2002
annual report

VIRCO MFG. CORPORATION

Company Profile

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

2002 Annual Report

1 Financial Highlights

2 To Our Shareholders

33 Management's Statement

34 Management's Discussion and Analysis and Results of Operations

44 Five Year Summary of Selected Financial Data

45 Report of Independent Auditors

46 Consolidated Balance Sheets

48 Consolidated Statements of Income

49 Consolidated Statements of Stockholders' Equity

50 Consolidated Statements of Cash Flows

51 Notes to Consolidated Financial Statements

66 Supplemental Stockholders' Information

67 Directors, Officers and Facilities

Financial Highlights

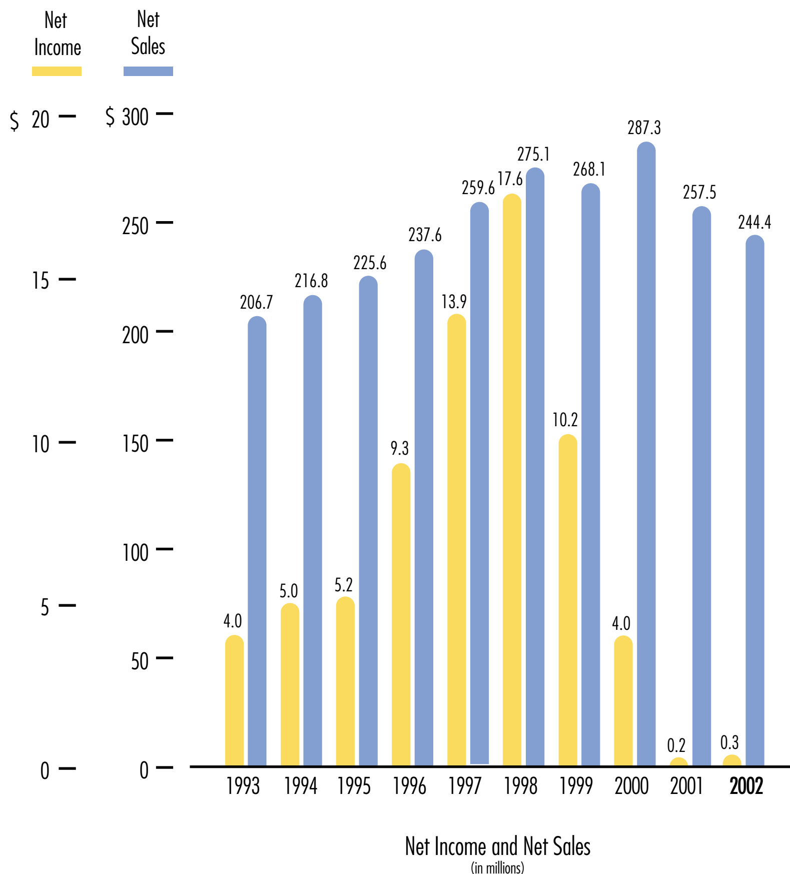
In thousands, except per share data	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Summary of Operations										
Net sales(3, 4)	**$ 244,355**	$ 257,462	$ 287,342	$ 268,079	$ 275,096	$ 259,586	$ 237,551	$ 225,559	$ 216,822	$ 206,738
Net income										
Net income from operations	**$ 282**	$ 246	$ 4,313	$ 10,166	$ 17,630	$ 13,852	$ 9,326	$ 5,209	$ 5,001	$ 4,302
Change in accounting methods	–	–	(297)	–	–	–	–	–	–	(275)
	$ 282	$ 246	$ 4,016	$ 10,166	$ 17,630	$ 13,852	$ 9,326	$ 5,209	$ 5,001	$ 4,027
Net income per share (1)	**$ 0.02**	$ 0.02	$ 0.29	$ 0.72	$ 1.20	$ 0.94	$ 0.64	$ 0.36	$ 0.35	$ 0.28
Stockholders' equity	**82,774**	90,223	94,141	93,834	88,923	77,077	63,921	55,386	50,466	45,637
Stockholders' equity per share (2)	**6.15**	6.71	6.90	6.82	6.30	5.39	4.48	3.88	3.55	3.20

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

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

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

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



Net Income and Net Sales
(in millions)

Results in 2002 reflected the difficult conditions in our markets. We have prudently trimmed costs to maintain profitable operations while avoiding the yo-yo effect caused by layoffs, plant closures, and the elimination of product lines.

To Our Shareholders

Left: Robert A. Virtue - President and CEO
Right: Douglas A. Virtue - Executive Vice President

May 8, 2003

In last year's letter we explained our values, our strategy, our plan for improving Virco's capital efficiency, and the contribution of risk management to long-term compounding of shareholder value.

This year we turned the forum over to our institutional owners by soliciting questions from Mr. Les Bryant of UBS PaineWebber; Mr. David Cohen of Athena Capital Management, Inc.; Mr. Joe Farley of Private Capital Management; Mr. Michael Gardner of Wedbush Morgan Securities; Mr. J. Ellwood Towle of Towle & Co.; Mr. Jamie Wilen of Wilen Management Company, Inc.; Mr. John Walthausen of Paradigm Capital Management, Inc.; and Mr. David Yamamoto of Wedbush Morgan Securities. We think you'll find their questions representative of shareholder concerns in general.

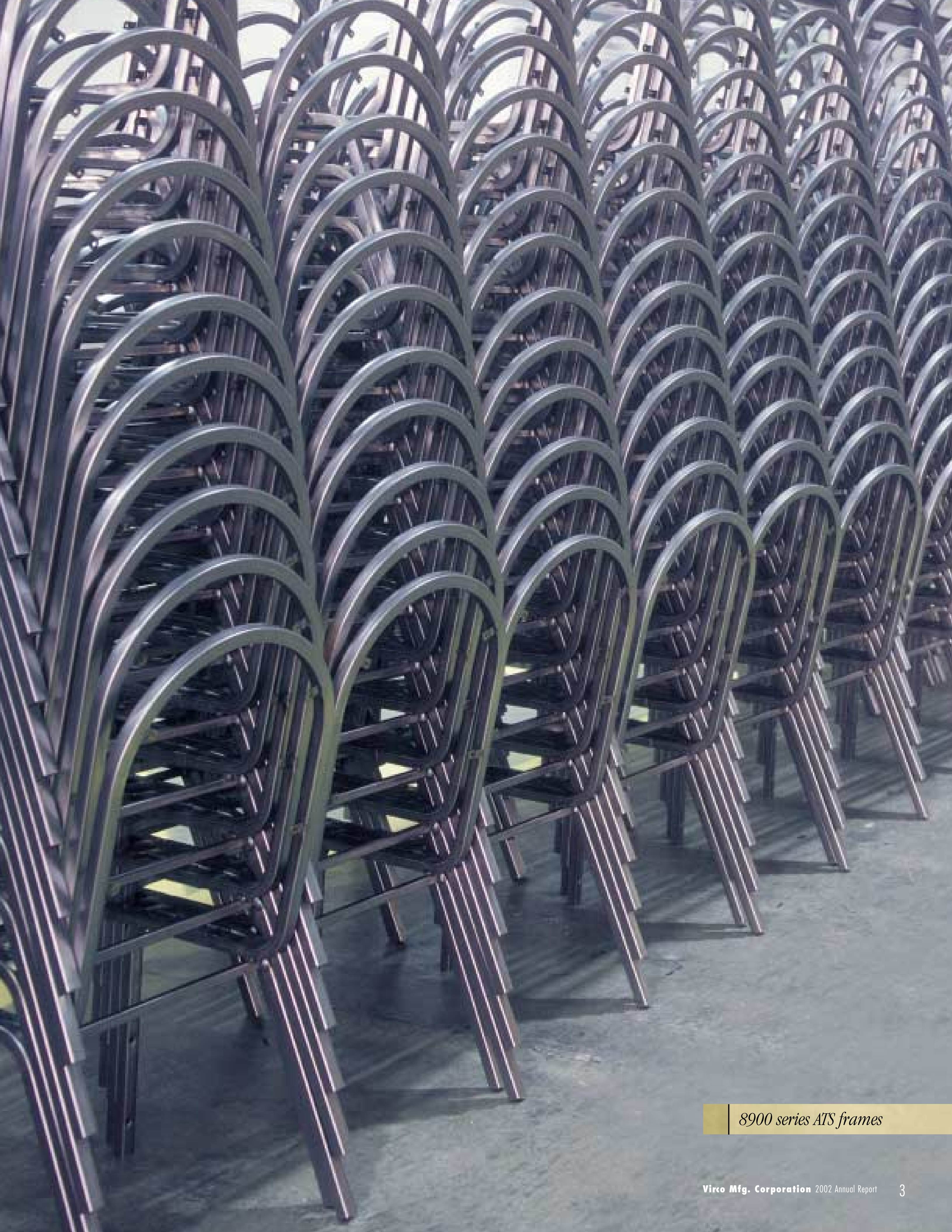
As most of you know the last three years have been very difficult for furniture manufacturers. Our cycle of heavy capital expenditures immediately preceded this downturn, a case of unfortunate timing that doesn't invalidate the reasons behind the investments.

The school furniture market is becoming more intensely seasonal with each passing year. Our new facilities, information systems and operating models specifically address this condition. As our investments gradually depreciate and volume returns to normal levels, we expect earnings to rebound.

Our most important job continues to be matching business activities to underlying market conditions. Over long periods of time this kind of congruence yields sustainable results, which is why we recommend investors match their expectations to our ten-year strategic horizon.

An interesting fact we uncovered while preparing this year's report is that Virco common stock delivered a net compounded return of 521.6% over the past decade. This performance compares very favorably to some of the finest companies in the U.S. You'll find an elaborated treatment of Virco as an investment in the answer to Question 2.

Much of this year's report assumes an understanding of Virco's basic business and strategy. For new investors we recommend our 2001 Annual Report as the best source for this information. If you'd like a copy, contact us at www.virco.com or 2027 Harpers Way, Torrance, CA 90501 and request one.



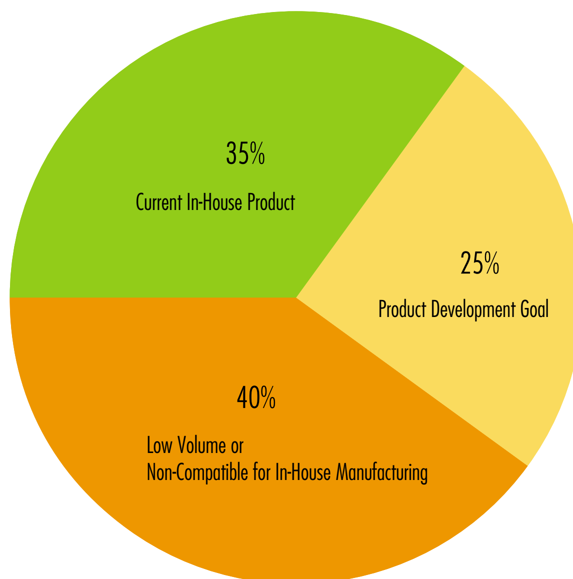
8900 series ATS frames

1. The last few annual reports you've done have been very informative and helpful. Can you give us an update on the initiatives you listed in last year's report? Specifically, how are you doing with ATS, with capacity utilization, and with your goal to capture 60% of the FF&E market?

[Michael Gardner and David Yamamoto]

We listed several quantifiable goals and we've made progress on all of them. We said we'd restrict capital expenditures to $6 - $7 million per year through 2004 as a way of reducing the overall capital structure of the company. Actual capex in 2002 was $3.5 million. Against depreciation of $13.5 million, this contributed $10 million to cash flow. We expect roughly the same result for the next two years, even though depreciation itself will be shrinking by about $1 million per year as our capital base slims down.

Assemble-to-Ship (ATS) matured further in 2002 and exceeded our expectations for both cost effectiveness and customer service. ATS anticipated two trends that are powerfully reshaping our industry, namely shorter public school order cycles and low-cost imports. ATS allows us to bank labor hours before receipt of actual orders, an extremely important advantage in our increasingly seasonal business. It's also the most efficient way to stockpile modular components regardless of where they're made. Our new Conway facility was specifically designed to execute ATS, but with lower sales volume the last three years it hasn't really been tested. We



Furniture, Fixtures and Equipment Product Assortment

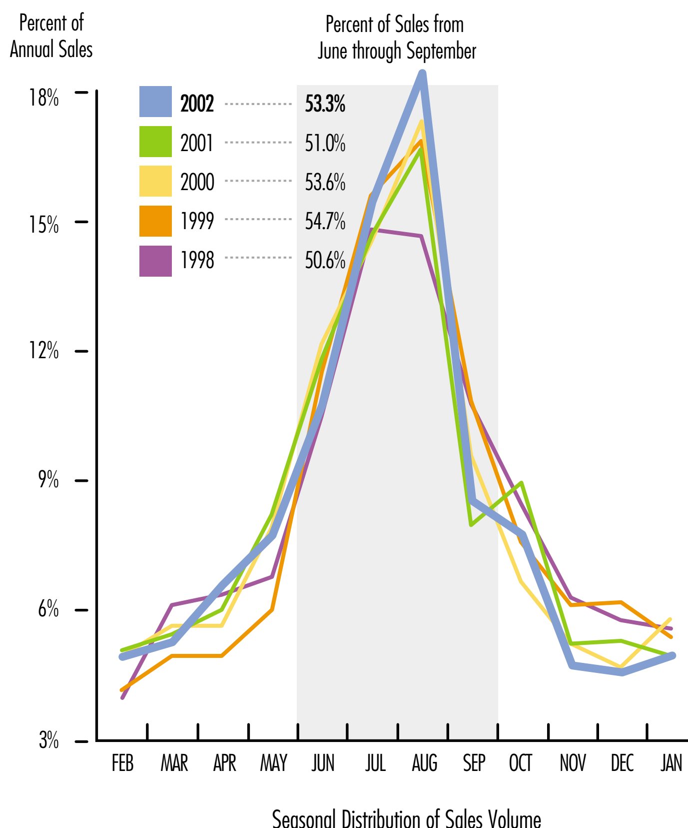
The Furniture, Fixtures and Equipment market probably exceeds $1 billion and includes many products that Virco doesn't make. Our goal for expansion in this market is to increase the percentage of functional needs satisfied by in-house products and sold through our Furniture Focus subsidiary.

feel confident that ATS gives us disproportionate room for growth relative to capital investment, but full proof will have to wait for higher demand.

Last year's report may have contributed to a misunderstanding of our initiative to manufacture 40 - 60% of the Furniture, Fixtures and Equipment (FF&E) product assortment in-house.

To recap, FF&E is the non-general contract portion of a new school construction project. Relative to the total value of a project, general contract buildings and grounds usually represent 80 - 90%. FF&E constitutes the remainder at 10 - 20%. Moveable classroom furniture is a subset of FF&E, and it's this portion of the product universe that we're trying to expand.

Our goal is to produce, in-house, the 40 - 60% of FF&E that fits our high-cube, highly seasonal profile. We've started with furniture or furniture-like equipment that fits naturally into existing manufacturing processes.



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

Furniture Focus™, our subsidiary that provides turnkey FF&E packages for new schools, has already demonstrated a pricing advantage due to the contributions of lower cost Virco furniture. By expanding the in-house portion of these packages we hope to further improve Furniture Focus' pricing advantage and gain market share. Virco furniture currently represents about 35% of a typical FF&E package. The products under development will probably bring that figure up to 40% by year-end.

We have no solid figures on the total size of the FF&E market, but it's certainly in excess of $1 billion. School Specialty is the recognized market leader with total annual sales of over $740 million, only a portion of which is FF&E. Regional and national dealers representing other manufacturers cumulatively control the rest of the market. With $12 million in annual revenue, Furniture Focus is presently a niche player. We won't even hazard a guess on what share of the overall market we might capture, but it's a big field with a lot of potential.

The FF&E product development initiative is doubly beneficial because any new products made in-house contribute to overhead absorption. Most traditional capacity measures don't apply to us since we're so vertically integrated. We still think the figure we gave in last year's report is accurate: with no major investments, our physical infrastructure will comfortably support up to $400 million in annual sales.

We also announced our intention of eliminating all long-term debt by the end of 2004 and consistently generating $15 - $20 million of cash flow, initially through depreciation in excess of capex, and later through improved earnings. Voluntary contributions to our employee pension fund and share repurchases of $4.4 million caused us to miss our cash flow target, but we just couldn't pass up the stock. If similar opportunities develop this year, we may miss our debt retirement goal by some months or perhaps a year. This discretionary deployment of capital doesn't diminish the fact that we're headed in the right direction. Our financial partner, Wells Fargo, feels comfortable with our ability to service our debt. We still don't know of a better investment than our own stock and we remain in the market.

Risk management also deserves mention as an ongoing initiative that may be under-appreciated as a contributor to Virco's performance. Write-offs, restatements of earnings and similar accounting "make-up calls" have become so commonplace that investors might be lulled into believing they don't matter. They're frequently described as "non-recurring," which doesn't change the fact that all write-offs were cash at one point. As we said in last year's report, capital that isn't preserved can't be compounded. We believe much of the credit for our strong performance over the last decade rests with our integrated risk management program. We have an extraordinarily dedicated staff that's avoided costly turnovers in a game that most observers would agree has turned quite ugly.

Lunada® series seating

2. "We've had difficulty, even with services like Reuters, calculating true net return for investors over a ten-year period. Not benchmarked returns, but actual dollar returns, including stock dividends and cash dividends. What has the real return been?"

[Michael Gardner and David Yamamoto]

"You do a great job of communicating but you're a relatively quiet little public company. How do you plan to wake up Wall Street and reap the benefits of your established relationships, your capabilities, and your capital investments?"

[Jamie Wilen]

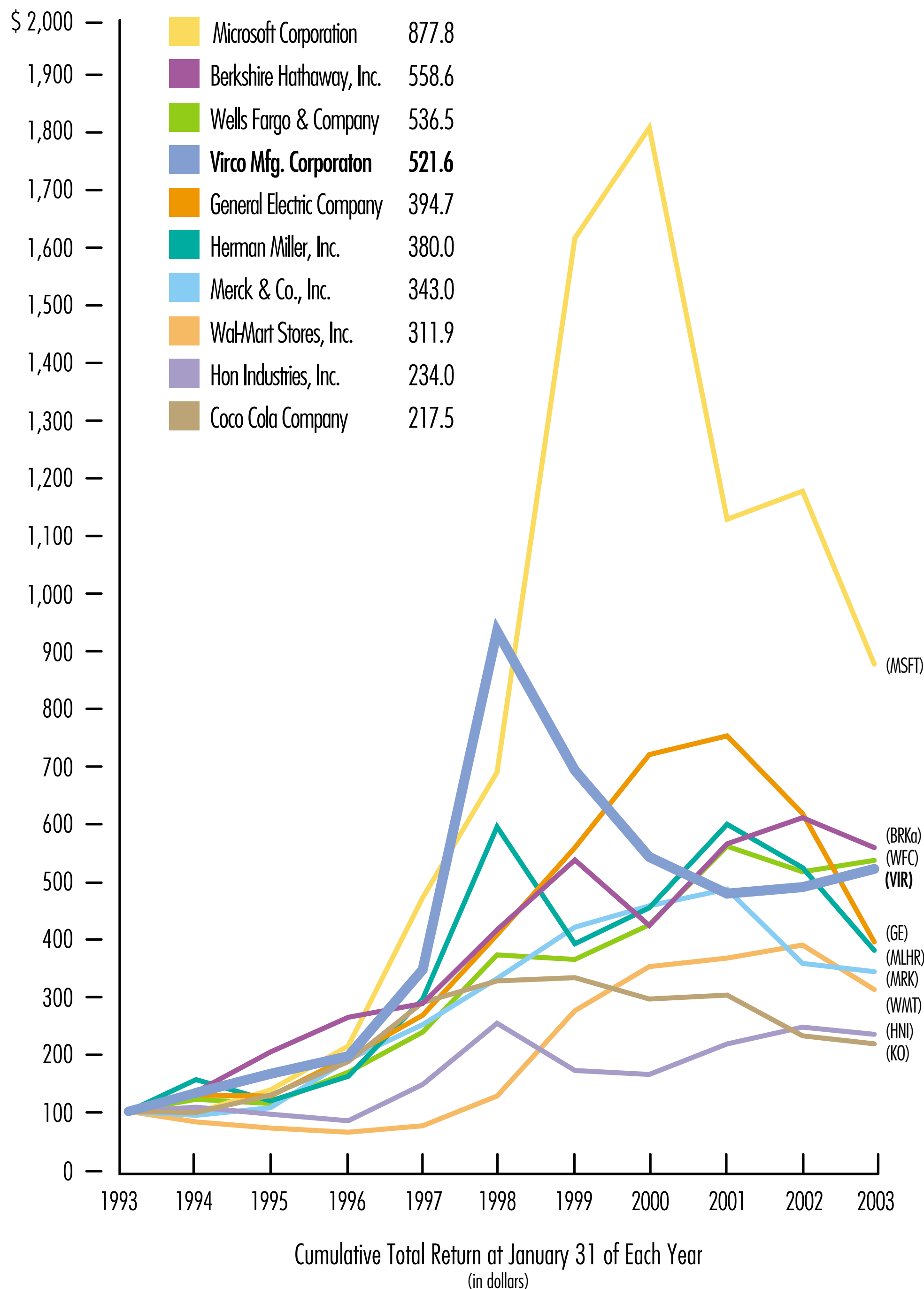
The quickest way to wake up Wall Street is with improved earnings. We explain later why we haven't used layoffs and plant closures to manage earnings, preferring instead to work for sustainable growth and operating improvements. But our performance over the past decade hasn't been bad, as the chart below shows.

We asked Media General Financial Services to calculate the net compounded return for $100 invested in Virco common stock on 31 January 1993, with the investment terminating on 31 January 2003. The same calculation was made for a list of companies we admire, only two of which would be considered part of our natural peer group. Here are the results:

Company	Symbol	10-Year Return
Microsoft Corporation	(MSFT)	$877.85
Berkshire Hathaway, Inc.	(BRKa)	$558.65
Wells Fargo & Company	(WFC)	$536.52
Virco Mfg. Corporation	(VIR)	$521.56
General Electric Company	(GE)	$394.68
Herman Miller, Inc.	(MLHR)	$380.04
Merck & Co., Inc.	(MRK)	$342.98
Wal-Mart Stores, Inc.	(WMT)	$311.88
Hon Industries, Inc.	(HNI)	$233.98
The Coca-Cola Company	(KO)	$217.51

Taking shorter snapshots over the decade can yield far better or far worse results, which is why we continually preach the advantages of patience. With a solid business, longer periods of time tend to work in your favor. There is also the avoidance of what Warren Buffett refers to as the "frictional loss of value" from taxation and transaction fees.

The following graph illustrates the ten year fluctuations in cumulative return for all of these companies and indirectly provides a warning against efforts at timing the market.



Cumulative Total Return at January 31 of Each Year
(in dollars)

$100 invested in Virco common stock on 31 January 1993 would have been worth $521.60 on 31 January 2003, including stock dividends, splits, and reinvestment of cash dividends. Short-term spikes tend to even out over time, reinforcing our recommendation that investors match their expectations to Virco's ten-year strategic horizon. Comparative results for some of America's finest companies are also shown.

Source: Data provided by Media General Financial Services.

3. "There may be concern about Virco specifically, or companies at large, that a family-controlled business can actually be managed for the greater good of all shareholders. Is Virco a true meritocracy? What is your commitment to non-family shareholders?"

[David Cohen]

"What is your ultimate objective in terms of financial structure and family control? Who's going to run the business? Where are you in the transition?"

[Jamie Wilen]

It's commonly assumed that closely held companies have a uniquely self-serving perspective at odds with outside shareholders. We disagree, in the sense that accountability and good performance are measurable regardless of who owns the company. We do believe that closely held companies have an easier time exercising disciplined strategies because of their insulation from short-term market pressures. Whether or not they do so is the acid test.

Broad ownership per se is no guarantee of accountability or performance. The bubble of the 90s proved the fallacy of such assumptions. The opposite argument could just as easily be made: that broad ownership leads to a loss of accountability through anonymity.

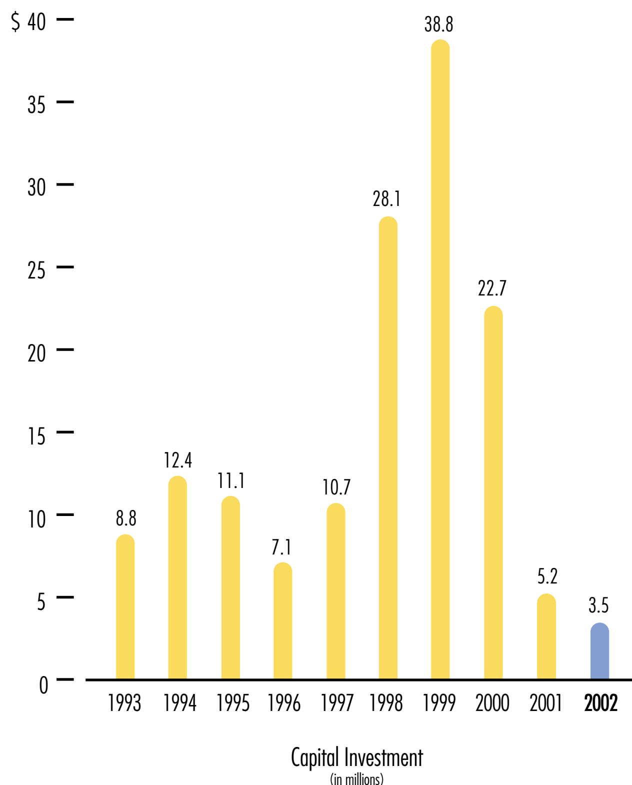
We make a special effort to be clear about our strategy, our goals, and our deployment of shareholders' earnings. We're content to stand on our record of candor and conservative accounting. We've never restated earnings in our 53-year history. We've never represented Virco as something it's not. We've told investors that our strategic horizon is ten years or more, and that expectations of quick hits are inconsistent with our timetable. If we ever publish a "Virco Owner's Manual," the first suggestion would be that shareholders match their expectations and investment horizon to Virco's strategic horizon, which is at least ten years.

The implication that there's only one best way for a company to meet shareholder needs implies that all shareholders have the same needs. Since most investors have portfolios within which individual stocks occupy a niche, the more appropriate question is whether or not Virco deserves a place in the portfolio. Our commitment to all of our shareholders is the same: we'll manage this business to the best of our ability, remaining true to the strategic direction we've described and well within our zone of competence. If this makes Virco inappropriate for certain portfolios, the stock market offers numerous alternatives.

The company's succession plan anticipates that Doug Virtue will become CEO when Robert Virtue retires. We're familiar with the statistic that only 13% of family-controlled companies make the transition to third generation leadership. We're confident that Doug will lead us successfully through this transition. He's been the architect of many recent initiatives, including Assemble-to-Ship, seasonal job shifting, and our targeted development of new products. Doug

is supported by a very experienced team of professional executives, including a generation of managers that's being prepared to lead the company for many years to come.

There's no better way to assess Virco's management than face-to-face. We encourage interested shareholders to attend our annual meeting on June 10 at our Torrance, California headquarters. In addition to the meeting, attendees can take a plant tour and visit with our management team at a level of intimacy rarely afforded shareholders in larger corporations. The meeting will begin at 10:00 a.m., the plant tour will run from 11:00 'til noon, and then we'll serve lunch. The meeting will conclude by 1:30 p.m.



Capital expenditures in 2002 totaled $3.5 million, well below last year's and over $10 million below depreciation. This pattern of reduced capex will be continued for at least the next two years.

4. "When are we going to get back to where we were a few years ago in terms of performance?

[Michael Gardner and David Yamamoto]

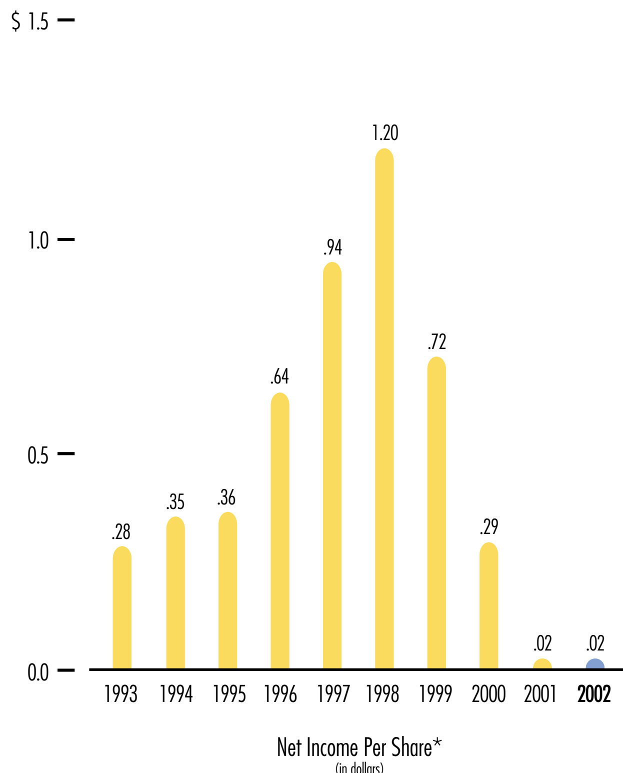
"There won't be any tremendous interest in Virco until earnings improve. Given this reality, what are your prospects for top line growth?

[J. Ellwood Towle]

"Given that municipal budgets are tight and getting tighter, is there any way Virco shareholders are likely to profit during this down cycle?"

[David Cohen]

These questions all assume that share price is determined by earnings, and that earnings are driven primarily by volume. While this is broadly true for any capital-intensive business, we've been successful at lowering Virco's breakeven point with a variety of cost-cutting initiatives. We'll answer these questions in terms of revenue growth.



Net Income Per Share*
(in dollars)

Earnings per share of $0.02 were essentially unchanged from 2001 despite an aggressive share repurchase program that returned $4.4 million to shareholders.

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

We hold a number of direct contracts with public institutions. We also have strong relationships with certain categories of retailers such as wholesalers, catalog houses and franchised educational distributors.

Because our quality and performance are consistently good, existing customers from both sides of our business have repeatedly asked us to expand our product line so they can use Virco to supply more of their needs. In the case of direct accounts this means adding new line items to existing contracts. In the case of retailers it means adding pages to catalogs and/or rack space in wholesale warehouses. In some cases these additions for Virco have come at the expense of competitors, which is why we think we've increased our market share even during this difficult recession.

What's significant about this approach to growth is that we're not guessing about what *might* work, but responding to actual demand from current accounts. Most of these new products will have the double benefit of absorbing more plant capacity once they come on line. We're also more confident about internally generated growth that avoids the integration risks associated with acquisitions.

An example of one of these product lines is I.Q.®, an integrated, ergonomically sound series of classroom chairs and desks designed to address both evolving demographics and greater technology use in K-14 classrooms. I.Q. has earned several industry awards and after only two years is our twelfth largest product line.

Furniture Focus represents a service-based approach to growth. Using a blend of Virco furniture and outsourced equipment, Furniture Focus provides complete package solutions for managers of new school construction projects or renovations.

When we purchased the company last year, operations were centered on the upper Midwest. This year we're expanding the Furniture Focus program nationwide and we've already landed significant orders in California and elsewhere that previously would have gone to competitors.

As this report is being written, incoming orders are running 17% behind last year. The President's Day storm in February closed eastern seaboard schools for two to three weeks, and though order rates have improved somewhat since then, this still looks to be a difficult year. Many of our customers are unable to forecast their purchases because they don't yet have their budgets. We remain focused on increasing our share of the available business so that when a recovery occurs we're positioned to grow beyond the levels of three years ago.

Sheraton - Albauquerque NM

5. "This is your third or fourth year of flat to down profits. Can you help us understand why you haven't made more dramatic efforts to cut your infrastructure and bring it more in line with current demand?"

[J. Ellwood Towle]

Big-bath write-offs are inconsistent with our policy of capital preservation. We also believe that layoffs and plant closures leave deep scars within a company, often resulting in permanent damage to competitiveness. For these reasons, we much prefer the more patient methods of depreciation and natural attrition to bring costs in line with demand.

Our current infrastructure is ideally configured for the classroom furniture market. Being early in its depreciation cycle doesn't invalidate the ultimate effectiveness of its design. Depreciation and disciplined reductions of capital expenditures are reducing the Property, Plant and Equipment (PP&E) portion of our balance sheet by $9 - $10 million per year. Within two years we'll be back to pre-Conway/SAP levels of PP&E.

When layoffs become a habitual method of maintaining a variable cost structure or calibrating profits, employees can rightly be expected to feel manipulated. Layoffs also jettison intellectual capital, a considerable loss given the growing expense of hiring and training qualified workers.

We're letting our natural attrition rate of 12%, which is quite low for a manufacturing company, reduce headcount without layoffs. Since February of 2001 attrition has eliminated over 400 positions. Counting seasonal workers at our summer peak, the number is over 800.

Virco's skilled and unified workforce is of greater value to shareholders than a quick pop in earnings. The loyalty of our employees is what made ATS possible. ATS permanently lowers operating costs and provides an ongoing business model that's more defensible against imports and better adapted to our market's intensifying seasonality.

The job shifting efficiencies of ATS will be expanded this summer by moving factory and warehouse employees to the field, where they'll perform delivery and installation services. With over 200 volunteers already signed up, the program is expected to generate material savings. We also expect a more conscientious level of customer service from our own employees.

To further match our annual cycle to that of our customers, we've made last year's voluntary sabbatical a permanent program. By foregoing two weeks of pay during the slow autumn season, employees receive a month off in addition to their normal vacation. In return they get a large block of free time that most people have to wait until retirement to enjoy. Last year about 65% of our workforce participated, generating $1.5 million in savings and inestimable goodwill. The program was so successful that we expect even greater participation this year. Over the long term the sabbatical could become a competitive benefit for attracting and retaining qualified employees.

Employee benefits generate deferred obligations that also affect short-term results and need to be reported accurately. Consisting primarily of health care and pensions, annual costs of these programs are subject to numerous actuarial and investment assumptions. By overstating anticipated investment returns and/or discount rates, benefit expenses can be made to look much lower than their true net present value. Such behavior has allowed some companies to report strong earnings while building a deferred obligation they won't be able to support. This is not the case at Virco.

We adopted more conservative assumptions early last year that resulted in a one-time additional contribution of $4 million on top of our annual $6 million pension investment, for a total of $10 million. Following this correction, we expect annual contributions of $6 - $7 million to keep our pension fully funded. We also brought our health care benefits more in line with other manufacturing companies by passing on a significant portion of the increased costs to our employees. We felt this was a better alternative than layoffs.

In summary, our infrastructure is appropriate and our accounting is solidly conservative. Weak earnings of the past three years won't be exacerbated with write-offs or subsequent revelations about un-funded pensions. By taking our earnings hits as they occur and avoiding the yo-yo effect of cuts and layoffs, we've enhanced the sustainability of our business. The beneficial effects may not become visible for another year or two, but as we've said before recessions tend to work in our favor.

6. "With your dominant position and your ability to deliver quality product on a timely basis, it's logical to expect you'd have pricing power. Yet we're not seeing acceptable margins. Do you have the ability to lead pricing? Is your product under-priced? Are you optimizing profitability?"

[Jamie Wilen]

"The broader commercial furniture industry has been victimized by extreme price-cutting. How has price-cutting affected Virco? Is the problem one of excess industry capacity versus low present demand, and if so, how long do you expect this condition to persist? How has the recent sale of one of your competitors affected pricing within your market niche?"

[David Cohen]

"About two thirds of the companies in our managerial portfolio provide us with quarterly earnings guidance. What is your rationale for not providing guidance?"

[J. Ellwood Towle]

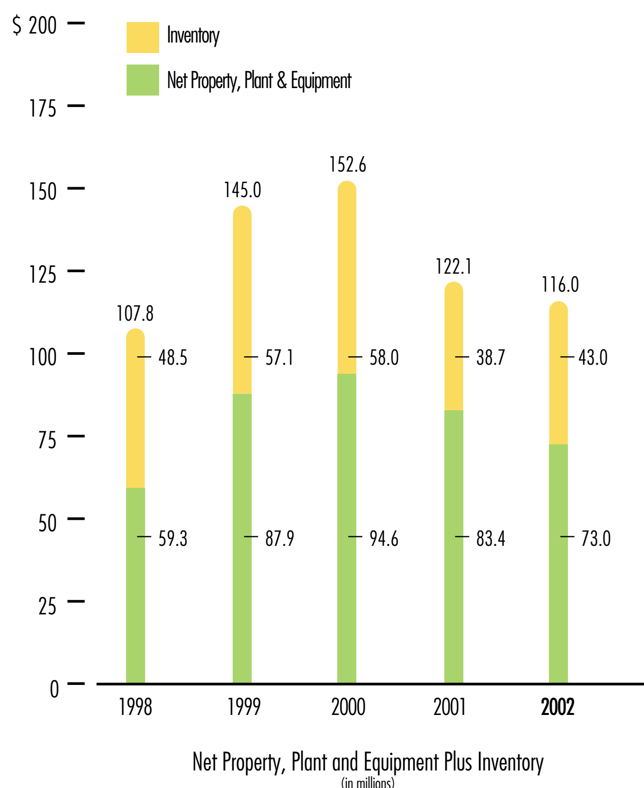
Warren Buffett and others have observed that pricing in commodity-based industries is often a lowest common denominator sort of activity. We have found this observation to be as true in the school furniture market as any other.

One of our keys therefore is to not compete on pure commodities, but instead to find ways of differentiating our product through hard-to-imitate combinations of design, function, availability and service. We have previously described our value equation, a literal mathematic equation that lets us compare the value of our total offering against competitors. Not surprisingly, where the net values are roughly equal we encounter severe competition and little inclination from customers to favor Virco for any reason other than price.

Although we prefer not to compete on price alone, we consider it mandatory to maintain our industry-leading cost structure. From time to time we have to be low-bid and strict cost controls provide us this option.

Our major problem right now is not pricing per se. Gross margins are up from 29.1% in 2000 to 31.4% in 2002. Actual selling prices per unit are going up, not down. It's the cost of our infrastructure associated with sales, delivery and installation that's impacting net earnings.

We have abandoned certain markets characterized by chronically low margins, such as the mass merchandise market for folding chairs and tables. In the classroom furniture market, irrational pricing tends to crop up sporadically either in certain regions or within particular product groups. While this behavior occasionally forces us to follow suit, we know over the long term



Net Property, Plant and Equipment Plus Inventory
(in millions)

The net Property, Plant and Equipment portion of our balance sheet continued to decline by $10 million per year as a result of the favorable relationship between depreciation and capital expenditures. The apparent increase in inventory is merely an acceleration of our normal seasonal buildup. Job shifting later this summer will reduce factory output and result in lower inventories by year-end.

it's not sustainable. Direct competitors pursuing these policies generally aren't enhancing their positions with new product offerings or investments in infrastructure. We retain our commitment to fair pricing that supports a full suite of customer requirements including updated functionality, quality, availability and field service.

High margins for us tend to come in waves, frequently on the heels of a recession during which our historical perspective and financial strength lead us to continue the kinds of investments that contribute to subsequent margin improvement. We have not learned how to predict exactly when these favorable swings will occur, which is why we don't offer guidance.

Regarding the recent sale of Sagus, whose Artco-Bell and Midwest brands are sold into public schools, the effect on pricing has been spotty. Both of these brands are marketed through dealers, all of whom have their own unique cost structures, strategies and financial conditions. Some dealers have remained extremely competitive, while others have raised prices or become more selective on the jobs they bid.

In the public bid arena, a price is also a promise to perform. One of the most encouraging trends for us has been the number of contracts we've been awarded where we weren't low, but the end user chose to go with Virco either because of our solid performance or disappointments with other suppliers.

Higher volume at current prices would contribute about one quarter of every dollar to the bottom line, while any savings we achieve from seasonal job shifting and other cost controls contribute dollar for dollar. That's why our current efforts at earnings enhancement are focused on the three areas described earlier: sales growth with existing customers through new product introductions; higher volume for Furniture Focus; and efficiency improvements below the line.

7. "How close do you feel Virco is to its optimal capital structure? If you aren't planning any major capital investments, what will you do with your excess cash flow?"

[David Cohen]

At current volume levels we obviously have too much capacity and too much of our capital wrapped up in Property, Plant and Equipment (PP&E). A very disciplined capital investment program is rapidly bringing this imbalance more in line. With depreciation of roughly $13 million per year and capital investments of $3 - $5 million, we're effectively reducing the net book value of our PP&E by more than 10% annually. What's important to remember is that true capacity isn't being reduced at an equivalent rate. Our large investments in 1998 and 1999 now represent what we think of as "operating annuities." We discussed this concept in last year's annual report under the Ascending Crescents section.

I.Q® classroom solutions

We last ascended one of these crescents in 1996 - 1998, following our headquarters relocation from Los Angeles to Torrance, California. We used the profits from that apex to build our new Conway factory and upgrade our information management system. These two major investments immediately preceded the current recession, but this unfortunate timing doesn't invalidate the model. Having invested shareholder dollars in what remains an ideally designed infrastructure for servicing our particular market, we think it would be foolish to write off assets when a little time and patience will deliver a superior result.

We answered the question about possible uses of excess cash flow in last year's annual report and we'll summarize it here again. Our intent remains to divide free cash about evenly between reinvestments in the company and redistribution to shareholders. Last year we returned $5.4 million or 4.6% of our market capitalization to shareholders. About $4.4 million of this was in the form of share repurchases, and $1 million was cash dividends.

There's been renewed interest in cash dividends following the market bubble of the late 90s. Two articles in the 3 February 2003 issue of Fortune Magazine addressed this shift in investor attitudes. In "Love That Tax Cut", Clifton Leaf wrote:

> …the dividend tax cut offers…an antidote to the short-term trading mentality that brought on the frenzied rise and fall of the stock market. That speculative fervor was propelled not only by such obvious culprits as greed and euphoria, but also by the U.S. tax code. By taxing corporate dividends twice…Uncle Sam has pushed most public shareholders to stow their investment profits into what you might think of as a humungous corporate tax shelter. While it sounds reasonable enough, this tax avoidance strategy has steadily made corporate managers less accountable to their shareholders and made shareholders more likely to jump in and out of stocks.

Despite the fact that a dividend tax cut now appears less likely, we concur with Leaf's analysis. A second article by Justin Fox titled "Show Us the Money" concluded with this statement:

> For…many other reasons (Enron, WorldCom, Tyco) it's become harder and harder to make the case that the interests of outside shareholders and corporate management are perfectly aligned…. [N]othing demonstrates management's good intentions better than cold, hard cash.

Given that share repurchases don't carry the same tax disadvantage as cash dividends, our redistribution of free cash flow to shareholders will probably remain more heavily weighted in that direction. We still intend to increase dividend payouts, both indirectly through our traditional 10% annual stock dividend, and directly through increases when and if we feel cash flow can support it.

As far as investments, we claim no special expertise outside our market. Unless we see real opportunities that we feel certain we can understand and manage, we don't intend to wage wars of acquisition with shareholders' earnings. We've said before that most segments of the commercial furniture industry are occupied by large, well-financed companies. While this recession has weakened some of them, it would still be arrogant of us to think we could successfully attack their positions.

Furniture Focus, for which we spent $2.4 million ($4.6 million with receivables), is more in line with what we consider a good acquisition. It's financially digestible for us, has limited integration risks, is consistent with our market direction and product lines, and has the potential for great expansion when melded into our existing sales model. We've also known the managers of Furniture Focus for over twenty years and we enjoy working with them. For the 50% of free cash that goes back into Virco, we intend to mix acquisitions like Furniture Focus with enhancements of our existing capabilities to further strengthen our hold on a market we understand.

8. "What is the timing of bond-funded construction projects? How long does it take Virco to benefit from these?"

[Michael Gardner and David Yamamoto]

"We've heard that 'no child will be left behind.' We've also heard that enrollments are growing rapidly. Given this favorable combination, why are we not selling more furniture?"

[David Cohen]

The simple answer is that these favorable conditions are being offset by a budget crisis so severe that teachers are losing their jobs. It's probably appropriate that classroom furniture falls to the bottom of most priority lists.

A number of powerful and conflicting forces are at work in the education market, resulting in a complex picture that can't be accurately summarized by a one-dimensional analysis. There's a common perception among business leaders and investors that the education market is a good place to be. Our immediate experience over the past three years is that actual funding is basically flat. We see a significant financial gulf between the emotional commitment to improved public education and real spending on furniture and equipment. Many programs mandated at state levels remain un-funded at local levels.

In previous reports we've described the dichotomy between bond-funded new schools and day-to-day replacement orders, which come out of a district's tax-supported general fund. When voters get a chance to determine exactly where their dollars are spent, very often they pick public schools or community colleges. When legislators divide dwindling tax receipts, very often they cut funding to these same institutions. In recent years bond approval has roughly kept pace with state and local budget cuts. It's as if parents and legislators are fighting a tug-o-war over school funding.

YMCA - Torrance CA

Furniture purchases related to bond funding typically lag approval by two to three years. This timetable isn't particularly relevant to our business, however, since at any given time the bond pipeline has projects of varying maturity moving through it. Given that total bond funding has been relatively steady over the past few years, it's more appropriate to think in terms of Virco's share of the business. As we explain below, bond-funded projects tend to emphasize upgraded furniture and this is where we've focused our product development efforts.

New construction of all kinds has traditionally been a driver of classroom furniture demand. Predictably, we are seeing more project-type orders from the emerging urban perimeters described by author Joel Garreau as "edge cities." Replacement orders from established districts are down.

Edge city campuses are often quite sophisticated, with non-institutional environments including seminar rooms instead of classrooms, computer labs, food courts and college-style libraries. Our recent product mix reflects this shift, with a notable emphasis on practical ergonomics, style and technology support.

Urban districts with flat or declining student populations generate relatively less new construction. Replacement orders tend to match existing furniture, which means older districts often buy more traditional designs. The decline in replacement orders has shown up in several of our older product lines. There's also been a geographic shift of business towards the Sunbelt, where student populations are growing most rapidly.

This leads to a discussion of how life cycle affects furniture demand. Our furniture frequently lasts 20 - 30 years, which means it's multi-generational. It literally outlives many of the enrollment bulges that periodically move through the public schools.

Market demand is therefore some variant of the following equation:

actual demand = incremental increase + replacements - deferred replacements

Because enrollments have grown more slowly than media reports imply, the incremental increase in students is not enough in itself to drive industry growth. Total K-12 enrollment in 1993 for both public and private schools was 48,813,000. Total enrollment in 2003 is estimated to be 53,293,000, an increase of only 9% during the last decade. Estimated enrollment for 2011 is 53,026,000, a decline from current levels. If it weren't for the uneven distribution of age group cohorts in the total student population (preschool, K-5, 6-8, 9-12) plus the growth of edge city districts, new enrollment alone would have supported less than 1% growth per year.

Unofficial conversations with other industry suppliers suggest that order volume for all kinds of school equipment is down, not up. These facts lead us to a more sober assessment of short-term market potential than is suggested by phrases such as "no child will be left behind." Investors looking for a demographic trend so powerful that it lifts an entire market may be disappointed by this analysis.

When the recovery comes, which it will, we expect it to be driven by replacement orders added to already strong new school demand. We expect progressive inner city school administrators to match the stimulating environments of edge city campuses, which means they too will be placing a greater emphasis on ergonomics and technology support.

For all these reasons, our strategy emphasizes opportunistic preparedness. Knowing that demand comes in unpredictable waves, we think in blocks of ten years as opposed to quarterly or annual increments. The last major wave for us occurred between 1996 and 2000, a period when enrollments grew only 3%. Profits from that high tide were reinvested in our current infrastructure and new products, which have prepared us to take advantage of the next wave. We remain steadfastly focused on this opportunity, in spite of present challenging conditions and a background of neutral student enrollment. [Readers can find more data on student enrollment and trends in education at the National Center for Education Statistics website (http://nces.ed.gov]

9. "Can you give us an update on the status of your distribution channels, especially the program you announced several years ago of selling direct instead of relying on retail partners?"

[John Walthausen]

We apparently confused shareholders four years ago when we announced that we were ending our exclusive relationships with certain educational distributors. We spoke in Virco jargon without thoroughly explaining the terms, which we'll attempt to do now.

Since our founding in 1950 we've always sold most of our public school accounts on a direct basis. The nature of public bidding, where price control is an essential competitive element, leads logically to a direct representation model. The service and support required by large districts also argues for a direct model, since relatively few dealers have the combination of infrastructure, financing and willingness to handle the necessary off-season inventories.

There are some regions of the country where for reasons of existing relationships, low volume, or remoteness it makes little sense for us to be direct. In these regions we've sold through what we internally refer to as *franchised education distributors.*

Depending on the particular arrangement, these franchised distributors have the exclusive right to represent our product line either to one or more school districts or a geographical region. They receive competitive pricing from us but establish their own final price to the school district. In all cases they provide field service; in most cases they provide freight and minor warehousing.

In general this two-tiered distribution system is not as cost effective as a direct model. It was never our dominant form of distribution; even at its peak, it represented less than 20% of our total volume to the public schools. Our announcement referred only to certain franchised distributors where analysis suggested that a direct model would allow us to be more competitive. In fact, two of the distributors we released are now back with us because our analysis proved wrong.

The side of our business previously referred to as *commercial* includes a wide range of retail partners with whom we continue to do a significant amount of business. These partners range from catalog retailers to wholesalers and full-service dealers, a relatively new category for us that is opening up some new opportunities.

It's important to understand that the commercial furniture market, including the highly specialized public school market, is going through an almost cataclysmic restructuring. Relationships between end users, dealers and suppliers are changing rapidly, especially with the advent of offshore contract manufacturers who have effectively permitted wholesalers and large dealers to compete directly against domestic manufacturers. End users are going through equally significant changes, especially in the public schools where budget cuts are resulting in staff reductions and the outsourcing of services to suppliers.

At the same time we terminated our exclusive relationships with certain franchised distributors, we rationalized our nationwide dealer pricing structure. By relating price as closely as possible to the net value of services and volume they provide to us, we attempted to put all of our dealers on a level playing field. The result has been a strengthening of our dealer network, especially among the three categories listed earlier. Our dealers are truly objective suppliers for their end users, free to recommend whatever furniture they feel is appropriate for a particular application.

Our distribution strategy is to let our end users decide how they want to be serviced. The flexibility of our system, and the legitimizing effect of its cost-related pricing structure, permits us to sell direct, through a franchised distributor, or through one of our many retail partners. This approach has resulted in a more natural and sustainable distribution model. For clarity, we still sell and service over two-thirds of our annual volume on a direct basis.

In a down year for the overall industry our volume increased with many retail partners, indicating they shifted business towards Virco due to the value of our products and services. We're very honest about our policy of selling direct to public schools, and we're also very disciplined when we make a commitment not to interfere with jobs that don't involve our direct accounts. The result has been a growing trust between us and our evolving network of full service dealers, many of whom also represent one of the major systems furniture manufacturers.

Which leads us to a discussion of the college and university market. Simply stated, four-year universities traditionally buy their furniture from full service dealers that provide space planning services plus local delivery and installation. Community colleges tend to behave more like public school districts, with bid-based purchasing that emphasizes price over service.

Our orientation has naturally led us toward community colleges, where we're quite successful, and away from universities. That's changing as full service dealers, newly acquainted with our products and now competing on an even price basis relative to their volume and service, introduce Virco to their existing accounts. We're both finding that in certain settings, particularly classrooms, seminar rooms and computer labs, Virco's products provide the best overall value for college and university accounts. As these relationships strengthen and as we continue to develop new products specifically for four-year universities, we expect our participation in this niche to grow nicely.

10. "Virco is perceived as a furniture stock, and imports have really hurt domestic furniture producers. What is your exposure to offshore competition and how are you dealing with the threat?"

[J. Ellwood Towle]

"We understand that educational furniture is bulky and hard to ship, but we still wonder if there aren't overseas opportunities that we're missing. What are the prospects for international business?"

[Jamie Wilen]

We have identified a threshold where the advantage of low-cost offshore labor is offset by freight expense. This figure is of competitive significance so we won't publish it, but we do believe we understand the boundaries of the China threat.

Our furniture is relatively inexpensive compared to its bulk. Freight represents a higher portion of the final sales price for classroom furniture than it does for fine home furnishings or even systems furniture. For reasons of durability, most classroom furniture must be built on fully welded, unitized frames. These factors mitigate against imports, even with their lower labor costs.

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Low off-season visibility of peak-season demand may be an even bigger problem for importers. As districts increasingly wait for the next year's budget to be passed before placing orders, the order/delivery cycle has gotten more compressed. To perform within what is becoming an 8 - 10 week peak delivery season, importers would have to lay in huge inventories to compensate for the lack of visibility and long shipping lead times.

This doesn't mean imports aren't an issue in our market. In fact, several of our direct competitors are making use of both imported components and fully assembled furniture. We have the ability at every public bid opening to evaluate their price and work backwards to discern their underlying cost structure.

Our ATS program, which we've been actively working on for four years, anticipated this competitive environment and is designed to address it. ATS makes use of an optimal blend of imports and in-house fabrication to keep us within the cost-effective threshold mentioned above. It also addresses non-manufacturing expenses through seasonal job shifting, which a pure import model fails to do.

With ATS it's advantageous to balance the necessary staff for peak season field activities with an equal amount of off-season fabrication work. The key is to minimize total cost, including delivery and field service, as opposed merely to manufacturing cost.

We believe future trends will move the import threshold in a favorable direction for us. Living standards in China will only go up. Freight costs will only go up. If imports have a theoretical moment of maximum competitiveness, it is approximately now. A tour of Wal-Mart will confirm that the import trajectory is further advanced among consumer goods than furniture, and having analyzed that market we feel confident that our China strategy is defensible.

The international market is the flip side of the China question. The bulk and relatively low value of classroom furniture provides a strong defense for all local manufacturers, whether they're competing against imports from China or the United States. We've done enough business in Latin America, Europe and the Middle East to learn that fully assembled furniture shipped from the U.S. will never beat the final price of local product. Even though our quality is better, the price differentials are so dramatic that success is infrequent.

Strong "buy local" sentiment also presents a significant challenge, but it's led us in a direction that has potential. By combining ATS components with local assembly and representation, we think we can overcome some of the price barriers while permitting local participation.

We should caution that the process of building an international presence will be slow, and that absent big individual hits from U.S.-sponsored reconstruction projects, investors should not expect dramatic volume increases on a year-to-year basis.

11. "We've been long-term holders of your stock and we've done well with you. You have a dominant position in a great market. Our concern is how defensible your position is. Are there any large companies that pose a threat to you? If so, might they also be a logical suitor?"

[Jamie Wilen]

There are many large companies that could pose a threat to us, and not all of them are manufacturers. Among manufacturers, Hon and KI have the best combinations of product mix, distribution and financial strength to challenge us in our core market. Perhaps of greater concern are large retailers such as Office Depot, Staples and School Specialty. With contract manufacturing capabilities expanding rapidly in China, these retailers have at least the theoretical ability to imitate our product line without committing their own capital to plants and equipment.

We feel uncomfortable speculating publicly about what these companies may or may not do. We've tried to establish a strategy that turns the unique characteristics of our market into what Warren Buffett calls a "protective moat. Most importantly, we subscribe to Harvard strategist Michael Porter's contention that webs of interlocking and mutually reinforcing business activities are harder for competitors to imitate, since they involve more potential trade-offs. Gary Hamel and C.K. Prahalad have alternately described this approach as a "portfolio of competencies."

In developing our strategy we began by listing all the activities required by our core customers, from needs assessment, raw material procurement, fabrication, and assembly, through delivery and post-installation follow-up. We then identified multiple models for executing these activities, from Virco's near vertical integration to School Specialty's pure retail approach. Hon's model of focused, low-cost manufacturing with diversified retail distribution falls in the center of these models. For each model, the activities and their costs were "stacked up" to yield a net cost of execution, as well as a more hypothetical ranking on a value continuum.

The conclusion of this stackup analysis is that each model has a sweet spot in terms of customers and/or markets, beyond which it becomes less efficient or fails to deliver the precise value required. This is a fancy way of saying that no company and no model can be all things to all customers.

Our expertise is providing bulky, relatively low-priced furniture to customers who have seasonal and/or bid-based purchasing patterns. Our model is ideal for these customers, but not for the core markets served by Hon, KI, or the large retailers. Conversely, their models are imperfect for our market, with its challenging seasonal logistics and unique bidding requirements.

If our activities were perfectly matched to our customers' needs, no more and no less, then in theory we would have a nearly unassailable position. In the real world this never happens,

because drawing our customer base broadly enough to achieve efficiency of scale inevitably adds activities and costs that compromise a pure position. The great challenge in strategic positioning is to balance these competing forces of perfect alignment with efficient market breadth.

Drawing the circle too broadly creates openings for small, highly specialized competitors willing to subsist on a fraction of our market. Drawing it too narrowly deprives us of critical economies, especially in activities where true minimum thresholds exist. Examples include the procurement of raw materials such as steel, wood and plastic; information management systems; and distribution.

Our experience has been that niche competitors will spring up in overextended markets as long as the potential for a 3 - 5% return on sales exists. Conversely, large competitors will often encroach on the boundaries of narrowly drawn markets seeking easy ways to grow. There is no final or best strategic position, but rather an expanding and contracting perimeter around a central core defined by a discrete set of customer needs. The best analogies to these fluctuating competitive relationships come from the biological sciences, which comfortably describe the ebb and flow of plant and animal populations in response to each other and changes in the underlying environment.

So in theory, both large and small companies could hurt us. The large manufacturers and retailers all have sufficient financing to take a run at our market, even if they don't ultimately succeed. Niche manufacturers can whittle away at individual customers or regions and disrupt pricing. But we've been through similar battles in the past with companies such as American Seating and Brunswick, which at the time were industry leaders with more market share than Virco. Those experiences taught us that size alone is not strategy.

We've received non-specific overtures from many potential suitors, including companies within our industry and far outside it. We've never gotten to the point of talking price. We don't see any better alternatives to our operating model, our values, or our track record. Our goal has never been to build up Virco's image so we could cash out. We reiterate that position here: *our model for returning value to shareholders is through regular, low risk compounding of capital, which ultimately gets reflected in share price and returned through dividends.* We don't have to sell the whole company for individual shareholders to realize a profit.

Everybody wants to do deals and relatively few want to run a business. We enjoy the challenge of running Virco. As long as we continue delivering solid returns to our owners, we don't see any advantage to a change in control.

12. "Please explain three issues related to your dividend policy. First, why are you issuing shares via your annual 10% stock dividend and simultaneously buying them back? Second, is the stock dividend related to your negative retained earnings? Third, given that last year's cash dividend payout exceeded 100% of earnings, is your cash dividend in jeopardy?"

[David Yamamoto]

Virco's 10% stock dividend has been the subject of thoughtful discussion, both within the company and among our shareholders. Although it is technically an issuance of shares, it is not an infusion of capital. It's like taking a pizza cutter to a pizza that's already cut: you don't end up with more pizza, just more pieces.

So why do the stock dividend? The simplest answer is that many of our investors like it. We've speculated on the mystery of how it works, given that it somehow seems to reinforce the magic of compounding. Other than reinforcing a buy-and-hold discipline we can't offer any further explanations. However, having discovered a successful method of returning value to shareholders we plan to continue it.

In answer to the second question, stock dividends have resulted in negative retained earnings due to a combination of accounting standards and relatively low profits during the last three years. Because such dividends are so uncommon, the accounting standards governing them haven't been updated since the 1950s. If a stock dividend is greater than 20%, it's treated as a stock split and there's an inconsequential effect on retained earnings. If the dividend is less than 20% (ours is 10%), it's treated as a reclassification from retained earnings to additional paid-in capital.

Over the last twenty years these standards have caused us to reclassify more than $122 million of retained earnings into additional paid-in capital. To break even on retained earnings while continuing our 10% stock dividend, undistributed net income would have to equal 10% of our market cap in any given year. While this might be possible for us at a price/earnings ratio of 10, it's impossible at any higher ratio.

Our cash dividend is not in jeopardy. We have not made extreme cuts to maintain our liquidity and we're not up against any cash flow problems. We fully expect earnings to return to acceptable levels within one or two years, and during the interim we can easily support the cash dividend out of operating cash flow. Our intent remains to gradually increase the cash dividend, not reduce it. The annual 10% stock dividend indirectly does just that by increasing the number of shares over which our quarterly $.02 per share dividend is paid. But we also intend to increase the per-share payout, perhaps within two years.

We still feel that buying back our own stock is one of the best investments we can make. We're confident about the future and that's not inconsistent with the compounding intent of our stock dividend.

We thank all of our owners and our financial partner, Wells Fargo, for their support during this difficult recession. We especially thank our institutional shareholders for their contributions to this year's report. We look forward to seeing as many of you as possible at our annual meeting.

Management's Statement

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

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

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

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

Based on a review and discussions of the Company's 2002 audited consolidated financial statements with management and discussions with the independent auditors, the Audit Committee recommended to the Board of Directors that the Company's 2002 audited consolidated financial statements be included in the Company's annual report on Form 10-K. The Board of Directors concurred.

Management's Discussion and Analysis and Results of Operations

This Management's Discussion and Analysis of Financial Condition and Results of Operations includes a number of forward-looking statements that reflect the Company's current views with respect to future events and financial performance. These forward-looking statements are subject to certain risks and uncertainties, including those discussed herein, in Item 1, and elsewhere in this report on Form 10-K, that could cause actual results to differ materially from historical results or those anticipated. Risks and uncertainties that could cause actual results to vary materially from anticipated results, include without limitation, material availability and cost of materials, especially steel, plastic, fuel and energy; availability and cost of labor, demand for the Company's products, and competitive conditions affecting selling prices and margins, capital costs and general economic conditions. In this report, words such as "anticipates," "believes," "expects," "estimates," "projects," "future," "intends," "plans," "potential," "may," "could" and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Revenue Recognition: Effective February 1, 2000, the Company changed its method of accounting for revenue recognition in accordance with Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements." Under the new accounting method adopted, the Company recognizes all sales when title passes and collectability is reasonably assured under its various shipping terms. In 2002 the Company purchased the assets of Furniture Focus™, a company that sells complete Furniture, Fixture, and Equipment (FF&E) packages to schools. For package orders, the Company records revenue upon completion of the project. The Company reports sales as net of sales returns and allowances.

Allowances for Doubtful Accounts: Considerable judgment is required when assessing the ultimate realization of receivables, including assessing the probability of collection, current economic trends, historical bad debts and the current creditworthiness of each customer. The Company maintains allowances for doubtful accounts that may result from the inability of our customers to make required payments. Over the past five years, the Company's allowance for doubtful accounts has approximately ranged from 0.7% to 1.3% of accounts receivable at year-end. The Company does not typically obtain collateral to secure credit risk. The primary reason that Virco's allowance for doubtful accounts represents such a small percentage of accounts receivable is that a large portion of the accounts receivable are attributable to low-credit-risk governmental entities, giving Virco's receivables a historically high degree of collectability. Over the next year, no significant change is expected in the Company's sales to government entities as a percentage of total revenues.

Inventory Valuation: Inventory is valued at the lower of cost or market. The Company uses the LIFO (last-in, first-out) method of accounting for the material component of inventory. The Company maintains allowances for estimated obsolete inventory to reflect the difference between the cost of inventory and the estimated market value. If market conditions are less favorable than those anticipated by management, additional allowances may be required.

Self-Insured Retention: For 2002, the Company was self-insured for product liability losses up to $250,000 per occurrence and was self-insured for workers compensation losses up to $200,000 per occurrence. For 2001, the Company was self-insured for product liability losses up to $100,000 per occurrence. The Company obtains annual actuarial valuations for the self-insured retentions. Product liability reserves for known and unknown (IBNR) losses are recorded at the net present value of the estimated losses using a 6.0% discount rate. Estimated workers compensation losses are funded during the insurance year and subject to retroactive loss adjustments.

Defined Benefit Obligations: The Company has three defined benefit plans, the Virco Employees Retirement Plan, the Virco Important Performers (VIP) Plan and the Non-Employee Directors Retirement Plan, which provide retirement benefits to employees and outside directors. Virco discounts the pension obligations under the plans using a 6.5% discount rate, 5.0% assumed rate of increases in compensation rates, and estimating an 6.5% return on plan assets. The Company obtains annual actuarial valuations for all three plans. Although the Company does not anticipate any change in these rates in the coming year, any moderate change should not have a significant effect on the Company's financial position, results of operations or cash flows.

Deferred Tax Assets and Liabilities: The Company has not provided an allowance against the deferred tax assets recorded in the financial statements. The Company had a net deferred tax asset of $2,396,000 at January 31, 2003. Management believes that it is more likely than not that future earnings will be sufficient to recover deferred tax assets.

RESULTS OF OPERATIONS (2002 VS. 2001)

Industry Outlook

The commercial furniture markets have suffered from the worst recorded recession in recent history during the past two years. As a group, the members of BIFMA (the Business and Institutional Furniture Manufacturer's Association) recorded a 19.1% decrease in shipments in calendar year 2002. This followed a 17.4% decrease in calendar year 2001. This compares to declines at Virco of 5.1% in 2002 and 10.4% in 2001. To date, it appears that the Company's core public school customers have been less affected by the recession. The outlook for 2003 suggests that the market for furniture will not improve in the short term. The unfortunate combination of a lethargic economy combined with political uncertainty is now being joined by significant budget challenges for many state and local governments. Most states collected less revenue in the 2002-2003 fiscal year than budgeted and many states have announced that they plan to reduce their budgets in the current fiscal year. As a large portion of many states' budgets may be used to fund education, it is anticipated that reduced state budgets may result in a decrease in sales of replacement furniture in fiscal 2003. Despite decreased budgets, many of these same states are passing bonds to finance school construction, which may result in an offsetting increase in sales of furniture. It is unclear how the net effect of budgetary deficits and bond-funded projects in states in which the Company sells its products will impact furniture sales in the 2003 fiscal year.

During this two year period, many furniture manufacturers have responded by shutting down significant portions of their manufacturing capacity and laying off thousands of workers, incurring large restructuring charges in the process. Virco has been servicing the education market for over 50 years, and has experienced many business cycles affecting the demand for education furniture. The Company believes that in the long term, demographics underlying the furniture industry will reward companies that survive the current downturn in sales. As such, Virco has responded to the current environment with a different approach, one that has preserved the Company's manufacturing and distribution infrastructure and saved the jobs of Virco's trained workforce. The Company has used a variety of tactics to reduce spending. Capital spending has been curtailed dramatically. Capital expenditures were reduced to approximately one quarter of depreciation expense in 2002 and one third of depreciation expense in 2001. The Company has embraced the Assemble-to-Ship (ATS) operating model, which facilitated a large reduction in inventory levels in 2001, and improved levels of customer service while maintaining reduced levels of inventory in 2002. To control and reduce the cost of Virco's workforce, the Company has used traditional measures such as wage freezes and hiring freezes, as well as more creative measures that address the unique demands of a highly seasonal business. The more creative measures include programs to encourage workforce flexibility and in 2002 the Company introduced a sabbatical program for employees during the traditionally slow fourth quarter.

Overview

For the year ended January 31, 2003, the Company earned a modest net income of $282,000 on net sales of $244,355,000 compared to a net income of $246,000 on net sales of $257,462,000 in the same period last year. Earnings were $0.02 per share for the year ended January 31, 2003, compared to $0.02 in the last year, after giving effect to the 10% stock dividend declared August 20, 2002. Cash flow from operations was $12,045,000 compared to $35,037,000 in the prior year. The reduction in cash flow from operations is primarily attributable to fluctuations in inventory levels. In the current year inventory increased by $4,356,000 compared to the prior year, when the large scale introduction of Assemble-to-Ship (ATS) facilitated a reduction in inventory of $19,356,000, a $23,712,000 change.

Management's Discussion and Analysis and Results of Operations

Sales

Virco's 2002 sales decreased by 5% in 2002 to $244,355,000, from $257,462,000 in 2001. During 2002, the Company adhered to a policy of turning down low margin and unprofitable business, despite substantial price competition in its primary markets. The Company continued to emphasize the value of Virco's products, the value of Virco's distribution and delivery capabilities, and the value of timely deliveries during the peak seasonal delivery period. Although this policy had an adverse effect on unit volume, the Company achieved a net increase in selling prices.

Effective May 1, 2002, Virco acquired certain assets of Furniture Focus, a reseller that offers complete package solutions for the Furniture, Fixtures and Equipment (FF&E) segments of bond-funded public school construction projects. This acquisition provided Virco with the ability to offer packages to its core customer base. Because the acquisition date was very close to the peak summer season, the marketing of package solutions or "PlanScape™" was limited to the five state region in which Furniture Focus has operated. Virco intends to begin marketing package solutions nationwide in 2003.

Cost of Sales

For fiscal 2002, cost of sales was 69% of sales compared to 70% of sales in the prior year. The improvement was primarily attributable to increases in selling prices. Raw material costs increased, primarily due to increased steel prices. Increased material costs were offset by reductions in labor and overhead spending. Virco began 2002 with a plan to maintain reduced levels of inventory and to use the Assemble-to-Ship (ATS) model to provide acceptable levels of service to our customers. In an effort to match spending to the continued low levels of output, Virco controlled headcount, capital expenditures, and other discretionary spending. As a result, manufacturing spending and production levels were flat compared to the prior year.

Inflation rates had a moderate impact on the Company's cost of sales for the first half of 2002. In the second half of 2002, the Company experienced significant increases in the cost of steel. On March 5, 2002, President Bush announced that he would impose, effective March 20th, tariffs of up to 30% on imports of selected steel products pursuant to Section 201 of the Trade Act of 1974. The duties were imposed for a three-year period and are to be progressively reduced each year as required by the World Trade Organization. Cold-rolled steel is the single largest raw material used by many in the educational furniture industry, including Virco, and is subject to the maximum 30% tariff. In addition, domestic steel manufacturers filed a dumping claim against certain international suppliers, which, if successful, could serve to prevent steel prices from falling in the future.

In 2003, the Company intends to more tightly integrate the ATS model with our marketing programs, product development programs, and product-stocking plan. This anticipated improvement in execution of ATS should allow the Company to offer a greater variety of product while continuing to improve on-time delivery performance. The ATS model should allow the Company to build inventory earlier in the year and reduce costly overtime and temporary labor costs during the summer. Production levels, which will vary depending upon selling volumes, are anticipated to be slightly lower than in 2002.

The Company anticipates continued upward pressure on costs, particularly in the areas of certain raw materials, transportation, energy, and benefits in the coming year and others. For more information, please see the section entitled "Inflation and Future Change in Prices" in the Management's Discussion and Analysis section contained in Virco's Annual Report to Shareholder for the year ended January 31, 2003.

Selling, General and Administrative and Others

Selling, general and administrative expenses for the year ended January 31, 2003, increased 1% from the prior year, and were 29.7% as a percentage of sales in 2002 as compared to 27.9% in 2001. Freight costs declined by approximately $500,000 due to a reduction in selling volume, and were slightly higher as a percentage of sales. Other SG&A costs were adversely affected by increased installation costs reflecting an increase in installed orders, the acquisition of Furniture Focus, and an increase in retirement plan costs, offset by other reductions in selling and administrative expenses.

Interest expense was approximately $1,100,000 less than in the prior year due to reduced levels of borrowing and lower interest rates. The Company anticipates a modest reduction in average borrowing levels and a reduction in the average interest rate paid in 2003. The Company entered into a swap agreement with Wells Fargo Bank, which had the effect of establishing a fixed rate of interest for $20,000,000 of loans for both 2001 and 2002. This interest swap expired in March 2003. Interest rates paid under the swap agreement were greater than the current rate paid under the Wells Fargo line of credit.

In the current year, Virco realized a $149,000 loss on disposition of fixed assets. This compares to a loss on sale of assets of approximately $86,000 in the prior year.

RESULTS OF OPERATIONS (2001 VS. 2000)

Overview

For the year ended January 31, 2002, the Company had a modest net income of $246,000 on net sales of $257,462,000 compared to a net income of $4,016,000 on net sales of $287,342,000 in the same period for fiscal 2000. Fiscal 2000 results included a pre-tax gain of $7,945,000 on the sale of real estate and other income of $4,052,000 related to the settlement of a dispute. The settlement was a non-recurring payment unrelated to the Company's ongoing operations. Earnings were $0.02 per share for the year ended January 31, 2002, compared to $0.29 in the same period last year, after giving effect to the 10% stock dividends declared August 20, 2002 and August 21, 2001. For 2001, furniture operations provided net income of $246,000 on net sales of $257,462,000. This compares to a loss on furniture operations of $3,391,000 (which excludes the one-time items mentioned above) on substantially higher sales of $287,342,000 in fiscal 2000. In addition, cash flow from operations reached a historical high of $35,037,000, due largely to a $19,356,000 reduction in inventories made possible by our Assemble-to-Ship program and the decrease in net sales due to the lingering effects of a decline in the commercial furniture market.

Sales

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

As a group, the members of BIFMA (the Business and Institutional Manufacturer's Association) reported a sales decline of 17.4% for calendar 2001, with an even more dramatic 29.2% decline in the fourth quarter. This compares with only a 10.4% decline at Virco. The Company's core public school customers were less affected by the overall recession. Sales to public schools declined modestly during 2001. Commercial sales were substantially less than the prior year, more closely reflecting the statistical results recorded by BIFMA.

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

Cost of Sales

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

Inflation rates did not have a significant net impact on the Company's cost of sales in 2001. Material costs decreased, offset by increased costs for certain utilities and employee benefits.

Selling, General and Administrative and Others

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

Interest expense was approximately $400,000 less in fiscal 2001 than in fiscal 2000 due to reduced levels of borrowing and lower interest rates. The Company expected to continue to reduce borrowing levels in 2002. The Company entered into a swap agreement with Wells Fargo Bank, which has the effect of establishing a fixed rate of interest for $20,000,000 of loans for both 2001 and 2002. The balance of borrowing is based upon LIBOR, and fluctuated with the market rate of interest.

In fiscal 2001, Virco realized an $86,000 loss on disposition of fixed assets. This compares to a gain on sale of assets of approximately $7,667,000 in the prior year, and a prior year pre-tax gain of $4,052,000 on a settlement.

LIQUIDITY AND CAPITAL RESOURCES

Working Capital Requirements

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

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

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

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

As the capital required for this summer season generally exceeds cash available from operations, Virco has historically relied on third party bank financing to meet seasonal cash flow requirements. Virco has established a long-term relationship with its primary lender, Wells Fargo Bank. On an annual basis, the Company prepares a forecast of seasonal working capital requirements, and renews its revolving line of credit. For the next fiscal year, Virco has entered into a revolving credit facility with Wells Fargo Bank, amended and restated February 2003, but effective at January 31, 2003, which provides a secured revolving line of credit that varies from $40,000,000 to $70,000,000. This credit facility is intentionally structured to provide additional working capital during the Company's traditional peak period. At September 1, 2003, the available commitment reduces to $60,000,000, and at November 1, 2003, the line reduces to $40,000,000. This is a two-year non-amortizing line with interest payable monthly at a fluctuating rate equal to the Bank's prime rate plus a fluctuating margin of 0.25% to 0.50% (4.75% at January 31, 2003).

The line also allows the Company the option to borrow under 30- 60- and 90-day fixed term rates at LIBOR plus a fluctuating margin of 1.50% to 2.50%. Approximately $13,345,000 was available for borrowing as of January 31, 2003.

Long-Term Capital Requirements

In addition to short-term liquidity considerations, the Company continually evaluates long-term capital requirements. In 1997, the Company initiated two large capital projects, which have had significant effects on cash flow for the past five years. In the 1998, 1999, and 2000 fiscal years the Company expended significant amounts of capital on these projects. Upon completion of these projects, the Company dramatically reduced capital spending. As shown in the Company's consolidated statements of cash flows, during 2001, capital expenditures were approximately one third of depreciation expense and during 2002, capital expenditures were approximately one quarter of depreciation expense.

The first project was the implementation of the SAP enterprise resources planning system, initiated in October 1997. The Company went live with the new system in March 1999, implemented a business-to-business website along with sales force automation in the first quarter of 2000, and upgraded to the most current version of SAP in the fourth quarter of 2000. The initial portion of this project was financed with a lease from General Electric Capital Corporation (GECC). Capital and training costs not funded by the lease were financed from cash flows from operations and from the loan facility from Wells Fargo. During fiscal year 2002 the Company paid off the balance on the capital lease.

The second project was the expansion and re-configuration of the Conway, Arkansas, manufacturing and distribution facility. During 1997, 1998, 1999, and 2000 the Company expended approximately $67,000,000 to purchase 100 acres of land, and build a 1,200,000 sq. ft. manufacturing and distribution facility equipped with new manufacturing and warehousing equipment. To finance this project, the Company borrowed $30,000,000 from Wells Fargo Bank that was scheduled to be repaid in three annual $10,000,000 installments, the first of which was paid on January 31, 2001; moreover, as explained below, the Company paid off the entire balance of this loan prior to January 31, 2002. In addition to the loan from Wells Fargo, the Company obtained equipment with operating leases from GE Capital, and used operating cash flow. As phases of the Conway expansion were completed, the Company was able to vacate several leased warehouses, sell a small production facility, and convert a second production facility into a warehouse. In addition, Virco sold a warehouse located in Torrance, California, which had been held as rental property.

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

Upon the completion of these substantial capital projects, the Company significantly reduced capital spending in 2002 and 2001. Management intends to limit future capital spending until growth in sales volume fully utilizes the new plant and distribution capacity. The Company has established a goal of limiting capital spending to between $5,000,000 to $7,000,000 for 2003, which is approximately one-half of anticipated depreciation expense.

The Company is currently marketing two properties for sale or lease, which have a cumulative estimated market value of approximately $8,000,000. One of these properties, a former production facility in Conway, Arkansas, is currently being utilized as a finished goods warehouse. A second property, located in Los Angeles, California, is currently leased to a third party.

Asset Impairment

In 2002, Virco acquired certain assets of Furniture Focus. As part of this acquisition, the Company recorded goodwill of $2,200,000. For 2003, the Company is rolling out the Furniture Focus package business throughout its nationwide sales force. Virco evaluates the impairment of goodwill at least annually, or when indicators of impairment occur. As of the year ended January 31, 2003, there has been no impairment to the goodwill recorded.

Virco made substantial investments in its infrastructure in 1998, 1999, and 2000. The investments included a new factory, new warehouse, and new production and distribution equipment. The factory, warehouse, and equipment acquired are used to produce, store, and ship a variety of product lines, and the use of any one piece of equipment is not dependent on the success or volume of any individual product. New products are designed to use as many common or existing components as practical. As a result, both our ATS inventory components and the machines used to produce them become more versatile. Virco evaluates the potential for impaired assets on a quarterly basis. As of the year ended January 31, 2003, there has been no impairment to the long-term assets of the corporation.

Contractual Obligations and Off Balance Sheet Arrangements

The Company leases manufacturing, transportation, and office equipment, as well as real estate under a variety of operating leases. The Company leases substantially all vehicles, including trucks and passenger cars under operating leases where the lessor provides fleet management services for the Company. The fleet management services provide Virco with operating efficiencies relating to the acquisition, administration, and operation of leased vehicles. The use of operating leases for manufacturing equipment has enabled the Company to qualify for and use Industrial Revenue Bond financing. Real estate leases have been used where the Company did not want to make a long-term commitment to a location, or when economic conditions favored leasing. The Company does not have any capital lease obligations or purchase commitments in excess of normal recurring obligations.

In thousands	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt Obligations	$ 28,992	$ 1,087	$ 27,905	$ 0	$ 0
Capital Lease Obligations	0	0	0	0	0
Operating Lease Obligations	26,000	8,946	11,899	4,651	504
Purchase Obligations	0	0	0	0	0
Other Long-Term Obligations	0	0	0	0	0
Total	$ 54,992	$ 10,033	$ 39,804	$ 4,651	$ 504

Virco's largest market is publicly funded school districts. A significant portion of this business is awarded on a bid basis. Many school districts require that a bid bond be posted as part of the bid package. In addition to bid bonds, many districts require a performance bond when the bid is awarded. At January 31, 2003, the Company had bonds outstanding valued at approximately $6,850,000. To the best of management's knowledge, in over 50 years of selling to schools, Virco has never had a bid or performance bond called.

The Company accrues an estimate of its exposure to warranty claims based upon both product sales data and warranty claims incurred. For 2002, warranty claims were higher than normal due to a recurring cosmetic complaint relating to a high volume component. At the current time, management cannot reasonably determine whether the warranty claims for the upcoming fiscal year will be less than, equal to, or greater than the warranty claims incurred in 2002. The following is a summary of the Company's warranty-claim activity during 2002.

Balance at January 31,2002	Provision	Costs Incurred	Balance at January 31, 2003
$ 150,000	$ 2,091,000	($ 1,341,000)	$ 900,000

Retirement Obligations

The Company provides retirement benefits to employees and non-employee directors under three defined benefit retirement plans; the Virco Employee's Retirement Plan, the Virco Important Performers (VIP) Retirement Plan, and the Retirement Plan for Non-Employee Directors. The Virco Employee Retirement Plan is a qualified retirement plan that is funded through a trust held at Wells Fargo Bank (Trustee). The other two plans are non-qualified retirement plans. The VIP Plan is secured by life insurance policies held in a rabbi trust and the plan for Non-Employee Directors is not funded. In 2002 the Company used more conservative assumptions for estimating the return on plan assets held in the Wells Fargo Trust (Trust) and the rate used to discount the Projected Benefit Obligation (PBO). For 2002 the Company used a 6.5% expected return on plan assets, a 5.0% expected rate of increase in compensation, and a 6.5% discount rate. The result of using these more conservative estimates was to increase annual pension expense for the fiscal year ended January 31, 2003, by approximately $1.5 million and to increase the PBO by approximately $6 million. The Company expects that it will continue to incur the higher annual pension expense through the foreseeable future. The combined impact of reduced discount rates and poor investment results over the past three years resulted in the plan being under-funded. To correct this condition, the Company made an $8 million contribution to the Trust in September 2002, and a total contribution of approximately $10 million for the fiscal year. The Company does not anticipate that it will need to make a similar large contribution in the future, and that annual funding will more closely approximate annual pension expense. The Company does not anticipate making any changes to the pension assumptions in the near future. If the Company were to have used different assumptions in fiscal year ended January 31, 2003, a 1% reduction in investment return would increase expense by approximately $125,000, a 1% change in the rate of compensation increase would increase expense by approximately $355,000 and a 1% reduction in the discount rate would increase expense by $1,240,000. A 1% reduction in the discount rate would increase the PBO by approximately $7.5 million. Refer to note 4 of the financial statements for additional information regarding the pension plans and related expenses.

Shareholders' Equity

In April 1998, the Board of Directors approved a stock buy-back program giving authorization to buy back up to $5,000,000 of Company stock. The authorization of this stock buy-back program was increased to $7,000,000, $14,000,000, $20,000,000 and $22,000,000 in January 1999, April 1999, December 2001 and December 2002, respectively. As of the end of January 2003 and 2002, the Company had repurchased approximately 1,383,000 and 884,000 shares at a cost of approximately $18,151,000 and $13,505,000 respectively. The Company intends to continue buying back shares of Virco common stock as long as the Company believes the shares are undervalued and either operating cash flow or borrowing capacity under the Wells Fargo Bank line is available.

Virco has established a track record of paying cash dividends to its stockholders for more than 20 consecutive years. The Company paid an annual cash dividend from 1983 through 1996. In 1996 the Company converted from one annual cash dividend to paying quarterly cash dividends. When combined with the effect of our annual stock dividend, Virco has a track record of 20 consecutive years of increasing cash dividends. Virco evaluates its dividend policy on a quarterly basis, and there can be no assurance that past dividend practices will be indicative of future practices. If the Company maintains its current dividend policy, it will pay cash dividends approximating $1.2 million in 2003.

In addition to the quarterly cash dividend policy, Virco has issued a 10% stock dividend or 3/2 stock split every year beginning in 1982. Although the stock dividend has no cash consequences to the Company, the accounting methodology required for 10% dividends has affected the equity section of the balance sheet. When the Company records a 10% stock dividend, 10% of the market capitalization of the Company on the date of the declaration is reclassified from retained earnings to additional paid in capital. During the period from 1982 through 2002, the cumulative effect of the stock dividends has been to reclassify over $122 million from retained earnings to additional paid in capital. The equity section of the balance sheet on January 31, 2003, reflects additional paid in capital of approximately $126 million and deficit retained earnings of approximately $19 million. The retained deficit is a result of the accounting reclassification, and is not the result of accumulated losses.

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

ENVIRONMENTAL AND CONTINGENT LIABILITIES

The Company and other furniture manufacturers are subject to federal, state, and local laws and regulations relating to the discharge of materials into the environment and the generation, handling, storage, transportation, and disposal of waste and hazardous materials. In addition to policies and programs designed to comply with environmental laws and regulations, Virco has enacted programs for recycling and resource recovery that have earned repeated commendations, including designation in 2002 as a WasteWise Partner of the Year and 2001 as a WasteWise Program

Champion for Large Businesses by the United States Environmental Protection Agency. Despite these significant accomplishments, environmental laws have changed rapidly in recent years, and Virco may be subject to more stringent environmental laws in the future. The Company has expended, and expects to continue to expend, significant amounts in the future for the investigation of environmental conditions, installation of environmental control equipment, and remediation of environmental contamination.

In 2002, the Company was self-insured for Product Liability losses up to $250,000 per occurrence and had a Workers Compensation deductible of $200,000 per occurrence. For the insurance year beginning April 1, 2003, the Company is self-insured for Product Liability losses up to $500,000 per occurrence and has a Workers Compensation deductible of $250,000 per occurrence, and a deductible of $50,000 for auto liability. In prior years the Company has been self-insured for Workers Compensation, Automobile, Product, and General Liability losses. The Company has purchased insurance to cover losses in excess of the self-insured retention or deductible up to a limit of $30,000,000. During the past 10 years the Company has aggressively pursued a program to improve product quality, reduce product liability claims and losses, and to more aggressively litigate product liability cases. This program has continued through 2002 and has resulted in reductions in product liability claims and litigated product liability cases. In addition, the Company has active safety programs to improve plant safety and reduce Workers Compensation losses. Management does not anticipate that any related settlement, after consideration of the existing reserves for claims and potential insurance recovery, would have a material adverse effect on the Company's financial position, results of operations, or cash flows.

INFLATION AND FUTURE CHANGE IN PRICES

Inflation rates had a modest impact on the Company's operating costs for the first half of 2002. In the second half of 2002, the Company experienced significant increases in the cost of steel. Please refer to the discussion of steel tariffs under the "Results of Operation" for 2002 section of this MD&A for additional information. In addition, the Company incurred increases in utilities costs in California, and increases in employee benefits, especially medical insurance.

For 2003, the Company anticipates upward pressure on costs, particularly in the areas of certain raw materials, transportation, energy and employee benefits. Although the increase in steel prices appears to have stabilized in 2003, prices have not returned to the lower levels of early 2002. There is pressure on raw material costs that are affected by the price of oil, especially plastics. Transportation costs are also expected to be adversely affected by increased oil prices, in the form of increased operation costs for our fleet, and surcharges on freight paid to third party carriers. For 2003, the Company has mitigated the increased costs of employee benefits, primarily by passing on a greater portion of medical costs to our employees.

To counter the impact of increased costs, the Company has raised the list prices for our product. As a significant portion of our business is through competitive bids, the Company is carefully considering the increased material cost in addition to increased transportation costs as part of the bidding process. Total material costs for 2003, as a percentage of sales, could be higher than in 2002. However, no assurance can be given that the Company will experience stable, modest or substantial increases in prices in 2003. The Company is working to control and reduce costs by improving production and distribution methodologies, investigating new packaging and shipping materials, and searching for new sources of purchased components and raw materials.

The Company uses the LIFO method of accounting for the material component of inventory. Under this method, the cost of products sold as reported in the financial statements approximates current cost, and reduces the distortion in reported income due to increasing costs. Depreciation expense represents an allocation of historic acquisition costs and is less than if based on the current cost of productive capacity consumed. In 2002 and 2001, the Company significantly reduced its expenditures for capital assets, but in the prior three fiscal years (1998, 1999, and 2000) the Company made the significant fixed asset acquisitions described above. The assets acquired result in higher depreciation charges, but due to technological advances should result in operating cost savings and improved product quality. In addition, some depreciation charges will be offset by a reduction in lease expense.

The Company is also subject to interest rate risk related to its $26,655,000 of borrowings as of January 31, 2003, and any seasonal borrowings used to finance additional inventory and receivables. Fluctuating interest rates may adversely affect the Company's results of operations and cash flows related to its variable rate bank borrowings. Accordingly, a 100 basis point upward fluctuation in the lender's base rate would cause the Company to incur additional interest charges of approximately $331,000 for the twelve months ended January 31, 2003. The Company would have benefited from a similar interest savings if the base rate were to have fluctuated downward by a like amount.

In February 2000, the Company entered into an interest rate swap agreement with Wells Fargo Bank to reduce exposure due to changes in interest rates. The initial notional swap amount is $30,000,000 for the period February 22, 2000, through February 28, 2001. The notional swap amount then decreased to $20,000,000 until the end of the swap agreement on March 3, 2003. Under this agreement, interest is payable monthly at 7.23% plus a fluctuating margin of 1.50% to 2.50%. At January 31, 2003, the carrying value approximated the fair value of $196,000. During the year ended January 31, 2003, the Company recorded a reduction of $544,000 (net of an applicable income tax of $363,000) in other comprehensive loss in order to account for the change in fair value. The fair value of the swap is estimated on pricing models using current assumptions.

FINANCIAL STRATEGY

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

ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, and requires such obligations and costs to be recognized at fair value in the period in which they are incurred. The Company will adopt SFAS No. 143 as of February 1, 2003, and does not expect any material effect upon the adoption of the Statement on the Company's financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 requires most gains and losses on extinguishment of debt to be classified as income or loss from continuing operations rather than as extraordinary items as previously required. SFAS No. 145 also amends SFAS No. 13 to require certain lease modifications to be treated as sales-leaseback transactions. Certain provisions of SFAS No. 145 are effective for transactions occurring after May 15, 2002, while other provisions are effective for fiscal years beginning after May 15, 2002. The adoption of SFAS No. 145 has not had a material effect on the Company's results of operations or financial condition.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which requires the recognition of costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect a material effect on its results of operations or financial condition as a result of the adoption of SFAS No. 146.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which elaborates on required disclosures by a guarantor in its financial statements about obligations under certain guarantees that it has issued and clarifies the need for a guarantor to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of the Interpretation, which are effective for the Company's year ended January 31, 2003, are included in note 9 to the consolidated financial statements, which discuss disclosures relative to its product warranty liability.

Five Year Summary of Selected Financial Data

In thousands except per share data	**2002**	2001	2000	1999	1998
Summary of Operations					
Net sales (4)(5)	**$ 244,355**	$ 257,462	$ 287,342	$ 268,079	$ 275,096
Net income before cumulative effect of change in accounting principle	**$ 282**	$ 246	$ 4,313	$ 10,166	$ 17,630
Cumulative effect of change in accounting principle, net of $191 tax benefit (5)	**–**	–	(297)	–	–
Net income	**$ 282**	$ 246	$ 4,016	$ 10,166	$ 17,630
Per share data					
Income before cumulative effect of change in accounting principle (1)					
Basic	**$ 0.02**	$ 0.02	$ 0.31	$ 0.74	$ 1.22
Assuming dilution	**0.02**	0.02	0.31	0.72	1.20
Cumulative effect of change in accounting principle (1)					
Basic	**–**	–	(0.02)	–	–
Assuming dilution	**–**	–	(0.02)	–	–
Net income (1)					
Basic	**0.02**	0.02	0.29	0.74	1.22
Assuming dilution	**0.02**	0.02	0.29	0.72	1.20
Pro forma amounts assuming the accounting change is applied retroactively					
Net income (5)	**$ 282**	$ 246	$ 4,313	$ 10,186	$ 17,663
Per share data					
Net income					
Basic	**0.02**	0.02	0.31	0.73	1.23
Assuming dilution	**0.02**	0.02	0.31	0.72	1.20
Dividends declared per share, adjusted for 10% stock dividend					
Cash dividends	**$ 0.08**	$ 0.07	$ 0.06	$ 0.06	$ 0.05
Other Financial Data					
Total assets	**$ 154,796**	$ 161,372	$ 199,549	$ 190,863	$ 151,380
Working capital	**$ 38,748**	$ 34,464	$ 43,173	$ 51,423	$ 47,405
Current ratio	**2.4/1**	2.2/1	1.9/1	2.3/1	2.4/1
Total long-term obligations	**$ 44,604**	$ 40,853	$ 55,075	$ 53,995	$ 25,690
Stockholders' equity	**$ 82,774**	$ 90,223	$ 94,141	$ 93,834	$ 88,923
Shares outstanding at year-end (3)	**13,111**	13,445	13,652	13,750	14,119
Stockholders' equity per share (2)	**$ 6.31**	$ 6.71	$ 6.90	$ 6.82	$ 6.30

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

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

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

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

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

Report of Independent Auditors

The Board of Directors and Stockholders
Virco Mfg. Corporation

We have audited the accompanying consolidated balance sheets of Virco Mfg. Corporation as of January 31, 2003 and 2002, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended January 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Virco Mfg. Corporation at January 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 31, 2003, in conformity with accounting principles generally accepted in the United States.

Long Beach, California
March 14, 2003

Consolidated Balance Sheets

In thousands, except per share data	January 31 2003	 2002
Assets		
Current assets:		
Cash	**$ 1,639**	$ 1,704
Trade accounts receivable (less allowance for doubtful accounts of $225 in 2002 and $200 in 2001)	**17,178**	19,251
Other receivables	**223**	175
Inventories:		
Finished goods	**16,510**	16,159
Work in process	**18,233**	12,322
Raw materials and supplies	**8,296**	10,202
	43,039	38,683
Prepaid expenses and other current assets	**1,495**	935
Deferred income taxes	**2,494**	1,711
Total current assets	**66,068**	62,459
Property, plant and equipment:		
Land and land improvements	**3,626**	3,548
Buildings and building improvements	**50,311**	50,245
Machinery and equipment	**101,648**	100,999
Leasehold improvements	**1,278**	1,375
	156,863	156,167
Less accumulated depreciation and amortization	**83,827**	72,761
Net property, plant and equipment	**73,036**	83,406
Other assets	**15,692**	15,507
Total assets	**$ 154,796**	$ 161,372

Consolidated Balance Sheets (continued)

In thousands, except per share data	January 31 2003	2002
Liabilities and stockholders' equity		
Current liabilities:		
Checks released but not yet cleared bank	**$ 2,506**	$ 2,930
Accounts payable	**8,395**	8,816
Income tax payable	**3,538**	1,282
Accrued compensation and employee benefits	**7,109**	8,602
Current portion of long-term debt	**1,087**	2,061
Other accrued liabilities	**4,685**	4,304
Total current liabilities	**27,320**	27,995
Noncurrent liabilities:		
Accrued self-insurance retention	**2,936**	2,777
Accrued pension expenses	**13,763**	11,429
Long-term debt, less current portion	**27,905**	26,647
Total noncurrent liabilities	**44,604**	40,853
Deferred income taxes	**98**	2,301
Commitments and contingencies		
Stockholders' equity:		
Preferred stock:		
Authorized 3,000,000 shares, $.01 par value; none issued or outstanding	**–**	–
Common stock:		
Authorized 25,000,000 shares, $.01 par value; issued 14,527,074 shares in 2003 and 13,167,399 shares in 2002	**145**	132
Additional paid-in capital	**126,284**	109,638
Retained deficit	**(18,927)**	(2,006)
Less treasury stock at cost (1,416,472 shares in 2003 and 944,352 shares in 2002)	**(18,634)**	(13,975)
Less accumulated comprehensive loss	**(6,094)**	(3,566)
Total stockholders' equity	**82,774**	90,223
Total liabilities and stockholders' equity	**$ 154,796**	$ 161,372

See accompanying notes.

Consolidated Statements of Income

In thousands, except per share data	Year ended January 31 2003	2002	2001
Net sales	**$ 244,355**	$ 257,462	$ 287,342
Costs of goods sold	**167,570**	180,275	203,765
Gross profit	**76,785**	77,187	83,577
Selling, general and administrative expenses	**72,536**	71,816	83,192
Provision for doubtful accounts	**267**	288	156
Interest expense	**3,410**	4,561	4,962
Loss (Gain) on sale of assets	**149**	86	(7,667)
Other income	**–**	–	(4,052)
Income before income taxes and cumulative effect of change in accounting principle	**423**	436	6,986
Provision for income taxes	**141**	190	2,673
Income before cumulative effect of change in accounting principle	**282**	246	4,313
Cumulative effect of change in accounting principle	**–**	–	(297)
Net income	**$ 282**	$ 246	$ 4,016
Amounts per common share - basic			
Income before cumulative effect of change in accounting principle	**$ 0.02**	$ 0.02	$ 0.31
Cumulative effect of change in accounting principle	**–**	–	(0.02)
Net income	**$ 0.02**	$ 0.02	$ 0.29
Amounts per common share - assuming dilution			
Income before cumulative effect of change in accounting principle	**$ 0.02**	$ 0.02	$ 0.31
Cumulative effect of change in accounting principle	**–**	–	(0.02)
Net income	**$ 0.02**	$ 0.02	$ 0.29
Weighted average shares outstanding:			
- basic	**13,344**	13,485	13,747
- assuming dilution	**13,458**	13,675	13,885

See accompanying notes.

Consolidated Statements of Stockholders' Equity

In thousands, except per share data	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Deficit)	Comprehensive Income (Loss)	Treasury Stock	ESOP Trust	Accumulated Comprehensive Loss	Total
Balance at January 31, 2000	10,330,476	$ 110	$ 84,635	$ 20,242	$ –	$ (10,692)	$ (41)	$ (420)	$ 93,834
Net income	–	–	–	4,016	4,016	–	–	–	4,016
Minimum pension liability, net of tax	–	–	–	–	(1,155)	–	–	(1,155)	(1,155)
Comprehensive income	–	–	–	–	2,861	–	–	–	–
Unearned ESOP shares	–	–	–	–	–	–	(655)	–	(655)
Stock issued under option plans	49,783	–	284	–	–	–	–	–	284
Stock dividend (10%)	1,030,100	10	12,737	(12,747)	–	–	–	–	–
Cash dividends	–	–	–	(866)	–	–	–	–	(866)
Purchase of treasury stock	(127,372)	–	–	–	–	(1,317)	–	–	(1,317)
Balance at January 31, 2001	11,282,987	120	97,656	10,645	–	(12,009)	(696)	(1,575)	94,141
Net income	–	–	–	246	246	–	–	–	246
Minimum pension liability, net of tax	–	–	–	–	(1,329)	–	–	(1,329)	(1,329)
Derivative instrument, net of tax	–	–	–	–	(662)	–	–	(662)	(662)
Comprehensive loss, net of tax	–	–	–	–	(1,745)	–	–	–	–
Unearned ESOP shares	–	–	–	–	–	–	696	–	696
Stock issued under option plans	13,847	–	30	–	–	–	–	–	30
Stock dividend (10%)	1,120,268	12	11,952	(11,952)	–	–	–	–	12
Cash dividends	–	–	–	(945)	–	–	–	–	(945)
Purchase of treasury stock	(194,055)	–	–	–	–	(1,966)	–	–	(1,966)
Balance at January 31, 2002	12,223,047	132	109,638	(2,006)	–	(13,975)	–	(3,566)	90,223
Net income	–	–	–	**282**	**282**	–	–	–	**282**
Minimum pension liability, net of tax	–	–	–	–	**(3,072)**	–	–	**(3,072)**	**(3,072)**
Derivative Instrument, net of tax	–	–	–	–	**544**	–	–	**544**	**544**
Comprehensive loss, net of tax	–	–	–	–	**(2,246)**	–	–	–	–
Stock issued under option plans	**147,004**	**1**	**469**	–	–	–	–	–	**470**
Stock dividend (10%)	**1,212,671**	**12**	**16,177**	**(16,189)**	–	–	–	–	–
Cash dividends	–	–	–	**(1,014)**	–	–	–	–	**(1,014)**
Purchase of treasury stock	**(472,120)**	–	–	–	–	**(4,659)**	–	–	**(4,659)**
Balance at January 31, 2003	**13,110,602**	**$ 145**	**$ 126,284**	**$ (18,927)**	**$ –**	**$ (18,634)**	**$ –**	**$ (6,094)**	**$ 82,774**

See accompanying notes.

Consolidated Statements of Cash Flows

In thousands, except per share data	Year ended January 31 **2003**	 2002	 2001
Operating activities			
Net income	**$ 282**	$ 246	$ 4,016
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of accounting change	**–**	–	297
Depreciation and amortization	**13,659**	15,813	13,412
Provision for doubtful accounts	**267**	288	156
Loss (Gain) on sale of property, plant and equipment	**149**	86	(7,667)
Deferred income taxes	**555**	(1,722)	(407)
Changes in assets and liabilities:			
Trade accounts receivable	**4,156**	5,020	1,742
Other receivables	**(48)**	411	341
Inventories	**(4,356)**	19,356	(981)
Income taxes	**2,256**	3,790	(755)
Prepaid expenses and other current assets	**(560)**	215	138
Accounts payable and accrued liabilities	**(4,443)**	(8,230)	560
Other	**128**	(236)	(4,383)
Net cash provided by operating activities	**12,045**	35,037	6,469
Investing activities			
Capital expenditures	**(3,532)**	(5,229)	(22,711)
Proceeds from sale of property, plant and equipment	**93**	570	10,258
Net investment in life insurance	**(109)**	1,385	–
Aquisition of business	**(4,550)**	–	–
Net cash used in investing activities	**(8,098)**	(3,274)	(12,453)
Financing activities			
Dividends paid	**(1,014)**	(945)	(866)
Issuance of long-term debt	**4,240**	–	19,817
Repayment of long-term debt	**(3,049)**	(28,237)	(12,000)
Proceeds from issuance of common stock	**178**	30	284
Purchase of treasury stock	**(4,367)**	(1,954)	(1,317)
ESOP loan	**–**	696	(655)
Net cash (used in) provided by financing activities	**(4,012)**	(30,410)	5,263
Net increase (decrease) in cash	**(65)**	1,353	(721)
Cash at beginning of year	**1,704**	351	1,072
Cash at end of year	**$ 1,639**	$ 1,704	$ 351
Supplemental disclosures of cash flow information			
Cash paid (received) during the year for:			
Interest, net of amounts capitalized	**$ 3,513**	$ 4,805	$ 4,953
Income tax, net	**(2,495)**	(1,935)	3,835

See accompanying notes.

1. Summary of Significant Accounting Policies

Business

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

Principles of Consolidation

The consolidated financial statements include the accounts of Virco Mfg. Corporation and its wholly owned subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2001 and 2000 information to conform to the 2002 presentation.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of accounts receivable. The Company performs ongoing credit evaluations of its customers and maintains allowances for potential credit losses. The Company purchases insurance on receivables from commercial sales to minimize the Company's credit risk. The Company does not typically obtain collateral to secure credit risk. A substantial percentage of the Company's receivables comes from low-risk government entities. No customers exceeded 10% of the Company's sales for each of the three years in the period ended January 31, 2003. Foreign sales were less than 5% for each of the three years in the period ended January 31, 2003.

Derivatives

The Company uses derivative financial instruments to reduce interest rate risks. The Company does not hold or issue derivative financial instruments for trading purposes. All derivatives are recognized as either assets or liabilities in the statement of financial condition and are measured at fair value. At January 31, 2003, the only derivative instrument is an interest rate swap that qualifies as a cash flow hedge. Changes in the fair value of the swap are recorded in other comprehensive income/loss as the hedge is effective in achieving offsetting changes in the fair value of cash flows of the liability.

Inventories

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

Property, Plant and Equipment

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

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

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

Interest costs, amounting to $38,000, $55,000 and $453,000 for the years ended January 31, 2003, 2002 and 2001, respectively, have been capitalized as part of the acquisition cost of property, plant and equipment.

The Company capitalizes costs associated with software developed for its own use. Such costs are amortized over three to seven years from the date the software becomes operational. The net book value of capitalized software was $5,149,000 and $7,593,000 at January 31, 2003 and 2002, respectively.

The net book value of assets held under capital leases included in machinery and equipment amounted to $0 and $2,294,000 at January 31, 2003 and 2002, respectively. Amortization of capital leases is included in depreciation expense.

Impairment of Long-Lived Assets

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets," which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." The adoption of the Statement on February 1, 2002 did not have a significant impact on the Company's financial position, results of operations, or cash flows.

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

Net Income Per Share

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

	2002	2001	2000
Numerator:			
Income before cumulative effect of the accounting change	$ **282,000**	$ 246,000	$ 4,313,000
Denominator:			
Denominator for basic earnings per share			
– weighted-average shares	**13,344,000**	13,485,000	13,747,000
Dilutive potential common shares	**114,000**	190,000	138,000
Denominator for diluted earnings per share			
– adjusted weighted-average shares and assumed conversions	**13,458,000**	13,675,000	13,885,000

On August 20, 2002, the Company's Board of Directors authorized a 10% stock dividend payable on September 30, 2002, to stockholders of record as of September 6, 2002. This resulted in the issuance of approximately 1,213,000 additional shares of common stock. All per share and weighted-average share amounts have been restated to reflect this stock dividend and any splits or dividends previously declared.

Goodwill and Intangible Assets

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 is effective for any business combination completed subsequent to June 30, 2001, and SFAS No. 142 is effective for fiscal years beginning after December 15, 2001. Under SFAS No. 142, goodwill and intangible assets deemed to have an indefinite life will no longer be amortized and will be subjected to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives. The adoption of SFAS No. 142 did not have a material effect on the Company's financial position, results of operations or cash flows as prior to April 2002 the Company did not have any recorded goodwill or any indefinite lived or finite lived intangible assets, other than deferred pension assets (see note 11). At January 31, 2003, goodwill totaled $2,200,000.

Environmental Costs

Costs incurred to investigate and remediate environmental waste are expensed as incurred, unless the remediation extends the useful life of the assets employed at the site. Remediation costs that extend the useful life of assets are capitalized and amortized over the useful life of the assets.

Advertising Costs

Advertising costs are expensed in the period in which they occur. Selling, general and administrative expenses include advertising costs of $2,921,000 in 2002, $4,237,000 in 2001 and $3,517,000 in 2000.

Product Warranty Expense

The Company provides for a product warranty on most of the products. It generally provides that customers can return a defective product during the specified warranty period following purchase in exchange for a replacement product or repair at no cost to the consumer. The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The Company recorded reserves of $900,000 and $150,000 as of January 31, 2003 and 2002, respectively.

Self-Insurance

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

Stock-Based Compensation Plans

In October 1995, the Financial Accounting Standards Board issued SFAS No. 123 "Accounting of Stock Based Compensation," which established accounting and reporting standards for stock based employee compensation plans effective after fiscal year 1996. SFAS No. 123 encourages entities to adopt the fair value based method of accounting; however, it also allows an entity to continue to measure compensation cost using the intrinsic value based method prescribed by Accounting Principles Board No. 25. Entities electing to remain on the "intrinsic value based" method must make certain pro forma disclosures as if the new fair value method had been applied. At this time, the Company has not adopted the recognition provision of SFAS No. 123, but has provided pro forma disclosures.

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 148, "Accounting For Stock Based Compensation–Transition and Disclosure." SFAS No. 148 amended SFAS No. 123 "Accounting For Stock-Based Compensation", to provide new guidance concerning the transition when a company changes from the intrinsic-value method to the fair-value method of accounting for employee stock-based compensation cost. As amended by SFAS No. 148, SFAS No. 123 also requires additional disclosure regarding such cost in annual financial statements and in condensed interim financial statements. Certain disclosure provisions of SFAS No. 148 were adopted by the Company in its financial statements prepared as of January 31, 2003.

SFAS No. 123, as amended by SFAS No. 148, requires pro forma information regarding net income and net income per share to be disclosed for new options granted after fiscal year 1996. The fair value of these options was determined at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: risk-free interest rates of 4.11% to 6.26%; dividend yield of 0.10% to 0.98%; volatility factor of the expected market price of the Company's common stock of 0.26 to 0.40; and a weighted-average expected life of the option of five years.

The estimated fair value of the options is amortized to expense over the options' vesting period for pro forma disclosures. The per share "pro forma" for the effects of SFAS No. 123, as amended by SFAS No. 148, is not indicative of the effects on reported net income (loss) for future years. The Company's "reported" and "pro forma" information is as follows:

In thousands, except per share data	Year Ended January 31		
	2003	2002	2001
Net income, as reported	**$ 282**	$ 246	$ 4,016
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of tax effects	**(41)**	(42)	(102)
Pro forma net income	**$ 241**	$ 204	$ 3,914
Basic earnings per share:			
Net income, as reported	**$ .02**	$ .02	$ .29
Net income, pro forma	**.02**	.02	.28
Diluted earnings per share:			
Net income, as reported	**$ .02**	$ .02	$ .29
Net income, pro forma	**.02**	.01	.28

Use of Estimates and Assumptions

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

Revenue Recognition

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

In 2002, the Company purchased certain assets of Furniture Focus, a company which sells complete educational furniture packages to schools. For package orders, the Company records revenue upon completion of the projects and delivery of all products. The Company reports sales as net of sales returns and allowances.

Shipping and Handling Fees

Shipping and handling fees are included as revenue in net sales. Costs related to shipping and handling are included in operating expenses. For the years ended January 31, 2003, 2002 and 2001, shipping and handling costs of approximately $27,590,000, $27,491,000 and $31,903,000, respectively, were included in selling, general and administrative expenses.

Fiscal Year End

Fiscal years 2002, 2001 and 2000, refer to the years ended January 31, 2003, 2002 and 2001, respectively.

Future Accounting Requirements

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations," which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs, and requires such obligations and costs to be recognized at fair value in the period in which they are incurred. The Company will adopt SFAS No. 143 as of February 1, 2003, and does not expect any material effect upon the adoption of the Statement on the Company's financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 requires most gains and losses on extinguishment of debt to be classified as income or loss from continuing operations rather than as extraordinary items as previously required. SFAS No. 145 also amends SFAS No. 13 to require certain lease modifications to be treated as sales-leaseback transactions. Certain provisions of SFAS No. 145 are effective for transactions occurring after May 15, 2002, while other provisions are effective for fiscal years beginning after May 15, 2002. The adoption of SFAS No. 145 has not had a material effect on the Company's results of operations or financial condition.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which requires the recognition of costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 is effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect a material effect on its results of operations or financial condition as a result of the adoption of SFAS No. 146.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others: (the Interpretation or FIN No. 45)." The Interpretation's disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company adopted FIN No. 45 effective January 31, 2003, and disclosed the Company's accounting policy and methodology used in determining its liability for product warranties. A tabular reconciliation of the changes in the Company's product warranty liability is included in Note 9.

2. Inventories

The current material cost for inventories exceeded LIFO cost by $3,519,000 and $2,048,000 at January 31, 2003 and 2002, respectively. Liquidation of prior year LIFO layers due to a reduction in certain inventories (decreased) increased income by $(423,000), $(825,000) and $111,000 in the years ended January 31, 2003, 2002 and 2001, respectively.

Details of inventory amounts, including the material portion of inventory which is valued at LIFO, at January 31, 2003 and 2002, are as follows (in thousands):

	January 31, 2003			
	Material Content at FIFO	LIFO Reserve	Labor, Overhead and Other	Total
Finished goods	**$ 10,772**	**$ (981)**	**$ 6,719**	**$ 16,510**
Work in process	**9,822**	**(1,314)**	**9,725**	**18,233**
Raw materials and supplies	**9,520**	**(1,224)**	**–**	**8,296**
Total	**$ 30,114**	**$ (3,519)**	**$ 16,444**	**$ 43,039**

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

3. Notes Payable

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

	January 31	
	2003	2002
Revolving credit line with Wells Fargo Bank (a)	**$ 26,655**	$ 22,414
IRB with the City of Torrance (b)	**2,141**	3,165
Equipment credit line with GECC (c)	**–**	884
Derivative instrument (a)	**196**	1,103
Other	**–**	1,142
	28,992	28,708
Less current portion	**1,087**	2,061
	$ 27,905	$ 26,647
Outstanding stand-by letters of credit	**$ –**	$ 2,411

(a) A revolving credit facility with Wells Fargo Bank, amended and restated in February 2003, but effective at January 31, 2003 provides a secured revolving line of credit that ranges from $40,000,000 to $70,000,000 to allow for additional working capital requirements during the Company's traditional peak period. This is a two-year non-amortizing line with interest payable monthly at a fluctuating rate equal to the Bank's prime rate, plus a fluctuating margin of 0.25% - 0.50% (4.75% at January 31, 2003). The line also allows the Company the option to borrow under 30- 60- and 90-day fixed term rates at LIBOR plus a fluctuating margin of 1.50% to 2.50%. Approximately $13,345,000 was available for borrowing as of January 31, 2003.

The $26,655,000 due under Wells Fargo Bank's line of credit will be payable in the fiscal year ending January 31, 2005, if the agreement is not renewed. The Company intends to renew the agreement.

On February 22, 2000, the Company entered into an interest rate swap agreement with Wells Fargo Bank. The initial notional swap amount was $30,000,000 for the period February 22, 2000 through February 28, 2001. The notional swap amount decreased to $20,000,000 until its expiration on March 3, 2003. The swap agreement is in consideration for a fixed rate at 7.23% plus a fluctuating margin of 1.50% to 2.50%. The Company adopted SFAS No. 133 "Accounting for Derivatives and Hedging Activities" on February 1, 2001. The adjustment to adopt SFAS No. 133 resulted in recording a liability of $920,000 and an offset to other comprehensive loss, which was $552,000 net of applicable income tax benefit of $368,000. At January 31, 2003, the carrying value of the swap approximated the fair value of $196,000, with an offset to other comprehensive loss of $118,000 net of an applicable tax benefit of $78,000. The revolving credit facility with Wells Fargo Bank is subject to various financial covenants including a liquidity requirement, a leverage requirement, a cash flow coverage requirement and profitability requirements. The agreement also places certain restrictions on capital expenditures, dividends and the repurchase of the Company's common stock. The revolving credit facility is secured by the Company's accounts receivable, inventory and equipment.

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

(c) Credit agreement with General Electric Capital Corporation (GECC) to finance the initial portion of the new business information system. This is a four-year amortizing capital lease with principal and interest (approximately 7.5%) payable of $87,500 monthly. The Company has the option of buying out the lease three years into the lease period. During the year ended January 31, 2003, the Company exercised the buy-out option.

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

Year ending January 31	
2004	$ 1,087
2005	27,905
	$ 28,992

The Company believes that the carrying value of debt under the Wells Fargo credit facility approximates fair value at January 31, 2003 and 2002, as the majority of the long-term debt bears interest at variable rates or is fixed for periods equal to or less than 90 days. The carrying value of other debt instruments approximates their fair value given the Company's incremental borrowing rate for similar types of financing arrangements.

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

4. Retirement Plans

Qualified Pension Plan

The Company and its subsidiaries cover all employees under a noncontributory defined benefit retirement plan, the Virco Employees' Retirement Plan (the Plan). Benefits under the Plan are based on years of service and career average earnings. The Company's general funding policy is to contribute amounts deductible for federal income tax purposes. Minimum pension liability adjustments for the years 2002, 2001 and 2000 were $3,072,000, $1,329,000 and $1,155,000, respectively (net of taxes of $2,005,000, $850,000 and $768,000, respectively), and are included in comprehensive loss. Assets of the Plan are invested in common trust funds.

The following table sets forth (in thousands) the funded status of the Plan at December 31, 2002 and 2001:

	Pension Benefits	
	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of year	**$ 21,163**	$ 19,435
Service cost	**1,437**	1,017
Interest cost	**1,684**	1,515
Plan amendments	**503**	438
Actuarial loss	**4,520**	748
Benefit paid	**(520)**	(1,990)
Benefit obligation at end of year	**$ 28,787**	$ 21,163
Change in plan assets:		
Fair value at beginning of year	**$ 8,808**	$ 10,193
Actual return on plan assets	**(1,696)**	(2,116)
Company contributions	**10,482**	2,721
Benefits paid	**(520)**	(1,990)
Fair value at end of year	**$ 17,074**	$ 8,808
Funded status of plan	**$ (11,713)**	$ (12,355)
Unrecognized net transition amount	**(184)**	(225)
Unrecognized prior service cost	**4,333**	4,430
Unrecognized net actuarial loss	**14,700**	8,702
Net amount recognized	**$ 7,136**	$ 552
Statements of financial position:		
Accrued benefit liability	**$ (7,077)**	$ (8,680)
Intangible asset	**4,333**	4,430
Accumulated other comprehensive income	**9,880**	4,802
Net amount recognized	**$ 7,136**	$ 552
Weighted average assumptions:		
Discount rate	**6.50%**	7.75%
Expected return on plan assets	**6.50%**	8.00%
Rate of compensation increase	**5.00%**	5.00%

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

	December 31		
	2002	2001	2000
Components of net cost:			
Service cost	**$ 1,437**	$ 1,017	$ 930
Interest cost	**1,684**	1,515	1,425
Expected return on plan assets	**(820)**	(821)	(1,089)
Amortization of transition amount	**(42)**	(42)	(42)
Amortization of prior service cost	**601**	562	528
Recognized net actuarial loss	**1,039**	398	148
Benefit cost	**$ 3,899**	$ 2,629	$ 1,900

VIP Retirement Plan

The Company also provides a supplementary retirement plan for certain key employees, the VIP Retirement Plan (VIP Plan). The VIP Plan provides a benefit up to 50% of average compensation for the last five years in the VIP Plan, offset by benefits earned under the Virco Employees' Retirement Plan. The VIP Plan is funded by a life insurance program. The cash surrender values of the policies funding the VIP Plan were $2,419,000 and $2,138,000 at January 31, 2003 and 2002, respectively. These cash surrender values are included in other assets in the consolidated balance sheets.

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

The following table sets forth (in thousands) the funded status of the VIP Plan at December 31, 2002 and 2001:

	Nonqualified VIP Pension	
	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of year	**$ 4,821**	$ 4,298
Service cost	**820**	490
Interest cost	**431**	323
Plan amendments	**(503)**	(438)
Actuarial loss	**2,453**	492
Benefit paid	**(266)**	(344)
Benefit obligation at end of year	**$ 7,756**	$ 4,821
Change in plan assets:		
Company contributions	**$ 266**	$ 344
Benefits paid	**(266)**	(344)
Fair value at end of year	**$ –**	$ –
Funded status of plan	**$ (7,756)**	$ (4,821)
Unrecognized prior service cost	**(3,121)**	(3,035)
Unrecognized net actuarial loss	**4,816**	2,718
Accrued benefit cost	**$ (6,061)**	$ (5,138)
Statements of financial position:		
Accrued benefit liability	**$ (6,061)**	$ (5,138)
Net amount recognized	**$ (6,061)**	$ (5,138)
Weighted average assumptions:		
Discount rate	**6.50%**	7.75%
Rate of compensation increase	**5.00%**	5.00%

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

		December 31	
	2002	2001	2000
Components of net cost:			
Service cost	**$ 820**	$ 490	$ 417
Interest cost	**431**	323	299
Amortization of prior service cost	**(417)**	(366)	(314)
Recognized net actuarial loss	**355**	193	157
Benefit cost	**$ 1,189**	$ 640	$ 559

Non-Employee Directors Retirement Plan

In April 2001, the Board of Directors established a non-qualified plan for non-employee directors of the Company. This Non-Employee Directors Retirement Plan provides a lifetime annual retirement benefit equal to the director's annual retainer fee for the fiscal year in which the director terminates his or her position with the Board, subject to the director providing 10 years of service to the Company. At January 31, 2003, this Plan did not hold any assets.

The following table sets forth (in thousands) the funded status of the Non-Employee Directors Retirement Plan at December 31, 2002:

	Non Employee Director Pension	
	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of year	**$ 485**	$ 461
Service cost	**29**	24
Interest cost	**34**	36
Plan amendments	**–**	–
Actuarial loss	**6**	(36)
Benefit paid	**–**	–
Benefit obligation at end of year	**$ 554**	$ 485
Change in plan assets:		
Fair value of plan assets at inception and end of year	**$ –**	$ –
Funded status of plan	**$ (554)**	$ (485)
Unrecognized prior service cost	**286**	373
Unrecognized net actuarial loss	**(30)**	(36)
Net amount recognized	**$ (298)**	$ (148)
Statements of financial position:		
Accrued benefit liability	**$ (554)**	$ (485)
Intangible asset	**256**	337
Net amount recognized	**$ (298)**	$ (148)
Weighted average assumptions:		
Discount rate	**6.50%**	7.75%
Rate of compensation increase	**5.00%**	5.00%

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

	December 31	
	2002	2001
Components of net cost:		
Service cost	**$ 29**	$ 24
Interest cost	**34**	36
Amortization of prior year service cost	**88**	88
Benefit cost	**$ 151**	$ 148

401(k) Retirement Plan

The Company's Retirement Plan, which covers all U.S. employees, allows participants to defer from 1% to 15% of their eligible compensation through a 401(k) retirement program. Through December 31, 2001, this Plan included an employee stock ownership component. This Plan continues to include the Virco Stock Fund as one of the investment options. Shares owned by this Plan are held by the Plan Trustee, Security Trust Company. At January 31, 2003, this Plan held 561,914 shares of Virco Stock. While these shares were included in the employee stock ownership component prior to the dissolution of the ESOP Plan, allocated shares held by the Trust were included in shares outstanding and the related dividends were charged to retained earnings. For the fiscal years ended January 31, 2003, 2002 and 2001, there was no employer match and therefore no compensation cost to the Company.

Life Insurance

The Company provides current and post-retirement life insurance to certain salaried employees with split dollar life insurance policies under the Dual Option Life Insurance Plan. Cash surrender values of these policies, which are included in other assets in the consolidated balance sheets, were $3,915,000 and $3,523,000 at January 31, 2003 and 2002, respectively.

Deferred Compensation Plan

The Company established, effective January 1, 1997, a Deferred Compensation Plan, which allows certain key employees to defer up to a maximum of 90% of their base annual salary and/or up to 90% of their annual bonus on a pretax basis. The total participant deferrals were $1,772,000 and $1,461,000 for the years ended January 31, 2003 and 2002, respectively. The Deferred Compensation Plan is funded with investment funds held in the rabbi trust and are included in other assets in the consolidated balance sheets.

5. Stock Options and Stockholders' Rights

The Company's two stock plans are the 1997 Employee Incentive Plan (the 1997 Plan) and the 1993 Employee Incentive Stock Plan (the 1993 Plan). Under these stock plans, the Company may grant an aggregate of approximately 1,432,000 shares (as adjusted for the stock split and stock dividends) to its employees in the form of stock options. Non-employee directors automatically receive a grant for options to purchase 2,000 shares of common stock on the first business day following each annual meeting of the Company's stockholders.

As of January 31, 2003, 373,000 shares remain available for future grant. Options granted under the plans have an exercise price equal to the market price at the date of grant, have a maximum term of 10 years and generally become exercisable ratably over a five-year period. During the year, certain optionees satisfied the exercise price of their options by exchanging shares already owned rather than paying cash. As a result, 29,632 and 1,051 shares were recorded as treasury stock for the years ended January 31, 2003 and 2002, respectively.

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

	2003		2002		2001	
	Options	**Weighted-Average Exercise Price**	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	**659,475**	**$ 9.09**	714,679	$ 9.34	768,970	$ 8.97
Granted	**13,200**	**13.59**	38,720	8.37	6,655	9.40
Exercised	**(149,431)**	**3.15**	(16,498)	2.20	(60,946)	4.64
Forfeited	**(41,470)**	**11.68**	(77,426)	12.27	–	–
Outstanding at end of year	**481,774**	**10.82**	659,475	9.09	714,679	9.34
Exercisable at end of year	**433,280**	**$ 10.81**	578,076	$ 8.96	597,166	$ 8.90
Weighted-average fair value of options granted during the year		**$ 5.54**		$ 3.45		$ 3.27

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

Information regarding stock options outstanding as of January 31, 2003, is as follows:

	Options Outstanding			Options Exercisable	
Price Range	Number of Shares	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$ 1.87 to 8.55	153,428	4.00 years	$ 6.67	132,812	$ 6.42
10.14 to 13.59	223,870	6.34	11.68	196,475	11.52
15.06 to 16.07	104,476	4.69	15.80	103,993	15.01
	481,774	5.23	10.82	433,280	10.81

The Company has elected to account for its employee stock options under Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" (APB 25) and related interpretations in accounting for employee stock options. No compensation expense is recorded under APB 25 because the exercise price of the Company's employee common stock options equals the market price of the underlying common stock on the grant date.

On October 15, 1996, the Board of Directors declared a dividend of one preferred stock purchase right (a Right) for each outstanding share of the Company's common stock. Each Right entitles a stockholder to purchase for an exercise price of $50.00 ($20.70, as adjusted for the stock split and stock dividend), subject to adjustment, one one-hundredth of a share of Series A Junior Participating Cumulative Preferred Stock of the Company, or under certain circumstances, shares of common stock of the Company or a successor company with a market value equal to two times the exercise price. The Rights are not exercisable, and would only become exercisable for all other persons when any person has acquired or commences to acquire a beneficial interest of at least 20% of the Company's outstanding common stock. The Rights expire on October 25, 2006, have no voting privileges, and may be redeemed by the Board of Directors at a price of $.001 per Right at any time prior to the acquisition of a beneficial ownership of 20% of the outstanding common shares. There are 200,000 shares (483,153 shares as adjusted by the stock split and stock dividend) of Series A Junior Participating Cumulative Preferred Stock reserved for issuance upon exercise of the Rights.

6. Provision for Income Taxes

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

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

	January 31		
	2003	2002	2001
Statutory	**34.0%**	34.0%	34.0%
State taxes (net of federal tax)	**1.0**	4.1	3.2
Nondeductible expenses and other	**(1.7)**	5.5	1.1
	33.3%	43.6%	38.3%

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

Notes to Consolidated Financial Statements (continued)

	January 31		
	2003	2002	2001
Current			
Federal	**$ (333)**	$ 1,562	$ 2,690
State	**(81)**	350	390
	(414)	1,912	3,080
Deferred			
Federal	**469**	(1,449)	(350)
State	**86**	(273)	(57)
	555	(1,722)	(407)
	$ 141	$ 190	$ 2,673

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

	January 31	
	2003	2002
Deferred tax assets		
Accrued vacation and sick leave	**$ 1,209**	$ 1,090
Retirement plans	**3,996**	3,308
Insurance reserves	**1,607**	1,306
Inventory	**574**	244
Other	**372**	1,068
	7,758	7,016
Deferred tax liabilities		
Tax in excess of book depreciation	**(4,148)**	(4,288)
Capitalized software development costs	**(1,214)**	(3,318)
	(5,362)	(7,606)
Net deferred tax liability	**$ 2,396**	$ (590)

7. Commitments

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

Minimum future lease payments (in thousands) for operating leases in effect as of January 31, 2003, are as follows:

Year ending January 31	
2004	$ 8,946
2005	7,560
2006	4,339
2007	2,997
2008	1,654
Thereafter	504
	$ 26,000

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

Year ended January 31	
2003	**$ 9,969**
2002	11,042
2001	12,937

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

Minimum future lease-receipts (in thousands) for leases relating to properties owned or subleased as of January 31, 2003, are as follows:

Year ending January 31	
2004	$ 628
2005	627
2006	33
2007	33
2008	33
Thereafter	112
	$ 1,466

8. Contingencies

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

The Company is subject to contingencies pursuant to environmental laws and regulations that in the future may require the Company to take action to correct the effects on the environment of prior disposal practices or releases of chemical or petroleum substances by the Company or other parties. At January 31, 2003 and 2002, there are no required reserves for such environmental contingencies.

The Company has a self-insured retention for product and general liability losses up to $250,000 per occurrence. The Company has purchased insurance to cover losses in excess of the retention up to a limit of $30,000,000. The Company has obtained an actuarial estimate of its total expected future losses for liability claims and recorded the net present value of $4,130,000 at January 31, 2003, based upon the Company's estimated payout period of four years using a 6% discount rate.

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

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

9. Warranty

The Company accrues an estimate of its exposure to warranty claims based upon both current and historical product sales data and warranty costs incurred. The majority of the Company's products carry a five-year warranty. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The warranty liability is in accrued liabilities in the accompanying consolidated balance sheet.

Changes in the Company's warranty liability were as follows (in thousands):

	January 31	
	2003	2002
Balance at January 31, 2002	**$ 150**	$ 150
Provision	**2,091**	703
Costs incurred	**(1,341)**	(703)
Balance at January 31, 2003	**$ 900**	$ 150

10. Gain on Sale of Assets and Other Income

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

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

11. Acquisition of business

In April 2002, the Company entered into an agreement with Dew-El Corporation to purchase certain assets of Furniture Focus™, Inc., an Ohio reseller that offers complete package solutions for the furniture, fixtures and equipment segments of bond-funded public school construction projects, primarily in the upper Midwest. In May 2002, the Company paid $2,400,000 in cash for certain assets of the corporation and recorded goodwill of $2,200,000. The goodwill is not expected to be deductible for income tax. In addition, the Company purchased approximately $2,150,000 of accounts receivable. The financial statements for the fiscal 2002 included nine months of Furniture Focus operations. The additional revenue and operating results as a result of this acquisition did not have a significant effect on the Company's financial position, operations or cash flows.

12. Quarterly Results (Unaudited)

The Company's quarterly results for the years ended January 31, 2003 and 2002 are summarized as follows (in thousands, except per share data):

	Apr. 30	Jul. 31	Oct. 31	Jan. 31
Year ended January 31, 2003				
Net sales	**$ 41,168**	**$ 83,164**	**$ 85,022**	**$ 35,001**
Gross profit	**13,056**	**29,080**	**28,893**	**5,756**
Net income (loss)	**(2,137)**	**4,260**	**3,244**	**(5,085)**
Per common share (1)(2)				
Net income:				
Basic	**(0.16)**	**0.32**	**0.24**	**(0.39)**
Assuming dilution	**(0.16)**	**0.32**	**0.24**	**(0.39)**
Year ended January 31, 2002				
Net sales	$ 42,457	$ 89,193	$ 86,232	$ 39,580
Gross profit	11,483	28,349	28,591	8,764
Net income (loss)	(3,765)	4,490	3,912	(4,391)
Per common share (1)(2)				
Net income:				
Basic	(0.27)	0.34	0.29	(0.33)
Assuming dilution	(0.27)	0.33	0.29	(0.33)

(1) Net income per share has been adjusted to reflect the 10% stock dividend declared in August 2002 and 2001.

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

Supplemental Stockholders' Information

Annual Meeting

The Annual Meeting of Virco stockholders will be held on Tuesday, June 10, 2003, at 10:00 a.m., at 2027 Harpers Way, Torrance, California. The record date for this meeting is May 2, 2003. The Proxy Statement and Proxy pertaining to this meeting will be mailed on or about May 16, 2003.

SEC Form 10-K

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

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

Virco Common Stock

The American Stock exchange is the principal market on which Virco Mfg. Corporation (VIR) stock is traded. As of April 16, 2002, there were approximately 350 registered stockholders according to the transfer agent records. There are approximately 1,500 beneficial stockholders.

Stockholder Records

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

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

Additional Services for Stockholders

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

Quarterly Dividend and Stock Market Information

	Cash Dividends Declared		Common Stock Range			
	1-31-2003	1-31-2002	1-31-2003		1-31-2002	
			High	Low	High	Low
1st Quarter	$ 0.02	$ 0.02	$ 9.54	$ 8.09	$ 9.09	$ 8.06
2nd Quarter	0.02	0.02	13.70	9.18	8.80	8.14
3rd Quarter	0.02	0.02	12.18	8.43	9.45	8.50
4th Quarter	0.02	0.02	10.48	7.98	8.18	7.41

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

Directors, Officers and Facilities

Directors

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

Donald S. Friesz
Former Vice President - Sales and
Marketing

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

Robert K. Montgomery
Partner, Gibson, Dunn & Crutcher

Glen D. Parish
Vice President and General Manager
Conway Division

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

Douglas A. Virtue
Executive Vice President

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

Officers

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

Douglas A. Virtue
Executive Vice President

Robert E. Dose
Vice President - Finance,
Secretary and Treasurer

Glen D. Parish
Vice President and General Manager
Conway Division

Wesley D. Roberts
Vice President and
Chief Information Officer

D. Randal Smith
Vice President - Marketing

Lori L. Swafford
Vice President - Legal Affairs

Larry O. Wonder
Vice President - Sales

Independent Auditors

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Long Beach, California 90831

Legal Counsel

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Conway Division
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Conway, Arkansas 72032

Greenview High School
Jamestown, OH

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