

2001 Annual Report



VIRCO MFG. CORPORATION



Company Profile

Virco Mfg. Corporation, founded in 1950 and headquartered in Torrance, California, is a leader in the furniture manufacturing industry and the nation's largest producer of educational furniture.

2001 Annual Report

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Financial Highlights

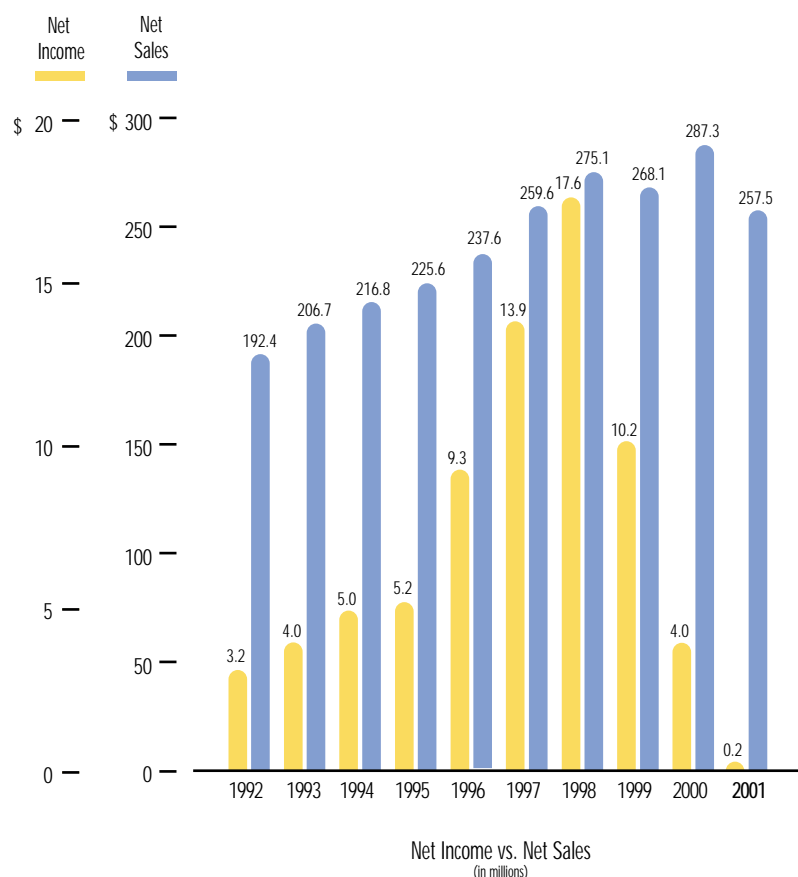
<i>In thousands, except per share data</i>	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
Summary of Operations										
Net sales - continuing operations ^(3, 4)	\$ 257,462	\$ 287,342	\$ 268,079	\$ 275,096	\$ 259,586	\$ 237,551	\$ 225,559	\$ 216,822	\$ 206,738	\$ 192,356
Net income										
Continuing operations	246	4,313	10,166	17,630	13,852	9,326	5,209	5,001	4,302	3,827
Discontinued operations	—	—	—	—	—	—	—	—	—	(668)
Change in accounting methods	—	(297)	—	—	—	—	—	—	(275)	—
	\$ 246	\$ 4,016	\$ 10,166	\$ 17,630	\$ 13,852	\$ 9,326	\$ 5,209	\$ 5,001	\$ 4,027	\$ 3,159
Net income per share ⁽¹⁾	\$ 0.02	\$ 0.32	\$ 0.79	\$ 1.32	\$ 1.04	\$ 0.71	\$ 0.40	\$ 0.38	\$ 0.31	\$ 0.24
Stockholders' equity	90,223	94,141	93,834	88,923	77,077	63,921	55,386	50,466	45,637	41,937
Stockholders' equity per share ⁽²⁾	7.38	7.59	7.51	6.93	5.92	4.93	4.27	3.90	3.53	3.24

(1) Based on average number of shares outstanding each year after giving retroactive effect for stock dividends and 3 for 2 stock split.

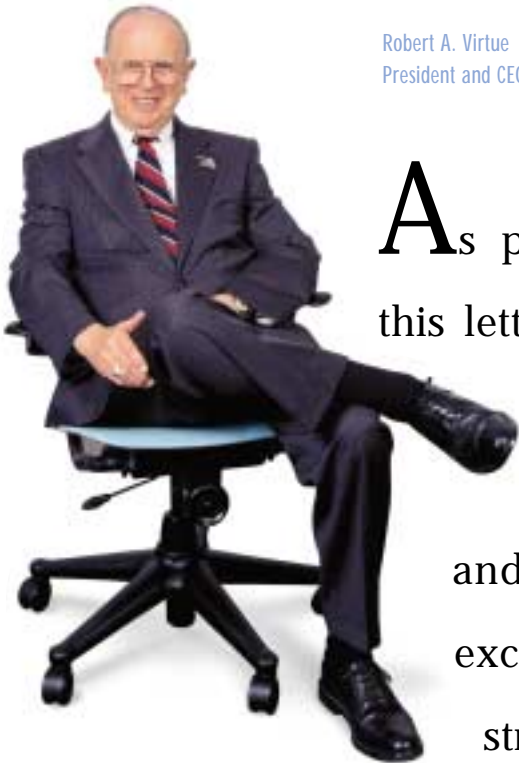
(2) Based on number of shares outstanding at year-end giving effect for stock dividends and 3 for 2 stock split.

(3) The prior period statements of operations contain certain reclassifications to conform to the presentation required by EITF No. 00-10, "Accounting for Shipping and Handling Fees and Costs," which the Company adopted during the fourth quarter of the year ended January 31, 2001.

(4) During the fourth quarter of 2000, the Company changed its method of accounting for revenue recognition in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements." Pursuant to Financial Accounting Standards Board Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," effective February 1, 2000, the Company recorded the cumulative effect of the accounting change.



Although sales and earnings both declined in fiscal 2001, these results mask significant improvements in underlying operations.



Robert A. Virtue
President and CEO

As promised in our Fourth Quarter Report, this letter will consist of three sections: a recap of our fiscal 2001 performance; an update on shipments, incoming orders and business prospects for 2002; and excerpts from our Five-Year Plan focusing on strategies for growth.

1 In the year just ended operations delivered a modest \$246,000 profit on sales of \$257,462,000. This compares to a loss on operations of \$3,391,000 on substantially higher sales of \$287,342,000 in fiscal 2000. Three consecutive quarters of improving margins provide evidence that operations are appropriately scaled to earn a profit at current levels of revenue. In addition, cash flow from operations reached a record \$35,037,000, due largely to a \$19,356,000 reduction in inventories made possible by our Assemble-to-Ship (ATS) program.



To Our Shareholders (continued)

You will recall that last year's results were enhanced by two non-operating events: the sale of a warehouse in California and the receipt of payment for a claim. Together these gains more than offset our fiscal 2000 operating losses. In the interest of clarity we have provided two sets of comparative figures, both with and without these non-recurring gains, in each of this year's reports. This is the last time we'll show both sets of numbers:

As Reported, Including Real Estate and Claims Settlement in the Year 2000

<i>In thousands, except per share data</i>	Three Months Ended		Twelve Months Ended	
	1/31/02	1/31/01	1/31/02	1/31/01
Sales	\$ 39,580	\$ 45,316	\$ 257,462	\$ 287,342
Net (loss)/income	(4,391)	(7,279)	246	4,016
Net (loss)/income per share	(0.36)	(0.59)	0.02	0.32

Continuing Furniture Operations Only

<i>In thousands, except per share data</i>	Three Months Ended		Twelve Months Ended	
	1/31/02	1/31/01	1/31/02	1/31/01
Sales	\$ 39,580	\$ 45,316	\$ 257,462	\$ 287,342
Net Op.(loss)/income	(4,391)	(7,279)	246	(3,391)
Net (loss)/income per share	(0.36)	(0.59)	0.02	(0.27)

2001 was an extremely difficult year for the commercial furniture industry. As a group the members of BIFMA (the Business and Institutional Manufacturer's Association) reported a sales decline of 17.4% for the calendar year, with an even more dramatic 29.2% decline in the fourth quarter. There was a positive carryover of demand from the technology boom in the first half of 2001, which helped moderate many companies' reported results. It seems now, however, that the new "floor" is somewhat below last year's average, with many industry leaders reporting continuing declines into May of this year. One consequence of the recession has been a sharp reduction in capacity. Estimates are that the industry has shed 16,000 workers and eliminated 20% of factory space since January, 2001.

To Our Shareholders (continued)

Although we took some unusual measures to steer Virco through this downturn, including a temporary 10% pay cut for all employees and extended plant closures during the 2001 holiday season, we managed to avoid crippling layoffs. The temporary pay cut was lifted at the end of January. We began our new fiscal year on full hours and full pay. Production rates continue to be ahead of last year's even though spending levels have not increased, indicating that the efficiencies of ATS are now reaching the factory floor.

Other accomplishments worth noting include:

- Total operating costs declined \$25,000,000, or 13% (operating costs include all expenses except raw material);
- Operating costs were virtually equal to 1999, the year before we took on the added expense of our new Conway plant and our SAP management information system;
- We paid off all long-term debt associated with the Conway plant in 2001 and we expect to have no long-term debt by 2004;
- We satisfied our loan covenants and renegotiated a revolving line of credit with Wells Fargo that provides an additional \$10,000,000 of working capital during our peak summer season;
- We strengthened our balance sheet and preserved shareholder equity with effective risk management;
- We kept our plants open, our workforce employed, and took no writedowns for restructuring.

We reported at the end of our fourth quarter the passing of long-time board member Jack Stafford. As this report was going to press, former Virco President Donald C. Heyl also passed away. Don served as President from 1967 through 1982, and played a significant role in the growth of the company from a small start-up to a market leader.

Both Jack and Don were "old school" in financial matters. They had a preference for hard assets and they demanded honest reporting, even if the news wasn't always good. Virco's balance sheet and financial structure reflect their conservative values. We have no exotic derivatives, special purpose entities, or complex revenue recognition issues. We have no off-balance sheet financing arrangements except for operating leases, such as the lease on our Torrance plant. Hard assets consisting of inventories, receivables, and plant, property and equipment are currently valued at 120% of our market cap. Most of our plants and equipment are new, meaning that capital investments will be less than depreciation for at least the next three to five years. By 2004 our only significant borrowings will be for the seasonal financing of inventories and receivables.

We feel these strengths are not currently reflected in our share price, which is why we are continuing to buy back shares as they become available. We still have over \$6,000,000 remaining under our current repurchase authorization and we intend to use much of it this year.



Prospects for 2002 are neutral to slightly positive. Preliminary first quarter results show that sales declined a bit more than \$1MM compared to the prior year, but our net operating loss (typical in quarters one and four) improved by approximately \$1.5MM.

Based on these “early returns”, we have staffed and scheduled our factories to support sales volume of approximately \$260MM. Because our delivery season peaks in mid-summer, factory output tends to be front-loaded in our fiscal year. Should demand fall short of these early projections, we have sufficient time to adjust downward as necessary.

Operating efficiencies are continuing to improve, thanks primarily to ATS. On lower first quarter sales volume we still recognized a net improvement in earnings, with the bulk of the improvement coming from lower cost of sales as opposed to higher prices. This suggests that summer shipments may contribute stronger earnings than last year.

On the negative side our resale partners are still in the midst of a recession. Whether weakness in the commercial sector will offset improvements elsewhere is hard for us to predict, but the first quarter provided a moderately encouraging start to the year.

The acquisition of Furniture Focus, which we announced in our fourth quarter report, is now complete. Furniture Focus will contribute approximately \$5-\$7MM of additional revenue in 2002, net of inter-company product transfers. We have added 17 Furniture Focus employees to the Virco sales team, along with \$4,000,000 worth of backlog.

The purchase was for \$2,425,000 in cash, which came out of this year’s \$6,000,000 capital expenditures budget. Following several years of heavy investment in production machines, we have now bought a “sales machine”.

By helping small- to mid-sized school districts manage the Furniture, Fixtures and Equipment (FF&E) budget for new school construction, Furniture Focus provides a kind of expertise many of these districts can’t afford to maintain on their own. About two-thirds of Furniture Focus’ revenue consists of bond-funded project management business. The other third is day-to-day fill-in business from existing customers. We intend to gradually extend the Furniture Focus package-selling model across our nationwide sales force, supplying an additional form of revenue we aren’t currently able to access. At this stage we cannot predict how large our package business will ultimately become – much depends on the staffing and purchasing decisions made by our public school customers.

During the past year we have received numerous questions from shareholders about Virco's plans for the future, especially regarding sales growth. We maintain a five-year plan that addresses sales growth and many other important strategic issues. We have dedicated the rest of this year's annual report to excerpts from the Virco Five-Year Plan. We begin with an annotated summary:

1. Values: A Compass to Action in Difficult Times

We believe that values and integrity supersede strategy or tactics. Values provide superior guidance in unpredictable circumstances. Unwavering adherence to values is also the best defense against damage to corporate reputation and the loss of shareholder capital.

2. State of the Commercial Furniture Industry

The industry is currently in recession, with many companies reporting year-over-year revenue declines of 20-35%. Major players are deeply and inflexibly entrenched in their current market positions. The long-standing systems paradigm is under scrutiny by end users, and is also threatened by advances in wireless technologies. These changes have created uncertainty and price cutting in the center of the office furniture market, with repercussions in the surrounding niches.

3. Strategic Positioning

Virco is the overall high-value/low-cost supplier of moveable furniture for publicly funded institutions characterized by extreme seasonality and/or a bid-based purchasing function. In addition, Virco provides the same furniture to resellers whose end users share these characteristics. By concentrating on this niche, Virco avoids financially destructive head-to-head battles with larger competitors in other segments of the commercial furniture market.

4. Prospects for Growth and New Product Development

Balancing the desire for profitable growth with a rational assessment of competitors' capabilities, Virco will continue to be a niche player focusing on the customer segment described above. New products and services will be aimed at deepening control in this niche, not expanding into others. In pursuing this growth strategy we prefer to develop products and services internally, saving the inflated costs for control associated with many acquisitions.

5. Ascending Crescents and Future Cash Flow

The *ascending crescents* are cycles of heavy capital investment followed by gradually improving profits and cash flow, which lead eventually to capacity constraints and another cycle of investment. Virco's last peak occurred in fiscal 1997 and 1998; the next peak is beginning now and may last longer. *Net cash flow* (operating cash flow minus capital investments) will average \$15-\$20MM per year for the next three to five years.

6. Virco as an Investment

Virco's common stock is ranked 74th in total return over the past five years among all American corporations paying dividends [*Mergent's Dividend Achievers 2001 Edition*]. This strong performance is possible because stable, informed ownership permits the execution of a superior long-term strategy. Distribution of future net earnings in the proportion of 50-65% retained, 15-30% share repurchases and 10-25% dividends will optimize financial performance through continued stability of ownership and compounding of reinvested earnings.

7. Risk Management and Preservation of Shareholder Capital

The concept of compounding only works when principal is preserved. Virco's risk management strategy seeks to balance the long-term avoidance of major loss with administrative costs and the occasional short-term loss of business opportunities.

8. Succession Planning and Management Development

Successful execution of a long-term strategy depends on management that is both capable and deep. A new executive level of Senior Vice President will be considered, with one position each in sales, operations and administration. A new three-tiered compensation plan will also be researched, with rewards tied to the execution of daily responsibilities, the achievement of annual profit goals, and the development of long-term intrinsic value.

9. Summary

Accepting the entrenched positions of major competitors, with a desire to maintain or improve return on committed capital, growth will be aimed at deepening mix and units with existing customers, and selling similar customers both in the U.S. and overseas. Capital structure will be intentionally trimmed through lower rates of investment and refinement of inventory management. New products and services will be developed primarily from within the company. The only acquisitions that will be considered are those that enhance Virco's current strategic position, are reasonably priced, and offer excellent prospects for integration.

Following are excerpts from each of the Plan's nine sections. As with any plan, ours is subject to regular modification based on changes in the competitive environment. All the normal disclaimers regarding forward-looking statements apply.

Values:

Adherence to values comes before strategy or tactics. As the longest-term of these three planning elements, values should remain constant through multiple generations of a company's leaders. Each leader may individually craft several strategies which are implemented by hundreds of tactical maneuvers. But values, the beliefs about how a business treats its employees, shareholders, customers, suppliers and even competitors, must not change.

Virco's core values are voice, dignity, fairness, leadership and merit. Together these add up to integrity, but we find their individual explication beneficial in decision-making. It was dignity, fairness and leadership that led us to a 10% pay cut plus three weeks of plant closures during the fourth quarter of 2001. Our employees' dignity was preserved because unemployment is hard on self-respect and families. Fairness dictated that everybody share in the sacrifice, from the CEO down. Leadership was required to devise an unconventional solution to lower demand that allowed us to preserve our loyal, experienced workforce.

Values go to the heart of a company's reputation. They are therefore essential to the preservation and compounding of shareholder capital. Recent high profile examples of companies that knew of bad practices yet failed to correct them illustrate the damage that can be done when values are sacrificed for short-term gain.

Pursuing a values-first approach will place Virco's future results clearly in the range of previous results, which may at times be frustrating to investors seeking more dramatic short-term appreciation. One of our duties is to help investors set reasonable expectations by continually explaining the principles that guide our decision-making. We will attempt to do this in every quarterly and annual report, as well as in our catalogs, on our website, and in other public communications.

State of the Commercial Furniture Industry:

We continue to receive reports from industry newsletters, our field sales force, common customers and suppliers as to the depth of the current commercial furniture recession. Quarter-over-quarter sales declines of 20-30% are still being reported, mostly by the large office furniture manufacturers. We note with interest that these declines far exceed the general economic downturn and suspect that some negative synergy is exacerbating the effect.

Two events are now converging that may threaten the primacy of hardwired cubicle systems, which are the dominant product lines for these companies. First is the growing recognition among end users that once committed to a particular manufacturer, they have few options in terms of choice or cost. The recent spate of office closures and downsizings has further highlighted the relative inflexibility and low resale value of systems.



Second, wireless technology combined with greater workforce mobility is undermining the need for hardwired cubicles. As wireless continues to advance, the data support advantage that cubicles enjoy over freestanding desks may diminish. Because they aren't hardwired, freestanding desks and panel dividers can be purchased for about one third the price, making them a far better value for customers who don't require linkage. Since they're also less complicated, freestanding desks can be bought and installed by the end users themselves.

From Virco's perspective the competitive terrain outside our niche is hazardous. Confronted with significant declines in business, the large systems manufacturers are taking drastic action to preserve market share. We believe our best efforts lie in reinforcing our current position, as opposed to battling the industry giants at a time when they're under strain.

S Strategic Positioning:

Virco's strategy is best understood in terms of Michael Porter's analytical framework for studying competition [from Porter, Michael. *On Competition*. Boston: Harvard Business Review Books, 1998. See especially chapters 1 and 2].

A sharply condensed explication of Porter's model is that strategy is the establishment of a distinct competitive position defined by unique or uniquely executed business activities, which ideally exhibit mutually reinforcing fit and are defended from rivals' encroachment by the cost of trade-offs. Warren Buffett, the Chairman of Berkshire Hathaway, has described a similar model using the terms "franchise" in place of position and activities, and "protective moat" in place of fit and trade-offs. [See Buffett's *Letters from Annual Reports* on the Internet at berkshirehathaway.com.]

In both models, a key to strategic success is maintaining focus and discipline when confronted with the temptation to straddle or reposition for the sake of growth. Buffett is especially firm on this point because of the capital that often gets squandered on ill-conceived expansion efforts. With this background, Virco's strategic position is to be:

The overall high-value/low-cost supplier of moveable furniture for publicly funded institutions characterized by extreme seasonality and/or a bid-based purchasing function. In addition, Virco will supply the same furniture to resellers whose end users share these characteristics.

The wording of this position is carefully chosen and has deep implications for our corporate strategy. Key concepts are:

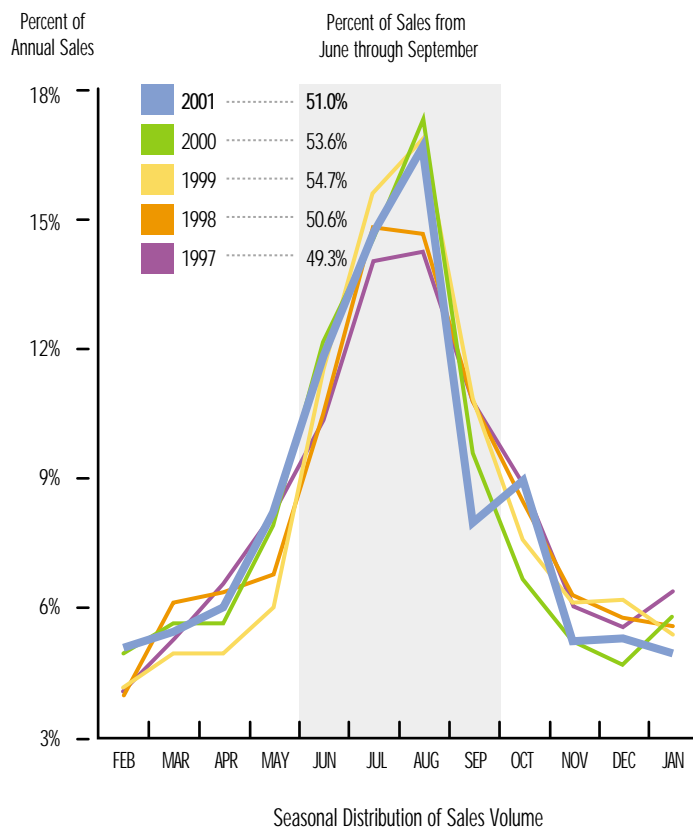
- *overall high-value/low-cost supplier*, which aggregates procurement, manufacturing, financing, selling and servicing costs into a total price/value equation for the customer;
- *moveable furniture*, which excludes cubicle systems and fixed seating;

To Our Shareholders (continued)

- *publicly funded*, which includes school districts and others who because of public oversight place great importance on value;
- *extreme seasonality*, which is our key logistical and financing constraint; and
- *bid-based purchasing*, which brings clarity to all participants about prices, features and underlying cost structures.

Recalling Porter's concept of establishing and defending a strategic position through unique or uniquely pursued activities, here is an enumerated list of Virco's key activities, all integrated by the theme of high-value/low-cost:

1. Virco sells and services most customers on a direct, low-cost basis, as opposed to the higher-cost, multi-layered dealer model used by virtually all of our competitors. Certain end users are serviced by dealer-partners who contribute significant value to the "value equation", primarily through the provision of services that are financially inefficient for us to perform on our own.
2. Virco utilizes a vertically integrated manufacturing function to beat competitors' product costs. Public bid recaps and feedback from other sources confirm that our approach is more cost effective than a model based on heavy outsourcing.



The key logistical constraint in Virco's market niche continues to be a 4:1 ratio between summer and off-season deliveries. Our ability to deal with the financing, inventory and service issues created by this seasonality constitutes both our greatest skill and our best defense against new entrants into the market.



3. Our direct sales model allows us to engage in customer-directed furniture design, meeting precise functional needs quickly and effectively.
4. Direct sales also permit the execution of nationwide pricing, which is better suited to emerging trends of regional and national buying consortiums. This contrasts with the more fragmented approach pursued by competitors, who rely on dealers to set prices based primarily on local conditions.
5. We finance and warehouse our own off-season inventory, a crucial strategic activity in a niche with a 4:1 peak-season to off-season shipping ratio.
6. Utilizing the ATS model further improves the value, versatility and density of the inventory we build, while simultaneously providing more choice for our customers and insulating our factories from inefficient short runs.

As suggested by this list, these activities are mutually reinforcing and involve costly trade-offs should competitors try to imitate us. The opposite is also true: if we stray from our adherence to these particular activities, we will increase our cost structure and compromise our ability to meet the needs of our current customers.

Prospects for Growth and New Product Development:

We believe the maximum financial efficiency of Virco's current infrastructure will occur between \$300MM and \$400MM in annual revenue. Our short-term growth target is the lower end of that range. Within five years, we may approach the upper figure. Importantly, we don't have to get there to succeed – we've streamlined to the point where we can operate profitably at \$250-\$260MM per year.

Given our simultaneous desire to preserve capital and grow into something approaching ideal efficiency, our challenge is to identify opportunities that permit both. This requires careful strategic aim.

We have identified three methods of growth. Listed in order of preference, these are:

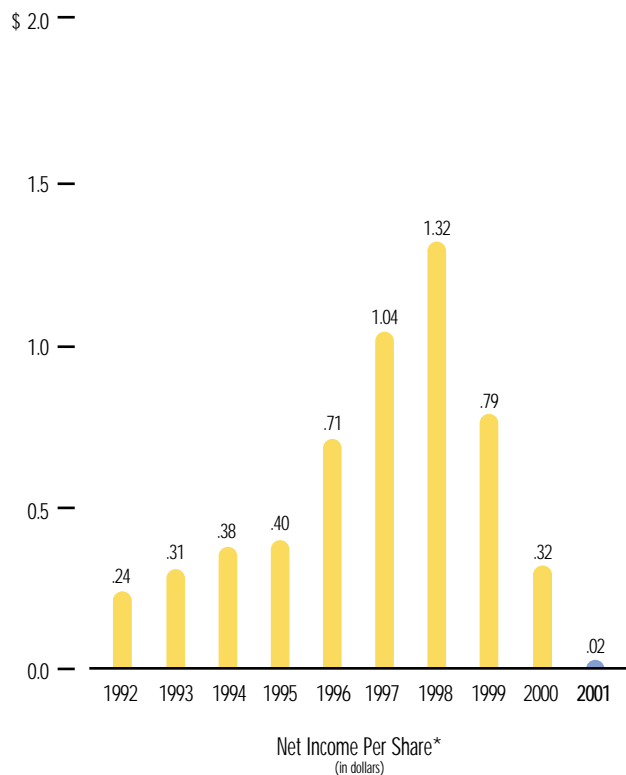
1. Growth through *expanded mix*, where we sell existing customers a broader array of internally developed Virco products;
2. Growth through *penetration*, where we identify new customers with extreme seasonality and/or a bid-based purchasing function; and
3. Growth through *acquisition*, where we buy an entire company for its products, customer list, distribution capabilities, or a combination of traits.

To Our Shareholders (continued)

In all cases we seek to avoid head-to-head battles with stronger competitors. Total capital expenditures, whether for new product development, acquisitions, or regular maintenance of our present infrastructure, will be kept within the \$6-\$7MM range annually through at least 2004. We will only seek new volume with margins that equal or exceed current margins. And we will not chase revenue that creates trade-offs or conflicts with our current strategic position.

This disciplined stance has caused us to reject a number of acquisitions over the past five years. Most of the companies we considered were either too expensive, burdened with outdated factories, or had product lines that overlapped ours. Furniture Focus had none of these drawbacks, and it met all the growth criteria listed earlier.

Perhaps most importantly, Furniture Focus will give us a broad enough product offering to justify a separate purchase order within the Furniture, Fixtures and Equipment budget for bond-funded school construction projects. This will prevent other packagers, such as discount office chains, from combining a competitor's furniture with non-furniture items as a way of excluding Virco from the bidding process. If we are able to supply enough of the total FF&E budget, public administrators will likely see the benefit of our bid. We believe our low-cost approach to manufacturing, sales and service will allow us to earn our share of public awards by eliminating the multiple layers involved in other distribution models. But to even be considered for a bid, our offering must represent a substantial portion of the FF&E budget line.



As with sales and earnings, the decline in net income per share masks improvements in operating margin. Absent one-time gains from real estate and claims settlement, fiscal 2000 furniture operations actually generated a loss of (\$0.27) per share, compared to earnings of \$.02 in 2001.

* Based on average number of shares outstanding each year after giving retroactive effect for stock dividends and 3 for 2 stock split.

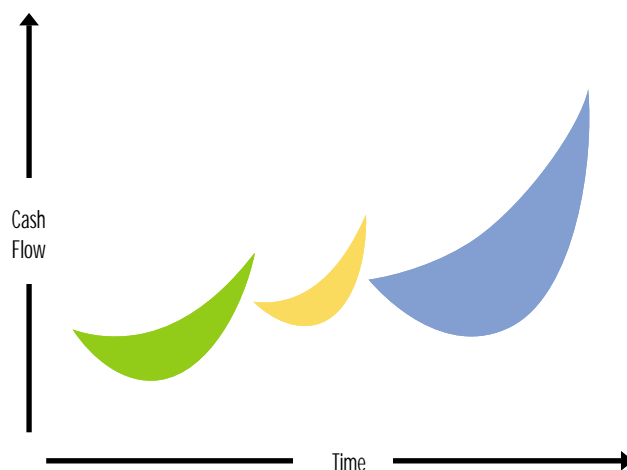
Our current goal is to develop products that will total 40-60% of the average FF&E expenditures for new schools. We are currently able to supply approximately 25-40%, depending on the particular project. Once the functional gaps in our product line are identified, new product development will become a vital part of this strategic growth model.

Warren Buffet has repeatedly pointed out the advantages of buying only portions of companies, warning that the “premium for control”, which accountants call goodwill, often costs more than it’s worth. Internal development of new products offers many of the same cost advantages as partial ownership. Although slower than acquisitions, it is also less costly, has fewer integration problems, and avoids the goodwill premium that in our market niche has usually included redundant or outdated products we wouldn’t retain in any event.

Internal product development leading to expanded mix with existing customers will yield gradual, sustainable and profitable growth. It will probably not generate double-digit growth rates, except when underlying demand expands by like amounts. Because we are structured to operate profitably and support our debt at \$260MM in annual revenue, we are not forced to pursue growth in the more competitive center of the commercial furniture market.

Ascending Crescents and Future Cash Flow:

The ascending crescents are multi-year patterns of cash flow through a business. Each crescent begins with heavy capital investment, initially depressing cash flow. A period of assimilation follows as the business grows into its new capacity or integrates an acquisition. As capacity is approached and efficiencies peak, a parallel peak of positive cash flow develops. If capacity becomes a constraint, more capital is invested and a new crescent begins.



As we digest our recent capital investments, net cash flow (operating cash flow minus capital expenditures) will assume a pattern of ascending crescents.

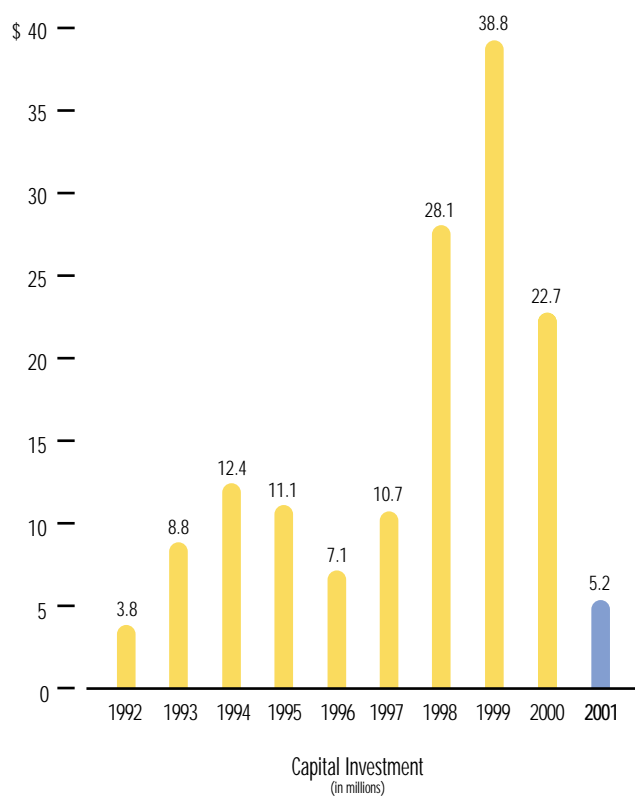
Ascending Crescents

To Our Shareholders (continued)

The shape of the crescents is determined by the absolute size of the investments relative to a business' total capitalization. Typically the larger the business, the smaller the crescents. For a company our size, investments on the scale of Conway and SAP result in exaggerated crescents. But when the turn comes, the results can be proportionately exciting.

Every string of ascending crescents has a strategic cap, where the economic limits (defined by demand) of the pure strategic position are reached. Beyond this strategic cap straddling occurs, reducing returns on any additional infusions of capital. We believe our current position offers profitable growth opportunities up to at least \$400MM in annual revenue.

While there are several ways to evaluate return on invested capital, Virco's extreme seasonal demands for inventories and receivables financing skew most measures. In our thinking there is *essential capital* without which the company loses its defining structure, and *seasonal capital*, which should be valued on the basis of its interest expense. We include as essential capital plant, property and equipment (PPE), year-end inventories, long-term debt, and goodwill. To these we add seasonal interest expense. The total is what we call *committed capital*, the amount it takes in any given year to run the business and sustain our competitive strategic position.



Following a cycle of heavy investment in the late 1990's, capital expenditures returned to normal "maintenance" levels in 2001. Capital budgets for the next three to five years will keep expenditures at these lower levels, and thus contribute to higher cash flow.

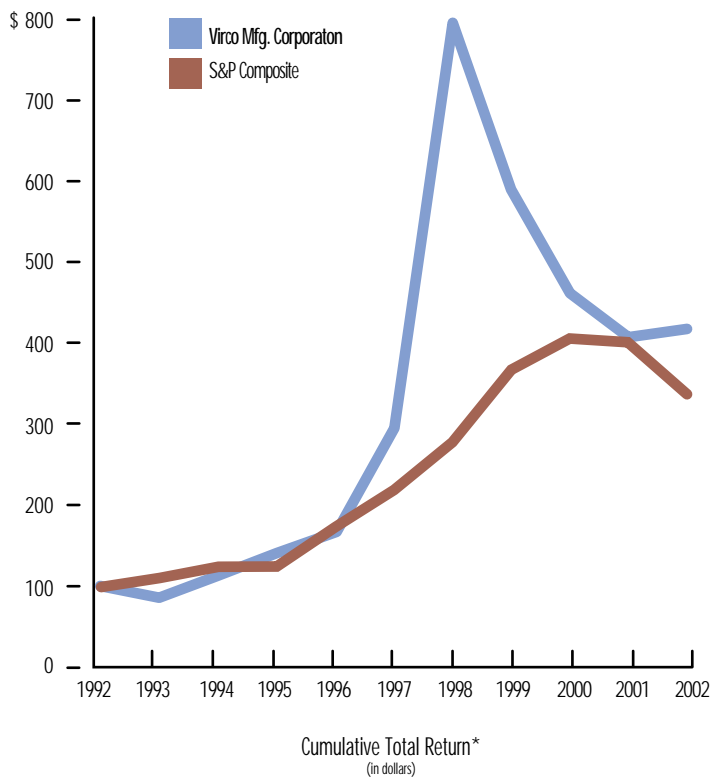


A review of Virco's performance using this model shows that fiscal years 1997 and 1998 generated the highest returns on committed capital, the highest cash flows, and the healthiest mix between cash flow and earnings. It also shows that our capital base ballooned in fiscal 2000 by almost \$80MM, a barely digestible sum that established the low point of a new crescent.

One of the reasons for our relatively confident stance during this industry downturn is that our trajectory is now ascending. We are presented with a model of consistent and improving net cash flow that will likely average between \$15-\$20MM for the next three years, allowing us to completely erase our long-term debt by 2004.

Virco as an Investment:

In determining how to manage Virco as an investment, we must give consideration to three important factors: 1) the interests of shareholders, now evenly distributed between "inside" and "outside" owners; 2) the establishment of performance goals based on historic reasonableness; and 3) the ability of current management to meet these goals. The third point is addressed more fully in the section on succession planning.



Assuming reinvestment of both cash and stock dividends, a \$100 investment in Virco made in 1992 would be worth \$419 today. The same investment in the Standard and Poors Composite would be worth \$339. We continue to believe our long-term strategy will yield superior (if uneven) results for investors with a similar long-term approach.

* Assumes \$100 invested on 1/31/1992. Assumes dividend reinvested.

Source: Data provided by Media General Financial Services.

To Our Shareholders (continued)

According to *Mergent's Dividend Achievers 2001 Edition*, Virco's common stock ranks 74th out of all dividend-paying American Corporations in 5-year total return. Mergent says total return "represents one of the best measures of how well an investor in any stock has fared because it reflects both dividend payments and price appreciation". Here are some of the rankings from Mergent:

Company	Rank	5-Year Return
Virco	74	141 %
Hon	79	136
3M	106	114
PepsiCo	118	106
Phillip Morris	143	88
Coca-Cola	162	73
Wesco Financial	183	58

Mergent publishes several reports of interest to investors. See www.mergentinc.com or call (800) 342-5647.

We do not expect to significantly improve our historical rate of return over the next five years. As the market has discounted our short-term stumble at the beginning of this crescent, so too may it discount outsized gains as we approach the peak. Neither response can we control. This said, we will still have significant free cash to manage.

Our plan is to distribute cash flow in approximately the following proportions: 50-65% to the corporation in the form of retained earnings/capital investment; 15-30% to shareholders for the repurchase of shares; and 10-25% to shareholders in the form of gradually increasing dividend payments. In any given year the ratios between these distributions may vary, but we intend to divide free cash about evenly between reinvestment and redistribution to shareholders.



Risk Management and Preservation of Shareholder Capital:

A crucial and perhaps under-appreciated aspect of our strategy is risk management. Capital that isn't preserved can't be compounded. Loss of shareholder capital, whether through operating mistakes or deeper damage to reputation, can undo many years' worth of effort.

Traditionally, risk management has been considered the responsibility of narrowly defined legal, human resources and finance departments. At Virco we think of it as everyone's job, and we include manufacturing, warehousing, design engineering, delivery, installations and information technology in our risk management strategies.

In the simplest sense, downward restatements of earnings are belated admissions of loss. In our 52-year history we have never restated earnings. It shall remain a vital part of our strategy to have a farsighted management team skilled in all aspects of risk management.

Succession Planning and Management Development:

We view succession planning as the single greatest challenge facing Virco. For both family- and non-family controlled companies, making smooth transitions between capable managers at all levels is a key to stability and uninterrupted compounding.

Succession planning is the offensive counterpart to risk management.

Our ability to attract and retain outstanding managers rests on several factors, starting with a strict adherence to the values of voice, dignity, fairness, leadership and merit. Compensation is also crucial, and we will undertake a total review of our compensation structure during fiscal 2002 to ensure consistency between goals, pay and incentives.

We will also explore the creation of three new Senior Vice President positions, one each in sales, operations and administration. Our intent is to develop a succession chain that insures continuity at all levels of management, from the CEO down to the factory floor.

Summary:

Growth that leads to a diffusion of strategic focus, results in destructive head-to-head competition, or dilutes existing rates of return, is counterproductive. Only if such growth is essential for maintaining critical mass in a particular market, or efficiencies of scale in procurement, manufacturing or distribution, can it be justified. Even then, capital-intensive diffusing growth can only be rationalized if it leads to later superior returns. Post-mortems of many mergers and acquisitions show such returns are elusive.

We believe Virco currently has sufficient economies of scale to remain competitive in our market niche. We do not envision a threshold of, say, \$500MM below which we will not be able to compete. We also see no advantages that would be offered by merging with larger companies, most of whom cannot match our low cost of operations.

For these reasons, our goals for the next five years center on the preservation and reasonable compounding of shareholder capital. If we seem to have belabored this point, it is because we feel compelled to counter the conventional wisdom that has led some of our competitors into their current dilemmas.

A critical review of the past five years at Virco shows that we made several mistakes, which by studying we intend not to make again:

- Capital investments in Conway and SAP were barely digestible. The Conway facility was too large for current levels of business, while SAP ended up costing more than expected because of implementation difficulties.
- Anticipated volume to offset increased fixed costs has yet to materialize.
- Lowering prices in fiscal 2000 to fill up our factories backfired, reminding us that we can't absorb our way to prosperity.

We also accomplished a number of things that demonstrate the soundness of our strategy:

- Heavy investments in the late 1990's now form a kind of operating annuity, as illustrated by the ascending crescents.
- We have successfully prepared ourselves to support a government shift to internet-based bidding and purchasing.
- Assemble-to-Ship represents a more efficient operating model for dealing with the unique seasonal constraints of our market niche.
- New product development continues to accelerate, providing another kind of annuity for the future.

In conclusion, we again want to thank everybody, from shareholders, employees and customers to our partners at Wells Fargo, for your support during the past few years. It's been a challenging period for Virco, but we are now well positioned to take advantage of our investments. We look forward to seeing as many shareholders as possible at our Annual Meeting, to be held this year at our Torrance, California, headquarters on June 18 at 2:00 p.m.

Management's Statement

The financial statements of Virco Mfg. Corporation were prepared by management, which is responsible for the integrity and objectivity of the financial information presented, including amounts that must necessarily be based on judgments and estimates. The statements were prepared in conformity with accounting principles generally accepted in the United States, and in situations where acceptable alternative accounting principles exist, management selected the method that it believed was most appropriate in the circumstances.

Virco depends upon the Company's system of internal controls in meeting its responsibilities for reliable financial statements. This system is designed to be cost-effective while providing reasonable assurance that assets are safeguarded and transactions are properly recorded and executed in accordance with management's authorization. Judgments are required to assess and balance the relative cost and expected benefits of these controls.

The financial statements have been audited by our independent auditors, Ernst & Young LLP. The independent auditors provide an objective, independent review as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial condition. They obtain and maintain an understanding of Virco's accounting and financial controls, and conduct such tests and procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The Audit Committee of the Board of Directors, which is composed of Directors from outside the Company, maintains an ongoing appraisal of the effectiveness of audits and the independence of the auditors. The Committee meets periodically with the auditors and management. The independent auditors have free access to the Committee, without management present, to discuss the results of their audit work and their opinions on the adequacy of internal financial controls and the quality of financial reporting.

Based on a review and discussions of the Company's 2001 audited consolidated financial statements with management and discussions with the independent auditors, the Audit Committee recommended to the Board of Directors that the Company's 2001 audited consolidated financial statements be included in the Company's annual report on Form 10-K. The Board of Directors concurred.

Management's Discussion and Analysis and Results of Operations

This Management's Discussion and Analysis of Financial Condition and Results of Operations includes a number of forward-looking statements that reflect the Company's current views with respect to future events and financial performance. These forward-looking statements are subject to certain risks and uncertainties, including those discussed herein, in Item 1, and elsewhere in this report on Form 10-K, that could cause actual results to differ materially from historical results or those anticipated. In this report, words such as "anticipates," "believes," "expects," "future," "intends," "plans," "potential," "may," "could" and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

Critical Accounting Policies and Estimates

This discussion and analysis of Virco's financial condition and results of operations is based upon our financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires Virco management to make estimates and judgments that affect the Company's reported assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, management evaluates such estimates, including those related to allowance for doubtful accounts, valuation of inventory including LIFO reserves, self-insured retention for products and general liability insurance, self-insured retention for workers compensation insurance, liabilities under defined benefit and other compensation programs, and estimates related to deferred tax assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. This forms the basis of judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Factors that could cause or contribute to these differences include the factors discussed above under Item 1, Business, and elsewhere in this report on Form 10-K. Virco's critical accounting policies are as follows:

Revenue Recognition: Effective February 1, 2000, the Company changed its method of accounting for revenue recognition in accordance with Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements." Under the new accounting method adopted, the Company recognizes all sales when title passes under its various shipping terms. The Company reports sales as net of sales returns and allowances.

Allowances for Doubtful Accounts: Considerable judgment is required when assessing the ultimate realization of receivables, including assessing the probability of collection, current economic trends, historical bad debts and the current creditworthiness of each customer. The Company maintains allowances for doubtful accounts that may result from the inability of our customers to make required payments. The primary reason that Virco's allowance for doubtful accounts represents such a small percentage of accounts receivable is that a large portion of the accounts receivable are attributable to low-credit-risk governmental entities, giving Virco's receivables a high degree of collectability.

Inventory Valuation: The Company uses the LIFO method of accounting for the material component of inventory. The Company maintains allowances for estimated obsolete inventory to reflect the difference between the cost of inventory and the estimated market value. If market conditions are less favorable than those anticipated by management, additional allowances may be required.

Self-Insured Retention: For 2001, the Company was self-insured for Product Liability losses up to \$100,000 per occurrence. The Company obtains annual actuarial estimates of total expected future losses for liability claims and records the net present value of losses.

Defined Benefit Obligations: The Company has three defined benefit plans, the Virco Employees Retirement Plan, the Virco Important Performers (VIP) Plan and the Non-Employee Directors Retirement Plan, which provide retirement benefits to employees and outside directors. Virco discounts the pension obligations under the plans using a 7.75% discount rate and estimating an 8.00% return on plan assets. The Company obtains annual actuarial valuations for all three plans. Although the Company does not anticipate any change in these rates in the coming year, any change would not have a significant effect on the Company's financial position, results of operations or cash flows.

Deferred Tax Assets and Liabilities: The Company has not provided an allowance against the deferred tax assets recorded in the financial statements. The Company had a net deferred tax liability of \$590,000 at January 31, 2002. Management believes that it is more likely than not that future earnings will be sufficient to recover deferred tax assets.

Results of Operations (2001 VS. 2000)

For the year ended January 31, 2002, the Company had a modest net income of \$246,000 on net sales of \$257,462,000 compared to a net income of \$4,016,000 on net sales of \$287,342,000 in the same period last year. Prior year results included a pre-tax gain of \$7,945,000 on the sale of real estate and other income of \$4,052,000 related to the settlement of a dispute. The settlement was a non-recurring payment unrelated to the Company's ongoing operations. Earnings were \$0.02 per share for the year ended January 31, 2002, compared to \$0.32 in the same

period last year, after giving effect to the 10% stock dividend declared August 21, 2001. For 2001, furniture operations provided net income of \$246,000 on net sales of \$257,462,000. This compares to a loss on furniture operations of \$3,391,000 (which excludes the one-time items mentioned above) on substantially higher sales of \$287,342,000 in fiscal 2000. In addition, cash flow from operations reached a historical high of \$35,037,000, due largely to a \$19,356,000 reduction in inventories made possible by our Assemble-to-Ship Program and the decrease in net sales due to the lingering effects of a decline in the commercial furniture market.

Sales

In recent years, Virco's sales force has been organized into two groups, "Education" and "Commercial". During November of 2001, the Company announced a reorganization of the sales force. Instead of having two representatives pursuing separate customers within the same geographical territory, Virco now has only one National Sales Group. It became increasingly clear that the needs of Virco's commercial and educational customers were evolving towards greater similarity and that combining the Company's sales efforts would allow individual representatives to plow more deeply in a smaller field. In addition, Virco also established a Corporate Sales Group to pursue wholesalers, mail order accounts and national chains where management believes that it would be more efficient to have a single sales representative or group approach such persons, as they tend to have needs that transcend the geographic boundaries established for our local accounts.

By traditional measures, Virco's 2001 results may not look impressive, but viewed in the context of the worst recorded recession in recent history of the commercial furniture industry, management is reasonably satisfied. As a group, the members of BIFMA (the Business and Institutional Manufacturer's Association) reported a sales decline of 17.4% for calendar 2001, with an even more dramatic 29.2% decline in the fourth quarter. This compares with only a 10.4% decline at Virco. The Company's core public school customers appear to have been affected less by the overall recession. Sales to public schools declined modestly during 2001, but management believes that many of them will be functioning under reduced budgets next year. Commercial sales were substantially less than the prior year, more closely reflecting the statistical results recorded by BIFMA. The reduction in commercial sales experienced in the recent year is expected to continue in the next fiscal year. Virco's quarterly reports on Form 10-Q and related press releases will provide updated information on order volume.

Because of the recession in the furniture industry, the Company experienced substantial price competition in its primary markets. During 2001, the Company adhered to a policy of turning down low margin and unprofitable business. Although this policy had an adverse effect on unit volume, the Company achieved a net increase in selling prices. Consequently, the gross margin percentage for the year increased modestly compared to 2000, despite unfavorable manufacturing variances related to reductions in production levels.

Subsequent to year end, Virco signed a letter of intent to purchase the assets of Furniture Focus, a reseller that offers complete package solutions for the Furniture, Fixtures and Equipment (FF&E) segments of bond-funded public school construction projects. We expect the acquisition to add between \$5,000,000 and \$7,000,000 in sales over the remainder of fiscal 2002.

Cost of Sales

Virco began 2001 with a plan to reduce inventory levels and to implement the Assemble-to-Ship (ATS) model. The effect of the reduction in sales volume, combined with management's decision to implement the ATS model to reduce inventories, resulted in a substantial reduction in production hours. In effort to match spending to the lower levels of output, Virco reduced headcount, capital expenditures, and other discretionary spending. Despite reductions in spending, the Company incurred increased manufacturing variances compared to the prior year. These variances were more than offset by the effects of reduced costs for certain raw materials, and an increase in selling prices. The net effect was a modest increase in gross margins for the year.

In 2002, the Company intends to more fully implement the ATS model and further reduce levels of inventory. The intended reduction in inventory will not be as significant as achieved in 2001. Production levels, which will vary depending upon selling volumes, are anticipated to be approximately level with the prior year.

Inflation rates did not have a significant net impact on the Company's cost of sales in 2001. Material costs decreased, offset by increased costs for certain utilities and employee benefits. The Company anticipates upward pressure on costs, particularly in the areas of certain raw materials, transportation, energy, and benefits in the coming year and others. For more information, please see the section entitled "Inflation and Future Change in Prices" in the Management's Discussion and Analysis section contained in Virco's Annual Report to Shareholder for the year ended January 31, 2002.

Management's Discussion and Analysis and Results of Operations

Selling, General and Administrative and Others

Selling, general and administrative expense for the year ended January 31, 2002, decreased by approximately \$11,376,000 compared to the same period last year. These costs decreased both in absolute dollars and as a percentage of sales. Freight costs declined by approximately \$3,500,000 due to a reduction in selling volume, and were slightly lower as a percentage of sales. Other SG&A costs were lower in absolute dollars and as a percentage of sales due to reductions in staffing, reduced sales incentives, and other reductions in spending, including a temporary 10% reduction in salaries and wages during the fourth quarter.

Interest expense was approximately \$400,000 less than in the prior year due to reduced levels of borrowing and lower interest rates. The Company expects to continue to reduce borrowing levels in 2002. The Company has entered into a swap agreement with Wells Fargo Bank, which has the effect of establishing a fixed rate of interest for \$20,000,000 of loans for both 2001 and 2002. The balance of borrowing is based upon LIBOR, and will fluctuate with the market rate of interest.

In the current year, Virco realized an \$86,000 loss on disposition of fixed assets. This compares to a gain on sale of assets of approximately \$7,667,000 in the prior year, and a prior year pre-tax gain of \$4,052,000 on a settlement.

Results of Operations (2000 VS. 1999)

Sales

For the year ended January 31, 2001, sales increased 7.2% to \$287,300,000, compared to \$268,100,000 for the same period last year. Approximately 90% of the increase in sales for the year ended January 31, 2001, was from education sales, with the balance from commercial sales. The increase in revenues was attributable to the Company pursuing an aggressive pricing policy during the educational bidding season of late 1999/early 2000. The attained sales growth was substantially less than the Company had planned to achieve with this pricing strategy.

Education sales, which were primarily composed of sales to publicly funded K-12 schools and represent 64% of corporate revenues, increased by \$17,300,000 to \$184,100,000 from \$166,800,000 in the prior year. Sales of our newer computer furniture, Plateau® tables, Core-a-Gator® lightweight folding tables, mobile tables and mobile cabinets improved, as did many of our older product lines. Due to aggressive pricing, the sales increase was achieved primarily by unit volume, not price increases.

Virco's commercial sales included private schools, pre-schools, churches, convention centers, agencies at city, county, state and federal levels, furniture distributors, retailers and catalog retailers. Commercial sales, which represented 36% of corporate revenues, increased by \$1,900,000 to \$103,200,000 from \$101,300,000 in the prior year. The breadth of Virco's product line for target niche markets, and the continuing success of its Quick Ship stocking program favorably affected sales for the commercial sales channels.

Cost of Sales

During the 1999 fiscal year, the Company initiated production at a new manufacturing plant and implemented a new enterprise resources planning system. The combined effect of these two significant events resulted in inadequate levels of customer service during the summer of 1999. In addition, the new manufacturing facility provided the Company with enhanced capacity to support a substantial sales increase. In order to address both of these concerns, the Company pursued two objectives in 2000 which adversely affected gross margins. The first objective was to substantially improve the level of customer service by increasing the stocking plan for inventories to ensure better service during the summer delivery season. The second objective was to increase sales and utilize the new factory capacity through aggressive pricing. To support these two objectives, the Company ran its factories at high levels of output for the first eight months of the year in order to build to the enhanced stocking plan and in anticipation of increased sales. The aggressive pricing strategy did increase sales, but not to the extent anticipated. In order to return inventories to more normal levels, the Company significantly reduced production in the third and fourth quarters, resulting in unfavorable manufacturing variances. The Company reduced its work force and spending in the fourth quarter, but not in time to prevent the decline in manufacturing efficiency related to the sharply curtailed production levels. The aggressive pricing strategy affected the entire sales volume, not only at the margin, and the Company experienced a slight reduction in prices for the year, while absorbing cost increases related to some materials, labor and benefit costs, and additional capacity from the plant expansion. As a result of the events described above, gross profits for the year ended January 31, 2001, as a percent of sales, decreased by 5.5% to 29.1% from 34.6% in the prior year.

Selling, General and Administrative

Selling, general and administrative expense for the year ended January 31, 2001, increased both in total dollars and as a percentage of sales compared to the same period last year. The higher selling, freight and warehousing expense was primarily attributable to growth in unit sales volume, increased freight rates, costs incurred during the consolidation of our Conway warehouses, and reduction in selling prices, which increased these costs as a percentage of sales. The increase in general and administration expense was primarily attributable to greater depreciation expense, as well as system maintenance services, training costs and other expenses relating to the implementation of sales force automation, a business-to-business website, and an upgrade of the Company's SAP enterprise resource planning system.

In December, the Company announced a corporate reorganization and reduction in force. As part of this reorganization, the Company reduced its workforce by 141 employees. This reduction was distributed proportionately among managerial, administrative, and support positions at both divisions and at the Corporate headquarters. The reduction in force did not include any direct labor. In the fourth quarter, the Company incurred approximately \$1,500,000 in severance costs related to this reduction in force.

Interest expense increased by \$2,577,000 for the year ended January 31, 2001, compared to the same period last year. This was attributable to increases in interest rates during the year and a larger average borrowing balance due to increased levels of inventory and the completion of the Company's capital expansion in Conway, Arkansas.

During 2000, the Company benefited from two one-time events which favorably affected income. In the first quarter the Company sold a warehouse located in Torrance, California, that had been held as rental property. The sale resulted in a pre-tax gain of approximately \$7,945,000. In the third quarter, the Company realized a \$4,052,000 pre-tax gain from a settlement of certain claims.

Liquidity and Capital Resources

Virco addresses liquidity and capital requirements in the context of short-term seasonal requirements and the long-term capital requirements of the business. The Company's core business of selling furniture to publicly funded educational institutions is extremely seasonal. The seasonal nature of this business permeates most of Virco's operational, capital, and financing decisions.

The Company's working capital requirements during and in anticipation of the peak summer season require management to make estimates and judgments that affect our assets, liabilities, revenues and expenses. Virco's management expends a significant amount of time during the year, and especially in the first quarter, developing a stocking plan and estimating the number of employees, the amount of raw materials, and the types of components and products that will be required during the peak season. If management underestimates any of these requirements, Virco's ability to timely meet customer orders or to provide adequate customer service may be diminished. If management overestimates any of these requirements, the Company may be required to absorb higher storage, labor and related costs, each of which may affect profitability. On an ongoing basis, management evaluates such estimates, including those related to market demand, labor costs, and inventory levels, and continually strives to improve Virco's ability to correctly forecast business requirements during the peak season each year.

As part of Virco's efforts to address seasonality, financial performance and quality without sacrificing service or market share, management has been refining the Company's ATS operating model. ATS is Virco's version of mass-customization, which assembles standard, stocked components into customized configurations before shipment. The Company's ATS program reduces the total amount of inventory and working capital needed to support a given level of sales. It does this by increasing the inventory's versatility, delaying costly assembly until the last moment, and reducing the amount of warehouse space needed to store finished goods.

In addition, Virco finances its largest balance of accounts receivable during the peak season. This occurs for two primary reasons. First, accounts receivable balances naturally increase during the peak season as shipments of products increase. Second, many customers during this period are government institutions, which tend to pay accounts receivable more slowly than commercial customers.

As the capital required for this summer season generally exceeds cash available from operations, Virco has historically relied on third party bank financing to meet seasonal cash flow requirements. Virco has established a long-term relationship with its primary lender, Wells Fargo Bank. On an annual basis, the Company prepares a forecast of seasonal working capital requirements, and renews its revolving line of credit. For the next fiscal year, we have entered into a revolving credit facility with Wells Fargo Bank, amended and restated March 2002, but effective at January 31, provides a secured revolving line of credit that varies from \$40,000,000 to \$70,000,000. This credit facility is intentionally structured to provide additional working capital during the Company's traditional peak period. At October 1, 2002, the available commitment reduces to \$40,000,000.

Management's Discussion and Analysis and Results of Operations

This is a three-year non-amortizing line with interest payable monthly at a fluctuating rate equal to the Bank's prime rate plus a fluctuating margin of 0.25% to 0.50% (4.75% at January 31, 2002). The line also allows the Company the option to borrow under 30- 60- and 90-day fixed term rates at LIBOR plus a fluctuating margin of 1.50% to 2.50%. Approximately \$25,175,000 was available for borrowing as of January 31, 2002.

In addition to short-term liquidity considerations, the Company continually evaluates long-term capital requirements. In 1997, the Company initiated two large capital projects, which had significant cash flow effects on the 1998, 1999, and 2000 fiscal years. The first project was the implementation of the SAP enterprise resources planning system, initiated in October 1997. The Company went live with the new system in March 1999, implemented a business-to-business website along with sales force automation in the first quarter of 2000, and upgraded to the most current version of SAP in the fourth quarter of 2000. General Electric Capital Corporation (GECC) financed the initial portion of this project under a lease arrangement, which is treated as a capital lease for book purposes and an operating lease for tax purposes. As of January 31, 2002, the Company had expended \$13,100,000 relating to this project. Capital and training costs not funded by the lease are financed by cash flows from operations and from the loan facility with Wells Fargo Bank.

The second project was the expansion and re-configuration of the Conway, Arkansas, manufacturing and distribution facility. During the fourth quarter of 1997, the Company expended approximately \$1,200,000 to acquire roughly 70 acres of land for the expansion. In 1998, the Company expended approximately \$20,600,000 to buy an additional 30 acres of land, initiate construction of a 400,000 sq. ft. manufacturing facility and purchase production equipment for the Conway, Arkansas location. During 1999, the Company expended approximately \$29,200,000 to complete construction of the factory, purchase additional production equipment, construct and complete the first 400,000 sq. ft. segment of the planned 800,000 sq. ft. distribution facility, and initiate the construction of a second 400,000 sq. ft. segment of that facility. In 2000, the Company expended approximately \$15,974,000 to complete the expansion and to acquire high-density racking and material handling systems. To finance this project, the Company borrowed \$30,000,000 from Wells Fargo Bank that was scheduled to be repaid in three annual \$10,000,000 installments, the first of which was paid on January 31, 2001; moreover, as explained below, the Company paid off the entire balance of this loan prior to January 31, 2002. In addition to the loan from Wells Fargo, the Company acquired equipment with operating leases from GE Capital, and used operating cash flow.

As phases of the Conway expansion were completed, the Company was able to vacate several leased warehouses, sell a small production facility, and convert a second production facility into a warehouse. In addition, Virco sold a warehouse located in Torrance, California, which had been held as rental property.

Upon the completion of these substantial capital projects, the Company significantly reduced capital spending in 2001, with depreciation expense exceeding capital spending by approximately \$10,584,000. Management intends to limit future capital spending until growth in sales volume fully utilizes the new plant and distribution capacity. The Company has established a goal of limiting capital spending to between \$5,000,000 to \$7,000,000 for 2002, which is approximately one-half of anticipated depreciation expense. Subsequent to year-end, the Company entered into an agreement to purchase the assets of Furniture Focus Corporation for \$2,400,000. The \$2,400,000 purchase price is included in the \$5,000,000 to \$7,000,000 the Company has budgeted for capital expenditures.

In the fourth quarter of 2001, primarily due to the reduction in inventory related to the implementation of the previously described ATS model and the reduced levels of capital expenditures, Virco was able to pay off the \$20,000,000 balance on the loan facility with Wells Fargo Bank which was used to finance the Conway expansion.

The Company is currently marketing three properties for sale or lease, which have a cumulative estimated market value of approximately \$8,000,000. One of these properties, a former production facility in Conway, Arkansas, is currently being utilized as a finished goods warehouse. A second property, located in Los Angeles, California, is vacant. The third property, a former production facility located in Newport, Tennessee, has been leased to a third party who has an option to purchase the property at any time during the first three years of the lease.

In April 1998, the Board of Directors approved a stock buy-back program giving authorization to buy back up to \$5,000,000 of Company stock. The authorization of this stock buy-back program was increased to \$7,000,000, \$14,000,000 and \$20,000,000 in January 1999, April 1999 and December 2001, respectively. As of the end of January 2002 and 2001, the Company had repurchased approximately 884,000 and 690,000 shares at a cost of approximately \$13,505,000 and \$11,539,000 respectively. The Company intends to continue buying back shares of Virco common stock as long as the Company feels the shares are undervalued and either operating cash flow or borrowing capacity under the Wells Fargo Bank line is available.

Management believes cash generated from operations and from the previously described sources will be adequate to meet its capital requirements.

Environmental and Contingent Liabilities

The Company and other furniture manufacturers are subject to federal, state, and local laws and regulations relating to the discharge of materials into the environment and the generation, handling, storage, transportation, and disposal of waste and hazardous materials. The Company has expended, and can be expected to expend, significant amounts in the future for the investigation of environmental conditions, installation of environmental control equipment, and remediation of environmental contamination.

In 2001, the Company was self-insured for Product Liability losses up to \$100,000 per occurrence. For the insurance year beginning April 1, 2002, the Company is self-insured for Products and General Liability losses up to \$250,000 per occurrence and a Workers Compensation deductible of \$200,000 per occurrence. In prior years the Company has been self-insured for Workers Compensation, Automobile, Product, and General Liability losses. The Company has purchased insurance to cover losses in excess of the self-insured retention or deductible up to a limit of \$30,000,000. In 1993, the Company initiated a program to reduce product liability losses and to more aggressively litigate product liability cases. This program has continued through 2001 and has resulted in reductions in litigated product liability cases. Management does not anticipate that any related settlement, after consideration of the existing reserves for claims and potential insurance recovery, would have a material adverse effect on the Company's financial position, results of operations, or cash flows.

Inflation and Future Change in Prices

Inflation rates in the U.S. did not have a significant net impact on the Company's operating results for the fiscal year just ended. Material costs decreased, offset by increased costs for certain utilities and employee benefits. The Company anticipates upward pressure on costs, particularly in the areas of certain raw materials, transportation, energy and employee benefits in the coming year. In April 2002, under section 201 steel sanction, a 30% tariff was imposed on imported steel. In addition, domestic steel manufacturers have filed a dumping claim against certain international suppliers. The effect of these actions could cause the Company to incur at least \$2,000,000 of incremental steel costs in year 2002. Total material costs for 2002, as a percentage of sales, could be higher than in 2001. However, no assurance can be given that the Company will experience stable, modest or substantial increases in prices in 2002. The Company is working to control and reduce costs by improving production and distribution methodologies, investigating new packaging and shipping materials, and searching for new sources of purchased components.

The Company uses the LIFO method of accounting for the material component of inventory. Under this method, the cost of products sold as reported in the financial statements approximates current cost, and reduces the distortion in reported income due to increasing costs. Depreciation expense represents an allocation of historic acquisition costs and is less than if based on the current cost of productive capacity consumed. In 2001, the Company significantly reduced its expenditures for capital assets, but in the prior three fiscal years (1998, 1999, and 2000) the Company made the significant fixed asset acquisitions described above. The assets acquired result in higher depreciation charges, but due to technological advances should result in operating cost savings and improved product quality. In addition, some depreciation charges will be offset by a reduction in lease expense.

The Company is also subject to interest rate risk related to its \$28,708,000 of borrowings as of January 31, 2002, and any seasonal borrowings used to finance additional inventory and receivables during the summer. Fluctuating interest rates may adversely affect the Company's results of operations and cash flows related to its variable rate bank borrowings. Accordingly, a 100 basis point upward fluctuation in the lender's base rate would cause the Company to incur additional interest charges of approximately \$476,000 for the twelve months ended January 31, 2002. The Company would benefit from a similar interest savings if the base rate were to fluctuate downward by a like amount.

In February 2000, the Company entered into an interest rate swap agreement with Wells Fargo Bank to reduce exposure due to changes in interest rates. The initial notional swap amount is \$30,000,000 for the period February 22, 2000, through February 28, 2001. The notional swap amount then decreased to \$20,000,000 until the end of the swap agreement, March 3, 2003. Under this agreement, interest is payable monthly at 7.23% plus a fluctuating margin of 1.50% to 2.50%. At January 31, 2002, the carrying value approximated the fair value of \$1,103,000. During the year ended January 31, 2002, the Company recorded an additional loss amount of \$662,000 (net of an applicable income tax benefit of \$441,000) in other comprehensive loss in order to account for the change in fair value. The fair value of the swap is estimated on pricing models using current assumptions.

Management's Discussion and Analysis and Results of Operations

Financial Strategy

Virco's financial strategy is to continue to increase levels of profitability by targeting specific profitable market segments and customers. The Company has organized its sales force, developed products, and acquired production and distribution facilities for the specific needs of these customers. During the fiscal years 1998, 1999, and 2000, the Company made significant capital expenditures to support future sales growth in these targeted markets. For the next several years, the Company intends to increase sales to these markets, and to service these sales without making further significant investments in facilities or working capital.

Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets," which supersedes Accounting Principles Board Opinion No. 17. SFAS No. 141 is effective for any business combination completed subsequent to June 30, 2001, and SFAS No. 142 is effective for fiscal years beginning after December 15, 2001. Under SFAS No. 142, goodwill deemed to have an indefinite life will no longer be amortized and will be subjected to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives. Accordingly, the Company will apply the provisions of SFAS No. 141 should it enter into any business combinations. The Company believes SFAS No. 142 will not have a significant effect on the Company's financial position, results of operations or cash flows.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, and requires such obligations and costs to be recognized at fair value in the period in which they are incurred. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002, although earlier application is encouraged. The Company expects to adopt SFAS No. 143 as of February 1, 2003, and has not yet determined what impact, if any, the adoption of the Statement will have on the Company's financial position and results of operations.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." FAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company expects to adopt FAS 144 as of February 1, 2002, and it does not expect that the adoption of the Statement will have a significant impact on the Company's financial position and results of operations.

Five Year Summary of Selected Financial Data

<i>In thousands except per share data</i>	2001	2000	1999	1998	1997
Summary of Operations					
Net sales ⁽⁴⁾⁽⁵⁾	\$ 257,462	\$ 287,342	\$ 268,079	\$ 275,096	\$ 259,586
Net income before cumulative effect of change in accounting principle	\$ 246	\$ 4,313	\$ 10,166	\$ 17,630	\$ 13,852
Cumulative effect of change in accounting principle, net of \$191 tax benefit ⁽⁵⁾	–	(297)	–	–	–
Net income	\$ 246	\$ 4,016	\$ 10,166	\$ 17,630	\$ 13,852
Per share data					
Income before cumulative effect of change in accounting principle ⁽¹⁾					
Basic	\$ 0.02	\$ 0.34	\$ 0.81	\$ 1.35	\$ 1.06
Assuming dilution	0.02	0.34	0.79	1.32	1.04
Cumulative effect of change in accounting principle ⁽¹⁾					
Basic	–	(0.02)	–	–	–
Assuming dilution	–	(0.02)	–	–	–
Net income ⁽¹⁾					
Basic	0.02	0.32	0.81	1.35	1.06
Assuming dilution	0.02	0.32	0.79	1.32	1.04
Pro forma amounts assuming the accounting change is applied retroactively					
Net income ⁽⁵⁾	\$ 246	\$ 4,313	\$ 10,186	\$ 17,663	\$ 13,963
Per share data					
Net income					
Basic	0.02	0.35	0.81	1.35	1.07
Assuming dilution	0.02	0.34	0.80	1.32	1.04
Dividends declared per share, adjusted for 10% stock dividend					
Cash dividends	\$ 0.08	\$ 0.07	\$ 0.06	\$ 0.06	\$ 0.05
Other Financial Data					
Total assets	\$ 161,372	\$ 199,549	\$ 190,863	\$ 151,380	\$ 122,015
Working capital	\$ 34,464	\$ 43,173	\$ 51,423	\$ 47,405	\$ 43,784
Current ratio	2.2/1	1.9/1	2.3/1	2.4/1	2.5/1
Total long-term obligations	\$ 40,853	\$ 55,075	\$ 53,995	\$ 25,690	\$ 13,512
Stockholders' equity	\$ 90,223	\$ 94,141	\$ 93,834	\$ 88,923	\$ 77,077
Shares outstanding at year-end ⁽³⁾	12,223	12,411	12,500	12,836	13,011
Stockholders' equity per share ⁽²⁾	\$ 7.38	\$ 7.59	\$ 7.51	\$ 6.93	\$ 5.92

(1) Based on average number of shares outstanding each year after giving retroactive effect for stock dividends and 3 for 2 stock split.

(2) Based on number of shares outstanding at year-end after giving effect for stock dividends and 3 for 2 stock split.

(3) Adjusted for stock dividends and 3 for 2 stock split.

(4) The prior period statements of operations contain certain reclassifications to conform to the presentation required by EITF No. 00-10, "Accounting for Shipping and Handling Fees and Costs," which the Company adopted during the fourth quarter of the year ended January 31, 2001.

(5) During the fourth quarter of 2000, the Company changed its method of accounting for revenue recognition in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements." Pursuant to Financial Accounting Standards Board Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements," effective February 1, 2000, the Company recorded the cumulative effect of the accounting change.

Report of Independent Auditors

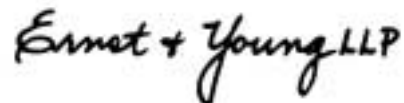
The Board of Directors and Stockholders Virco Mfg. Corporation

We have audited the accompanying consolidated balance sheets of Virco Mfg. Corporation as of January 31, 2002 and 2001, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended January 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Virco Mfg. Corporation at January 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 31, 2002, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, during the year ended January 31, 2001, the Company changed its method of revenue recognition for certain of its product sales.

The signature of Ernst & Young LLP is written in a cursive, handwritten style in black ink.

Long Beach, California
March 15, 2002, except for
Note 10 as to which the date is
March 28, 2002

Consolidated Balance Sheets

	January 31	
<i>In thousands, except per share data</i>	2002	2001
Assets		
Current assets:		
Cash	\$ 1,704	\$ 351
Trade accounts receivable (less allowance for doubtful accounts of \$200 in 2002 and 2001)	19,251	24,559
Other receivables	175	586
Inventories:		
Finished goods	16,159	27,009
Work in process	12,322	14,442
Raw materials and supplies	10,202	16,588
	<u>38,683</u>	<u>58,039</u>
Income taxes receivable	—	2,508
Prepaid expenses and other current assets	935	1,150
Deferred income taxes	1,711	1,780
Total current assets	<u>62,459</u>	<u>88,973</u>
Property, plant and equipment:		
Land and land improvements	3,548	3,880
Buildings and building improvements	50,245	50,382
Machinery and equipment	100,999	98,024
Leasehold improvements	1,375	1,218
	<u>156,167</u>	<u>153,504</u>
Less accumulated depreciation and amortization	72,761	58,859
Net property, plant and equipment	<u>83,406</u>	<u>94,645</u>
Other assets	15,507	15,931
Total assets	<u>\$ 161,372</u>	<u>\$ 199,549</u>

Consolidated Balance Sheets (continued)

	January 31	
<i>In thousands, except per share data</i>	2002	2001
Liabilities and stockholders' equity		
Current liabilities:		
Checks released but not yet cleared bank	\$ 2,930	\$ 2,216
Accounts payable	8,816	13,930
Income tax payable	1,282	-
Accrued compensation and employee benefits	8,602	11,471
Current portion of long-term debt	2,061	12,101
Other accrued liabilities	4,304	6,082
Total current liabilities	27,995	45,800
Noncurrent liabilities:		
Accrued self-insurance retention	2,777	2,598
Accrued pension expenses	11,429	8,736
Long-term debt, less current portion	26,647	43,741
Total noncurrent liabilities	40,853	55,075
Deferred income taxes	2,301	4,533
Commitments and contingencies		
Stockholders' equity:		
Preferred stock:		
Authorized 3,000,000 shares, \$.01 par value; none issued or outstanding	-	-
Common stock:		
Authorized 25,000,000 shares, \$.01 par value;		
issued 13,167,399 shares in 2001 and 12,032,233 shares in 2000	132	120
Additional paid-in capital	109,638	97,656
Retained (deficit) earnings	(2,006)	10,645
Less treasury stock at cost (944,352 shares in 2001 and 749,246 shares in 2000)	(13,975)	(12,009)
Less unearned ESOP shares	-	(696)
Less accumulated comprehensive loss	(3,566)	(1,575)
Total stockholders' equity	90,223	94,141
Total liabilities and stockholders' equity	\$ 161,372	\$ 199,549

See accompanying notes.

Consolidated Statements of Income

<i>In thousands, except per share data</i>	Year ended January 31		
	2002	2001	2000
Net sales	\$ 257,462	\$ 287,342	\$ 268,079
Costs of goods sold	180,275	203,765	175,247
Gross profit	77,187	83,577	92,832
Selling, general and administrative expenses	71,816	83,192	73,360
Provision for doubtful accounts	288	156	188
Interest expense	4,561	4,962	2,385
Loss (Gain) on sale of assets	86	(7,667)	206
Other income	-	(4,052)	-
Income before income taxes and cumulative effect of change in accounting principle	436	6,986	16,693
Provision for income taxes	190	2,673	6,527
Income before cumulative effect of change in accounting principle	246	4,313	10,166
Cumulative effect of change in accounting principle	-	(297)	-
Net income	\$ 246	\$ 4,016	\$ 10,166
Amounts per common share - basic			
Income before cumulative effect of change in accounting principle	\$ 0.02	\$ 0.34	\$ 0.81
Cumulative effect of change in accounting principle	-	(0.02)	-
Net income	\$ 0.02	\$ 0.32	\$ 0.81
Amounts per common share - assuming dilution			
Income before cumulative effect of change in accounting principle	\$ 0.02	\$ 0.34	\$ 0.79
Cumulative effect of change in accounting principle	-	(0.02)	-
Net income	\$ 0.02	\$ 0.32	\$ 0.79
Pro forma amounts assuming the accounting change is applied retroactively			
Net income	\$ 246	\$ 4,313	\$ 10,186
Net income per common share - basic	0.02	0.35	0.81
Net income per common share - assuming dilution	0.02	0.34	0.80
Weighted average shares outstanding:			
- basic	12,259	12,497	12,629
- assuming dilution	12,432	12,623	12,806

See accompanying notes.

Consolidated Statements of Stockholders' Equity

<i>In thousands, except per share data</i>	Common Stock		Additional Paid-In Capital	Retained Earnings (Deficit)	Comprehensive Income(Loss)	Treasury Stock	ESOP Trust	Accumulated Comprehensive Loss	Total
	Shares	Amount							
Balance at January 31, 1999	9,643,927	\$ 100	\$ 68,361	\$ 26,928	\$ —	\$ (5,814)	\$ (246)	\$ (406)	\$ 88,923
Net income	—	—	—	10,166	10,166	—	—	—	10,166
Minimum pension liability, net of tax	—	—	—	—	(14)	—	—	(14)	(14)
Comprehensive income					10,152				
Unearned ESOP shares	—	—	—	—	—	—	205	—	205
Stock issued under option plans	33,261	—	232	—	—	—	—	—	232
Stock dividend (10%)	947,704	10	16,042	(16,052)	—	—	—	—	—
Cash dividends	—	—	—	(800)	—	—	—	—	(800)
Purchase of treasury stock	(294,416)	—	—	—	—	(4,878)	—	—	(4,878)
Balance at January 31, 2000	10,330,476	110	84,635	20,242	—	(10,692)	(41)	(420)	93,834
Net income	—	—	—	4,016	4,016	—	—	—	4,016
Minimum pension liability, net of tax	—	—	—	—	(1,155)	—	—	(1,155)	(1,155)
Comprehensive income					2,861				
Unearned ESOP shares	—	—	—	—	—	—	(655)	—	(655)
Stock issued under option plans	49,783	—	284	—	—	—	—	—	284
Stock dividend (10%)	1,030,100	10	12,737	(12,747)	—	—	—	—	—
Cash dividends	—	—	—	(866)	—	—	—	—	(866)
Purchase of treasury stock	(127,372)	—	—	—	—	(1,317)	—	—	(1,317)
Balance at January 31, 2001	11,282,987	120	97,656	10,645	—	(12,009)	(696)	(1,575)	94,141
Net income	—	—	—	246	246	—	—	—	246
Minimum pension liability, net of tax	—	—	—	—	(1,329)	—	—	(1,329)	(1,329)
Derivative Instrument, net of tax	—	—	—	—	(662)	—	—	(662)	(662)
Comprehensive loss, net of tax					(1,745)				
Unearned ESOP shares	—	—	—	—	—	—	696	—	696
Stock issued under option plans	13,847	—	30	—	—	—	—	—	30
Stock dividend (10%)	1,120,268	12	11,952	(11,952)	—	—	—	—	12
Cash dividends	—	—	—	(945)	—	—	—	—	(945)
Purchase of treasury stock	(194,055)	—	—	—	—	(1,966)	—	—	(1,966)
Balance at January 31, 2002	12,223,047	\$ 132	\$ 109,638	\$ (2,006)	\$ —	\$ (13,975)	\$ —	\$ (3,566)	\$ 90,223

See accompanying notes.

Consolidated Statements of Cash Flows

<i>In thousands, except per share data</i>	Year ended January 31		
	2002	2001	2000
Operating activities			
Net income	\$ 246	\$ 4,016	\$ 10,166
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of accounting change	–	297	–
Depreciation and amortization	15,813	13,412	9,993
Provision for doubtful accounts	288	156	188
Loss (Gain) on sale of property, plant and equipment	86	(7,667)	112
Deferred income taxes	(1,722)	(407)	2,735
Changes in assets and liabilities:			
Trade accounts receivable	5,020	1,742	3,820
Other receivables	411	341	(619)
Inventories	19,356	(981)	(8,589)
Income taxes	3,790	(755)	(2,557)
Prepaid expenses and other current assets	215	138	(347)
Accounts payable and accrued liabilities	(8,230)	560	8,182
Other	(236)	(4,383)	(2,506)
Net cash provided by operating activities	35,037	6,469	20,578
Investing activities			
Capital expenditures	(5,229)	(22,711)	(38,849)
Proceeds from sale of property, plant and equipment	570	10,258	128
Net investment in life insurance	1,385	–	(956)
Net cash used in investing activities	(3,274)	(12,453)	(39,677)
Financing activities			
Dividends paid	(945)	(866)	(800)
Issuance of long-term debt	–	19,817	26,794
Repayment of long-term debt	(28,237)	(12,000)	(2,468)
Proceeds from issuance of common stock	30	284	232
Purchase of treasury stock	(1,954)	(1,317)	(4,878)
ESOP loan	696	(655)	205
Net cash (used in) provided by financing activities	(30,410)	5,263	19,085
Net increase (decrease) in cash	1,353	(721)	(14)
Cash at beginning of year	351	1,072	1,086
Cash at end of year	\$ 1,704	\$ 351	\$ 1,072
Supplemental disclosures of cash flow information			
Cash paid (received) during the year for:			
Interest, net of amounts capitalized	\$ 4,805	\$ 4,953	\$ 2,277
Income tax, net	(1,935)	3,835	6,416

See accompanying notes.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Business

Virco Mfg. Corporation, which operates in one business segment, is engaged in the design, production and distribution of quality furniture for the commercial and education markets. Over 50 years of manufacturing has resulted in a wide product assortment. Major products include student desks, computer furniture, chairs, activity tables, folding chairs and folding tables. The Company manufactures its products in Torrance, California, and Conway, Arkansas, for sale primarily in the United States.

Principles of Consolidation

The consolidated financial statements include the accounts of Virco Mfg. Corporation and its wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2000 and 1999 information to conform to the 2001 presentation.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of accounts receivable. The Company performs ongoing credit evaluations of its customers and maintains allowances for potential credit losses. The Company purchases insurance on receivables from commercial sales to minimize the Company's credit risk. A substantial percentage of the Company's receivables comes from low-risk government entities. No customers exceeded 10% of the Company's sales for each of the three years in the period ended January 31, 2002. Foreign sales were less than 5% for each of the three years in the period ended January 31, 2002.

Derivatives

The Company uses derivative financial instruments to reduce interest rate risks. The Company does not hold or issue derivative financial instruments for trading purposes. All derivatives are recognized as either assets or liabilities in the statement of financial condition and are measured at fair value. At January 31, 2002, the only derivative instrument is an interest rate swap that qualifies as a cash flow hedge. Changes in the fair value of the swap are recorded in other comprehensive income/loss as the hedge is effective in achieving offsetting changes in the fair value of cash flows of the liability.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method of valuation for the material content of inventories and the first-in, first-out (FIFO) method for labor and overhead.

Property, Plant and Equipment

Property, plant and equipment are stated at cost, less accumulated depreciation. Depreciation and amortization is computed on the straight-line method for financial reporting purposes based upon the following estimated useful lives:

Land improvements	5 to 25 years
Buildings and building improvements	5 to 40 years
Machinery and equipment	3 to 10 years
Leasehold improvements	Life of lease

Certain assets are depreciated under accelerated methods for income tax purposes.

Interest costs, amounting to \$55,000, \$453,000 and \$1,461,000 for the years ended January 31, 2002, 2001 and 2000, respectively, have been capitalized as part of the acquisition cost of property, plant and equipment.

The Company capitalizes costs associated with software developed for its own use. Such costs are amortized over three to seven years from the date the software becomes operational. The net book value of capitalized software was \$7,593,000 and \$10,004,000 at January 31, 2002 and 2001, respectively.

The book value of assets held under capital leases included in machinery and equipment amounted to \$2,294,000 and \$2,856,000 at January 31, 2002 and 2001, respectively. Amortization of capital leases is included in depreciation expense

Impairment of Long-Lived Assets

An impairment loss is recognized in the event facts and circumstances indicate the carrying amount of an asset may not be recoverable, and an estimate of future undiscounted cash flows is less than the carrying amount of the asset. Impairment is recorded based on the excess of the carrying amount of the impaired asset over the fair value. Generally, fair value represents the Company's expected future cash flows from the use of an asset or group of assets, discounted at a rate commensurate with the risks involved.

Net Income Per Share

Basic net income per share is calculated by dividing net income by the weighted-average number of common shares outstanding. Diluted net income per share is calculated by dividing net income by the weighted-average number of common shares outstanding plus the dilution effect of convertible securities. The following table sets forth the computation of basic and diluted earnings per share before cumulative effect of the accounting change:

	2001	2000	1999
Numerator:			
Income before cumulative effect of the accounting change	\$ 246,000	\$ 4,313,000	\$ 10,166,000
Denominator:			
Denominator for basic earnings per share			
– weighted-average shares	12,259,000	12,497,000	12,629,000
Dilutive potential common shares	173,000	126,000	177,000
Denominator for diluted earnings per share			
– adjusted weighted-average shares and assumed conversions	12,432,000	12,623,000	12,806,000

On August 21, 2001, the Company's Board of Directors authorized a 10% stock dividend payable on September 28, 2001, to stockholders of record as of September 6, 2001. This resulted in the issuance of approximately 1,120,000 additional shares of common stock. All per share and weighted-average share amounts have been restated to reflect this stock dividend and any splits or dividends previously declared.

Intangible Assets

Intangible assets, which consist principally of deferred pension assets and which are included in other noncurrent assets, are recorded at cost and are amortized over their estimated useful lives using the straight-line method.

Environmental Costs

Intangible assets, which consist principally of deferred pension assets and which are included in other noncurrent assets, are recorded at cost and are amortized over their estimated useful lives using the straight-line method.

Advertising Costs

Advertising costs are expensed in the period in which they occur. Selling, general and administrative expenses include advertising costs of \$4,237,000 in 2001, \$3,517,000 in 2000 and \$3,775,000 in 1999.

Notes to Consolidated Financial Statements (continued)

Self-Insurance

The Company has a self-insured retention for workers' compensation, automobile and general and product liability claims. Consulting actuaries assist the Company in determining its liability for the self-insured component of claims, which have been discounted to their net present value.

Stock-Based Compensation Plans

Stock-based compensation is recognized using the intrinsic-value method. For disclosure purposes, pro forma net income and earnings per share impacts are provided as if the fair-value method had been applied. The Financial Accounting Standards Board issued Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation." The Interpretation addressed implementation practice issues in accounting for compensation costs under existing rules prescribed by Accounting Principles Board No. 25. The new rules were applied by the Company prospectively after July 1, 2000.

Use of Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue Recognition

Effective February 1, 2000, the Company changed its method of accounting for revenue recognition in accordance with Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements." Previously, the Company had recognized revenue upon shipment of merchandise to the customer even though at each fiscal year-end and quarter a portion of its merchandise was shipped FOB destination. The company believes it had given up substantially all the risks and rewards of ownership upon shipment. Under the new accounting method adopted retroactive to February 1, 2000, the Company now recognizes all sales when title passes under its various shipping terms. The cumulative effect of the change on prior years resulted in a charge to income of \$297,000 (net of income taxes of \$191,000), which is included in income for the year ended January 31, 2001. There was no effect on the Company's net income for the year ended January 31, 2001, before the cumulative effect of the accounting change was made. The pro forma amounts presented in the income statement were calculated assuming the accounting change was made retroactively to prior periods.

Shipping and handling fees are included as revenue in net sales. Costs related to shipping and handling are included in operating expenses. For the years ended January 31, 2002, 2001 and 2000, shipping and handling costs of approximately \$27,491,000, \$31,903,000 and \$24,656,000, respectively, were included in selling, general and administrative expenses.

Fiscal Year End

Fiscal years 2001, 2000 and 1999, refer to the years ended January 31, 2002, 2001 and 2000, respectively.

Future Accounting Requirements

In June 2001 the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets," which supersedes Accounting Principles Board Opinion No. 17. SFAS No. 141 is effective for any business combination completed subsequent to June 30, 2001, and SFAS No. 142 is effective for fiscal years beginning after December 15, 2001. Under SFAS No. 142, goodwill deemed to have an indefinite life will no longer be amortized and will be subjected to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives. Accordingly, the Company will apply the provisions of SFAS No. 141 should it enter into any business combinations. The Company believes the adoption of SFAS No. 142 will not have a material effect on the Company's financial position, results of operations or cash flows.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, and requires such obligations and costs to be recognized at fair value in the period in which they are incurred. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002, although earlier application is encouraged. The Company expects to adopt SFAS No. 143 as of February 1, 2003, and has not yet determined what impact, if any, the adoption of the Statement will have on the Company's financial position and results of operations.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets," which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." FAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company expects to adopt FAS 144 as of February 1, 2002 and it does not expect that the adoption of the Statement will have a significant impact on the Company's financial position and results of operations.

2. Inventories

The current material cost for inventories exceeded LIFO cost by \$2,048,000 and \$3,585,000 at January 31, 2002 and 2001, respectively. Liquidation of prior year LIFO layers due to a reduction in certain inventories (decreased) increased income by (\$825,000), \$111,000 and \$59,000 in the years ended January 31, 2002, 2001 and 2000, respectively.

Details of inventory amounts, including the material portion of inventory which is valued at LIFO, at January 31, 2002 and 2001, are as follows (in thousands):

	January 31, 2002			
	Material Content at FIFO	LIFO Reserve	Labor, Overhead and Other	Total
Finished goods	\$ 10,583	\$ (493)	\$ 6,069	\$ 16,159
Work in process	6,081	(586)	6,827	12,322
Raw materials and supplies	11,171	(969)	—	10,202
Total	\$ 27,835	\$ (2,048)	\$ 12,896	\$ 38,683

	January 31, 2001			
	Material Content at FIFO	LIFO Reserve	Labor, Overhead and Other	Total
Finished goods	\$ 18,858	\$ (1,211)	\$ 9,362	\$ 27,009
Work in process	8,626	(1,059)	6,875	14,442
Raw materials and supplies	17,903	(1,315)	—	16,588
Total	\$ 45,387	\$ (3,585)	\$ 16,237	\$ 58,039

Notes to Consolidated Financial Statements (continued)

3. Notes Payable

Outstanding balances (in thousands) for the Company's long-term debt were as follows:

	January 31	
	2002	2001
Revolving credit line with Wells Fargo Bank ^(a)	\$ 22,414	\$ 28,555
Term loan with Wells Fargo Bank ^(a)	–	20,000
IRB with the City of Torrance ^(b)	3,165	4,124
Equipment credit line with GECC ^(c)	884	1,857
Derivative instrument ^(a)	1,103	–
Other	1,142	1,306
	<u>28,708</u>	<u>55,842</u>
Less current portion	2,061	12,101
	<u>\$ 26,647</u>	<u>\$ 43,741</u>
Outstanding stand-by letters of credit	\$ 2,411	\$ 3,163

(a) A revolving credit facility with Wells Fargo Bank, amended and restated in March 2002, but effective at January 31, provides a secured revolving line of credit that ranged from \$40,000,000 to \$70,000,000 to allow for additional working capital requirements during the Company's traditional peak period. At October 1, 2002, the available commitment reduces to \$40,000,000. This is a three-year non-amortizing line with interest payable monthly at a fluctuating rate equal to the Bank's prime rate, plus a fluctuating margin of 0.25% - 0.50% (4.75% at January 31, 2002). The line also allows the Company the option to borrow under 30- 60- and 90-day fixed term rates at LIBOR plus a fluctuating margin of 1.50% to 2.50%. Approximately \$25,175,000 was available for borrowing as of January 31, 2002.

On February 22, 2000, the Company entered into an interest rate swap agreement with Wells Fargo Bank. The initial notional swap amount was \$30,000,000 for the period February 22, 2000, through February 28, 2001. The notional swap amount decreased to \$20,000,000 until expiration on March 3, 2003. The swap agreement is in consideration for a fixed rate at 7.23% plus a fluctuating margin of 1.50% to 2.50%. The Company adopted SFAS No. 133 "Accounting for Derivatives and Hedging Activities" on February 1, 2001. The adjustment to adopt SFAS 133 resulted in recording a liability of \$920,000 and an offset to other comprehensive loss, which was \$552,000 net of applicable income tax benefit of \$368,000. At January 31, 2002, the carrying value of the swap approximated the fair value of \$1,103,000, with an offset to other comprehensive loss of \$662,000 net of an applicable tax benefit of \$441,000. The revolving credit facility and the term loan with Wells Fargo Bank are subject to various financial covenants including a liquidity requirement, a leverage requirement, a cash flow coverage requirement and profitability requirements. The agreement also places certain restrictions on capital expenditures, dividends and the repurchase of the Company's common stock. The revolving credit facility and the term loan are secured by the Company's accounts receivable, inventory and equipment.

(b) Ten-year \$8,900,000 IRB issued through the City of Torrance. This 5.994% fixed interest rate bond is payable in monthly installments of \$99,000, including interest, through December 2004.

(c) In October 1998, the Company finalized a credit agreement with General Electric Capital Corporation (GECC) to finance the initial portion of the new business information system. This is a four-year amortizing capital lease with principal and interest (approximately 7.5%) payable of \$87,500 monthly. The Company has the option of buying out the lease three years into the lease period. As of January 31, 2002, the Company has not exercised the buy-out option.

Long-term debt repayments are approximately as follows (in thousands):

Year ending January 31	
2003	2,061
2004	25,592 *
2005	1,055
	<u>\$ 28,708</u>

* The \$22,414,000 due under Wells Fargo Bank's line of credit will be payable in the fiscal year ending January 31, 2004, if the agreement is not renewed. The Company intends to renew the agreement.

The Company believes that the carrying value of debt under the Wells Fargo credit facility approximates fair value at January 31, 2002 and 2001, as the majority of the long-term debt bears interest at variable rates or is fixed for periods equal to or less than 90 days. The carrying value of other debt instruments approximates their fair value given the Company's incremental borrowing rate for similar types of financing arrangements.

For fiscal year 2000, the Company guaranteed a \$1,500,000 line of credit from Wells Fargo Bank to the Virco Employee Stock Ownership Plan (ESOP), of which \$696,000 was outstanding under the line at January 31, 2001. The ESOP plan was dissolved during the year ended January 31, 2002.

4. Retirement Plans

The Company and its subsidiaries cover all employees under a noncontributory defined benefit retirement plan, the Virco Employees' Retirement Plan (the Plan). Benefits under the Plan are based on years of service and career average earnings. The Company's general funding policy is to contribute amounts deductible for federal income tax purposes. Minimum pension liability adjustments for the years 2001, 2000 and 1999 were \$1,329,000, \$1,155,000 and \$14,000, respectively (net of taxes of \$1,026,000, \$716,000 and \$9,000, respectively), and are included in comprehensive loss. Assets of the Plan are invested in common trust funds.

The following table sets forth (in thousands) the funded status of the Plan at December 31, 2001 and 2000:

	Pension Benefits	
	2001	2000
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 19,435	\$ 15,916
Service cost	1,017	930
Interest cost	1,515	1,425
Plan amendments	438	2,384
Actuarial loss	748	384
Benefit paid	(1,990)	(1,604)
Benefit obligation at end of year	<u>\$ 21,163</u>	<u>\$ 19,435</u>
Change in plan assets:		
Fair value at beginning of year	\$ 10,193	\$ 11,657
Actual return on plan assets	(2,116)	(1,099)
Company contributions	2,721	1,239
Benefits paid	(1,990)	(1,604)
Fair value at end of year	<u>\$ 8,808</u>	<u>\$ 10,193</u>
Funded status of plan	\$ (12,355)	\$ (9,242)
Unrecognized net transition amount	(225)	(267)
Unrecognized prior service cost	4,430	4,555
Unrecognized net actuarial loss	8,702	5,415
Net amount recognized	<u>\$ 552</u>	<u>\$ 461</u>
Statements of financial position:		
Accrued benefit liability	\$ (8,680)	\$ (6,718)
Intangible asset	4,430	4,555
Accumulated other comprehensive income	4,802	2,624
Net amount recognized	<u>\$ 552</u>	<u>\$ 461</u>
Weighted average assumptions:		
Discount rate	7.75%	8.00%
Expected return on plan assets	8.00%	9.75%
Rate of compensation increase	5.00%	5.00%

The total pension expense for the Plan (in thousands) included the following components:

	December 31		
	2001	2000	1999
Components of net cost:			
Service cost	\$ 1,017	\$ 930	\$ 752
Interest cost	1,515	1,425	1,091
Expected return on plan assets	(821)	(1,089)	(936)
Amortization of transition amount	(42)	(42)	(42)
Amortization of prior service cost	562	528	294
Recognized net actuarial loss	398	148	128
Benefit cost	<u>\$ 2,629</u>	<u>\$ 1,900</u>	<u>\$ 1,287</u>

Notes to Consolidated Financial Statements (continued)

The Company also provides a supplementary retirement plan for certain key employees, the VIP Retirement Plan (VIP Plan). The VIP Plan provides a benefit up to 50% of average compensation for the last five years in the VIP Plan, offset by benefits earned under the Virco Employees' Retirement Plan. The VIP Plan is funded by a life insurance program. The cash surrender values of the policies funding the VIP Plan were \$2,138,000 and \$1,977,000 at January 31, 2002 and 2001, respectively. These cash surrender values are included in other assets in the consolidated balance sheets.

The following table sets forth (in thousands) the funded status of the VIP Plan at December 31, 2001 and 2000:

	Nonqualified Pension	
	2001	2000
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 4,298	\$ 4,004
Service cost	490	417
Interest cost	323	299
Plan amendments	(438)	(1,240)
Actuarial loss	492	1,166
Benefit paid	(344)	(348)
Benefit obligation at end of year	<u>\$ 4,821</u>	<u>\$ 4,298</u>
Change in plan assets:		
Company contributions	\$ 344	\$ 348
Benefits paid	(344)	(348)
Fair value at end of year	<u>\$ -</u>	<u>\$ -</u>
Funded status of plan	\$ (4,821)	\$ (4,298)
Unrecognized prior service cost	(3,035)	(2,964)
Unrecognized net actuarial loss	2,718	2,420
Accrued benefit cost	<u>\$ (5,138)</u>	<u>\$ (4,842)</u>
Statements of financial position:		
Accrued benefit liability	\$ (5,138)	\$ (4,842)
Net amount recognized	<u>\$ (5,138)</u>	<u>\$ (4,842)</u>
Weighted average assumptions:		
Discount rate	7.75%	8.00%
Expected return on plan assets	8.00%	9.75%
Rate of compensation increase	5.00%	5.00%

The total plan expense for the VIP retirement plan included the following components (in thousands):

	December 31		
	2001	2000	1999
Components of net cost:			
Service cost	\$ 490	\$ 417	\$ 296
Interest cost	323	299	254
Amortization of prior service cost	(366)	(314)	(181)
Recognized net actuarial loss	193	157	369
Benefit cost	<u>\$ 640</u>	<u>\$ 559</u>	<u>\$ 738</u>

The Company's retirement plan, which covers all U.S. employees, allows participants to defer from 1% to 15% of their eligible compensation through a 401(k) retirement program. Through December 31, 2001, the plan included an employee stock ownership component. The Plan continues to include the Virco Stock Fund as one of the investment options. Shares owned by the plan are held by the Plan Trustee, Security Trust Company. At January 31, 2002, the Plan held 577,476 shares of Virco Stock. While these shares were included in the employee stock ownership component prior to the dissolution of the ESOP Plan, allocated shares held by the Trust were included in shares outstanding and the related dividends were charged to retained earnings. For the fiscal years ended January 31, 2002, 2001 and 2000, there was no employer match and therefore no compensation cost to the Company.

The Company provides current and post-retirement life insurance to certain salaried employees with split dollar life insurance policies under the Dual Option Life Insurance Plan. Cash surrender values of these policies, which are included in other assets in the consolidated balance sheets, were \$3,523,000 and \$3,550,000 at January 31, 2002 and 2001, respectively.

The Company established, effective January 1, 1997, a Deferred Compensation Plan, which allows certain key employees to defer up to a maximum of 90% of their base annual salary and/or up to 90% of their annual bonus on a pretax basis. The total participant deferrals were \$1,461,000 and \$1,226,000 for the years ended January 31, 2002 and 2001, respectively. The Deferred Compensation Plan is funded with investment funds held in the Rabbi Trust and are included in other assets in the consolidated balance sheets.

The Company maintains a Rabbi Trust to hold assets related to the VIP Retirement Plan, the Dual Option Life Insurance Plan, and the Deferred Compensation Plan. Substantially all assets funding these Plans are held in the Rabbi Trust.

In April 2001, the Board of Directors established a non-qualified plan for non-employee directors of the Company. The Plan provides a lifetime annual retirement benefit equal to the director's annual retainer fee for the fiscal year in which the director terminates his or her position with the Board, subject to the director providing 10 years of service to the Company. At January 31, 2002, the Plan did not hold any assets.

The following table sets forth (in thousands) the funded status of the Non-Employee Directors Retirement Plan at December 31, 2001:

	Nonqualified Pension 2001
Change in benefit obligation:	
Benefit obligation at beginning of year	\$ 461
Service cost	24
Interest cost	36
Plan amendments	-
Actuarial loss	(36)
Benefit paid	-
Benefit obligation at end of year	<u>\$ 485</u>
Change in plan assets:	
Fair value of plan assets at inception and end of year	<u>\$ -</u>
Funded status of plan	\$ (485)
Unrecognized prior service cost	373
Unrecognized net actuarial loss	(36)
Net amount recognized	<u>\$ (148)</u>
Statements of financial position:	
Accrued benefit liability	\$ (485)
Intangible asset	\$ 337
Net amount recognized	<u>\$ (148)</u>
Weighted average assumptions:	
Discount rate	7.75%
Expected return on plan assets	-
Rate of compensation increase	-

Notes to Consolidated Financial Statements (continued)

The total plan expense for the Non-Employee Directors retirement plan included the following components (in thousands):

	December 31 2001
Components of net cost:	
Service cost	\$ 24
Interest cost	36
Amortization of prior year service cost	88
Recognized net actuarial gain/loss	—
Benefit cost	<u>\$ 148</u>

5. Stock Options and Stockholders' Rights

The Company's two stock plans are the 1997 Employee Incentive Plan (the 1997 Plan) and the 1993 Employee Incentive Stock Plan (the 1993 Plan). Under these stock plans, the Company may grant an aggregate of 1,301,921 shares (as adjusted for the stock split and stock dividends) to its employees in the form of stock options. Non-employee directors automatically receive a grant for options to purchase 2,000 shares of common stock on the first business day following each annual meeting of the Company's stockholders.

As of January 31, 2002, 313,768 shares remain available for future grant. Options granted under the plans have an exercise price equal to the market price at the date of grant, have a maximum term of 10 years and generally become exercisable ratably over a five-year period. During the year, certain optionees satisfied the exercise price of their options by exchanging shares already owned rather than paying cash. As a result, 1,051 and 983 shares were recorded as treasury stock for the years ended January 31, 2002 and 2001, respectively.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair-value method of SFAS No. 123. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following ranges of weighted-average assumptions: risk-free interest rates of 4.69% to 6.26%; dividend yield of 0.10% to 0.98%; volatility factor of the expected market price of the Company's common stock of 0.26 to 0.39; and a weighted-average expected life of the option of five years.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The pro forma effect only takes into account options granted since January 1, 1993, and is likely to increase in future years as additional options are granted and amortized ratably over the vesting period. The Company's pro forma information follows (in thousands except for net income per share information):

	Year ended January 31		
	2002	2001	2000
Pro forma net income	\$ 204	\$ 3,914	\$ 9,698
Pro forma net income per share — assuming dilution	\$ 0.02	\$ 0.31	\$ 0.76

A summary of the Company's stock option activity, and related information for the years ended January 31 are as follows:

	2002		2001		2000	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	649,708	\$ 10.27	699,063	\$ 9.87	618,698	\$ 7.09
Granted	35,200	9.21	6,050	10.35	155,727	12.15
Exercised	(14,998)	2.42	(55,405)	5.10	(75,362)	3.08
Forfeited	(70,387)	13.50	—	—	—	—
Outstanding at end of year	<u>599,523</u>	<u>10.00</u>	<u>649,708</u>	<u>10.27</u>	<u>699,063</u>	<u>9.87</u>
Exercisable at end of year	525,524	\$ 9.86	542,878	\$ 9.79	584,075	\$ 9.55
Weighted-average fair value of options granted during the year		\$ 3.80		\$ 3.60		\$ 5.13

The data included in the above table have been retroactively adjusted, if applicable, for stock dividends and the stock split.

Information regarding stock options outstanding as of January 31, 2002, is as follows:

Price Range	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
\$ 2.06 to 9.70	272,745	2.59 years	\$ 5.34	240,896	\$ 4.80
11.16 to 15.29	217,739	7.22	12.57	179,031	12.46
18.22 to 19.44	109,039	5.69	16.60	107,575	16.58
	<u>599,523</u>	4.83	10.00	<u>527,502</u>	9.80

On October 15, 1996, the Board of Directors declared a dividend of one preferred stock purchase right (a Right) for each outstanding share of the Company's common stock. Each Right entitles a stockholder to purchase for an exercise price of \$50.00 (\$22.77, as adjusted for the stock split and stock dividend), subject to adjustment, one one-hundredth of a share of Series A Junior Participating Cumulative Preferred Stock of the Company, or under certain circumstances, shares of common stock of the Company or a successor company with a market value equal to two times the exercise price. The Rights are not exercisable, and would only become exercisable for all other persons when any person has acquired or commences to acquire a beneficial interest of at least 20% of the Company's outstanding common stock. The Rights expire on October 25, 2006, have no voting privileges, and may be redeemed by the Board of Directors at a price of \$.001 per Right at any time prior to the acquisition of a beneficial ownership of 20% of the outstanding common shares. There are 200,000 shares (439,230 shares as adjusted by the stock split and stock dividend) of Series A Junior Participating Cumulative Preferred Stock reserved for issuance upon exercise of the Rights.

6. Provision for Income Taxes

The Company uses the liability method to determine the provision for income taxes. Deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Notes to Consolidated Financial Statements (continued)

The provisions for the last three years are reconciled to the statutory federal income tax rate using the liability method as follows:

	January 31		
	2002	2001	2000
Statutory	34.0%	34.0%	35.0%
State taxes (net of federal tax)	4.1	3.2	3.1
Nondeductible expenses and other	5.5	1.1	1.0
	<u>43.6%</u>	<u>38.3%</u>	<u>39.1%</u>

Significant components of the provision for income taxes (in thousands) attributed to income before income taxes and cumulative effect of the accounting change are as follows:

	January 31		
	2002	2001	2000
Current			
Federal	\$ 1,562	\$ 2,690	\$ 2,952
State	350	390	840
	<u>1,912</u>	<u>3,080</u>	<u>3,792</u>
Deferred			
Federal	(1,449)	(350)	2,347
State	(273)	(57)	388
	<u>(1,722)</u>	<u>(407)</u>	<u>2,735</u>
	<u>\$ 190</u>	<u>\$ 2,673</u>	<u>\$ 6,527</u>

Deferred tax assets and liabilities (in thousands) are comprised of the following:

	January 31	
	2002	2001
Deferred tax assets		
Accrued vacation and sick leave	\$ 1,090	\$ 1,242
Retirement plans	3,308	2,678
Insurance reserves	1,306	1,410
Inventory	244	322
Other	1,068	216
	<u>7,016</u>	<u>5,868</u>
Deferred tax liabilities		
Tax in excess of book depreciation	(4,288)	(4,381)
Capitalized software development costs	(3,318)	(4,240)
	<u>(7,606)</u>	<u>(8,621)</u>
Net deferred tax liability	<u>\$ (590)</u>	<u>\$ (2,753)</u>

7. Commitments

The Company has long-term leases on real property and equipment, which expire at various dates. Certain of the leases contain renewal, purchase options and require payment for property taxes and insurance.

Minimum future lease payments (in thousands) for operating leases in effect as of January 31, 2002, are as follows:

Year ending January 31	
2003	\$ 10,314
2004	7,914
2005	6,064
2006	3,200
2007	906
Thereafter	868
	<u>\$ 29,266</u>

Rent expense relating to operating leases was as follows (in thousands):

Year ending January 31	
2002	\$ 11,042
2001	12,937
2000	10,516

The Company leases machinery and equipment from GECC under a 10-year operating lease arrangement. The Company has the option of buying out the leases three to five years into the lease period.

Minimum future lease-receipts (in thousands) for leases relating to properties owned or subleased as of January 31, 2002, are as follows:

Year ending January 31	
2003	\$ 33
2004	33
2005	33
2006	33
2007	33
Thereafter	147
	<u>\$ 312</u>

8. Contingencies

The Company and other furniture manufacturers are subject to federal, state and local laws and regulations relating to the discharge of materials into the environment and the generation, handling, storage, transportation and disposal of waste and hazardous materials. The Company has expended, and may be expected to expend significant amounts for the investigation of environmental conditions, installation of environmental control equipment and remediation of environmental contamination.

The Company is subject to contingencies pursuant to environmental laws and regulations that in the future may require the Company to take action to correct the effects on the environment of prior disposal practices or releases of chemical or petroleum substances by the Company or other parties. At January 31, 2002 and 2001, there are no required reserves for such environmental contingencies.

The Company has a self-insured retention for product and general liability losses up to \$100,000 per occurrence. The Company has purchased insurance to cover losses in excess of \$100,000 up to a limit of \$30,000,000. The Company has obtained an actuarial estimate of its total expected future losses for liability claims and recorded the net present value of \$3,908,000 at January 31, 2002, based upon the Company's estimated payout period of four years using a 10% discount rate.

Workers' compensation, automobile, general and product liability claims may be asserted in the future for events not currently known by management. Management does not anticipate that any related settlement, after consideration of the existing reserve for claims incurred and potential insurance recovery, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

The Company and its subsidiaries are defendants in various legal proceedings resulting from operations in the normal course of business. It is the opinion of management that the ultimate outcome of all such matters will not materially affect the Company's financial position, results of operations or cash flows.

9. Gain on Sale of Assets and Other Income

On April 25, 2000, the Company completed the sale of its Torrance, California, warehouse, which was held as rental property. The Company received \$9,385,000 in cash and recorded a \$7,945,000 pre-tax gain on disposition during the quarter ended April 30, 2000.

In October 2000, the Company entered into a confidential settlement of a dispute involving past services related to the installation of non-manufacturing equipment for which it received a final cash payment in November 2000. This payment is a non-recurring amount unrelated to the Company's ongoing operations. In the third quarter ended October 31, 2000, the Company recognized \$4,052,000 in other income from this settlement.

10. Subsequent Event

Subsequent to the year ended January 31, 2002, the Company entered into an agreement with Dew I to purchase Furniture Focus, Inc., an Ohio reseller that offers complete package solutions for the Furniture, Fixtures and Equipment (FF&E) segments of bond-funded public school construction projects, primarily in the upper Midwest. Pending the successful completion of due diligence, the Company will pay \$2,400,000 in cash for certain assets of the corporation.

11. Quarterly Results (Unaudited)

The Company's quarterly results for the years ended January 31, 2002 and 2001, are summarized as follows (in thousands, except per share data):

	April 30	July 31	Oct. 31	Jan. 31
Year ended January 31, 2002				
Net sales	\$ 42,457	\$ 89,193	\$ 86,232	\$ 39,580
Gross profit	11,483	28,349	28,591	8,764
Net (loss) income	(3,765)	4,490	3,912	(4,391)
Per common share ⁽¹⁾⁽²⁾				
Net income				
Basic	(0.30)	0.37	0.32	(0.36)
Assuming dilution	(0.30)	0.36	0.32	(0.36)
Year ended January 31, 2001				
Net sales	\$ 46,432	\$ 96,578	\$ 99,016	\$ 45,316
Gross profit	14,481	31,768	29,593	7,735
Income (Loss) before cumulative effect of accounting change	2,617	4,262	4,713	(7,279)
Cumulative effect of accounting change, net of tax				
Revenue recognition	(297)	—	—	—
Net income (loss)	\$ 2,320	\$ 4,262	\$ 4,713	\$ (7,279)
Per common share ⁽¹⁾⁽²⁾				
Income (Loss) before cumulative effect of accounting changes				
Basic	\$ 0.21	\$ 0.34	\$ 0.38	\$ (0.59)
Assuming dilution	0.21	0.34	0.37	(0.59)
Net income:				
Basic	0.19	0.34	0.38	(0.59)
Assuming dilution	0.18	0.34	0.37	(0.59)

(1) Net income per share has been adjusted to reflect the 10% stock dividend declared in August 2001 and 2000.

(2) Per common share amounts for the quarters and full years have each been calculated separately. Accordingly, quarterly amounts may not add to the annual amounts because of differences in the average common shares outstanding during each period and with regard to diluted per common share amounts only, because of the effect of potentially dilutive securities only in the periods in which the effect would have been dilutive.

Supplemental Stockholders' Information

Annual Meeting

The Annual Meeting of Virco stockholders will be held on Tuesday, June 18, 2002, at 2:00 p.m., at 2027 Harpers Way, Torrance, California. The record date for this meeting is May 3, 2002. The Proxy Statement and Proxy pertaining to this meeting will be mailed on or about May 24, 2002.

SEC Form 10-K

A copy of the annual report to the Securities and Exchange Commission on Form 10-K may be obtained without charge upon written request to:

Corporate Secretary
Virco Mfg. Corporation
2027 Harpers Way
Torrance, CA 90501

Virco Common Stock

The American Stock exchange is the principal market on which Virco Mfg. Corporation (VIR) stock is traded. As of April 23, 2002, there were approximately 350 registered stockholders according to the transfer agent records. There are approximately 1,500 beneficial stockholders.

Stockholder Records

Records pertaining to stockholdings and dividends are maintained by Mellon Investor Services. Inquiries with respect to these matters, as well as notices of address changes, should be directed to: Mellon Investor Services, 85 Challenger Road, Ridgefield Park, NJ 07660, telephone 1-800-356-2017.

If a stock certificate is lost or mutilated, immediately communicate with Mellon Investor Services at the above address.

Additional Services for Stockholders

Information about the Company is now available to stockholders at the Company's website (www.virco.com). A brief description of Virco's product line is offered together with illustrations showing a sampling of our furniture.

Quarterly Dividend and Stock Market Information

	Cash Dividends Declared		Common Stock Range			
	1-31-2002	1-31-2001	1-31-2002		1-31-2001	
			High	Low	High	Low
1st Quarter	\$ 0.02	\$ 0.02	\$ 10.00	\$ 8.86	\$ 10.69	\$ 8.06
2nd Quarter	0.02	0.02	9.68	8.95	12.29	8.26
3rd Quarter	0.02	0.02	10.40	9.32	12.05	10.68
4th Quarter	0.02	0.02	10.20	8.15	10.23	7.73

The data included in the above table has been retroactively adjusted, if applicable, for the stock split and stock dividends.

Directors, Officers and Facilities

Directors

Robert A. Virtue
President, Chairman of the Board
and Chief Executive Officer

Donald S. Friesz
Former Vice President - Sales and
Marketing

Evan M. Gruber
Chairman and Chief Executive Officer
Modtech Holdings, Inc.

Robert K. Montgomery
Partner, Gibson, Dunn & Crutcher

George W. Ott
President, Ott and Hansen, Inc.

Glen D. Parish
Vice President and General Manager
Conway Division

Donald A. Patrick
Management Consultant
Diversified Business Resources, Inc.

Douglas A. Virtue
Executive Vice President

Dr. James R. Wilburn
Dean of the School of Public Policy
Pepperdine University

Officers

Robert A. Virtue
President, Chairman of the Board
and Chief Executive Officer

Douglas A. Virtue
Executive Vice President

Robert E. Dose
Vice President - Finance
Secretary and Treasurer

Robert J. Mills
Vice President - Engineering
and Product Development

Glen D. Parish
Vice President and General Manager
Conway Division

Wesley D. Roberts
Vice President and
Chief Information Officer

D. Randal Smith
Vice President - Marketing

Lori L. Swafford
Vice President - Legal Affairs

Larry O. Wonder
Vice President - Sales

Independent Auditors

Ernst & Young LLP
One World Trade Center
Long Beach, California 90831

Legal Counsel

Gibson, Dunn & Crutcher
2029 Century Park East
Los Angeles, California 90067

Corporate Headquarters

2027 Harpers Way
Torrance, California 90501
(310) 533-0474

Major Facilities

Torrance Division
2027 Harpers Way
Torrance, California 90501

Conway Division
Highway 65, South
Conway, Arkansas 72032



2001 Annual Report



VIRCO MFG. CORPORATION

2027 HARPERS WAY • TORRANCE, CA 90501

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