



# *One Hundred Years* 1902 - 2002



*One Hundred Years*

## C O R P O R A T E   P R O F I L E

The Company sells oil field pumping units, power transmission products, foundry castings and highway trailers throughout the world. The Company has vertically integrated all vital technologies required to design, manufacture and market its products. Lufkin's common stock is traded on the Nasdaq Stock Market (National Market) under the symbol LUFK.

## N O T I C E   O F   A N N U A L   M E E T I N G

The Annual Meeting of Shareholders of Lufkin Industries, Inc. will be held at the Museum of East Texas, 503 North Second Street, Lufkin, Texas on May 1, 2002, at 9:00 a.m. local time.

Cover:  
Ledger illustrated on cover and elsewhere in this report represents a hand posted Lufkin Payroll ledger from November 1902. It included 40 employees earning between 50¢ and \$3.30 per day.

# LUFKIN FOUNDRY & MACHINE CO., L

NAME	1	2	3	4	5	6	7	8	9	10	11
<i>R. E. Harris</i> <small>&lt;Helper&gt;</small>	1317	150		145	150	150	150	150	175	150	150
<i>G. L. Raymond</i> <small>P.M.</small>	7625	125		125	250	250	250	250	250	250	250
<i>J. L. Gandy</i> <small>&lt;machinist&gt;</small>	5593	330		330	330	330	330	330	330	330	330
<i>L. D. Koganzugh</i>	5780	200		200	200	200	200	200	200	200	200
<i>W. M. ...</i>	5322	1000		250				165			



# One Hundred Years

1902 - 2002



*Through their spirit, vision, dedication and deep commitment to quality and excellence, Lufkin Industries' employees have built a company known for its reliability, industry product standards, financial strengths and market leadership.*

*The faces of the Lufkin Industries' employees highlight the strength of this one hundred year old company.*



## FINANCIAL HIGHLIGHTS

(Thousands of dollars, except per share amounts)	December 31,	
	2001	2000
Sales	<b>\$278,907</b>	\$254,603
Operating expenses	<b>245,903</b>	242,473
Earnings before income taxes	<b>32,300</b>	11,242
Net earnings	<b>19,542</b>	6,970
Earnings per share:		
Basic	<b>\$3.12</b>	\$1.11
Diluted	<b>\$3.03</b>	\$1.11
Dividends per share	<b>\$0.72</b>	\$0.72
Total assets	<b>246,069</b>	233,582
Working capital	<b>60,533</b>	43,338
Long-term notes payable, net of current portion	<b>339</b>	7,043
Shareholders' equity	<b>170,999</b>	152,651



# One Hundred Years 1902 - 2002

*The experience of a century.  
The vision of another.*



## LETTER TO SHAREHOLDERS



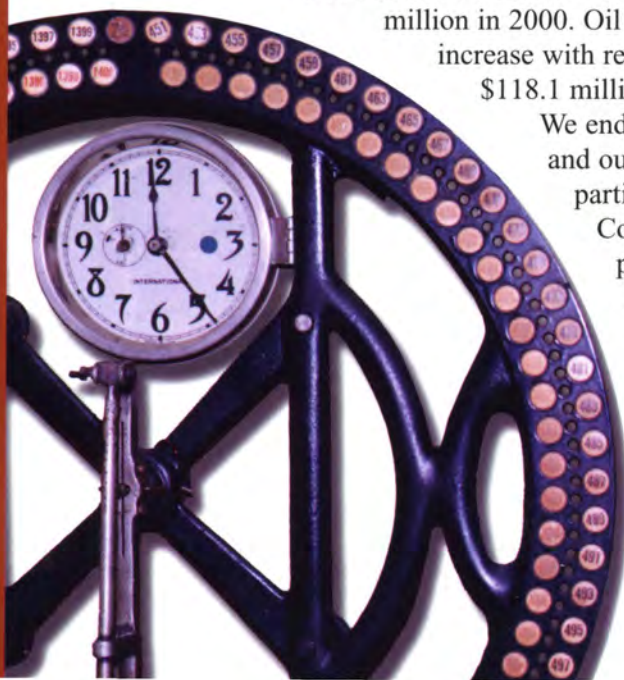
**DOUGLAS V. SMITH**  
President and  
Chief Executive Officer

February 2002 ushered in Lufkin Industries' second century of operation. This milestone capped the Company's excellent performance in 2001, a year in which Lufkin achieved its strongest financial performance in fifteen years. Lufkin's leadership position in its energy segment demonstrated the Company's earnings potential when oil and gas development is expanding. The past year also demonstrated the positives and negatives of diversification. The strong demand for oil field products more than offset the recession in the industrial and transportation markets. Our past efforts to broaden products and services in our Oil Field Division, together with improvements in our production capabilities in this

division were rewarded during 2001. The ability to shift production capacity to areas of demand enabled the Company to capitalize on openings in the market and capture market share. Recent expansions in the aftermarket segments of existing businesses also contributed to our improved financial performance in 2001.

I am pleased to report that for the year ended December 31, 2001, Lufkin Industries earned \$19.5 million, or \$3.03 per diluted share. This compares with earnings of \$7.0 million, or \$1.11 per diluted share, in 2000. Sales for the year 2001 increased 9.5% to \$278.9 million compared with sales of \$254.6 million in 2000. Oil field products showed the most significant increase with revenues up 54.3% to \$182.3 million from \$118.1 million in 2000.

We ended 2001 with a very sound balance sheet and our cash generation from operations was particularly strong in 2001. During 2001, the Company paid down debt by \$9.5 million, paid dividends of \$4.5 million and invested \$7.9 million in capital projects. Lufkin ended the year with \$18.1 million in cash or cash equivalents, an increase of \$16.1



Early 1900's manual IBM time clock used by Lufkin Industries to record work hours of its employees.



million from the December 31, 2000, level of \$2.0 million. Debt, net of escrowed funds, as of the end of 2001 was \$1.1 million compared with \$10.7 million at the end of 2000. For the year 2001, earnings before interest, taxes, depreciation and amortization (EBITDA) was \$44.5 million (\$6.93 per diluted share), or 16% of revenues, compared with EBITDA for 2000 of \$23.6 million (\$3.75 per diluted share), or 9% of revenues. For 2001, Lufkin generated \$34.8 million in cash flow from operations compared with \$14.1 million in 2000.

Lufkin's backlog at December 31, 2001, increased to \$64.4 million from \$61.1 million at September 30, 2001, and \$63.6 million at December 31, 2000. Power Transmission's backlog grew to \$31.5 million compared with \$30.3 million at the third quarter of 2001 and \$20.8 million at December 31, 2000. Trailer products' backlog increased to \$13.5 million, up from \$4.8 million at the third quarter of 2001 and \$9.5 million at December 31, 2000. Oil Field's backlog decreased to \$19.4 million from \$26.0 million at the end of the third quarter of 2001 and \$33.3 million at the end of 2000.

**OIL FIELD**

Beginning with this annual report, results of our Foundry operation have been consolidated into the Oil Field Division. This reflects the fact that, in recent years, over 50% of the Foundry's output was produced for the Oil Field Division. Demand for iron castings for the machine tool, material handling and other markets has continued to languish for our Foundry. While we will continue to pursue external opportunities to fully use capacity, overall utilization will likely be at lower levels than that of early 2001.

The energy market outlook is significantly changed today from what it was a year ago, with oil prices down on average by 35% to 40% in early 2002. In our segment of the market, activity was down over 35% at the end of 2001 in the United States and by over 40% in Canada. Most major projects in the United States are continuing, and our long-term alliances and relationships with large producers are serving us well. Our international markets are steady, with the notable exception of Argentina. This has historically been a good market for our products, but the currency issues, payment terms and



**SALES MIX**

Oil Field 66%

Power Transmission 22% Trailer 12%



# One Hundred Years 1902 - 2002



*Over 25% of our employees have worked for the company for twenty-five years or more.*



underlying economic struggle create uncertainty for 2002. Our exposure to Argentina is very small, and we are watching this market very closely. During 2001, we expanded our international presence in the Middle East by establishing an office in Cairo, Egypt with field service operations with a major domestic oil company and an Egyptian company.

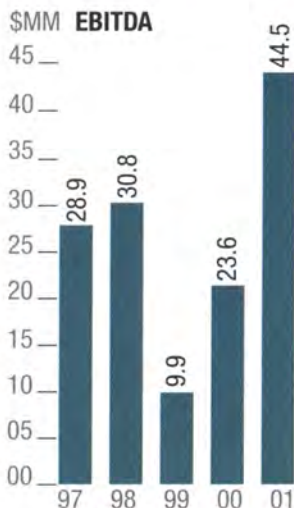
While demand for oil field pumping units softened in 2002, demand for our automation products continues to grow. Automation sales are expected to be up in 2002 as oil producers concentrate on cost savings and more effective reservoir management. The strategies of increasing our presence in the service sector and providing new automation products served us well in 2001. Our strength in this sector positions the Oil Field Division to weather this cyclical downturn in the drilling and completion activity.

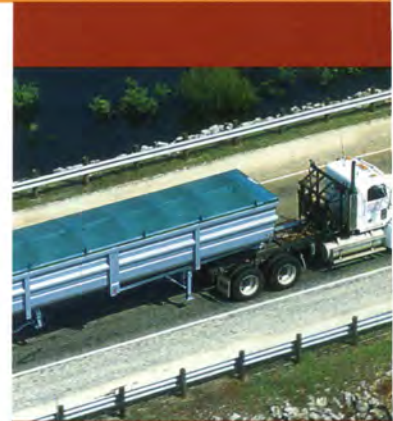
### POWER TRANSMISSION

Our power transmission products serve the gear needs of the industrial markets as well as the oil and gas business. Backlog at the end of 2001 was at a 30-month high. This should favorably impact revenues during the second quarter of 2002. The demand for oil and gas projects that utilize Lufkin gears continues to grow. We see strength in this sector through at least the first half of 2002. We are also seeing a rebound in the refining and petrochemical markets in the first quarter of 2002. The growing demand for gas is fueling construction of LNG plants, which will require large, high-speed gears. In addition, demand for gears is increasing in such industrial applications as sugar, aluminum and rubber mills, served by our gear products, as companies begin to reinvest after a long period of deferring both maintenance and investments in capital equipment.

We have seen some consolidation in the custom-engineered gear business during the past few years. This has improved the outlook by reducing some of the excess capacity. However, the benefits have been partially offset by the strength of the dollar, which places United States manufacturers at a disadvantage relative to European and Asian competitors. Lufkin France, our 1998 acquisition, has enabled Lufkin to better compete in Europe with respect to currency.

Based on national economic projections, we expect U.S. manufacturing and industrial capital spending to rebound in the second half of 2002. This should correspondingly increase the demand for our products. In addition, our Gear Repair and Service operations continue to be strong performers, both domestically and internationally. We expect to expand Lufkin's presence in the aftermarket in 2002.





### TRAILER

The uncertainty surrounding the United States economy causes us to expect continued weakness in our Trailer Division for 2002. However, our backlog has begun to grow and activity has increased in our manufacturing operations, but we do not expect to see real demand pick up until late this year. While we have seen downsizing and consolidation in the industry, Lufkin has maintained its core organization and its service centers. We have used this difficult period to develop a new dump trailer and restructure our sales and distribution relationships. We believe that our long-standing reputation for quality, our financial strength and our regional locations position us well for the future.

### SUMMARY

As we celebrate Lufkin's 100th anniversary, the business conditions we confront are indeed some of the most challenging in our history. The uncertainties of the energy markets are coupled with the uncertainty of the world economy. The terror of September 11, 2001, has introduced additional concerns. Lufkin Industries is fortunate to have talented, hardworking employees, solid financial resources, coupled with industry leading products and services. We will continue to pursue strategic opportunities, improve our competitive position and stay prepared for any contingency.

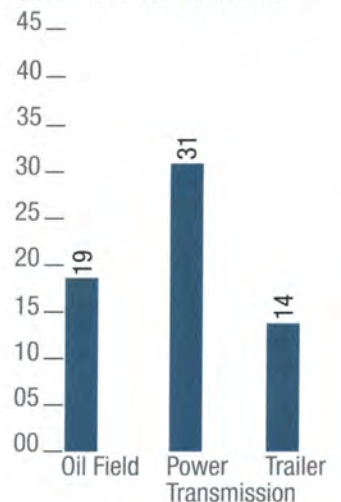
Two of our board members are retiring in May 2002. Mr. L.R. Jalenak, Jr. has served with the board for eleven years and we are indebted to him for his contributions including chairing the audit committee. Mr. W.W. Trout, Jr. has been associated with Lufkin Industries his entire life. The Trout family has provided leadership for the company since 1905. We thank both Mr. Jalenak and Mr. Trout for their years of service to Lufkin Industries.

Sincerely,

Douglas V. Smith  
President and Chief Executive Officer



\$MM DIVISION BACKLOG



# One Hundred Years

## 1902 - 2002



### LUFKIN AT A GLANCE

#### OIL FIELD PRODUCTS AND SERVICE

Lufkin is recognized as a world leader in the manufacturing, installation and service of artificial lift oil field equipment and services. Its network of domestic and international manufacturing and services facilities enables the Company to provide prompt responses with engineered solutions to the demanding requirement of global oil markets. The Company's primary products include conventional, Mark II, mobile, low profile and air-balanced beam-pumping units; its beam-type pumping unit is recognized as the industry standard. The Company's focused expansion into auxiliary products and service has expanded its capability to be a full service provider of oil field equipment and services. Its automation technology equipment and services continue to provide its customers with cost savings in operating and maintaining its artificial lift equipment as well as extending the effectiveness of its primary assets--the oil reservoirs. The Lufkin Foundry represents a vertical integration resource as part of the Company's Oil Field Division. Additionally, it has its own solid base of commercial customers for engineered grey and ductile iron castings.

#### POWER TRANSMISSION PRODUCTS AND SERVICE

Lufkin is one of the leading manufacturers of mechanical power transmission equipment, used in a wide variety of industrial applications worldwide. Markets for the Company's products include: oil and gas production, transmission and processing; power generation; tire and rubber production; metals processing; marine propulsion and sugar processing. The Company's precision gears are primarily parallel shaft and enclosed gear drives engineered to meet specific performance requirements. Lufkin also provides full life-cycle gear product support with service, installation, maintenance, repair and up rating in the aftermarket.

#### TRAILER PRODUCTS AND SERVICE

Lufkin produces many different sizes and styles of vans; platforms; and high capacity, lightweight dump trailers primarily for the North American transportation market. The Company's trailers are known for their quality construction, reliability, innovation of design and competitive price. Lufkin's expertise in designing and building high quality new products has enabled the Company to expand the market for its trailers and has provided additional growth opportunities.



*Lufkin employees can be found working in 9 countries and on 5 continents throughout the world.*



## O I L F I E L D

Lufkin's oil field product and service offerings comprise three areas: capital goods, which are mainly new pumping units, used pumping units, parts or other packaged artificial lift equipment; service, which includes installation, repair and maintenance of existing oil field equipment; and automation, which consists of manufactured computer control equipment and analytical services for artificial lift wells.

Lufkin's Oil Field Division has a significant global presence with manufacturing facilities on four continents and in eight countries. In an effort to leverage the Company's vertical integration structure, Lufkin established oil field pumping unit manufacturing capabilities in its French Power Transmission gear manufacturing facility in keeping with its objective to better respond to international market opportunities. Known for its strong capabilities in the mix of larger pumping unit sizes in oil lift applications, Lufkin reinforced its full range artificial lift product offerings by placing units in the application of pumping water from natural gas wells. Plus, through a reengineering effort, Lufkin revitalized its Churchill product line in the application of pumping water from coal bed methane projects. Lufkin has expanded its network of service centers in the United States to 14 and added capabilities in Canada, Indonesia and Egypt. It has expanded its automation manufacturing to two locations in Texas (Houston and Midland) with service presence in Canada, Oklahoma City and Bakersfield. Additionally, Lufkin has sales representation affiliations in 15 countries. Lufkin has expanded the scope of its sales and service offerings to include one off specific application sales of new and used equipment and service to full turn key sales and service contracts to include full range packages of artificial lift equipment, installation, service and automation applications.



*One Hundred Years*  
*Lufkin Industries, Inc., and its employees and retirees have*  
*contributed \$1.5 million dollars to the United Way Campaign*  
*during the past 8 years.*



#### POWER TRANSMISSION

The strengthening backlog in Lufkin's Power Transmission Division reflects increased capital spending in several sectors served by this division. Oil and gas development projects in the deep-water Gulf of Mexico and West Africa fueled demand for high-speed gear units used in gas compression applications. New environmental legislation aimed at lowering sulfur levels in gasoline and diesel fuels also spurred demand for gear units used in refinery applications. We expect both of these sectors to continue to generate strong product demand in 2002. While general industrial demand was low during most of 2001, there was an increased demand registered during quarter four that reflected a return to capital spending in tire and rubber and metal working sectors that had been dormant for several years.

Lufkin, recognized as an industry leader in both gear engineering and manufacturing, strengthened its global market presence as a result of the consolidation and discontinuation of several domestic and international competitors. During 2001, Lufkin realized a significant contribution from its French operation and its gear repair and service operations. Lufkin operates sales offices in 11 states and in four countries (United States, Canada, France and Japan). To capitalize on after-market service and repair opportunities, Lufkin employs a network of service representatives operating from 14 states in the United States and Canada, as well as service and repair representatives in the United Kingdom and Western Europe, which are supported from the Company's manufacturing center in France.

Lufkin has manufacturing and repair facilities on two continents (North America and Europe). Likewise, it maintains major engineering resources at each of these locations, as well as a highly experienced engineering-orientated sales force capable of providing a full range of engineered solutions to its customers.

Industry-leading metallurgical expertise, coupled with extensive product testing facilities and an excellent quality assurance organization, round out the technical support organization. Lufkin's cycle times are the shortest in the industry and have proven to offer a powerful competitive advantage in markets in which customers value speed of delivery. This package of capabilities enables Lufkin to operate as a technically differentiated supplier of solutions in the high-value added sector of the gear industry. As a result of the value that our customers assign to our products and services, we operate a number of partnering agreements with major customers that add value to both our customers and ourselves.





## T R A I L E R

In spite of severely depressed trailer markets and a consolidation of manufacturers in this industry, Lufkin has been able to flex its cost structure, expand its dealer presence and gain market position. Through the Company's vertical integration and the strength of its balance sheet, Lufkin has positioned itself for recovery and gain as the markets improve by retaining key industry experienced personnel, managing both its new and used trailer inventories for burden-free quick response and by adding no new debt. Lufkin has maintained its network of six trailer service centers in Texas, Arkansas, Louisiana and Tennessee. It has expanded its network of full service dealers to 26 in 19 states and in three countries (United States, Canada and Mexico).

Through its engineering strength, Lufkin continued to add new trailers to its diverse product and service offerings by introducing a bottom dump trailer, an extendable drop frame unit and a double drop flatbed trailer. The Company continued to meet customer needs by offering varying sizes and styles of vans, platforms and high capacity and light-weight dump trailers.

Lufkin is recognized as a strong entity in its regional market of the South Central United States. In its 63 years of trailer business, Lufkin is known for manufacturing a well-engineered trailer that is of the highest quality that will perform and last through the demands of rugged use. As the economists predict an end to the recession, with continued low interest rates and with moderate fuel costs, Lufkin is positioned for a strong recovery in this market.



## FINANCIAL REVIEW

### Common Stock Information

Quarter	2001			2000		
	Stock Price		Dividend	Stock Price		Dividend
	High	Low		High	Low	
First	<b>\$22.500</b>	<b>\$16.188</b>	<b>\$.18</b>	\$17.063	\$13.750	\$.18
Second	<b>31.480</b>	<b>18.375</b>	<b>.18</b>	20.000	14.000	.18
Third	<b>29.500</b>	<b>20.250</b>	<b>.18</b>	21.875	15.688	.18
Fourth	<b>27.250</b>	<b>22.750</b>	<b>.18</b>	22.500	13.750	.18

The Company's common stock is traded on the Nasdaq Stock Market (National Market) under the symbol LUFK and as of March 1, 2001, there were approximately 620 record holders of its common stock.

The Company has paid cash dividends for 62 consecutive years. Total dividend payments were \$4,481,000 and \$4,549,000 in 2001 and 2000, respectively.

### Quarterly Financial Data (Unaudited)

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2001</b>				
Net sales	<b>\$63.5</b>	<b>\$73.2</b>	<b>\$75.6</b>	<b>\$66.6</b>
Gross profit	<b>14.7</b>	<b>18.3</b>	<b>19.0</b>	<b>16.0</b>
Net earnings	<b>3.0</b>	<b>5.3</b>	<b>6.6</b>	<b>4.6</b>
Basic earnings per share	<b>.49</b>	<b>.85</b>	<b>1.04</b>	<b>.72</b>
Diluted earnings per share	<b>.49</b>	<b>.83</b>	<b>1.01</b>	<b>.70</b>
<b>2000</b>				
Net sales	\$56.8	\$67.8	\$65.7	\$64.3
Gross profit	8.3	12.1	11.6	12.2
Net earnings	0.2	2.1	2.3	2.4
Basic earnings per share	.03	.33	.36	.39
Diluted earnings per share	.03	.33	.36	.38

### Additional Financial Information

Shareholders may obtain additional information for the year ended December 31, 2001, from the Company's Form 10-K Report filed with the Securities and Exchange Commission. A copy of such report may be obtained without charge by written request to the Secretary, Lufkin Industries, Inc., P.O. Box 849, Lufkin, Texas 75902-0849.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Results of Operations

Net revenues for the year ended December 31, 2001, increased to \$278.9 million from \$254.6 million for the year ended December 31, 2000. Net revenues for 1999 were \$246.0 million. Revenues for 1999 have been restated to reflect the reclassification of freight charges billed to customers as revenue and the related expenses as cost of sales in accordance with the guidance specified by EITF 00-10. The company previously accounted for freight charged to customers as a reduction of cost of sales. Gross profit, operating income and net earnings were not affected by this reclassification.

The Company reported net earnings of \$19.5 million or \$3.03 per share (diluted) for the year ended December 31, 2001, compared to net earnings of \$7.0 million or \$1.11 per share (diluted) for the year ended December 31, 2000. A net loss of \$1.3 million or \$0.20 per share (diluted) was reported for the year ended December 31, 1999.

The company has changed its segment reporting methodology to consolidate the Foundry segment into the Oil Field segment. All prior period data has been adjusted to reflect this change. This segment consolidation has occurred for several reasons: a management restructuring reflecting this change has taken place, lower domestic spending by customers and increased foreign imports has decreased the demand for domestic iron castings and transfers to the oil field product line have become a significant percentage of the output of Foundry, causing the activity level of oil field products to directly impact the financial performance of Foundry. However, the Company will continue to aggressively pursue external casting opportunities.

The sales mix of the Company's operating segments for the three years ended December 31, 2001, was as follows:

	Percent of total sales		
	2001	2000	1999
Oil Field	65%	46%	28%
Power Transmission	23	25	29
Trailer	12	29	43
Total	100%	100%	100%

### Year Ended December 31, 2001 Compared to Year Ended December 31, 2000:

The following table summarizes the Company's net revenues and gross profit by operating segment (in thousands of dollars):

Year Ended December 31,	2001	2000	Increase (Decrease)	% Increase (Decrease)
<b>Net Revenues</b>				
Oil Field	\$ 182,271	\$ 118,097	\$ 64,174	54.3
Power Transmission	62,498	62,923	(425)	(0.7)
Trailer	34,138	73,583	(39,445)	(53.6)
Total	\$ 278,907	\$ 254,603	\$ 24,304	9.5
<b>Gross Profit</b>				
Oil Field	\$ 48,876	\$ 23,739	\$ 25,137	105.9
Power Transmission	18,946	15,590	3,356	21.5
Trailer	227	4,921	(4,694)	(95.4)
Total	\$ 68,049	\$ 44,250	\$ 23,799	53.8

Oil Field revenues for the year ended December 31, 2001, increased 54.3% to \$182.3 million from \$118.1 million in the year ended December 31, 2000. Increases in production activity among oil producers resulted in significant increases in both new pumping unit sales and oil field service activity. However, lower energy prices and corresponding production activity in the fourth quarter of 2001 was reflected in the backlog of Oil Field, which declined to \$19.4 million at December 31, 2001, from \$33.3 million at December 31, 2000.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Results of Operations (continued)

Gross profit for Oil Field increased to \$48.9 million, or 105.9%, for the year ended December 31, 2001, compared to \$23.7 million for the year ended December 31, 2000, due to the above noted increases in product volume associated with higher production activity. Gross margin improved to 26.8% in 2001 compared to 20.1% in 2000 due primarily to increased leverage on the Company's fixed costs.

Direct selling, general and administrative expenses for Oil Field increased to \$9.5 million, or 33.7%, for the year ended December 31, 2001, from \$7.1 million for the year ended December 31, 2000. This increase was due to higher third-party sales commissions and higher internal sales activity in conjunction with above noted increase in revenue. Also, administrative expenses increased due to higher legal expenses associated with ongoing and routine litigation.

Revenues for the Company's Power Transmission segment decreased slightly to \$62.5 million for the year ended December 31, 2001, compared to \$62.9 million for the year ended December 31, 2000. The uncertain economic conditions experienced in the last several years in many of the Company's domestic and international industrial markets continued to exist in 2001. However, the activity level in these markets has shown improvement, as evidenced by the Power Transmission backlog of \$31.5 million as of December 31, 2001, compared to \$20.8 million as of December 31, 2000.

Power Transmission gross profit and gross margin, however, increased to \$18.9 million and 30.3%, respectively, for the year ended December 31, 2001, from \$15.6 million and 24.8%, respectively, for the year ended December 31, 2000. This improvement was due to a combination of higher margins on new equipment sales and increased absorption of fixed overhead costs resulting from volume increases attributable to gearboxes supplied to the Company's Oil Field segment.

Direct selling, general and administrative expenses for Power Transmission decreased to \$10.1 million, or 5.7%, for the year ended December 31, 2001, from \$10.7 million for the year ended December 31, 2000. This decrease was due to lower personnel-related expenses, reduced severance payments and lower depreciation expense, partially offset by higher bad debt expense.

Trailer revenues for the year ended December 31, 2001, decreased 53.6% to \$34.1 million from \$73.6 million for the year ended December 31, 2000, due to the continued industry-wide decline in the market for new trailers that began in 1999. Due to a combination of lower shipping volumes, higher fuel costs, higher personnel costs and higher insurance rates, freight companies have either significantly reduced orders for new trailers or have gone out of business. Trailer manufacturers have seen revenue declines of as much as 75%, with several shutting down completely. Some improvement has been seen in the trailer market, as demonstrated in the increased backlog to \$13.5 million as of December 31, 2001, compared to \$9.5 million as of December 31, 2000. This backlog level, though, was still well below traditional levels.

Trailer gross profit and margin declined to \$0.2 million and 0.7%, respectively, for the year ended December 31, 2001, from \$4.9 and 6.7%, respectively, for the year ended December 31, 2000, due to fixed manufacturing overhead not declining at the same rate as revenue.

Direct selling, general and administrative expenses for Trailer decreased to \$2.2 million, or 16.9%, for the year ended December 31, 2001, from \$2.6 million for the year ended December 31, 2000. This decrease was due to a combination of lower personnel-related expenses and insurance claims.

Pension income, which is reported as a reduction of cost of sales in each segment, decreased to \$5.9 million, or 6.9%, for the year ended December 31, 2001, from \$6.4 million for the year ended December 31, 2000. Pension income is based on expected long-term return projections and not on current year activity.

Corporate administrative expenses, which are allocated to the segments primarily based on third-party revenues, increased to \$13.3 million, or 13.6%, for the year ended December 31, 2001, from \$11.7 million for the year ended December 31, 2000, due to increased legal expenses and non-recurring expenses related to the Company's 100th anniversary.

Interest expense for the year ended December 31, 2001, totaled \$0.9 million compared to \$1.4 million for the year ended December 31, 2000, due to lower average short and long-term debt balances in 2001 compared to 2000. Since the majority of outstanding debt will be repaid in July 2002, interest expense will be greatly reduced after that date. Other income (expense) of \$(0.3) million for 2001 was reduced from \$0.1 million for 2000.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Results of Operations (continued)

#### Year Ended December 31, 2000 Compared to Year Ended December 31, 1999:

The following table summarizes the Company's net revenues and gross profit by operating segment (in thousands of dollars):

Year Ended December 31,	2000	1999	Increase (Decrease)	% Increase (Decrease)
<u>Net Revenues</u>				
Oil Field	\$ 118,097	\$ 69,188	\$ 48,909	70.7
Power Transmission	62,923	71,475	(8,552)	(12.0)
Trailer	73,583	105,337	(31,754)	(30.1)
Total	\$ 254,603	\$ 246,000	\$ 8,603	3.5
<u>Gross Profit</u>				
Oil Field	\$ 23,739	\$ 6,372	\$ 17,367	272.6
Power Transmission	15,590	14,546	1,044	7.2
Trailer	4,921	11,724	(6,803)	(58.0)
Total	\$ 44,250	\$ 32,642	\$ 11,608	35.6

Oil Field revenues for the year ended December 31, 2000, increased 70.7% to \$118.1 million from \$69.2 million in the year ended December 31, 1999. Increased production activity among oil producers resulted in significant increases in both new pumping unit sales and oil field service activity. Oil Field backlog reflected this increase in activity, increasing to \$33.3 million at December 31, 2000, from \$10.0 million at December 31, 1999.

Gross profit for the Oil Field Division increased to \$23.7 million for the year ended December 31, 2000, compared to \$6.4 million for 1999 due primarily to the increase in volumes noted above. Gross margin for the comparable periods improved to 20.1% in 2000 compared to 9.2% in 1999 due primarily to increased leverage on the Company's fixed costs.

Direct selling, general and administrative expenses ("SG&A") for Oil Field decreased to \$7.1 million, or 2.9%, for the year ended December 31, 2000, from \$7.3 million for the year ended December 31, 1999. Excluding the effects of non-recurring severance, relocation and legal expenses of \$0.6 million in 1999, direct SG&A in 2000 would have increased by 5.6%. This increase was primarily related to the expansion of the automation product line during 2000.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Results of Operations (continued)

Revenues for the Company's Power Transmission segment decreased 12.0% to \$62.9 million for the year ended December 31, 2000, compared to \$71.5 million for the year ended December 31, 1999, as uncertain economic conditions experienced in late 1999 in many of the Company's domestic and international industrial markets continued to exist in 2000. The petrochemical markets were impacted by higher energy prices, the steel and aluminum markets were depressed by lower volumes and foreign imports and consolidations in the oil and gas markets put new capital projects on hold. The Company's Power Transmission backlog at December 31, 2000, declined slightly to \$20.8 million from \$21.4 million at December 31, 1999.

Power Transmission gross profit and gross margin, however, increased to \$15.6 million and 24.8%, respectively, for the year ended December 31, 2000, from \$14.5 million and 20.4%, respectively, for 1999. This increase was due primarily to improvements in product mix, along with increased absorption of fixed overhead costs in 2000 resulting from volume increases attributable to gearboxes supplied to the Company's Oil Field Division.

Direct selling, general and administrative expenses ("SG&A") for Power Transmission decreased to \$10.7 million, or 8.2%, for the year ended December 31, 2000, from \$11.7 million for the year ended December 31, 1999. Excluding the effects of non-recurring severance and legal expenses of \$0.5 million in 1999, direct SG&A in 2000 would have decreased by 3.7%. This decrease was due to personnel-related cost reductions and lower depreciation expense.

Trailer revenues for the year ended December 31, 2000, decreased 30.1% to \$73.6 million from \$105.3 million for the year ended December 31, 1999. Due to a combination of lower shipping volumes, higher fuel costs, higher personnel costs and higher insurance rates, freight companies significantly reduced orders for new trailers. Backlog for the Trailer segment totaled \$9.5 million at December 31, 2000, compared to \$42.2 million at December 31, 1999.

Trailer gross profit and gross margin decreased to \$4.9 million and 6.7%, respectively, for the year ended December 31, 2000, from \$11.7 million and 11.1%, respectively, for the prior year due to fixed manufacturing overhead not declining at the same rate as revenue and pricing pressure on new trailers.

Direct selling, general and administrative expenses ("SG&A") for Trailer increased to \$2.6 million, or 19.6%, for the year ended December 31, 2000, from \$2.2 million for the year ended December 31, 1999. Excluding the effects of non-recurring legal expenses of \$0.3 million in 1999, direct SG&A in 2000 would have increased by 26.4%. This increase was due to higher insurance claims experienced in 2000.

Pension income, which is reported as a reduction of cost of sales in each segment, increased to \$6.4 million, or 16.3%, for the year ended December 31, 2000, from \$5.5 million for the year ended December 31, 1999. Pension income is based on expected long-term return projections and not on current year activity.

Corporate administrative expenses, which are allocated to the segments primarily based on third-party revenues, increased to \$11.7 million, or 0.4%, for the year ended December 31, 2000, from \$11.6 million for the year ended December 31, 1999.

Interest expense for the year ended December 31, 2000, totaled \$1.4 million compared to \$1.2 million for the year ended December 31, 1999, due primarily to higher average short-term debt balances in 2000 compared to the prior year. Other income (expense) for 1999 includes a non-recurring charge of \$228,000 recorded in the first quarter related to the consolidation and relocation of the Company's primary Oil Field manufacturing facilities to the Company's Lufkin, Texas Buck Creek facility.

### Liquidity and Capital Resources

The Company has historically relied on cash flows from operations and third-party borrowings to finance its operations, including acquisitions, dividend payments and stock repurchases.

The Company's cash balance totaled \$18.1 million at December 31, 2001, compared to \$2.0 million at December 31, 2000. For the year ended December 31, 2001, net cash provided by operating activities was \$34.8 million, cash used in investing activities totaled \$7.8 million and cash used in financing activities amounted to \$10.8 million. Significant components of cash provided by operating activities include net earnings

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Liquidity and Capital Resources (continued)

adjusted for non-cash expenses of \$29.7 million and a net decrease in working capital of \$5.1 million. Cash used in investing activities included capital expenditures totaling \$7.9 million, primarily for additions and replacements of production equipment and operating vehicles in the Oil Field segment. Capital expenditures for 2002 are projected to be at or somewhat above the level seen in 2001. Significant components of cash used in financing activities included net payments of short-term debt of \$7.8 million, payments on long-term debt of \$1.7 million, proceeds from stock option exercises of \$3.2 million and dividend payments of \$4.5 million or \$0.72 per share.

Total debt balances at December 31, 2001, including current maturities of long-term debt, consisted of \$6.9 million of notes payable to various banks and individuals. As of December 31, 2001, the Company had no outstanding debt associated with its short-term demand facilities or with the Bank Facility discussed below. Total debt decreased by \$9.7 million during 2001 due to repayment of short-term borrowings of \$7.8 million, principal payments on long-term notes payable totaling \$1.7 million and a \$0.2 million decrease in the Company's foreign currency denominated debt as a result of changes in exchange rates. Approximately 74% of the outstanding debt at December 31, 2001, will be repaid in July 2002.

The Company completed an agreement in the first quarter of 2000 with a domestic bank (the "Bank Facility") for an unsecured revolving line of credit that provides for up to \$20.0 million of borrowings outstanding at any one time expiring September 1, 2002, along with an additional \$5.0 million demand facility. Borrowings under the Bank Facility bear interest, at the Company's option, at either (i) the prime rate or (ii) the London Interbank Offered Rate ("LIBOR") plus an applicable margin, depending on certain ratios as defined in the agreement. As of December 31, 2001, no amounts were outstanding of the \$25.0 million of the revolving line of credit under the terms of the Bank Facility.

The Company has two additional short-term demand lines. One demand line (the "LIBOR Demand Line") is an unsecured revolving line of credit with a domestic bank that provides up to \$5.0 million of borrowings at any one time and expires on September 22, 2002. Borrowings under the LIBOR Demand Line bear interest at LIBOR plus 1%. As of December 31, 2001, no amounts were outstanding of the \$5.0 million of the revolving line of credit under the terms of the LIBOR Demand Line. The second demand line (the "Floating Demand Line") is an unsecured discretionary line of credit with a domestic bank that provides up to \$5.0 million of borrowings at any one time. The Floating Demand Line expires on December 30, 2002, and is renewable annually. Borrowings under the Floating Demand Line bear interest at a floating rate agreed to by the Company and the bank. As of December 31, 2001, no amounts were outstanding of the \$5.0 million of the discretionary line of credit under the terms of the Floating Demand Line.

The Company currently has a stock repurchase plan under which the Company is authorized to spend up to \$17.1 million for purchases of its common stock. Pursuant to this plan, the Company has purchased a total of 826,870 shares of its common stock at an aggregate purchase price of \$16.9 million. No shares were purchased during the year ended December 31, 2001. Purchased shares are added to treasury stock and are available for general corporate purposes including the funding of the Company's stock option plans. As of December 31, 2001, the Company held 502,348 shares of treasury stock at an aggregate cost of approximately \$10.4 million. Authorizations of approximately \$0.2 million remained at December 31, 2001.

The Company believes that its cash flows from operations and its available borrowing capacity under its credit agreements will be sufficient to fund its operations, including planned capital expenditures, dividend payments and stock repurchases, through December 31, 2002.

### Recently Issued Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations." This Statement eliminates the use of the pooling method of accounting and requires the use of purchase accounting for all business combinations initiated after June 30, 2001. Statement No. 141 also requires recognizing certain acquired intangible assets separate from goodwill.

In June 2001, the Financial Accounting Standards Board issued Statement No. 142, "Goodwill and Other Intangible Assets." Statement No. 142 addresses how goodwill and other intangible assets should be accounted

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Recently Issued Accounting Pronouncements (continued)

for after they have been initially recognized in the financial statements. As of January 1, 2002, goodwill and intangibles assets with indefinite lives will no longer be amortized but will be subject to annual impairment tests. The Company will establish reporting units as defined in the Statement and will assess the impairment of goodwill using a two-step process. Intangible assets not being amortized will also be subject to annual impairment tests and useful life reassessments. If impairment losses are required to be recognized upon the initial application of this Statement, they would be accounted for as a cumulative effect of a change in accounting principle. The Company has not yet completed the impairment tests prescribed by the Statement, but the Company does not believe the adoption of Statement No. 142 will have a significant impact on the Company's consolidated financial position or results of operations.

In June 2001, the Financial Accounting Standards Board issued Statement No. 143, "Accounting for Asset Retirement Obligations." This standard requires asset retirement costs to be capitalized as part of the cost of the related tangible long-lived asset and subsequently allocated to expense using a systematic and rational method over the useful life of the asset. The Statement is effective for fiscal years beginning after June 15, 2002. The transition adjustment resulting from the adoption of this Statement will be reported as a cumulative effect of a change in accounting principle. At this time, the Company does not believe the adoption of Statement No. 143 will have a significant impact on the Company's consolidated financial position or results of operations.

In August 2001, the Financial Accounting Standards Board issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This Statement supersedes Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and replaces the provisions of APB Opinion No. 30, "Reporting Results of Operations – Reporting the Effects of Disposal of a Segment of a Business" that deal with the disposal of a business segment. Statement No. 144 establishes a single accounting model for the treatment of long-lived assets in both continuing and discontinued operations and resolves implementation issues of Statement No. 121. Statement No. 144 requires that all long-lived assets be measured at the lower of carrying amounts or fair value. Discontinued operations will include components of any entity to be eliminated from continuing operations that is distinguishable from the rest of the Company and will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. The Statement is effective for financial statements issued for fiscal years beginning after December 15, 2001. At this time, the Company does not believe the adoption of Statement No. 144 will have a significant impact on the Company's consolidated financial position or results of operations.

### Legal Proceedings

A class action complaint was filed in the United States District Court for the Eastern District of Texas on March 7, 1997, by an employee and a former employee that alleged race discrimination in employment. Certification hearings were conducted in Beaumont, Texas in February of 1998 and in Lufkin, Texas in August of 1998. The District Court in April of 1999 issued a decision that certified a class for this case which includes all persons of a certain minority employed by the Company from March 6, 1994, to the present. The Company appealed this class certification decision by the District Court to the 5th Circuit United States Courts of Appeals in New Orleans, Louisiana. This appeal was denied on June 23, 1999.

The Company is defending this action vigorously. Furthermore, the Company believes that the facts and the law in this action support its position and is confident that it will prevail if this case is tried on its merits.

The Company is often subject to routine litigation arising in the normal course of its business. While the outcome of these proceedings cannot be predicted with certainty, management does not expect these matters to have a material adverse effect on the Company's consolidated financial position or results of operations.

### Forward-Looking Statements and Assumptions

This Annual Report contains forward-looking statements and information that are based on management's beliefs as well as assumptions made by and information currently available to management. When used in this report, the words "anticipate," "believe," "estimate," "expect" and similar expressions are intended to identify

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### **Forward-Looking Statements and Assumptions (continued)**

forward-looking statements. Such statements reflect the Company's current views with respect to certain events and are subject to certain assumptions, risks and uncertainties, many of which are outside the control of the Company. These risks and uncertainties include, but are not limited to, (i) oil prices, (ii) capital spending levels of oil producers, (iii) availability and prices for raw materials and (iv) general industry and economic conditions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, believed, estimated or expected. The Company does not intend to update these forward-looking statements and information.

### **Quantitative and Qualitative Disclosures About Market Risk**

The Company does not utilize financial instruments for trading purposes. The one derivative financial instrument held, a note payable that is a hedge on the Company's French operations, does not expose the Company to significant market risk. The Company's financial instruments include cash, accounts receivable, accounts payable, invested funds and debt obligations. The book value of accounts receivable, short-term debt and accounts payable are considered to be representative of their fair market value because of the short maturity of these instruments. The Company believes the carrying values of its long-term debt obligations approximate fair values because the interest rates on these obligations are comparable to what the Company believes it could currently obtain for debt with similar terms and maturities. The Company's accounts receivable are not concentrated in one customer or industry and are not viewed as an unusual credit risk.

**CONSOLIDATED BALANCE SHEETS**

December 31, 2001 and 2000

(Thousands of dollars, except share and per share data)

<b>Assets</b>	<b>2001</b>	<b>2000</b>
Current assets:		
Cash and cash equivalents	\$ 18,087	\$ 2,003
Invested funds	5,863	759
Receivables, net	35,956	40,413
Income taxes receivable	673	1,239
Inventories	34,824	35,146
Deferred income tax assets	2,179	4,219
Total current assets	97,582	83,779
Property, plant and equipment, net	81,296	85,004
Prepaid pension costs	49,437	43,492
Invested funds	-	5,106
Goodwill, net	10,045	8,841
Other assets, net	7,709	7,360
Total assets	\$ 246,069	\$ 233,582
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Short-term debt	\$ -	\$ 7,790
Current portion of long-term notes payable	6,598	1,809
Accounts payable	10,680	13,216
Accrued liabilities:		
Payroll and benefits	6,636	5,701
Accrued warranty expenses	2,275	2,194
Taxes payable	4,487	4,130
Commissions and other	6,373	5,601
Total current liabilities	37,049	40,441
Deferred income tax liabilities	26,658	22,475
Postretirement benefits	11,024	10,972
Long-term notes payable, net of current portion	339	7,043
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value, 2,000,000 shares authorized, none issued or outstanding	-	-
Common stock, par \$1 per share: 60,000,000 shares authorized; 6,892,381 shares issued	6,892	6,892
Capital in excess of par	18,200	18,069
Retained earnings	158,973	143,912
Treasury stock, 502,348 shares and 679,360 shares, respectively, at cost	(10,350)	(13,977)
Accumulated other comprehensive income:		
Cumulative translation adjustment	(2,716)	(2,245)
Total shareholders' equity	170,999	152,651
Total liabilities and shareholders' equity	\$ 246,069	\$ 233,582

See notes to consolidated financial statements.

**CONSOLIDATED STATEMENTS OF EARNINGS**

Years ended December 31, 2001, 2000 and 1999  
(Thousands of dollars, except per share data)

	<b>2001</b>	2000	1999
Net sales	<b>\$278,907</b>	\$254,603	\$246,000
Cost of sales	<b>210,858</b>	210,353	213,358
Gross profit	<b>68,049</b>	44,250	32,642
Selling, general and administrative expenses	<b>35,045</b>	32,120	32,825
Operating income (loss)	<b>33,004</b>	12,130	(183)
Investment income	<b>437</b>	412	29
Interest expense	<b>(873)</b>	(1,413)	(1,176)
Other income (expense), net	<b>(268)</b>	113	(683)
Earnings (loss) before income taxes	<b>32,300</b>	11,242	(2,013)
Income tax provision (benefit)	<b>12,758</b>	4,272	(745)
Net earnings (loss)	<b>\$ 19,542</b>	\$ 6,970	\$ (1,268)
Net earnings (loss) per share:			
Basic	<b>\$ 3.12</b>	\$ 1.11	\$ (0.20)
Diluted	<b>\$ 3.03</b>	\$ 1.11	\$ (0.20)

See notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME

Years ended December 31, 2001, 2000 and 1999  
(Thousands of dollars, except share and per share data)

	Common Stock		Capital In Excess Of Par	Retained Earnings	Treasury Stock	Cumulative Translation Adjustment	Compre- hensive Income (Loss)
	Shares	Amount					
Balance, December 31, 1998	6,892,381	\$6,892	\$18,080	\$147,413	\$(8,014)	\$(1,475)	
Comprehensive income (loss):							
Net earnings (loss)				(1,268)			\$(1,268)
Other comprehensive income, net of tax							
Foreign currency translation adjustment						(546)	(546)
Comprehensive income (loss)							<u>(1,814)</u>
Cash dividends, \$.72 per share				(4,654)			
Purchases of treasury stock (259,800 shares)					(4,072)		
Exercise of stock options (3,250 shares)			(14)		67		
Balance, December 31, 1999	6,892,381	6,892	18,066	141,491	(12,019)	(2,021)	
Comprehensive income (loss):							
Net earnings (loss)				6,970			6,970
Other comprehensive income, net of tax							
Foreign currency translation adjustment						(224)	(224)
Comprehensive income (loss)							<u>6,746</u>
Cash dividends, \$.72 per share				(4,549)			
Purchases of treasury stock (110,314 shares)					(2,009)		
Stock grant (1,334 shares)			3		27		
Exercise of stock options (1,500 shares)					24		
Balance, December 31, 2000	6,892,381	6,892	18,069	143,912	(13,977)	(2,245)	
Comprehensive income (loss):							
Net earnings (loss)				19,542			19,542
Other comprehensive income, net of tax							
Foreign currency translation adjustment						(471)	(471)
Comprehensive income (loss)							<u>\$19,071</u>
Cash dividends, \$.72 per share				(4,481)			
Stock grant (1,089 shares)			1		23		
Exercise of stock options (176,319 shares)			130		3,604		
Balance, December 31, 2001	6,892,381	\$6,892	\$18,200	\$158,973	\$(10,350)	\$(2,716)	

See notes to consolidated financial statements.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

Years ended December 31, 2001, 2000 and 1999  
(Thousands of dollars)

	2001	2000	1999
<b>Cash flows from operating activities:</b>			
Net earnings (loss)	<b>\$19,542</b>	\$ 6,970	\$ (1,268)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation and amortization	<b>11,523</b>	10,895	10,746
Deferred income tax provision	<b>4,536</b>	2,689	1,409
Pension income	<b>(5,945)</b>	(6,387)	(5,491)
Postretirement benefits	<b>51</b>	(144)	(265)
(Gain) loss on disposition of property, plant and equipment	<b>406</b>	468	1,032
Increase (decrease) in cash flows from changes in working capital excluding effects of acquisitions:			
Receivables, net	<b>4,538</b>	(5,947)	4,259
Income taxes receivable	<b>565</b>	1,322	1,006
Inventories	<b>18</b>	(2,683)	15,083
Accounts payable	<b>(2,321)</b>	3,437	(2,299)
Accrued liabilities	<b>1,852</b>	3,482	(2,439)
Net cash provided by operating activities	<b>34,765</b>	14,102	21,773
<b>Cash flows from investing activities:</b>			
Additions to property, plant and equipment	<b>(7,909)</b>	(6,225)	(7,172)
Proceeds from (cash used for) disposition of property, plant and equipment	<b>212</b>	448	(146)
Decrease in invested funds	<b>2</b>	-	282
(Increase) decrease in other assets	<b>(73)</b>	(557)	(2,129)
Net cash used in investing activities	<b>(7,768)</b>	(6,334)	(9,165)
<b>Cash flows from financing activities:</b>			
Proceeds from (payments of) short-term debt, net	<b>(7,790)</b>	2,590	(3,300)
Long-term notes payable issued	<b>-</b>	-	1,079
Payments of long-term notes payable	<b>(1,721)</b>	(2,725)	(2,166)
Dividends paid	<b>(4,481)</b>	(4,549)	(4,654)
Proceeds from exercise of stock options	<b>3,174</b>	24	53
Purchases of treasury stock	<b>-</b>	(2,009)	(4,072)
Net cash provided by (used in) financing activities	<b>(10,818)</b>	(6,669)	(13,060)
Effect of translation on cash and cash equivalents	<b>(95)</b>	(161)	(100)
Net increase (decrease) in cash and cash equivalents	<b>16,084</b>	938	(552)
Cash and cash equivalents at beginning of year	<b>2,003</b>	1,065	1,617
Cash and cash equivalents at end of year	<b>\$18,087</b>	\$ 2,003	\$ 1,065

See notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**(1) Corporate Organization and Summary of Major Accounting Policies**

Lufkin Industries, Inc. and its consolidated subsidiaries (collectively, the "Company") manufactures and sells oil field pumping units, power transmission products and highway trailers throughout the world.

**Principles of consolidation:** The consolidated financial statements include the accounts of Lufkin Industries, Inc. and its consolidated subsidiaries after elimination of all significant intercompany accounts and transactions.

**Use of estimates:** 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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

**Foreign currencies:** Assets and liabilities of foreign operations are translated into U.S. dollars at the exchange rate in effect at the end of each accounting period, with any resulting gain or loss shown in accumulated other comprehensive income in the shareholder's equity section of the balance sheet. Income statement accounts are translated at the average exchange rates prevailing during the period. Any gains or losses on transactions denominated in another foreign currency are generally included in income as incurred.

**Cash equivalents:** The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

**Invested funds:** The Company's invested funds, consisting of government securities, are classified as held-to-maturity securities and are carried at cost. Substantially all of the Company's invested funds at December 31, 2001 and 2000 were restricted for payment of certain of the Company's long-term notes payable.

**Receivables:** The following is a summary of the Company's receivable balances:

(Thousands of dollars)	2001	2000
Accounts receivable	\$36,506	\$40,899
Notes receivable	268	119
	<u>36,774</u>	<u>41,018</u>
Allowance for doubtful accounts	(818)	(605)
Net receivables	<u>\$35,956</u>	<u>\$40,413</u>

**Inventories:** The Company reports its inventories by using the last-in, first-out (LIFO) and the first-in, first-out (FIFO) methods less reserves necessary to report inventories at the lower of cost or estimated market. Inventory costs include material, labor and factory overhead. In July, 1998, the Company began capitalizing certain maintenance and supplies inventories to better match the estimated cost of such inventories with the related equipment produced. Such inventories were capitalized and were amortized over the three years of their estimated use and had the effect of increasing net earnings by \$0.3 million (\$0.05 per diluted share), \$0.7 million (\$0.12 per diluted share) and \$1.2 million (\$0.19 per diluted share) in 2001, 2000 and 1999, respectively.

**Property, plant and equipment (P. P. & E.):** The Company records investments in these assets at cost. Improvements are capitalized, while repair and maintenance costs are charged to operations as incurred. Gains or losses realized on the sale or retirement of these assets are reflected in income. The Company periodically reviews its P. P. & E. for possible impairment whenever events or changes in circumstance might indicate that the carrying amount of an asset may not be recoverable. Depreciation for financial reporting purposes is provided on a straight-line method based upon the estimated useful lives of the assets. Accelerated depreciation methods are used for tax purposes. The following is a summary of the Company's P. P. & E. balances and useful lives:

(Thousands of dollars)	Useful Life (In Years)	2001	2000
Land	-	\$ 2,556	\$ 2,354
Land improvements	10-25	6,693	6,669
Buildings	12.5-40	59,976	57,689
Machinery and equipment	3-12.5	165,427	167,457
Furniture and fixtures	5-12.5	3,726	5,488
Computer equipment	3-7	12,546	15,393
Total property, plant and equipment		<u>250,924</u>	<u>255,050</u>
Less accumulated depreciation		<u>(169,628)</u>	<u>(170,046)</u>
Total property, plant and equipment, net		<u>\$ 81,296</u>	<u>\$ 85,004</u>

Depreciation expense related to property, plant and equipment was \$11.0 million, \$10.5 million and \$10.5 million in 2001, 2000 and 1999, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(1) Corporate Organization and Summary of Major Accounting Policies (continued)**

**Goodwill and other assets:** The cost over fair value of net tangible assets of acquired businesses ("Goodwill") is amortized on a straight-line method over forty years. Management periodically evaluates recorded Goodwill balances, net of accumulated amortization, for impairment based on the undiscounted cash flows associated with the asset compared to the carrying amount of that asset. Management believes that there have been no events or circumstances that warrant revision to the remaining useful life or affect the recoverability of Goodwill in any of its business units. Certain other intangible assets, which include covenants not to compete, are amortized using the straight-line method over their estimated lives. Amortization expense related to Goodwill and other intangible assets was \$518,000, \$364,000 and \$277,000 in 2001, 2000 and 1999, respectively. Accumulated Goodwill amortization was \$953,000 and \$721,000 for the years ended December 31, 2001 and December 31, 2000, respectively.

**Earnings per share:** Earnings per share amounts are based on the weighted average number of shares of common stock and common stock equivalents outstanding during the period. The weighted average number of shares used to compute basic and diluted earnings per share for 2001, 2000 and 1999 is illustrated below:

(Thousands of dollars, except share and per share data)	2001	2000	1999
Numerator:			
Numerator for basic and diluted earnings per share - net earnings (loss)	\$19,542	\$6,970	\$(1,268)
Denominator:			
Denominator for basic earnings per share - weighted-average shares	6,270,505	6,256,974	6,462,890
Effect of dilutive securities: employee stock options	148,436	32,748	-
Denominator for diluted earnings per share - adjusted weighted-average shares and assumed conversions	6,418,941	6,289,722	6,462,890
Basic earnings (loss) per share	\$3.12	\$1.11	\$(0.20)
Diluted earnings (loss) per share	\$3.03	\$1.11	\$(0.20)

Options to purchase a total of 120,986, 562,874 and 916,793 shares of the Company's common stock were excluded from the calculation of fully diluted earnings per share for 2001, 2000 and 1999, respectively, because their effect on fully diluted earnings per share for the period was antidilutive.

**Income taxes:** Deferred income tax assets or liabilities are recorded based on the difference between the financial statement and income tax bases of assets and liabilities using enacted tax rates.

**Financial instruments:** The Company's financial instruments include cash, accounts receivable, accounts payable and debt obligations. The book value of accounts receivable, short-term debt and accounts payable are considered to be representative of their fair value because of the short maturity of these instruments. The Company believes the carrying value of its long-term debt approximates fair value because the interest rates of this debt are comparable to what the Company believes it could currently obtain for debt with similar terms and maturities.

The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting of Derivative Instruments and Hedging Activities", and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities", an amendment of SFAS No. 133 as of the quarter ended March 31, 2001. These Statements establish accounting and reporting standards that require every derivative instrument, including certain derivative instruments embedded in other contracts, to be recorded on the balance sheet as either an asset or a liability measured at its fair value.

As of December 31, 2001, the Company had only one reportable derivative. A note payable, described in Footnote 4, has been designated as a hedge against its investment in its French operations. The changes in the fair value of this instrument are recorded in accumulated other comprehensive income.

**Revenue recognition:** Revenue is not recognized until it is realized or realizable and earned. The criteria to meet this guideline are: persuasive evidence of an arrangement exists, delivery has occurred or services

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (1) Corporate Organization and Summary of Major Accounting Policies (continued)

have been rendered, the price to the buyer is fixed or determinable and collectibility is reasonably assured. The Company also recognizes Bill-and-Hold transactions when the product is completed and is ready to be shipped and the risk of loss on the product has been transferred to the customer.

Amounts billed for shipping are classified as sales and costs incurred for shipping are classified as cost of sales in the consolidated income statement.

**Recently issued accounting pronouncements:** In June 2001, the Financial Accounting Standards Board issued Statement No. 141, "Business Combinations." This Statement eliminates the use of the pooling method of accounting and requires the use of purchase accounting for all business combinations initiated after June 30, 2001. Statement No. 141 also requires the recognition of certain acquired intangible assets separate from goodwill.

In June 2001, the Financial Accounting Standards Board issued Statement No. 142, "Goodwill and Other Intangible Assets." Statement No. 142 addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. As of January 1, 2002, goodwill and intangible assets with indefinite lives will no longer be amortized but will be subject to annual impairment tests. The Company will establish reporting units as defined in the Statement and will assess the impairment of goodwill using a two-step process. Intangible assets not being amortized will also be subject to annual impairment tests and useful life reassessments. If impairment losses are required to be recognized upon the initial application of this Statement, they would be accounted for as a cumulative effect of a change in accounting principle. The Company has not yet completed the impairment tests prescribed by the Statement, but the Company does not believe the adoption of Statement No. 142 will have a significant impact on the Company's consolidated financial position or results of operations.

In June 2001, the Financial Accounting Standards Board issued Statement No. 143, "Accounting for Asset Retirement Obligations." This standard requires asset retirement costs to be capitalized as part of the cost of the related tangible long-lived asset and subsequently allocated to expense using a systematic and rational method over the useful life of the asset. The Statement is effective for fiscal years beginning after June 15, 2002. The transition adjustment resulting from the adoption of this Statement will be reported as a cumulative effect of a change in accounting principle. At this time, the Company does not believe the adoption of Statement No. 143 will have a significant impact on the Company's consolidated financial position or results of operations.

In August 2001, the Financial Accounting Standards Board issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This Statement supersedes Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and replaces the provisions of APB Opinion No. 30, "Reporting Results of Operations – Reporting the Effects of Disposal of a Segment of a Business" that deal with the disposal of a business segment. Statement No. 144 establishes a single accounting model for the treatment of long-lived assets in both continuing and discontinued operations and resolves implementation issues of Statement No. 121. Statement No. 144 requires that all long-lived assets be measured at the lower of carrying amounts or fair value. Discontinued operations will include components of any entity to be eliminated from continuing operations that is distinguishable from the rest of the Company and will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. The Statement is effective for financial statements issued for fiscal years beginning after December 15, 2001. At this time, the Company does not believe the adoption of Statement No. 144 will have a significant impact on the Company's consolidated financial position or results of operations.

**Other:** Certain prior year amounts have been reclassified to conform with the current year presentation.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(2) Income Taxes**

Net deferred income tax assets and liabilities are comprised of the following:

(Thousands of dollars)	2001	2000
Current deferred income tax assets		
Gross assets	\$ 2,746	\$ 5,588
Gross liabilities	(567)	(1,369)
Total current deferred income tax assets, net	2,179	4,219
Noncurrent deferred income tax liabilities		
Gross assets	8,429	7,177
Gross liabilities	(35,087)	(29,652)
Total noncurrent deferred income tax liabilities, net	(26,658)	(22,475)
Net deferred income tax liabilities	<b>\$(24,479)</b>	<b>\$(18,256)</b>

The tax effects of significant temporary differences representing deferred income tax assets and liabilities are as follows:

(Thousands of dollars)	2001	2000
Inventories	\$ (456)	\$ (1,283)
Prepaid pension costs	(18,101)	(15,929)
Payroll and benefits	773	966
Accrued warranty expenses	767	680
Postretirement benefits	4,066	4,019
Tax credit carryforwards	253	253
Depreciation	(12,378)	(10,769)
Net operating loss	-	2,463
Other, net	597	1,344
Net deferred income tax liabilities	<b>\$(24,479)</b>	<b>\$(18,256)</b>

The income tax provision (benefit) for 2001, 2000 and 1999 consisted of the following:

(Thousands of dollars)	2001	2000	1999
Current	\$ 8,222	\$ 1,583	\$(2,154)
Deferred	4,536	2,689	1,409
Total	<b>\$12,758</b>	<b>\$ 4,272</b>	<b>\$ (745)</b>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(2) Income Taxes (continued)**

A reconciliation of the income tax provision as computed at the statutory U.S. income tax rate and the income tax provision presented in the consolidated financial statements is as follows:

(Thousands of dollars)	2001	2000	1999
Tax provision computed at statutory rate	<b>\$11,305</b>	\$3,935	\$ (704)
Tax effect of:			
Expenses for which no benefit was realized	<b>591</b>	353	158
State taxes net of federal benefit	<b>777</b>	254	(143)
Other, net	<b>85</b>	(270)	(56)
Provision for income taxes	<b>\$12,758</b>	\$4,272	\$ (745)

Cash payments for income taxes totaled \$5,791,000, \$597,000 and \$2,164,000 for 2001, 2000 and 1999, respectively.

For income tax reporting purposes at December 31, 2001, the Company had foreign tax credit carryforwards totaling \$253,000 which expire in 2003.

**(3) Inventories**

Inventories used in determining cost of sales were as follows:

(Thousands of dollars)	2001	2000
Finished goods	<b>\$ 2,485</b>	\$ 6,191
Work in process	<b>4,036</b>	2,624
Raw materials	<b>28,303</b>	26,331
Total	<b>\$34,824</b>	\$35,146

Inventories accounted for on a LIFO basis were \$22,300,000 and \$23,893,000 and on a FIFO basis were \$12,524,000 and \$11,253,000 at December 31, 2001 and 2000, respectively. Had the FIFO method been used in determining all inventory values, inventories would have been \$17,565,000 and \$19,449,000 higher at December 31, 2001 and 2000, respectively.

During 2001 and 2000, LIFO inventories were reduced in certain LIFO pools and these reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs in prior years. The impact of the reductions increased net income in 2001 by approximately \$328,000, net of taxes (\$0.05 per diluted share), but did not have a material impact on net income in 2000.

**(4) Debt Obligations**

The Company's short-term debt obligations at December 31, 2001 and 2000 consisted of the following:

(Thousands of dollars)	2001	2000
Bank Facility (discussed below): Interest at bank's borrowing rate plus applicable margin, unsecured	<b>\$ -</b>	\$ 4,550
Floating Demand Line (discussed below): Revolving line of credit with a domestic bank, payable daily, floating interest rate agreed to by Company and bank, renewable annually, unsecured	-	-
LIBOR Demand Line (discussed below): Discretionary line of credit with a domestic bank, payable daily, interest at LIBOR plus 1.00%, unsecured	-	3,240
Total	<b>\$ -</b>	\$ 7,790

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(4) Debt Obligations (continued)**

The Company completed an agreement in the first quarter of 2000 with a domestic bank (the "Bank Facility") for an unsecured revolving line of credit that provides for up to \$20.0 million of borrowings outstanding at any one time expiring September 1, 2002, along with an additional \$5.0 million demand facility. Borrowings under the Bank Facility bear interest, at the Company's option, at either (i) the prime rate or (ii) the London Interbank Offered Rate ("LIBOR") plus an applicable margin, depending on certain ratios as defined in the agreement. The amount noted in the table above in 2000 were comprised of borrowings under the demand facility. As of December 31, 2001, no amounts were outstanding of the \$25.0 million of the revolving line of credit under the terms of the Bank Facility.

The Company has two additional short-term demand lines. One demand line (the "LIBOR Demand Line") is an unsecured revolving line of credit with a domestic bank that provides up to \$5.0 million of borrowings at anyone time and expires on September 22, 2002. Borrowings under the LIBOR Demand Line bear interest at LIBOR plus 1%. As of December 31, 2001, no amounts were outstanding of the \$5.0 million of the revolving line of credit under the terms of the LIBOR Demand Line. The second demand line (the "Floating Demand Line") is an unsecured discretionary line of credit with a domestic bank that provides up to \$5.0 million of borrowings at any one time. The Floating Demand Line expires on December 30, 2002 and is renewable annually. Borrowings under the Floating Demand Line bear interest at a floating rate agreed to by the Company and the bank. As of December 31, 2001, no amounts were outstanding of the \$5.0 million of the discretionary line of credit under the terms of the Floating Demand Line.

The Company's long-term notes payable at December 31, 2001 and 2000 consist of the following:

(Thousands of dollars, except payment amounts)	2001	2000
Notes payable to individuals, interest of 6.65%, due in quarterly installments ranging from \$9,000 to \$19,000 with balloon payments at maturity ranging from \$996,000 to \$2,162,000 maturing July 2002, unsecured	\$ 5,106	\$5,281
Notes payable to banks denominated in French francs, interest ranging from 3.7% to 4.9%, due in quarterly installments ranging from \$6,000 to \$37,000, secured by certain assets, maturing through 2004	667	1,111
Note payable to bank denominated in Euros, interest equal to the Eurocurrency rate plus 1.75%, unsecured, quarterly installments of approximately \$300,000, maturing December 2002.	1,164	2,460
Less-current maturities of long-term notes payable	(6,598)	(1,809)
Total	\$ 339	\$7,043

The Company has designated the note payable denominated in Euros as a hedge against its investment in its French operations.

Under the terms of the notes payable to individuals, invested funds in the amount of \$5,106,000 at December 31, 2001, are restricted for the payment of these notes.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(4) Debt Obligations (continued)**

Principal payments of long-term notes payable as of December 31, 2001 are as follows:

(Thousands of dollars)

Year ending December 31,	
2002	\$ 6,598
2003	200
2004	139
2005	-
2006	-
<b>Total</b>	<b>\$ 6,937</b>

Cash payments for interest totaled \$838,000, \$1,347,000 and \$1,279,000 in 2001, 2000 and 1999, respectively.

**(5) Stock Option Plans**

The Company has two stock option plans, the 2000 plan for employees and the 1996 plan for non-employee directors, that provide for the granting of options to outside directors and key employees to purchase an aggregate of not more than 1,050,000 shares of the Company's common stock at fair market value on the date of grant. Options become exercisable from the initial grant date to four years after the grant date. The options expire ten years from the date of grant. Outstanding options may be canceled and reissued under terms specified in the plans. The 1990 plan, which originally was authorized to grant 1,100,000 options, will remain in effect until all awards granted under this plan have been satisfied or expire. As of December 31, 2001, 528,584 options remained exercisable from the 1990 plan.

The following table summarizes activity under the Company's stock option plans:

	2001	2000	1999
Options outstanding, beginning of year	<b>997,853</b>	916,793	745,510
Granted (per share)			
1999 (\$14.000 to \$18.125)			230,833
2000 (\$14.625 to \$18.250)		139,175	
2001 (\$18.375 to \$25.960)	<b>145,457</b>		
Exercised (per share)			
1999 (\$15.875)			(3,250)
2000 (\$15.875)		(1,500)	
2001 (\$14.000 to \$21.750)	<b>(176,319)</b>		
Forfeited (per share)			
1999 (\$15.875 to \$38.000)			(56,300)
2000 (\$14.000 to \$38.000)		(56,615)	
2001 (\$14.000 to \$38.000)	<b>(17,300)</b>		
Options outstanding, end of year	<b>949,691</b>	997,853	916,793

The following table summarizes information about stock options outstanding at December 31, 2001:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/01	Wtd. Avg. Remaining Contractual Life	Wtd. Avg. Exercise Price	Number Exercisable at 12/31/01	Wtd. Avg. Exercise Price
\$14.000-\$18.375	443,696	7.6 years	\$16.09	255,305	\$16.06
\$19.000-\$22.570	288,613	5.3 years	\$21.34	262,739	\$21.30
\$22.750-\$33.375	135,534	8.3 years	\$26.83	51,967	\$28.19
\$35.250-\$39.875	81,848	5.8 years	\$37.75	81,461	\$37.74
\$14.000-\$39.875	949,691	6.9 years	\$21.08	651,472	\$21.85

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(5) Stock Option Plans (continued)**

The Company accounts for its stock option plans under APB Opinion No. 25 under which no compensation cost has been recognized. Had compensation cost for these plans been accounted for consistent with SFAS Statement No. 123, "Accounting for Stock-Based Compensation", the Company's net earnings and earnings per share would have been reduced to the following pro forma amounts, (in thousands except per share data):

		<b>2001</b>	2000	1999
Net earnings (loss)	As reported	<b>\$19,542</b>	\$6,970	\$(1,268)
	Pro forma	<b>\$18,853</b>	\$6,230	\$(2,007)
Basic earnings (loss) per share	As reported	<b>\$3.12</b>	\$1.11	\$(0.20)
	Pro forma	<b>\$3.01</b>	\$1.00	\$(0.31)
Diluted earnings (loss) per share	As reported	<b>\$3.03</b>	\$1.11	\$(0.20)
	Pro forma	<b>\$2.94</b>	\$0.99	\$(0.31)

The effects of applying SFAS No. 123 to the pro forma disclosure amounts may not be indicative of future amounts. SFAS No. 123 does not apply to options awarded prior to 1995, and additional awards in future years are anticipated. The fair value of each option grant in 2001 is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

Expected dividend yield	2.80% - 3.80%
Expected stock price volatility	35.74% - 37.91%
Risk free interest rate	4.68% - 5.43%
Expected life of options	8-10 years

Options granted during 2001 had a weighted average fair value of \$8.33 per option and a weighted average exercise price of \$22.98 per option. At December 31, 2001, 756,239 options authorized remained available to be granted.

**(6) Stock Repurchase Plan**

The Company has a stock repurchase plan under which the Company has been authorized to spend up to \$17,100,000 for purchases of its common stock. The Company repurchased no shares in 2001, 110,314 shares at an aggregate cost of \$2,009,000 in 2000 and 259,800 shares at an aggregate cost of \$4,072,000 in 1999. Repurchased shares are added to treasury stock and are available for general corporate purposes including the funding of the Company's stock option plans. Authorizations of approximately \$152,000 remained at December 31, 2001.

**(7) Capital Stock**

The Company has adopted a "Shareholder Rights Plan" (the "Plan") designed to protect against unsolicited attempts to acquire control of the Company that the Board believes are not in the best interest of the shareholders. The Plan provides for the possible issuance of a dividend of one common stock purchase right for each outstanding share of common stock. Under certain conditions, each right may be exercised to purchase one share of common stock at an exercise price of \$75, subject to adjustment. Under certain circumstances, the rights entitle holders to purchase the common stock of the Company or an acquiring company having a value of twice the exercise price of the rights. The rights would become exercisable, or transferable apart from the common stock, ten days after a person or group acquired 20% or more, or announced or made a tender offer for 30% or more, of the outstanding common stock. Under certain circumstances, all rights owned by an acquiring person would be null and void. The rights expire on May 31, 2006, and may be redeemed by the Company at any time prior to the occurrence of certain events at \$.05 per right.

The Company is also authorized to issue 2,000,000 shares of preferred stock, the terms and conditions to be determined by the Board of Directors in creating any particular series.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**(8) Retirement Benefits**

The Company has noncontributory pension plans covering substantially all employees. The benefits provided by these plans are measured by length of service, compensation and other factors, and are currently funded by trusts established under the plans. Funding of retirement costs for these plans complies with the minimum funding requirements specified by the Employee Retirement Income Security Act, as amended. Plan investment assets are invested primarily in equity securities, United States government securities and cash equivalents.

The following tables illustrate the change in benefit obligation, change in plan assets and funded status of the pension plans:

(Thousands of dollars)	2001	2000	1999
Change in projected benefit obligation:			
Projected benefit obligation, beginning of year	\$119,323	\$113,060	\$118,045
Service cost	3,222	2,942	3,772
Interest cost	8,399	8,071	7,733
Amendments	-	1,252	-
Actuarial (gain) loss	3,849	227	(10,481)
Benefits paid	(6,357)	(6,229)	(6,009)
Projected benefit obligation, end of year	\$128,436	\$119,323	\$113,060
Change in plan assets:			
Fair value of plan assets, beginning of year	\$188,521	\$181,438	\$179,426
Actual return on plan assets	3,873	13,312	8,021
Benefits paid	(6,357)	(6,229)	(6,009)
Fair value of plan assets, end of year	\$186,037	\$188,521	\$181,438
Funded status:			
Excess of fair value of plan assets over projected benefit obligation	\$ 57,601	\$ 69,198	\$ 68,378
Unrecognized net actuarial gain	(3,962)	(20,670)	(24,152)
Unrecognized prior service cost	1,995	2,088	929
Unrecognized net transition asset	(6,197)	(7,124)	(8,050)
Prepaid pension costs	\$ 49,437	\$ 43,492	\$ 37,105
Components of net periodic pension cost (income):			
Service cost	\$ 3,222	\$ 2,942	\$ 3,772
Interest cost	8,399	8,071	7,733
Expected return on plan assets	(16,632)	(16,005)	(15,845)
Amortization of unrecognized (gain) loss	(934)	(1,395)	(1,151)
Net periodic pension cost (income)	\$ (5,945)	\$ (6,387)	\$ (5,491)
Weighted-average assumptions at year end:			
Discount rate	7.00%	7.25%	7.50%
Expected return on plan assets	9.00%	9.00%	9.00%
Rate of compensation increase	5.00%	5.00%	5.00%

The Company also has defined contribution retirement plans covering substantially all of its employees. The Company makes contributions of 75% of employee contributions up to a maximum employee contribution of 6% of employee earnings. Employees may contribute up to an additional 6% (in 1% increments) which is not subject to match by the Company. All obligations of the Company are funded through December 31, 2001. The Company's expense for these plans totaled \$1,948,000, \$1,715,000 and \$1,817,000 in 2001, 2000 and 1999, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(8) Retirement Benefits (continued)**

The Company sponsors two defined benefit postretirement plans that cover both salaried and hourly employees. One plan provides medical benefits, and the other plan provides life insurance benefits. Both plans are contributory, with retiree contributions adjusted periodically. The Company accrues the estimated costs of the plans over the employee's service periods.

The following tables illustrate the change in benefit obligation, change in plan assets and funded status of the postretirement plans:

(Thousands of dollars)	2001	2000	1999
Accumulated postretirement benefit obligation:			
Retirees	\$ 5,367	\$ 5,748	\$ 5,921
Fully eligible active plan participants	1,151	1,073	1,351
Other active plan participants not yet eligible	3,083	2,722	2,777
Total accumulated postretirement benefit obligation	\$ 9,601	\$ 9,543	\$10,049
Change in accumulated postretirement benefit obligation:			
Accumulated postretirement benefit obligation, beginning of year	\$ 9,543	\$10,049	\$12,464
Service cost	183	159	214
Interest cost	654	677	701
Participant contributions	1,239	1,069	1,067
Actuarial (gain) loss	(63)	(432)	(2,436)
Benefits paid	(1,955)	(1,979)	(1,961)
Accumulated postretirement benefit obligation, end of year	\$ 9,601	\$ 9,543	\$10,049
Fair value of plan assets	\$ -	\$ -	\$ -
Funded status:			
Excess of total accumulated postretirement benefit obligation over fair value of plan assets	\$ 9,601	\$ 9,543	\$10,049
Unrecognized net actuarial (gain) loss	1,423	1,429	1,067
Accrued postretirement benefit cost	\$11,024	\$10,972	\$11,116
Components of net periodic postretirement benefit cost:			
Service cost	\$ 183	\$ 159	\$ 214
Interest cost	654	677	701
Amortization of net actuarial gain	(69)	(71)	-
Net periodic postretirement benefit cost	\$ 768	\$ 765	\$ 915
Weighted average assumptions at year end:			
Discount rate	7.00%	7.25%	7.50%

The Company's postretirement health care plan is unfunded. For measurement purposes, the submitted claims medical trend was assumed to be 9.25% in 1997. Thereafter, the Company's obligation is fixed at the amount of the Company's contribution for 1997.

**(9) Commitments and Contingencies**

**Legal proceedings:** A class action complaint was filed in the United States District Court for the Eastern District of Texas on March 7, 1997, by an employee and a former employee which alleged race discrimination in employment. Certification hearings were conducted in Beaumont, Texas in February of 1998 and in Lufkin, Texas in August of 1998. The District Court in April of 1999 issued a decision that certified a class for this case, which includes all persons of a certain minority employed by the Company from March 6, 1994, to the present. The Company appealed this class certification decision by the District Court to the 5th Circuit United States Court of Appeals in New Orleans, Louisiana. This appeal was denied on June 23, 1999.

The Company is defending this action vigorously. Furthermore, the Company believes that the facts and the law in this action support its position and is confident that it will prevail if this case is tried on its merits.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(9) Commitments and Contingencies (continued)**

There are various other claims and legal proceedings arising in the ordinary course of business pending against or involving the Company wherein monetary damages are sought. It is management's opinion that the Company's liability, if any, under such claims or proceedings would not materially affect its consolidated financial position or results of operations.

**(10) Business Segment Information**

The Company operates with three business segments--Oil Field, Power Transmission and Trailer. As stated in the Management's Discussion and Analysis section, the Foundry segment has been combined with the Oil Field segment. Prior period data has been adjusted to reflect this change. The three operating segments are supported by a common corporate group. The accounting policies of the segments are the same as those described in the summary of major accounting policies. Corporate expenses and certain assets are allocated to the operating segments primarily based upon third party revenues. The following is a summary of key business segment and product group information:

(Thousands of dollars)	2001	2000	1999
<b>Sales:</b>			
Oil Field	<b>\$182,271</b>	\$118,097	\$69,188
Power Transmission	<b>62,498</b>	62,923	71,475
Trailer	<b>34,138</b>	73,583	105,337
Total sales	<b>\$278,907</b>	\$254,603	\$246,000
<b>Sales by geographic region:</b>			
United States	<b>\$195,169</b>	\$194,221	\$204,199
Europe	<b>14,752</b>	10,642	15,742
Canada	<b>19,281</b>	12,664	6,421
Latin America	<b>26,009</b>	26,476	7,589
Other	<b>23,696</b>	10,600	12,049
Total sales	<b>\$278,907</b>	\$254,603	\$246,000
<b>Earnings (loss) before income taxes:</b>			
Oil Field	<b>\$33,306</b>	\$11,181	\$(6,461)
Power Transmission	<b>4,348</b>	1,171	(1,388)
Trailer	<b>(5,545)</b>	(610)	6,543
Corporate	<b>191</b>	(500)	(707)
Total earnings (loss) before income taxes	<b>\$32,300</b>	\$11,242	\$(2,013)
<b>Assets:</b>			
Oil Field	<b>\$117,901</b>	\$113,730	\$100,209
Power Transmission	<b>66,331</b>	65,272	68,110
Trailer	<b>25,823</b>	31,182	35,610
Corporate	<b>36,014</b>	25,261	17,437
Total assets	<b>\$246,069</b>	\$235,445	\$221,366
<b>Capital expenditures:</b>			
Oil Field	<b>\$6,508</b>	\$4,613	\$5,188
Power Transmission	<b>1,051</b>	1,004	963
Trailer	<b>147</b>	471	682
Corporate	<b>203</b>	137	339
Total capital expenditures	<b>\$7,909</b>	\$6,225	\$7,172
<b>Depreciation/Amortization:</b>			
Oil Field	<b>\$4,510</b>	\$4,054	\$3,618
Power Transmission	<b>4,611</b>	4,447	4,681
Trailer	<b>713</b>	759	809
Corporate	<b>1,689</b>	1,635	1,638
Total depreciation/amortization	<b>\$11,523</b>	\$10,895	\$10,746

## REPORT OF INDEPENDENT PUBLIC ACCOUNTANT

To the Shareholders of Lufkin Industries, Inc.:

We have audited the accompanying consolidated balance sheets of Lufkin Industries, Inc. (a Texas corporation) and subsidiaries (collectively, the Company) as of December 31, 2001 and 2000, and the related consolidated statements of earnings, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 2001 and 2000, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

*Arthur Andersen LLP*

Houston, Texas  
February 8, 2002



## BOARD OF DIRECTORS

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Manager of his own investments

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Manager of his own investments

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Manager of his own investments

J. H. Lollar  
Managing Partner, New Gulf Exploration, LP

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Retired President, Stewart & Stevenson

D. V. Smith  
President and Chief Executive Officer

\* H. J. Trout, Jr.  
Manager of his own investments

W. W. Trout, Jr.  
Retired Vice President

\* T. E. Wiener  
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\* Member Executive Committee

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Assistant Secretary

S. T. Coker  
Assistant Secretary





LUFKIN INDUSTRIES, INC.