson Services, Inc. and subsidiaries and our report dated April 11, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

April 11, 2006
Houston, Texas

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)	**January 31, 2006**	**2005**
Assets		
Current Assets:		
Cash and cash equivalents	$ 333,171	$ 128,515
Short-term investments	3,800	2,480
Accounts receivable, net	66,244	62,136
Inventories	22,140	17,803
Deferred income tax asset	7,165	5,872
Income tax receivable	189	7,223
Other current assets	3,967	1,655
Total assets of discontinued operations	33,681	318,753
Total Current Assets	470,357	544,437
Property, Plant and Equipment, net	49,179	37,856
Deferred Income Tax Asset	10,940	26,438
Intangibles and Other Assets, net	47,235	4,611
Total Assets	$ 577,711	$ 613,342
Liabilities and Shareholders Equity		
Current Liabilities:		
Notes payable and current portion of long-term debt	$ 25,158	$
Accounts payable	64,165	43,441
Accrued payrolls and incentives	8,947	13,178
Unearned revenue	53,146	63,335
Other current liabilities	26,258	22,713
Total liabilities of discontinued operations	25,943	99,193
Total Current Liabilities	203,617	241,860
Long-Term Debt, net of current portion	65	25,000
Accrued Postretirement Benefits and Pension	53,543	57,621
Other Long-Term Liabilities	4,700	4,141
Total Liabilities	261,925	328,622
Shareholders Equity:		
Common stock, without par value, 100,000,000 shares authorized; 29,303,260 and 28,865,070 shares issued, respectively	70,588	59,616
Accumulated other comprehensive loss	(32,155)	(36,048)
Retained earnings	277,353	261,152
Total Shareholders Equity	315,786	284,720
Total Liabilities & Shareholders Equity	$ 577,711	$ 613,342

See accompanying notes to the consolidated financial statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)	Year Ended January 31, 2006	2005	2004
Sales	$ 726,352	$ 549,803	$ 445,686
Cost of sales	682,592	476,005	366,694
Gross profit	43,760	73,798	78,992
Selling and administrative expenses	19,258	25,938	27,617
Pension curtailment expense			2,400
Other expense (income), net	(44)	407	(362)
Operating profit	24,546	47,453	49,337
Interest expense	1,897	2,029	3,202
Interest income	(2,934)	(1,388)	(1,475)
Earnings from continuing operations before income taxes	25,583	46,812	47,610
Income tax expense	8,367	16,085	16,453
Net earnings from continuing operations	17,216	30,727	31,157
Earnings (loss) from discontinued operations, net of tax expense (benefit) of $6,325, ($18,143) and ($48,921)	9,272	(28,019)	(84,360)
Gain (loss) on sale of discontinued operations, net of tax expense (benefit) of ($246) and $1,311	(360)	2,270	
Net earnings (loss)	$ 26,128	$ 4,978	$ (53,203)
Weighted average shares outstanding:			
Basic	29,117	28,749	28,560
Diluted	29,593	28,984	28,887
Earnings (loss) per share:			
Basic:			
Continuing operations	$ 0.59	$ 1.07	$ 1.09
Discontinued operations	0.31	(0.90)	(2.95)
Net earnings (loss) per share	$ 0.90	$ 0.17	$ (1.86)
Diluted:			
Continuing operations	$ 0.58	$ 1.06	$ 1.08
Discontinued operations	0.30	(0.89)	(2.92)
Net earnings (loss) per share	$ 0.88	$ 0.17	$ (1.84)

See accompanying notes to the consolidated financial statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands)	Shares Outstanding	Common Stock	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, January 31, 2003	28,491	$ 54,843	$ 328,868	$ (21,703)	$ 362,008
Net loss			(53,203)		(53,203)
Cash dividends			(9,704)		(9,704)
Other comprehensive loss				(3,831)	(3,831)
Exercise of stock options	154	2,213			2,213
Balance, January 31, 2004	28,645	57,056	265,961	(25,534)	297,483
Net earnings			4,978		4,978
Cash dividends			(9,787)		(9,787)
Other comprehensive loss				(10,514)	(10,514)
Exercise of stock options	220	2,560			2,560
Balance, January 31, 2005	28,865	59,616	261,152	(36,048)	284,720
Net earnings			26,128		26,128
Cash dividends			(9,927)		(9,927)
Other comprehensive income				3,893	3,893
Exercise of stock options	438	10,972			10,972
Balance, January 31, 2006	29,303	$ 70,588	$ 277,353	$ (32,155)	$ 315,786

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended January 31,		
	2006	2005	2004
Net earnings (loss)	$ 26,128	$ 4,978	$ (53,203)
Change in additional minimum pension liability, net of tax of $1,658, ($5,559) and ($2,191)	2,948	(9,882)	(3,896)
Unrealized income (loss) on forward contracts, net of tax of $3, ($174) and ($10)	5	(310)	163
Currency translation gain (loss), net of tax of $2,368, ($181) and ($54)	940	(322)	(98)
Comprehensive income (loss)	$ 30,021	$ (5,536)	$ (57,034)

See accompanying notes to the consolidated financial statements.

STEWART & STEVENSON SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended January 31,		
(In thousands)	2006	2005	2004
Operating Activities			
Net earnings (loss)	$ 26,128	$ 4,978	$ (53,203)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Net (earnings) loss from discontinued operations	(8,912)	25,749	84,360
Deferred tax provision (benefit)	10,190	(6,371)	(2,216)
Depreciation and amortization	9,708	9,844	9,649
Unrealized foreign exchange losses	1,502		
(Gain) loss on sale of business assets	(147)	685	
Change in operating assets and liabilities net of the effect of acquisition, divestiture and discontinued operations:			
Accounts receivable, net	(11,529)	(36,598)	(14,593)
Inventories	2,390	(2,115)	(8,237)
Income tax receivable	7,033	25,813	(28,144)
Accounts payable	17,559	11,778	24,291
Accrued payrolls and incentives	(6,291)	4,244	1,137
Unearned revenue	(9,592)	(5,008)	6,510
Other current liabilities	(5,418)	1,246	6,562
Accrued postretirement benefits and pension	529	(9,809)	(6,965)
Other, net	4,724	(314)	(1,080)
Net Cash Provided by Continuing Operations	37,874	24,122	18,071
Net Cash Provided by (Used in) Discontinued Operations	(67,883)	11,716	(12,734)
Net Cash Provided by (Used in) Operating Activities	(30,009)	35,838	5,337
Investing Activities			
Capital expenditures	(17,370)	(9,344)	(10,606)
Proceeds from sale of businesses	301,727	51,559	1,414
Acquisition of businesses, net of cash acquired	(44,559)		(1,788)
Disposal of property, plant and equipment, net	313	904	133
Short-term investments	(1,320)	5,265	(7,745)
Net investing activities of discontinued operations	66	150	480
Net Cash Provided by (Used in) Investing Activities	238,857	48,534	(18,112)
Financing Activities			
Loan acquisition costs	(76)	(412)	
Payments on long-term borrowings			(30,000)
Dividends paid	(9,927)	(9,787)	(9,704)
Proceeds from exercise of stock options	6,337	2,156	1,867
Net Cash Used in Financing Activities	(3,666)	(8,043)	(37,837)
Effect of exchange rate changes on cash	(526)		
Increase (decrease) in cash and cash equivalents	204,656	76,329	(50,612)
Cash and cash equivalents, beginning of fiscal year	128,515	52,186	102,798
Cash and cash equivalents, end of fiscal year	$ 333,171	$ 128,515	$ 52,186
Cash Paid For:			
Interest	$ 2,092	$ 2,139	$ 3,581
Income taxes (excluding refunds)	550	1,351	3,628

See accompanying notes to the consolidated financial statements.

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

Note 1: Organization and Business

Stewart & Stevenson Services, Inc. (together with its subsidiaries, the Company), a Texas corporation founded in 1902, is primarily engaged in the design, manufacture and service of medium and light tactical vehicles for the U.S. Army and others worldwide. During its history, the Company has also been engaged in the manufacture, distribution and service of a wide range of industrial products and diesel-powered equipment to various industries, including power generation, defense, marine, petroleum and transportation. During Fiscal 2005, the Company sold substantially all of the assets and business of its Power Products segment and Engineered Products segment (see Note 4), leaving the Company with one operating segment Tactical Vehicle Systems. All financial statements and notes included herein have been restated to reflect the Power Products segment, the Engineered Products segment and other former businesses as discontinued operations.

On February 27, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Armor Holdings, Inc. (Armor Holdings) and one of its wholly-owned subsidiaries, pursuant to which Armor Holdings agreed to acquire all of the outstanding common stock of the Company for $35.00 per share in a cash merger transaction. Upon completion of the merger, the Company will be a subsidiary of Armor Holdings and there will be no further market for the Company s common stock. The transaction is subject to Company shareholder approval, the expiration or termination of the Hart-Scott-Rodino waiting period and other customary conditions. Under specified circumstances, if the Merger Agreement is terminated, the Company would be required to pay Armor Holdings a termination fee. In addition, the Merger Agreement contains conditions to Armor Holdings obligations to consummate the merger, including the absence of a material adverse change (as defined in the Merger Agreement) since the date of the Merger Agreement. The Company has scheduled a special meeting of shareholders for May 9, 2006 to consider and vote upon the proposed merger. The Company anticipates that the transaction will close during the second quarter of Fiscal 2006. See Note 11.

Note 2: Summary of Significant Accounting Policies

Fiscal Year: The Company s fiscal year begins on February 1 of the year stated and ends on January 31 of the following year. For example, Fiscal 2005 commenced on February 1, 2005 and ended on January 31, 2006. The Company reports results on the fiscal quarter method with each quarter comprising approximately 13 weeks.

Use of Estimates and Assumptions: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from these estimates.

Consolidation: The consolidated financial statements include the accounts of Stewart & Stevenson Services, Inc. and all enterprises in which the Company has a controlling interest. All intercompany accounts and transactions have been eliminated.

Cash Equivalents: Interest-bearing deposits, investments in government securities, commercial paper, money market funds and other highly liquid investments with original maturities of three months or less are considered cash equivalents.

Short-Term Investments: Short-term investments include floating-rate municipal bonds and other marketable securities with original maturities of greater than three months. These investments are highly liquid and historical gains and losses on these types of investments have not been material.

Allowance for Doubtful Accounts: The Company extends credit to customers and other parties in the normal course of business and maintains an allowance for doubtful accounts for estimated losses resulting from the inability or unwillingness of customers to make required payments. The Company bases such estimates on its historical experience, existing economic conditions and any specific customer collection issues the Company has identified. Uncollectible accounts receivable are written off when a settlement is reached for an amount less than the outstanding balance or when the Company determines that the balance will not be collected. The allowance for doubtful accounts balance was $0.1 million at January 31, 2006 and 2005. As discussed in Note 10, the U.S. government is the Company s primary customer and government contracts account for over 85% of the Company s sales from continuing operations.

Inventories: Inventories are stated at the lower of cost or market, with cost determined on a first-in, first-out (FIFO) basis, and market determined on the basis of estimated realizable values. Production cost includes material, labor and manufacturing overhead. When circumstances dictate, the Company writes inventory down to its estimated realizable value based upon assumptions about future demand, technological innovations, market conditions, plans for disposal and the physical condition of

products. Shipping and handling costs related to non-manufactured products are expensed as incurred in cost of sales. Shipping and handling costs related to manufactured products are capitalized into inventory and expensed as products are sold.

Revenue Recognition: The majority of the Company s sales are derived from fixed price contracts to provide equipment. Revenue on equipment and parts sales is recognized when contract terms are met, collectibility is reasonably assured and a product is shipped or risk of ownership has been transferred to and accepted by the customer. Revenue from service agreements is recognized as earned, when services have been rendered. With respect to cost-plus-fixed-fee contracts, the Company recognizes the fee ratably as the actual costs are incurred, based upon the total fee amounts expected to be realized upon completion of the contracts. Amounts collected in advance of being earned are reflected on the balance sheet as unearned revenue. Bid and proposal costs are expensed as incurred.

Property, Plant and Equipment: Property, plant and equipment is stated at historical cost. Depreciation is computed over the estimated useful lives of the assets, using the straight-line method. When items are retired or otherwise disposed of, income is charged or credited for the difference between net book value and proceeds realized thereon. Ordinary maintenance and repairs are charged to expense as incurred, and replacements and betterments are capitalized. The range of estimated service lives used to calculate financial reporting depreciation for principal items of property, plant and equipment are as follows:

Machinery and equipment	2 7 years
Computer hardware and software	3 5 years
Building and leasehold improvements	10 25 years

The Company assesses the valuation of components of its property, plant and equipment and other long-lived assets whenever events or circumstances dictate that the carrying value might not be recoverable. The Company bases its evaluation on indicators such as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements and other external market conditions or factors that may be present. If such factors indicate that the carrying amount of an asset or asset group may not be recoverable, the Company determines whether impairment has occurred by analyzing an estimate of undiscounted future cash flows at the lowest level for which identifiable cash flows exist. If the estimate of undiscounted future cash flows during the estimated useful life of the asset is less than the carrying value of the asset, the Company recognizes a loss for the difference between the carrying value of the asset and its estimated fair value, measured by the present value of estimated future cash flows or third party appraisal, as appropriate under the circumstances.

Goodwill and Other Intangible Assets: Goodwill represents the excess of the aggregate purchase price over the fair value of net identifiable assets of businesses acquired. Goodwill and other intangible assets are evaluated at least annually for impairment, during the fourth quarter or when events or circumstances indicate that it is more likely than not that an impairment loss has been incurred. The goodwill impairment test is a two-step test and involves comparing the estimated fair value of each reporting unit to the reporting unit s carrying value, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill attributable to the reporting unit is not considered impaired, and the second step is unnecessary. If the fair value of a reporting unit is less than its carrying value, an indication of goodwill impairment exists, and in the second step, the fair value of the reporting unit is allocated to all of its assets and liabilities. The fair value of tangible net assets and both recognized and unrecognized intangible assets is deducted from the fair value of the reporting unit to determine the implied fair value of reporting unit goodwill. If the implied fair value of reporting unit goodwill is lower than its carrying amount, goodwill is impaired and is written down to its

implied fair value.

Deferred Income Tax Assets and Liabilities: The Company records deferred tax assets and liabilities for differences between the book basis and tax basis of net assets as well as taxable net operating loss carry forwards. The Company records a valuation allowance, when appropriate, to adjust deferred tax asset balances to the amount the Company expects to realize. The Company considers the amount of taxable income available in carryback years, future taxable income and potential tax planning strategies in assessing the potential need for a valuation allowance.

Insurance: The Company maintains a variety of insurance for its operations that it believes to be customary and reasonable. The Company is self-insured up to certain levels in the form of deductibles and retentions for general liability, vehicle liability, group medical and workers compensation claims. Other than normal business and contractual risks that are not insurable, the Company s risk is commonly insured against and the effect of a loss occurrence is not expected to be significant. The Company accrues for estimated self-insurance costs and uninsured exposures based on estimated development of claims filed and an estimate of claims incurred but not reported. The Company regularly reviews estimates of reported and unreported claims and provides for losses accordingly.

Internal-Use Software Costs: Internal and external costs incurred to develop internal-use computer software are capitalized. The cost of business process reengineering activities, data migration and training are expensed as incurred.

Capitalized Interest: The Company capitalizes interest costs related to the Company s construction of long-lived assets to be used in operations. The amount of interest capitalized is calculated based on the Company s average cost of borrowed funds. The Company capitalized $0.1 million during Fiscal 2005. No interest was capitalized during Fiscal 2004 or 2003. The capitalized amount was deducted from interest expense on the Company s consolidated statement of operations and was included in the cost of the related asset on the consolidated balance sheet.

Foreign Exchange Contracts: In April 2005, the Company acquired all outstanding shares of a light tactical vehicle manufacturer headquartered in the United Kingdom, for a total purchase price of approximately $48.2 million denominated in British pounds (see Note 4). The functional currency for this acquired business is the British pound. In connection with the acquisition, the Company established a British pound-denominated intercompany note in the amount of £12.5 million (approximately $22.1 million at January 31, 2006), which is to be repaid in annual installments through December 2009. Subsequently, the Company advanced an additional £4.2 million (approximately $7.4 million at January 31, 2006), under intercompany notes which are due to be repaid in Fiscal 2006. The Company entered into foreign currency forward contracts as a hedge against the economic exposure of these intercompany notes receivable and not for speculative or trading purposes. While these contracts affect the Company s results of operations, they do so only in connection with the underlying transactions. All derivative instruments are recognized as assets or liabilities in the balance sheet and are measured at fair value at the end of each period.

In addition, certain suppliers of the Company s U.S. operations bill in foreign currencies, particularly the Euro. The Company occasionally enters into foreign exchange forward contracts with maturities of up to 12 months, designated as cash flow hedges, to hedge these specific purchase commitments and anticipated transactions but not for speculative or trading purposes.

Translation of Foreign Currency: The British pound is the functional currency for the Company s United Kingdom subsidiaries which were acquired in Fiscal 2005. As such, assets and liabilities are translated into U.S. dollars at year-end exchange rates. Income and expense items are translated at average exchange rates during the year. Translation adjustments resulting from changes in exchange rates are reported in other comprehensive income. Gains or losses from foreign currency transactions are recognized in current earnings. Net foreign currency exchange gains included in other (income) expense, net in the consolidated statements of operations were $0.2 million during Fiscal 2005 and immaterial in Fiscal 2004 and 2003.

Fair Value of Financial Instruments: The Company s financial instruments consist primarily of cash equivalents, short-term investments, trade receivables, trade payables and debt instruments. The recorded values of cash equivalents, short-term investments, trade receivables, and trade payables are considered to be representative of their respective fair values. Generally, the Company s notes payable have interest rates which are tied to current market rates. The senior notes had a carrying value of $25 million at January 31, 2006 and 2005, and a fair value of $25 million and $26 million at January 31, 2006 and 2005, respectively. The fair values of the senior notes were estimated based on market

quotes obtained from brokers. The Company estimates that the recorded value of all of its other financial instruments approximates their fair values.

Warranty Costs: The Company generally provides product and service warranties for periods of 12 months to 24 months. Based on historical experience and contract terms, the Company provides for the estimated cost of product and service warranties at the time of sale or, in some cases, when specific warranty problems are identified. Accrued warranty costs are adjusted periodically to reflect actual experience. Certain warranty and other related claims involve matters of dispute that ultimately are resolved by negotiation, arbitration or litigation. Occasionally, a material warranty issue can arise that is beyond the Company s historical experience. The Company provides for any such warranty issues as they become known and estimable.

Pensions and Other Postretirement Benefits: The Company accounts for its defined benefit pension plans and its defined benefit postretirement medical plan in accordance with SFAS No. 87, Employers Accounting for Pensions and SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions, respectively. These standards require that amounts recognized in the financial statements be determined on an actuarial basis. Significant assumptions involved in determining the Company s pension and other postretirement benefit expense include the expected return on plan assets, expected healthcare cost and compensation increases and the discount rate for calculating future liability. The assumed long-term rate of return on assets is applied to a calculated value of plan assets which results in an estimated return on plan assets that

is included in current year pension income or expense. When the accumulated benefit obligation exceeds the fair value of defined benefit plan assets, the Company reflects the difference as an increase in pension liability with an offsetting charge to shareholder s equity (net of tax) through other comprehensive income (rather than net income).

Stock-Based Compensation: As permitted under Statement of Financial Accounting Standards (SFAS) No. 123, the Company continues to use the intrinsic value method of accounting prescribed by Accounting Principles Board Opinion (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 and all other provisions of the award are fixed. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment, which requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statements of operations based on their fair values. The Company is required to adopt the provisions of SFAS No. 123R in Fiscal 2006.

Pursuant to the provisions of the Company s stock option plans (see Note 9), as a result of the Board of Directors approving the Armor Holdings merger (See Note 1), all outstanding stock options became fully vested and exercisable on February 26, 2006. Primarily as a result of this accelerated vesting, the Company expects that the adoption of the provisions of SFAS No. 123R will result in a non-cash pre-tax charge to compensation expense in Fiscal 2006 totaling approximately $7.0 million. No additional future impact of SFAS No. 123R is anticipated unless the Company grants additional stock options in the future.

In connection with the sale of our Power Products and Engineered Products businesses in January 2006 (see Note 4), the Company entered into termination and release agreements with three former executives. Pursuant to such agreements, the Company accelerated the vesting of all stock option agreements held by the three executives, and extended their exercise term from 30 days after the date of termination to December 31, 2006. As a result of these modifications of terms, the Company recorded non-cash compensation expense totaling $3.3 million in Fiscal 2005, which was charged to gain (loss) on sale of discontinued operations in the consolidated statements of operations.

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 thousands, except per share data)		**Fiscal 2005**		**Fiscal 2004**		**Fiscal 2003**
Net earnings (loss):						
As reported	$	26,128	$	4,978	$	(53,203)
Pro forma compensation expense, determined under fair value method, net of tax		(2,483)		(1,424)		(1,094)
Pro forma	$	23,645	$	3,554	$	(54,297)
Basic earnings (loss) per share:						
As reported	$	0.90	$	0.17	$	(1.86)
Pro forma		0.81		0.12		(1.90)
Diluted earnings (loss) per share:						
As reported	$	0.88	$	0.17	$	(1.84)
Pro forma		0.80		0.12		(1.88)

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 with the following weighted-average assumptions used for grants in Fiscal 2005, 2004 and 2003:

	Fiscal 2005	Fiscal 2004	Fiscal 2003
Risk free interest rates	3.98%	3.00%	2.83%
Expected dividend yields	1.45%	2.97%	3.18%
Expected volatility	62.90%	64.80%	65.10%
Expected life (years)	4	5	5

Based on the above assumptions, the weighted average fair value of stock options granted in Fiscal 2005, 2004 and 2003 was $11.33, $5.72 and $5.13, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Earnings Per Share: Basic earnings per share have been calculated by dividing net earnings (loss) by the weighted average number of common shares outstanding during the year. Diluted earnings per share are computed considering the potential dilution that would occur if all securities or other contracts to issue common stock were exercised or converted into common stock. See Note 9.

Reclassifications: The accompanying consolidated financial statements and notes for prior fiscal years contain certain reclassifications, including the consistent classification of discontinued operations (see Note 5), to conform with the presentation used in Fiscal 2005.

Recent Accounting Pronouncements: In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB 43, Chapter 4, which clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges and requires the allocation of fixed production overheads to inventory based on the normal utilization of capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred by the Company beginning in Fiscal 2006. The Company does not believe the implementation of SFAS No. 151 will have a material impact on its consolidated financial statements.

Note 3: Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss consisted of the following components, net of tax, at January 31:

(In thousands)	**Fiscal 2005**	**Fiscal 2004**
Accumulated additional minimum pension liability	$ (29,414)	$ (32,362)
Unrealized income on forward contracts	5	
Currency translation loss	(2,746)	(3,686)
Accumulated other comprehensive loss	$ (32,155)	$ (36,048)

Note 4: Acquisitions and Divestitures

In January 2006, the Company completed the sale of substantially all the operating assets and business of the Engineered Products and Power Products Divisions for cash consideration of approximately $277 million and the assumption of certain liabilities. In March 2006, the cash consideration was adjusted upward by $6.4 million, based on the net asset value delivered at closing. The Company recognized a pre-tax gain of $9.7 million ($5.8 million after-tax) associated with these sales.

In August 2005, the Company sold substantially all of the inventory, property, plant and equipment, distribution rights, and operations of four Power Products Division distribution locations in California for cash consideration of approximately $9.4 million. As a result of this sale, the Company recorded a $3.4 million pre-tax ($2.0 million after-tax) loss on disposal of discontinued operations during Fiscal 2005, which included a $3.6 million estimated withdrawal liability from a union pension plan.

In April 2005, the Company acquired all outstanding shares of Automotive Technik (Holdings) Limited (ATHL), a light tactical vehicle manufacturer headquartered in the United Kingdom. The aggregate purchase price for the transaction was approximately $48.2 million, including cash of $47.0 million, notes of $0.2 million and transaction costs of approximately $1.0 million. The acquisition of ATHL broadens the Company s product offerings and provides additional marketing opportunities for the Company s Tactical Vehicle Systems business. The results of operations for ATHL are included in the Company s consolidated financial statements since the date of acquisition. Since the date of acquisition, the ATHL operations generated sales of $51.6 million and a pre-tax operating loss of $5.1 million during Fiscal 2005. Pro forma results from continuing

operations for Fiscal 2005 and Fiscal 2004, including the operating results of ATHL for this period are as follows (*in thousands*):

	Fiscal 2005	Fiscal 2004
Sales	$ 735,035	$ 598,774
Net earnings from continuing operations	17,105	30,586
Diluted earnings per share - continuing operations	$ 0.58	$ 1.06

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition:

(In thousands)	**April 8, 2005**
Cash and cash equivalents	$ 3,552
Other current assets	15,642
Property, plant and equipment	2,553
Identifiable intangible assets	16,684
Goodwill	30,593
Total assets acquired	69,024
Notes payable	149
Other current liabilities	17,901
Deferred tax liability	2,702
Long-term debt, net of current portion	68
Total liabilities assumed	20,820
Purchase price allocated	$ 48,204

In January 2005, the Company sold substantially all of the assets and business of the Airline Products business for proceeds of $60 million as well as the assumption of certain liabilities, subject to final adjustment based on the amount of working capital conveyed at closing. In November 2005, the Company reached an agreement with the buyer regarding certain contractual issues related to the sale, pursuant to which the Company agreed to refund $4.0 million of purchase price to the buyer. Primarily as a result of this dispute, the Company recorded pre-tax charges of $7.0 million ($4.2 million after-tax) to loss on sale of discontinued operations during Fiscal 2005, including the write-off of a $3.0 million receivable from the buyer.

Note 5: Discontinued Operations

As a result of the divestitures described in Note 4, the identified assets, liabilities and results of operations for the Airline Products, Power Products and Engineered Products businesses are reported as discontinued operations for all periods presented. Pursuant to the sales agreements for Power Products and Engineered Products divestitures, the Company retained certain assets including certain accounts receivable balances, three vacated facilities from the Power Products business, and the Engineered Products manufacturing facility which is being leased to the buyer of the business. The lease of the Engineered Products facility expires in July 2008, and has a purchase option that expires in July 2007. Additionally, the Company retained certain obligations of these businesses, for which the Company has recorded accruals it believes to be adequate.

The Company s discontinued operations also include the wind-down of the turnkey engineering, procurement and construction activities of the Distributed Energy Solutions business, which the Company decided to exit in Fiscal 2003, and the retained warranty and contract obligations from the Fiscal 2002 sale of the blowout preventer and controls, valve and drilling riser business previously included in the Engineered Products segment.

During Fiscal 2005, the Company recorded $4.3 million in pre-tax charges related to the settlement of a customer dispute in the Distributed Energy Solutions business, which was paid in August 2005.

Sales and operating profit (loss) from discontinued operations were as follows (*in thousands)*:

	Year Ended January 31,		
	2006	2005	2004
Sales			
Power Products	$ 535,122	$ 508,378	$ 509,981
Engineered Products	167,372	100,178	113,545
Airline Products		86,287	63,733
Distributed Energy Solutions	7,265	20,037	44,867
Total Sales	$ 709,759	$ 714,880	$ 732,126
Operating profit (loss)			
Power Products	$ 12,091	$ 13,352	$ (51,854)
Engineered Products	11,631	(11,574)	(15,358)
Airline Products		(5,752)	(12,594)
Distributed Energy Solutions	(8,125)	(42,188)	(53,475)
Total operating profit (loss)	15,597	(46,162)	(133,281)
Income tax expense (benefit)	6,325	(18,143)	(48,921)
Net earnings (loss) from discontinued operations	$ 9,272	$ (28,019)	$ (84,360)

In addition to the discontinued operating results above, the Company recorded a loss on sale of discontinued operations of $0.4 million (net of tax benefit of $0.2 million) in Fiscal 2005, and a gain on sale of discontinued operations of $2.3 million (net of tax expense of $1.3 million) in Fiscal 2004, related to the sale of the Airline Products, Power Products and Engineered Products businesses. The Fiscal 2005 loss on sale of discontinued operations includes a $7.0 million pretax charge related to the settlement of a dispute arising from the Fiscal 2004 sale of the Airline Products business and a net pre-tax gain of $6.4 million resulting from sales of the Power Products and Engineered Products businesses. The Fiscal 2004 gain on sale of discontinued operations resulted from the sale of the Airline Products business.

Assets and liabilities of discontinued operations as of January 31, 2006 and 2005 consisted of the following *(in thousands)*:

(In thousands)	**Fiscal 2005**	**Fiscal 2004**
Cash and cash equivalents	$ 39	$ 1,942
Accounts receivable, net	5,315	111,317
Recoverable costs and accrued profits not yet billed	656	27,557
Inventories	1,322	71,788
Property, plant and equipment, net	10,726	81,728
Deferred tax assets	12,846	12,167
Other assets	2,777	12,254
Total assets of discontinued operations	$ 33,681	$ 318,753
Notes payable	$	$ 1,671
Accounts payable	1,659	41,688
Accrued payrolls and incentives	5,146	10,812
Other liabilities	19,138	45,022
Total liabilities of discontinued operations	$ 25,943	$ 99,193

The property, plant and equipment balance at January 31, 2006 includes $8.7 million associated with a manufacturing facility that is under lease to the buyer of the Engineered Products business. The lease term expires in July 2008, and has a purchase option that expires in July 2007.

The Company believes it is more likely than not that the net deferred income tax assets as of January 31, 2006 will be realized, based on expected future taxable income from continuing operations.

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Note 6: Inventories

Summarized below are the components of inventories related to continuing operations, net of customer deposits:

(In thousands)	January 31, 2006	January 31, 2005
Raw materials and spare parts	$ 12,431	$ 8,422
Work in process	9,709	9,381
Total Inventories	$ 22,140	$ 17,803

Raw materials and spare parts include OEM equipment and components used in the manufacturing segment. The inventory balances above are stated net of inventory valuation allowances totaling $2.2 million and $0.2 million at the end of Fiscal 2005 and 2004, respectively.

Note 7: Debt Arrangements

Outstanding debt, which is generally unsecured, consists of the following:

(In thousands)	January 31, 2006	January 31, 2005
Senior notes, 7.38%, due May 2006	$ 25,000	$ 25,000
Other, denominated in foreign currency	223	
	25,223	25,000
Less current portion	(25,158)	
Long-term debt, net of current portion	$ 65	$ 25,000

In January 2005, the Company entered into a $100 million unsecured revolving credit facility which expires in January 2009. To date, no borrowings have been made under this facility. A commitment fee ranging from 17.5 to 37.5 basis points per annum is paid on the daily average unused balance of the facility based on the Company s leverage ratio. The revolving credit facility has a $25 million sub-facility which may be used for letters of credit. Approximately $7.0 million in letters of credit under the revolving credit facility were outstanding at January 31, 2006 and $93.0 million was available for borrowing. The Company has alternative interest rates that can be applied to any borrowings under the facility, which include prime rate and a LIBOR plus 75 to 150 basis points, depending on the Company s leverage ratio. The borrowing rate would have been 5.56% at January 31, 2006, which represents LIBOR plus 75 basis points.

The Company s revolving credit facility and senior notes are unsecured and their related agreements contain covenants that restrict indebtedness, guarantees, sales of assets and other customary items. Additional covenants in the revolving credit facility require the Company to maintain a minimum fixed charge coverage ratio and maximum leverage ratio. Based on the Company s financial condition as of January 31, 2006, the restrictions imposed by the Company s senior notes and revolving credit facility do not currently restrict the Company s ability to meet its obligations or to declare and pay dividends at historical levels.

The Company has additional letter of credit facilities totaling $12.5 million with financial institutions, to allow the issuance of letters of credit as needed to support ongoing commercial operations. These facilities expire in Fiscal 2007. Approximately $6.9 million of letters of credit under these facilities were outstanding as of January 31, 2006.

Note 8: Income Taxes

The components of the income tax provision from continuing operations are as follows:

(In thousands)	**Fiscal 2005**	**Fiscal 2004**	**Fiscal 2003**
Current provision (benefit)	$ (1,823)	$ 22,456	$ 18,669
Deferred provision (benefit)	10,190	(6,371)	(2,216)
Income tax provision	$ 8,367	$ 16,085	$ 16,453

The components of the income tax provision (benefit) from discontinued operations are as follows:

(In thousands)	Fiscal 2005	Fiscal 2004	Fiscal 2003
Current provision (benefit)	$ 8,759	$ (23,928)	$ (44,393)
Deferred provision (benefit)	(2,680)	7,096	(4,528)
Income tax provision (benefit)	$ 6,079	$ (16,832)	$ (48,921)

The sources of earnings from continuing operations before income taxes are as follows:

(In thousands)	Fiscal 2005	Fiscal 2004	Fiscal 2003
United States	$ 30,115	$ 46,814	$ 47,608
Foreign	(4,532)	(2)	2
	$ 25,583	$ 46,812	$ 47,610

A reconciliation between the income tax provision from continuing operations and income taxes computed by applying the statutory U.S. Federal income tax rate of 35% in Fiscal 2005, 2004 and 2003 is as follows:

(In thousands)	Fiscal 2005	Fiscal 2004	Fiscal 2003
Provision at statutory rate of 35%	$ 8,954	$ 16,384	$ 16,664
Other, net	(587)	(299)	(211)
Income tax provision	$ 8,367	$ 16,085	$ 16,453

The net deferred tax assets from continuing operations are determined under the liability method based on the difference between the financial statement and tax basis of assets and liabilities as measured by the enacted statutory tax rates. The deferred tax provision (benefit) is the result of changes in these temporary differences. The tax effects of the temporary differences which comprise the deferred tax asset at the end of Fiscal 2005 and 2004 are as follows:

(In thousands)	Fiscal 2005	Fiscal 2004
Deferred Tax Assets		
Postretirement benefit obligation	$ 4,564	$ 5,394
Accrued expenses and other reserves	9,023	7,943
Pension accounting	14,743	15,461
Net operating loss carryforwards	3,346	11,585
Other	314	1,202
Gross deferred tax assets	31,990	41,585
Deferred Tax Liabilities		
Property, plant, and equipment	1,578	2,878
Intangible assets	4,239	
Prepaid expenses and deferred charges	5,937	5,087
Other		