

VIRCO MFG CORPORATION

Form 10-K

April 15, 2011

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K**

(Mark One)

☒ **Annual Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the fiscal year ended January 31, 2011.**

☐ **Transition Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-8777**

**VIRCO MFG. CORPORATION**

(Exact name of registrant as specified in its charter)

DELAWARE

95-1613718

(State or other jurisdiction of incorporation or  
organization)

(IRS Employer Identification No.)

2027 Harpers Way, Torrance, California

90501

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code (310) 533-0474

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

Title of each class

Name of each exchange on which registered:

Common Stock, \$0.01 Par Value

NASDAQ

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

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

☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes ☐ No ☒

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting

Edgar Filing: VIRCO MFG CORPORATION - Form 10-K

company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting  
company ☐

(Do not check if a smaller  
reporting company)

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

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant on July 31, 2010, was \$41.8 million (based upon the closing price of the registrant's common stock on such day, as reported by the NASDAQ).

As of April 1, 2011, there were 14,204,998 shares of the registrant's common stock (\$0.01 par value) outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive proxy statement for its 2011 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission are incorporated by reference into Part III of this annual report on Form 10-K as set forth herein.

---

## **TABLE OF CONTENTS**

### **PART I**

<b><u>Item 1. Business</u></b>	3
<b><u>Item 1A. Risk Factors</u></b>	11
<b><u>Item 1B. Unresolved Staff Comments</u></b>	17
<b><u>Item 2. Properties</u></b>	17
<b><u>Item 3. Legal Proceedings</u></b>	18
<b><u>Item 4. Removed and Reserved</u></b>	18

### **PART II**

<b><u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u></b>	19
<b><u>Item 6. Selected Financial Data</u></b>	20
<b><u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	22
<b><u>Item 7A. Quantitative and Qualitative Disclosures about Market Risk</u></b>	35
<b><u>Item 8. Financial Statements and Supplementary Data</u></b>	36
<b><u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures</u></b>	61
<b><u>Item 9A. Controls and Procedures</u></b>	61
<b><u>Item 9B. Other Information</u></b>	62

### **PART III**

<b><u>Item 10. Directors, Executive Officers, and Corporate Governance</u></b>	63
<b><u>Item 11. Executive Compensation</u></b>	63
<b><u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u></b>	63
<b><u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u></b>	63
<b><u>Item 14. Principal Accounting Fees and Services</u></b>	63

### **PART IV**

<b><u>Item 15. Exhibits, Financial Statement Schedules</u></b>	64
--	----

<b><u>SIGNATURES</u></b>	66
--------------------------	----

<b><u>POWER OF ATTORNEY</u></b>	67
---------------------------------	----

**EX-10.31**

**EX-18**

**EX-21.1**

**EX-23.1**

**EX-31.1**

**EX-31.2**

**EX-32.1**

**Table of Contents**

**PART I**

***Cautionary Statement Regarding Forward-Looking Statements***

*This report on Form 10-K contains a number of forward-looking statements that reflect the Company's current views with respect to future events and financial performance, including, but not limited to, availability of funding for educational institutions, statements regarding plans and objectives of management for future operations, including plans and objectives relating to products, pricing, marketing, expansion, manufacturing processes, business strategies; the Company's ability to continue to control costs and inventory levels; availability and cost of raw materials, especially steel and petroleum-based products; the availability and cost of labor; the potential impact of the Company's Assemble-To-Ship program on earnings; market demand; the Company's ability to position itself in the market; references to current and future investments in and utilization of infrastructure; statements relating to management's beliefs that cash flow from current operations, existing cash reserves, and available lines of credit will be sufficient to support the Company's working capital requirements to fund existing operations; references to expectations of future revenues; pricing; and seasonality.*

*Such statements involve known and unknown risks, uncertainties, assumptions and other factors, many of which are out of the Company's control and difficult to forecast, that may cause actual results to differ materially from those which are anticipated. Such factors include, but are not limited to, changes in, or the Company's ability to predict, general economic conditions, the availability and cost of raw materials, the markets for school and office furniture generally and specifically in areas and with customers with which the Company conducts its principal business activities, the rate of approval of school bonds for the construction of new schools, the extent to which existing schools order replacement furniture, customer confidence, competition and other factors included in the Risk Factors section of this report.*

*In this report, words such as anticipates, believes, expects, will continue, future, intends, plans, estimates, projects, potential, budgets, may, could and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof.*

*Throughout this report, our fiscal years ended January 31, 2007, January 31, 2008, January 31, 2009, January 31, 2010 and January 31, 2011 are referred to as years 2006, 2007, 2008, 2009 and 2010, respectively.*

*Please note that this report includes trademarks of Virco, including, but not limited to, the following: ZUMA®, ZUMAFrd®, Ph.D., I.Q.®, Virtuoso®, Classic Series®, Martest 29®, Lunada®, Plateau®, Core-a-Gator®, Future Access®, Sigma®, Metaphor®, Telos®, TEXT® and Parameter®. Solely for convenience, from time to time we refer to our trademarks in this report without the ® and symbols, but such references are not intended to indicate that we will not assert, to the fullest extent under applicable law, our rights to our trademarks. In addition, other names and brands included in this report may be claimed by us as well or by third parties.*

**Item 1. Business**

***Introduction***

Designing, producing and distributing high-value furniture for a diverse family of customers is a 61-year tradition at Virco Mfg. Corporation (Virco or the Company, or in the first person, we, us and our). Virco was incorporated in California in February 1950, and reincorporated in Delaware in April 1984. Though Virco started as a local manufacturer of chairs and desks for Los Angeles-area schools, over the years, Virco has become the largest manufacturer and supplier of moveable educational furniture and equipment for the preschool through 12th grade market in the United States. The Company now manufactures a wide assortment of products, including mobile tables, mobile storage equipment, desks, computer furniture, chairs, activity tables, folding chairs and folding tables. Additionally, Virco has worked with accomplished designers such as Peter Glass, Richard Holbrook, and Bob Mills to develop additional products for contemporary applications. These include the best-selling ZUMA® and the recently introduced TEXT®, Metaphor® and Telos® classroom furniture collections, as well as I.Q.® Series items for educational settings; Ph.D.® and Ph.D. Executive seating lines; and the wide-ranging Plateau® Series. In 2008, Virco introduced the TEXT table collection for learning environments. Designed by the award-winning team of Peter Glass and Bob Mills, TEXT tables feature heavy-gauge tubular steel and proven Virco construction for extended product life, and elliptical legs, swooping yokes and arched feet for exceptional elegance. Selected TEXT

models can be equipped with a variety of technology-support and storage accessories. Lunada® tables made their debut at the end of 2008. Combining Virco's popular Lunada bi-point bases with a selection of 20 top sizes, Lunada tables make great choices for seminar, conference and related settings.

In 2009, Virco introduced Flip-Top Technology tables for computer classrooms and related environments. Flip-Top Technology tables feature a 6" deep locking flip-top compartment that secures cables, surge protectors and wires beneath the work surface. Also in 2009, utilizing our new flat metal forming capabilities, Virco introduced an array of desks, returns and bookcases.

## **Table of Contents**

In 2010, Virco introduced Parameter®, an invigorating collection of desks, returns and credenzas for use by teachers, principals and district administrators in their classrooms or offices. Parameter affordably combines all the functionality and more of traditional mid-priced desks with high-end design elements. Virco's flat metal forming capabilities are used to manufacture Parameter items. Several new products were released in the second half of 2010, including: Parameter and TEXT help desks for educators, which have a rounded work surface edge at one end where students can comfortably pull up a chair for assistance with their work; Parameter mobile pedestals; Parameter high-capacity wire management panels; Plateau adjustable-height tables; several 2000 Series EL (extra large) classroom furniture models with an expanded seating surface; and a new collection of Virco vertical files. Products targeted for release in 2011 include new filing and storage cabinets, as well as additions to the Parameter line. Virco's impressive flat metal forming capabilities are further enhanced when combined with our Assemble-to-Ship (ATS) strategy, which allows for the manufacture and storage of common components during the portion of the year when demand for our product is low followed by assembly to customer-specific combinations prior to shipment. The combination of flat metal forming and ATS enables Virco to offer an array of desks at three price points that provide a variety of furniture solutions for customer applications in a wide range of environments.

As of January 31, 2011, the Company's employment force was approximately 1,050 strong, manufacturing its products in 1.1 million square feet of fabrication facilities and 1.2 million square feet of assembly and warehousing facilities in Torrance, California and Conway, Arkansas. Additionally, the Company's PlanSCAPE project management software allows its sales representatives to provide CAD layouts of classrooms, as well as classroom-by-classroom planning documents for the budgeting, acquisition and installation of furniture, fixtures and equipment (FF&E).

In recent years, due to budgetary pressures, many schools have reduced or eliminated central warehouses, janitorial services, and professional purchasing functions. As a result, fewer school districts administer their own bids, and are more likely to use regional, state, or national contracts. A shift to site-based management combined with reductions in professional purchasing personnel has increased the reliance of schools on suppliers that provide for a variety of needs from one source rather than administering different vendor relationships for each item. In response to these changes, the Company has expanded both the products and the services it provides to its educational customers. Now, in addition to buying furniture FOB Factory, customers can purchase furniture for delivery to warehouses and school sites, and can also purchase full-service furniture delivery that includes the installation of the furniture in classrooms. Because the Company has been aggressively developing new furniture lines to enhance the range of products it manufactures and by purchasing furniture and equipment from other companies for re-sale with Virco products the Company is now able to provide one-stop shopping for all furniture, fixtures and equipment needs in the K-12 market. The expansion of the Company's product line combined with the expansion of its services over the years has provided Virco with the ability to serve various markets including the education market (the Company's primary market), which is made up of public and private schools (preschool through 12th grade), junior and community colleges; four-year colleges and universities; trade, technical and vocational schools; convention centers and arenas; the hospitality industry with respect to banquet and meeting facilities; government facilities at the federal, state, county and municipal levels; and places of worship. In addition, the Company also sells to wholesalers, distributors, traditional retailers and catalog retailers that serve these same markets.

Virco serves its customers through a well-trained, nationwide sales and support team. Virco's educational product line is marketed through an extensive direct sales force, as well as through a growing dealer network. In addition, Virco has 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 service such customers, as they tend to have needs that transcend the geographic boundaries established for Virco's local accounts. The Company also has an array of support services, including complete package solutions for the furniture, fixtures and equipment line item on school budgets; computer-assisted layout planning; transportation planning; and product delivery, installation, and repair.

Another important element of Virco's business model is the Company's emphasis on developing and maintaining key manufacturing, assembly, distribution, and service capabilities. For example, Virco has developed competencies in several manufacturing processes that are important to the markets the Company serves, such as finishing systems, plastic molding, metal fabrication and woodworking. Virco's physical facilities are designed to support its ATS

strategy. Warehouses have substantial staging areas combined with a large number of dock doors to support the seasonal peak in shipments during summer months.

During the last decade, many furniture manufacturers closed their domestic manufacturing facilities and began importing increasing quantities of furniture from international sources. During this same period, Virco elected to significantly reduce its work force, but retain its domestic factory locations. In recent years, the Company believes that its domestic manufacturing capabilities have evolved into a significant strength. The Company has effectively used product selection, color selection, and dependable execution of delivery and installation to customers to enhance its market position. With increasing costs from international sources and increasing freight costs, our factories are cost-competitive



## **Table of Contents**

for bulky educational furniture and equipment items. The Company's ATS strategy allows for low-cube component parts to be sourced globally, with fabrication of bulky welded steel frames, wood tops, and larger molded-plastic components to be performed locally. Domestic production of laminated wood tops and molded plastic enables the Company to market a color palette that cannot be matched in a short delivery window by imported finished goods. Domestic assembly allows the Company to use standard ATS components to assemble customer-specific product and color combinations shortly prior to delivery and installation.

Finally, management continues to hone Virco's ability to finance, manufacture and warehouse furniture within the relatively narrow delivery window associated with the highly seasonal demand for education sales. In 2010, approximately 50% of the Company's total sales were delivered in June, July, and August with an even higher portion of educational sales delivered in that period. Shipments of furniture in July and August can be six times greater than in the seasonally slow winter months. Virco's substantial warehouse space allows the Company to build adequate inventories to service this narrow delivery window for the education market.

### ***Principal Products***

Virco produces the broadest line of furniture for the K-12 market of any manufacturer in the United States. By supplementing products manufactured by Virco with products from other manufacturers, Virco provides a comprehensive product assortment that covers substantially all products and price points that are traditionally included on the furniture, fixtures and equipment line item on a new school project or school budget. Virco also provides a variety of products for preschool markets and has recently developed products that are targeted for college, university, and corporate learning center environments. The Company has an ambitious and on-going product development program featuring products developed in-house as well as products developed with accomplished designers. The Company's primary furniture lines are constructed of tubular metal legs and frames, combined with wood and plastic tops, plastic seats and backs, upholstered seats and backs, and upholstered rigid polyethylene and polypropylene shells. Virco also has flat metal forming capabilities to enable the production of desks, returns, bookcases, filing cabinets, mobile pedestals and related items.

Virco's principal manufactured products include:

**SEATING** Launched in 2004, the ergonomically supportive ZUMA® line designed by Peter Glass and Bob Mills posted the highest initial-year new product sales total in the Company's history. Since this record-breaking launch, ZUMA sales have continued to grow. Recent additions to the ZUMA line include two cantilever chairs with 13" and 15" seat heights; a tablet arm chair with a compact footprint; two rockers with 13" and 15" seat heights; and a chair with an articulating tablet arm which was introduced in Virco's 2009 Equipment for Educators® catalog. The ZUMAFRD collection, introduced in 2005, features Fortified Recycled Wood® hard plastic seats, backrests and work surfaces. ZUMAFRD products have up to 70% recycled content and are 98% recyclable. The Sage® line, designed to serve students in college, university and other adult education settings, and on high school campuses, was introduced in late 2006. Along with its original adult-height models, Sage now offers a 13" and a 15" 4-leg chair, and a corresponding pair of cantilever chairs. In addition to these chairs for younger, smaller students, Virco has introduced an articulating Sage tablet arm model for high school and adult learning venues. Selected adult-height Sage models can also now be ordered with a padded, upholstered seat. In 2007, the Company introduced the Metaphor® Series—an updated sequel to Virco's best-selling Classic Series® furniture with improvements in comfort, ergonomics, stackability, and manufacturing efficiencies—and the Telo® Series, a wide-ranging product line with ergonomically contoured Fortified Recycled Wood components. Other Virco seating alternatives include easily-adjustable Ph.D.® task chairs; I.Q.® Series classroom chairs; and comfortable, attractive Virtuoso® chairs by Charles Perry. Classic Series stack chairs and Martest 21® hard plastic seating models are popular choices in schools across America. Along with this range of seating, Virco offers folding chairs and upholstered stack chairs, as well as additional plastic stack chairs and upholstered ergonomic chairs.

**TABLES** In April 2008, Virco introduced the TEXT® table collection for learning environments. Designed by the award-winning team of Peter Glass and Bob Mills, TEXT tables feature heavy-gauge tubular steel and proven Virco construction for extended product life, and elliptical legs, swooping yokes and arched feet for exceptional elegance. Selected TEXT models can be equipped with a variety of technology-support and storage accessories. Lunada® tables made their debut at the end of 2008. Combining Virco's popular Lunada bi-point bases with a selection of 20 top sizes,

Lunada tables make great choices for seminar, conference and related settings. Designed for Virco by Peter Glass, Plateau® tables bring exceptional versatility, sturdy construction and great styling to working and learning environments. For durable, easy-to-use lightweight folding tables, Virco's Core-a-Gato® models are unsurpassed. When paired with attractive, durable Virco café tops, Lunada bases by Peter Glass provide eye-catching table solutions for hospitality settings. Virco also carries traditional folding and banquet tables, activity tables and office tables, as well as the computer tables and mobile tables described below.

**COMPUTER FURNITURE** The TEXT table collection described in the preceding paragraph provides educators an array of computer furniture choices for learning environments; Virco's recently released Flip-Top Technology table line also delivers popular computer furniture solutions. Future Access® computer tables come with an integral wire

## **Table of Contents**

management panel and all rectangular models have a smooth post-formed front and rear edge. Like our Future Access models, 8700 Series computer tables can be equipped with Virco's functional computing accessories, such as keyboard mouse trays, CPU holders and support columns for optional elevated shelves. The Plateau® Office Solutions collection offers desks and workstations with technology-support capabilities, while the Plateau Library/Technology Solutions line has specialty tables and other products for computing applications.

**DESKS/CHAIR DESKS** From the ergonomic and collaborative-learning strengths of our best-selling ZUMA® student desks to the continuing popularity of our traditional Classic Series chair desks and combo units, Virco's wide-ranging furniture models can be found in thousands of America's schools. Related products include teacher desks and tablet arm units. Selected models are available with durable, colorfast Martest 21® or Fortified Recycled Wood hard plastic components. For teachers, principals and district administrators, Virco has introduced the distinctive, stylish and modern Parameter® collection of desks, returns and credenzas; designed in collaboration with Peter Glass and Bob Mills, Parameter is also great for business environments.

**ADMINISTRATIVE OFFICE FURNITURE** In addition to the Plateau Office Solutions and Parameter desks and related products described above, Virco now manufactures a selection of desks, returns, bookcases and other items that employ the Company's flat metal forming capabilities. Moreover, Plateau Office Solutions bookcases in popular sizes are available for administrative offices.

**LABORATORY FURNITURE** For biology and chemistry classes, and other school- and college-based lab settings, Virco offers a variety of steel-based science tables; Virco manufactures the table bases of these items and equips them with specialty tops purchased from vendor partners. Virco's ZUMA, Sage, Tefos Metaphor®, I.Q.®, Classic Series, and 3000 Series collections also include pneumatically adjustable lab stools with high-range seat-height adjustment and a steel foot-ring.

**MOBILE FURNITURE** School cafeterias are perfect venues for Virco mobile tables, while classrooms benefit from the spacious storage capacity of Virco mobile cabinets. An array of Virco product lines includes mobile chairs for school settings and offices.

**STORAGE EQUIPMENT** For moving selected Virco chairs and folding tables, the Company carries a wide range of handling and storage equipment. As a service to our convention center, arena, and auditorium customers, Virco also manufactures stackable storage trucks that work with Virco upholstered stack chairs, folding chairs and folding tables. Virco's wide-ranging product selection includes hundreds of furniture models that are certified according to the Greenguard for Children and Schools Program for indoor air quality. In 2005 Virco's ZUMA and ZUMAFrd products earned the distinction of being the first classroom furniture models to be certified through the Greenguard for Children and Schools Program. All of the models in the Company's most recently introduced product lines including Flip-Top Technology tables and Parameter desks, returns and credenzas are Greenguard-certified. Along with Virco's leadership relative to Greenguard-certified furniture, the Company also introduced the classroom furniture industry's first Take-Back program in 2006, enabling qualifying schools, colleges, universities, and other organizations and customers to return selected out-of-service furniture components for recycling rather than sending these items to a landfill.

In order to provide a comprehensive product offering for the education market, the Company supplements Virco-manufactured products with items purchased for re-sale, including wood and steel office furniture, early learning products for pre-school and kindergarten classrooms, science laboratory furniture, and library tables, chairs and equipment. In 2009, Virco began carrying a complete line of specialty furniture and equipment from Wenger® Corporation for music rooms, performance areas and related spaces; Virco also now offers customized, space-efficient workstations by Interior Concepts for technology and language labs, media centers, computer classrooms, reception areas and offices. Wenger and Interior Concepts are two of the many vendors with which the Company partners in order to effectively position Virco as the preferred one-stop furniture and equipment source for K-12 schools. None of the products from vendor partners accounted for more than 10% of consolidated revenues in 2010.

To complement Virco's extensive selection of furniture and equipment, we offer customers a variety of valuable services in connection with the purchase of Virco products; revenues from these service levels are included in the purchase price of the furniture items. In addition to giving customers the option of purchasing Virco products and making their own delivery arrangements, Virco provides three levels of delivery service. When customers choose

Standard Delivery also known as tailgate delivery the delivery driver is responsible for moving the customer's goods to the tailgate of the truck only; therefore, the customer must have personnel on hand to unload the truck. For additional charges Virco also offers Inside Delivery (no installation), or Full-Service Delivery (delivered and installed). To assist customers involved with furniture, fixtures and equipment (FF&E) purchases for new school construction projects or school renovations, Virco's PlanSCAPE® service provides room-by-room computerized layout planning and full FF&E project management.

**Table of Contents**

***Customers***

Virco's major customers include educational institutions, convention centers and arenas, hospitality providers, government facilities, and places of worship. No customer accounted for more than 10% of Virco's consolidated revenues during 2010.

***Raw Materials***

Virco purchases steel, aluminum, plastic, polyurethane, polyethylene, polypropylene, plywood, particleboard, cartons and other raw materials from many different sources for the manufacture of its principal products. Management believes the Company is not more vulnerable with respect to the sources and availability of these raw materials than other manufacturers of similar products. The Company's largest raw material cost is for steel, followed by plastics and wood.

The price of these commodities, particularly steel and plastic, has been volatile in recent years. Steel and plastic prices increased significantly in 2004 and 2005, in part due to worldwide demand of these materials, especially in China. By comparison, in 2006 and 2007 the price of these commodities was relatively stable. In 2008, steel prices increased by more than 80% during a four month period from April to July. Additionally, during the period from April through the third quarter of 2008, the price of petroleum increased substantially, affecting the cost of plastic, inbound freight, freight to customers, and other energy costs. In the latter portion of 2008, the cost of these materials declined, and remained relatively stable during 2009. During 2010, the Company incurred increased steel costs, while other commodity costs were relatively stable, or increased moderately.

In addition to the raw materials described above, the Company purchases components used in the fabrication and assembly of furniture from a variety of overseas locations, but primarily from China. These components are classified as raw materials in the financial statements until such time that the components are consumed in a fabrication or assembly processes. These components are sourced from a variety of factories, none of which are owned or operated by the Company. Costs for these imported components increased moderately during the last three years, and are expected to increase further in 2011.

With respect to the Company's annual contracts (or those contracts that have longer terms), the Company may have limited ability to increase prices during the term of the contract. The Company has, however, negotiated increased flexibility under many these contracts that allow the Company to increase prices on future orders. Nevertheless, even with respect to these more flexible contracts, the Company does not have the ability to increase prices on orders received prior to any announced price increases. Due to the intensely seasonal nature of our business, the Company may receive significant orders during the first and second quarters for delivery in the second and third quarters. With respect to any of the contracts described above, if the costs of raw materials increase suddenly or unexpectedly, the Company cannot be certain that it will be able to implement corresponding increases in its sales prices in order to offset such increased costs. Significant cost increases in providing products during a given contract period can adversely impact operating results and have done so during prior years, especially 2004, 2005, and 2008. The Company typically benefits from any decreases in raw material costs under the contracts described above.

***Marketing and Distribution***

Virco serves its customers through a well-trained, nationwide sales and support team, as well as a growing dealer network. In addition, Virco has a Corporate Sales Group to pursue wholesalers, mail order accounts and national chains where management believes 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 Virco's local accounts.

Virco's educational product line is marketed through what management believes to be the largest direct sales force of any education furniture manufacturer. The Company's approach to servicing its customer base is very flexible, and is tailored to best meet the needs of individual customers and regions. When considered to be most efficient, the sales force will call directly upon school business officials, who may include purchasing agents or individual school principals where site-based management is practiced. Where it is considered advantageous, the Company will use large exclusive distributors and full-service dealer partners. The Company's direct sales force is considered to be an important competitive advantage over competitors who rely primarily upon dealer networks for distribution of their products.

Virco's sales force is assisted by the Company's proprietary PlanSCAPE<sup>®</sup> software and experienced PlanSCAPE managers when preparing complete package solutions for the FF&E segment of bond-funded public school construction projects. PlanSCAPE software also enables the entire Virco sales force to prepare quotations for less complicated projects.

A significant portion of Virco's business is awarded through annual bids with school districts or other buying groups used by school districts. These bids are typically valid for one year. Many contracts contain penalty, performance, and debarment provisions that can result in debarment for a number of years, a financial penalty, or calling of performance bonds.

Sales of commercial and contract furniture are made throughout the United States by distributorships and by Company sales representatives who service the distributorship network. Virco representatives call directly upon state and local

## **Table of Contents**

governments, convention centers, individual hospitality venues, and mass merchants. Sales to this market include colleges and universities, preschools, private schools, and office training facilities, which typically purchase furniture through commercial channels.

The Company sells to thousands of customers, and, as such no single customer represented more than 10 percent of the Company's consolidated revenues in 2010. Significant purchases of furniture using public funds often require annual bids or some form of authorization to purchase goods or services from a vendor. This authorization can include state contracts, local and national buying groups, or local school districts that piggyback on the bid of a larger district. In virtually all cases, purchase orders and payments are processed by the individual school districts, even though the contract pricing may be determined by a state contract, national or local buying group, or consortium of school districts. Schools usually can purchase from more than one contract or purchasing vehicle, if they are participants in buying groups as well as being eligible for a state or national contract.

Virco is the exclusive supplier of movable classroom furniture for one nationwide purchasing organization under which many of our customers price their furniture. See **Risk Factors**. Approximately 40% of our sales are priced through one contract, under which we are the exclusive supplier of classroom furniture. Sales priced under this contract represented approximately 43% of Virco's sales in 2010, 40% of sales in 2009, and 40% of sales in 2008. In the third quarter of 2008, the Company was awarded a three-year contract with this purchasing organization extending through 2011. In addition, the Company was awarded three one-year extensions extending through 2014. If Virco were unable to sell under this contract, we would be able to sell to the vast majority of our customers under alternative contracts.

### ***Seasonality***

The educational sales market is extremely seasonal. Approximately 50% of the Company's total sales in 2010 were delivered in June, July, and August with an even higher portion of educational sales delivered in that period. Shipments during peak weeks in July and August can be as great as six times the level of shipments in the winter months.

### ***Working Capital Requirements During the Peak Summer Season***

As discussed above, the market for educational furniture and equipment is marked by extreme seasonality, with the majority of shipments occurring from June to August each year, which is the Company's peak season. As a result of this seasonality, Virco builds and carries significant amounts of inventory during the peak summer season to facilitate the rapid delivery requirements of customers in the educational market. This requires a large up-front investment in inventory, labor, storage and related costs as inventory is built in anticipation of peak sales during the summer months. As the capital required for this build-up generally exceeds cash available from operations, Virco has historically relied on bank financing to meet cash flow requirements during the build-up period immediately preceding the high season. Currently, the Company has a line of credit with Wells Fargo Bank to assist in meeting cash flow requirements as inventory is built for, and business is transacted during, the peak summer season.

In addition, Virco typically is faced with a large 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 product shipments increase. Second, many customers during this period are government institutions, which tend to pay accounts receivable more slowly than commercial customers. Virco has historically enjoyed high levels of collectability on these accounts receivable due to the low-credit risk associated with such customers. Nevertheless, due to the time differential between inventory build-up in anticipation of the peak season and the collection on accounts receivable throughout the peak season, the Company must rely on external sources of financing.

Virco's working capital requirements during, and in anticipation of, the peak summer season require management to make estimates and judgments that affect assets, liabilities, revenues and expenses, and related contingent assets and liabilities. For example, management expends a significant amount of time in the first quarter of each year developing a stocking plan and estimating the number of temporary summer 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 meet customer orders in a timely manner or to provide adequate customer service may be diminished. If management overestimates any of these requirements, the Company may have to absorb higher storage, labor and related costs, each of which may negatively affect the Company's results of operations. On an

on-going basis, management evaluates its estimates, including those related to market demand, labor costs, and stocking inventory. Moreover, management continually strives to improve its ability to correctly forecast the requirements of the Company's business during the peak season each year based in part on annual contracts which are in place and management's experience with respect to the market.

As part of Virco's efforts to balance 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 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



## **Table of Contents**

warehouse space needed to store finished goods. As part of the ATS stocking program, Virco has endeavored to create a more flexible work force. The Company has developed compensation programs to reward employees who are willing to move from fabrication to assembly to the warehouse as seasonal demands evolve.

### ***Other Matters***

#### ***Competition***

Virco has numerous competitors in each of its markets. In the educational furniture market, Virco manufactures furniture and sells direct to educational customers. Competitors typically fall into two categories (1) furniture manufacturers that sell to dealers which re-sell furniture to the end user, and (2) dealers that purchase product from these manufacturers and re-sell to educational customers. The manufacturers that Virco competes with include Sagus International LLC (which markets product under Artco-Bell, American Desk, and Midwest Folding Products), Hon (HNI), KI Inc., Royal, Bretford, Smith System, Columbia, Scholarcraft and VS America. The largest competitor that purchases and re-sells furniture is School Specialty (SCHS). In addition to School Specialty, there are numerous smaller local education furniture dealers that sell into local markets. Competitors in contract furniture vary depending upon the specific product line or sales market and include Falcon Products, Inc., KI Inc., MTS and Mity Enterprises, Inc.

The educational furniture market is characterized by price competition, as many sales occur on a bid basis. Management compensates for this market characteristic through a combination of methods that include emphasizing the value of Virco's products and product assortment, the convenience of one-stop shopping for Equipment for Educators, the value of Virco's project management capabilities, the value of Virco's distribution and delivery capabilities, and the value of Virco's customer support capabilities and other intangibles. In addition, management believes that the streamlining of costs assists the Company in compensating for this market characteristic by allowing Virco to offer a higher value product at a lower price. For example, as discussed above, Virco has decreased distribution costs by avoiding re-sellers, and management believes that the Company's large direct sales force and the Company's sizeable manufacturing and warehousing capabilities facilitate these efforts. Although management prefers to compete on the value of Virco products and services, when market conditions warrant, the Company will compete based on direct prices and may reduce its prices to build or maintain its market share.

#### ***Backlog***

Sales order backlog at January 31, 2011, totaled \$17.6 million and approximated eight weeks of sales, compared to \$13.0 million at January 31, 2010, and \$16.5 million at January 31, 2009. Substantially all of the backlog will ship during 2011.

#### ***Patents and Trademarks***

In the last 10 years, the United States Patent and Trademark Office (the USPTO) has issued to Virco more than 50 patents on its various new product lines. These patents cover various design and utility features in Ph.D.<sup>®</sup> chairs, I.Q.<sup>®</sup> Series furniture, the ZUMAFrd family of products, and the ZUM® family of products, among others.

Virco has a number of other design and utility patents in the United States and other countries that provide protection for Virco's intellectual property as well. These patents expire over the next one to 17 years. Virco maintains an active program to protect its investment in technology and patents by monitoring and enforcing its intellectual property rights. While Virco's patents are an important element of its success, Virco's business as a whole is not believed to be materially dependent on any one patent. See Risk Factors An inability to protect our intellectual property could have a significant impact on our business.

In order to distinguish genuine Virco products from competitors' products, Virco has obtained the rights to certain trademarks and tradenames for its products and engages in advertising and sales campaigns to promote its brands and to identify genuine Virco products. While Virco's trademarks and tradenames play an important role in its success, Virco's business as a whole is not believed to be materially dependent on any one trademark or tradename, except perhaps Virco, which the Company has protected and enhanced as an emblem of quality educational furniture for over 60 years.

Virco has no franchises or concessions that are considered to be of material importance to the conduct of its business and has not appraised or established a value for its patents or trademarks.

### ***Employees***

As of January 31, 2011, Virco and its subsidiaries employed approximately 1,050 full-time employees at various locations. Of this number, approximately 850 are involved in manufacturing and distribution, approximately 125 in sales and marketing and approximately 75 in administration.

**Table of Contents*****Environmental Compliance***

Virco is subject to numerous environmental laws and regulations in the various jurisdictions in which it operates that (a) govern operations that may have adverse environmental effects, such as the discharge of materials into the environment, as well as handling, storage, transportation and disposal practices for solid and hazardous wastes, and (b) impose liability for response costs and certain damages resulting from past and current spills, disposals or other releases of hazardous materials. In this context, Virco works diligently to remain in compliance with all such environmental laws and regulations as these affect the Company's operations. Moreover, Virco has enacted policies for recycling and resource recovery that have earned repeated commendations, including designation in 2010 and 2009 from the Waste Reduction Awards Program in California, in 2003 as a WasteWise Hall of Fame Charter Member, in 2002 as a WasteWise Partner of the Year and in 2001 as a WasteWise Program Champion for Large Businesses by the United States Environmental Protection Agency. Additionally, all ZUMA® and ZUMAFrd products, and hundreds of other Virco furniture items including all models in the Company's recently introduced TEX® Table line, as well as Flip-Top Technology tables and Parameter® desks, returns and credenzas have been certified according to the GREENGUARD® Environmental Institute's stringent indoor air quality standard for children and schools. Moreover, all Virco products covered by the Consumer Product Safety Improvement Act of 2008 are in compliance with this legislation. All affected Virco models are also in compliance with the California Air Resources Board rule implemented on January 1, 2009, concerning formaldehyde emissions from composite wood products. Nevertheless, it is possible that the Company's operations may result in noncompliance with, or liability for remediation pursuant to, environmental laws. 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 may be expected to continue to expend, significant amounts in the future for compliance with environmental rules and regulations, for the investigation of environmental conditions, for the installation of environmental control equipment, or remediation of environmental contamination. See Risk Factors We could be required to incur substantial costs to comply with environmental requirements. Violations of, and liabilities under, environmental laws and regulations may increase our costs or require us to change our business practices.

***Financial Information About Industry Segment and Geographic Areas***

Virco operates in a single industry segment. For information regarding the Company's revenues, gross profit and total assets for each of the last three fiscal years, see the Company's consolidated financial statements.

During 2010, Virco derived 5-6% of its revenues from customers located outside of the United States (primarily in Canada and Panama). During the 2009 and 2008, Virco derived approximately 6-7% and 4-5% of its revenues from customers located outside of the United States (primarily in Canada). The Company determines sales to these markets based upon the customers' principal place of business. During 2010, 2009 and 2008, the Company did not have any long-lived assets outside of the United States.

***Executive Officers of the Registrant***

As of April 1, 2011, the executive officers of the Company, who are elected by and serve at the discretion of the Company's Board of Directors, were as follows:

Name	Office	Age at January 31, 2011	Has Held Office Since
R. A. Virtue (1)	President, Chairman of the Board and Chief Executive Officer	78	1990
D. A. Virtue (2)	Executive Vice President	52	1992
S. Bell (3)	Vice President General Manager, Conway Division	54	2004
R. E. Dose (4)	Vice President Finance, Secretary and Treasurer	54	1995

P. Quinones (5)	Vice President	Logistics, Marketing Services and Information Technology	47	2004
D. R. Smith (6)	Vice President	Corporate Marketing and Corporate Stewardship	62	1995
L. L. Swafford (7)	Vice President	Legal Affairs and Corporate Counsel	46	1998
N. Wilson (8)	Vice President	General Manager, Torrance Division	63	2004
L. O. Wonder (9)	Vice President	Sales	59	1995
B. Yau (10)	Vice President	Corporate Controller, Assistant Secretary and Assistant Treasurer.	52	2004

(1) Appointed Chairman in 1990; has been employed by the Company for 54 years and has served as the President since 1982 and Chief Executive Officer since 1988.

(2) Appointed in 1992; has been employed by the Company for 25 years and has served in Production Control, as

**Table of Contents**

Contract Administrator, as Manager of Marketing Services, as General Manager of the Torrance Division, and currently as Corporate Executive Vice President.

- (3) Appointed in 2004; has been employed by the Company for 22 years and has served in a variety of manufacturing, safety, and environmental positions, and currently Vice President General Manager, Conway Division.
- (4) Appointed in 1995; has been employed by the Company for 20 years and has served as the Corporate Controller, and currently as Vice President of Finance, Secretary and Treasurer.
- (5) Appointed in 2004; has been employed by the Company for 19 years in a variety customer and marketing service positions, and currently as Vice President of Logistics, Marketing Services and Information Technology.
- (6) Appointed in 1995; has been employed by the Company for 26 years in a variety of sales and marketing positions, and currently as Vice President of Corporate Marketing and Corporate Stewardship.
- (7) Appointed in 1998; has been employed by the Company for 15 years and has served as Associate Corporate Counsel, and currently as Vice President of Legal Affairs and Corporate Counsel.
- (8) Appointed in 2004; has been employed by the Company for 44 years in a variety of manufacturing, warehousing, and transportation positions, and currently as Vice President General Manager, Torrance Division.
- (9) Appointed in 1995; has been employed by the Company for 33 years in a variety of sales and marketing positions, and currently as Vice President of Sales.
- (10) Appointed in 2004; has been employed by the Company for 14 years and has served as Corporate Controller, and currently as Vice President Accounting, Corporate Controller, Assistant Secretary and Assistant Treasurer.

None of the Company's officers have employment contracts.

***Available Information***

Virco files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission ( SEC ). Stockholders may read and copy this information at the SEC's Public Reference Room at Station Place, 100 F Street, N.E., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. Stockholders may also obtain copies of this information by mail from the Public Reference Room at the address set forth above, at prescribed rates.

The SEC also maintains an Internet website that contains reports, proxy statements and other information about issuers like Virco who file electronically with the SEC. The address of that site is [www.sec.gov](http://www.sec.gov).

In addition, Virco makes available to its stockholders, free of charge through its Internet website, its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed, or furnished pursuant to, Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act ), as soon as reasonably practicable after Virco electronically files such material with, or furnishes it to, the SEC. The address of that site is [www.virco.com](http://www.virco.com).

**Item 1A. Risk Factors**

The following risk factors and other information included in this Annual Report on Form 10-K should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we presently deem less significant may also adversely affect our business, operating results, cash flows, and financial condition. If any of the following risks actually occur, our business, operating results, cash flows and financial condition could be materially adversely affected.

**Our product sales are significantly affected by education funding, which is a function of general economic conditions. If the economy continues to remain weak or further weakens, funding for education may fail to**

**improve or decrease further, which would adversely affect our business and results of operations.**

Our sales are significantly impacted by the level of education funding primarily in North America, which, in turn, is a function of the general economic environment. In a weak economy, like the one currently being experienced in the United States, state and local revenues decline, restricting funding for K-12 education spending which typically leads to a decrease in demand for school furniture. Sustained depressions in the per-student funding levels provided for in-state and local budgets could have a materially adverse impact on our business, financial condition and results of operations.

## **Table of Contents**

As part of the American Recovery and Reinvestment Act (ARRA), the Federal Government provided \$44 billion to be distributed through the Department of Education by April 30, 2009. Significant portions of this money were used to avoid reductions-in-force at educational institutions. It is anticipated that the amount of Federal assistance will decrease in 2011. This decrease and any continued depressions in state and local revenues and gaps in state budgets may require substantial additional reductions in school budgets, which in turn could lead to further declines in demand for school furniture, fixtures and equipment, which would materially adversely affect our revenue and results of operations.

In addition, geopolitical uncertainties, terrorist attacks, acts of war, natural disasters, increases in energy and other costs or combinations of such factors and other factors that are outside of our control could at any time have a significant effect on the economy, which in turn would affect government revenues and allocations of government spending. The occurrence of any of these or similar events in the future could cause demand for our products to decline or competitive pricing pressures to increase, either or both of which would adversely affect our business, operating results, cash flows and financial condition.

### **Gaps in state budgets may adversely affect our revenue and results of operations.**

Virtually all states are required to balance their operating budgets either on an annual or bi-annual basis. Unlike the federal government, states cannot maintain services during an economic downturn by running a deficit. Without federal economic assistance, states that have not recovered from the recent recession will need to address remaining shortfalls with a combination of spending cuts and/or tax increases. If states cut spending for education to address such budgetary shortfalls, our revenue and results of operations will be adversely affected. According to the Center on Budget and Policy Priorities, at least 34 states made cuts or have proposed cuts to K-12 and early education funding in their 2011 budgets, which is likely to negatively impact our performance in 2011.

### **Reduced levels of spending on education may significantly impact spending on furniture and increase price competition in the furniture market. If price competition increases, we may need to reduce our prices to build or maintain our market share, which in turn could lower our profit margins.**

The educational furniture market is characterized by price competition, as many sales occur on a bid basis. When state and local funding for education declines, schools typically reduce spending on all budget line items prior to reducing teacher and administrator salaries and benefits. This in turn can result in reduced demand for school furniture, which in turn can intensify price competition in our industry. This price competition could impact our ability to implement price increases or, in some cases, such as during an industry downturn, maintain prices. In addition, when market conditions warrant, we may need to reduce prices to build or maintain our market share. If we are unable to increase or maintain prices for our products, our profit margins could decline. Such decline will be compounded to the extent we are unable to maintain or reduce the cost of our products, which may be especially difficult in the current environment given the volatility of the commodities markets.

### **Our efforts to introduce new products that meet customer requirements may not be successful, which could limit our sales growth or cause our sales to decline.**

To keep pace with industry trends, such as changes in education curriculum and increases in the use of technology, and with evolving regulatory and industry requirements, including environmental, health, safety and similar standards for the education environment and for product performance, we must periodically introduce new products. The introduction of new products requires the coordination of the design, manufacturing and marketing of such products, which may be affected by factors beyond our control. The design and engineering of certain of our new products can take up to a year or more, and further time may be required to achieve customer acceptance. Accordingly, the launch of any particular product may be later or less successful than we originally anticipated. Additionally, our competitors may develop new product designs that achieve a high level of customer acceptance, which could give them a competitive advantage over us in making future sales. Difficulties or delays in introducing new products or lack of customer acceptance of new products could limit our sales growth or cause our sales to decline.

### **The majority of our sales are generated under annual contracts, which combined with the seasonal nature of our business, may limit our ability to raise prices on a timely basis during a given year in response to increases in costs.**

We commit to annual contracts that determine selling prices for goods and services for periods of one year, and occasionally longer. Though the Company has negotiated increased flexibility under many of these contracts that may allow the Company to increase prices on future orders, the Company does not have the ability to raise prices on orders received prior to any announced price increase. Due to the intensely seasonal nature of our business, the Company may receive significant orders during the first and second quarters for delivery in the second and third quarters. With respect to any of the contracts described above, if the costs of providing our products or services increase between the date the orders are received and the shipping date, we may not be able to implement corresponding increases in our sales prices for such products or services in order to offset the related increased costs. Significant cost increases in providing either the services or products during a given contract period could therefore lower our profit margins. By way of example, in



## **Table of Contents**

2008, we incurred a severe increase in the price of steel. Steel prices increased by more than 80% during a four month period from April to July. During the period from April through the third quarter of 2008, the price of petroleum increased substantially, affecting the cost of plastic, inbound freight, freight to customers, and other energy costs. During the third quarter of 2008, we successfully raised the sales prices under a significant number of our annual contracts in an effort to recover margin lost to increased costs. Due to the seasonal nature of our business, however, approximately 2/3 of orders received and approximately 75% of shipments for the year were priced prior to the third quarter increase.

### **We depend on outside suppliers who may be unable to meet our volume and quality requirements, and we may be unable to obtain alternative sources.**

We require substantial amounts of raw materials and components to manufacture our products, which we purchase from outside sources. Raw materials comprised our single largest total cost for 2010, 2009 and 2008. Contracts with most of our suppliers are short-term. These suppliers may not continue to provide raw materials and components to us at attractive prices, or at all, and we may not be able to obtain the raw materials we need in the future from these or other providers on the scale and within the time frames we require. In the current economic environment, many of the Company's suppliers may experience difficulty obtaining financing and may go out of business. The Company may have difficulty replacing these suppliers, especially if the supplier fails as the Company is entering the seasonal summer shipping season. Moreover, we do not carry significant inventories of raw materials, components or finished goods that could mitigate an interruption or delay in the availability of raw materials and components. In addition, because we purchase components from international sources, primarily China, we are subject to fluctuations in currency exchange rates as well as the impact of natural disasters, war and other factors that may disrupt the transportation systems or shipping lines used by our suppliers, and other uncontrollable factors such as changes in foreign regulation or economic conditions. Any failure to obtain raw materials and components on a timely basis, or any significant delays or interruptions in the supply of raw materials, could prevent us from being able to manufacture products ordered by our customers in a timely fashion, which could have a negative impact on our reputation and could cause our sales to decline.

### **Increases in basic commodity, raw material and component costs could adversely affect our profitability.**

Fluctuations in the price, availability and quality of the commodities, raw materials and components used in manufacturing our products could have an adverse effect on our costs of sales, profitability and our ability to meet customers' demand. The price of commodities, raw materials and components, including steel and plastics, our largest raw material categories, have been volatile in recent years, and the cost, quality and availability of such commodities have been significantly affected in recent years by, among other things, changes in global supply and demand, changes in laws and regulations (including tariffs and duties), changes in exchange rates and worldwide price levels, natural disasters, labor disputes, terrorism and political unrest or instability. These factors could lead to further price increases or supply interruptions in the future. As discussed above, in the short term, rapid changes in raw material costs can be very difficult for us to offset with price increases because, in the case of many of our contracts, we have committed to selling prices for goods and services for periods of one year, and occasionally longer. Our profit margins could be adversely affected if commodity, raw material and component costs remain high or escalate further, and, we are unable to pass along a portion of the higher costs to our customers.

### **We are affected by the cost of energy, and increases in energy prices could reduce our margins and profits.**

The profitability of our operations is sensitive to the cost of energy relative to our transportation costs, the costs of petroleum-based materials (like plastics), and the costs of operating our manufacturing facilities. Petroleum prices have fluctuated significantly in recent years. Prices and availability of petroleum products are subject to political, economic and market factors that are generally outside our control. Political events in petroleum-producing regions as well as hurricanes and other weather-related events may cause petroleum prices to increase. If such prices increase, our transportation costs may be adversely affected in the form of increased operation costs for our fleet and surcharges on freight paid to third-party carriers. If our transportation costs continue to increase, and/or the price of petroleum-based products and cost of operating our manufacturing facilities increase, these increases could have a negative impact on our gross margins and profitability.

**Approximately 40% of our sales are priced through one contract, under which we are the exclusive supplier of classroom furniture.**

A nationwide contract/price list which allows schools and school districts to purchase furniture without bidding accounts for the pricing of a significant portion of our sales. This contract/price list is sponsored by a nationwide purchasing organization that does not purchase products from the Company. By providing a public bid specification and authorization service to publicly-funded agencies, the organization's contract/price list enables such agencies to make authorized expenditures of taxpayer funds. For all sales under this contract/price list, Virco has a direct selling relationship with the purchaser, whether it is a school, a district, or another publicly-funded agency. In addition, Virco

## **Table of Contents**

can ship directly to the purchaser; perform installation services at the purchaser's location; and finally bill directly to, and collect from, the purchaser. Although Virco sells direct to hundreds of individual schools and school districts, and these schools and school districts can purchase our products and services under several bids and contracts available to them, approximately 43% of Virco's sales in 2010 were priced under this nationwide contract/price list. In the 3rd quarter of 2008, the Company was awarded a three-year contract with this purchasing organization extending through 2011. In addition, the Company was awarded three one-year extensions extending through 2014. If Virco were to lose its exclusive supplier status under this contract/price list, and other manufacturers were allowed to sell under this contract/price list, it could cause Virco's sales, or growth in sales, to decline.

**We operate in a seasonal business, and require significant amounts of working capital through our existing credit facility to fund acquisitions of inventory, fund expenses for freight and installation, and finance receivables during the summer delivery season. Restrictions imposed by the terms of our existing credit facility may limit our operating and financial flexibility.**

Our credit facility, among other things, largely prevents us from incurring any additional indebtedness, limits capital expenditures, restricts dividends and stock repurchases, and provides for seasonal variations in the maximum borrowing amount, including a reduced maximum level of borrowing during the fourth fiscal quarter. Our credit facility also provides for quarterly financial covenants, which currently include a maximum leverage ratio and a minimum net income requirement. As a result of the foregoing, our operation and financial flexibility may be limited, which may prevent us from engaging in transactions that might further our growth strategy or otherwise be considered beneficial to us.

A breach of any of the covenants, or certain other provisions, in our credit facility could result in a default, which, if not cured or waived, may permit acceleration of the indebtedness under our credit facility. If the indebtedness under our credit facility were to be accelerated, we cannot be certain that we will have sufficient funds available to pay such indebtedness or that we will have the ability to refinance the accelerated indebtedness on terms favorable to us or at all. Any such acceleration could also result in a foreclosure on all or substantially all of our assets, which would have a negative impact on the value of our common stock and jeopardize our ability to continue as a going concern.

**We may not be able to renew our credit facility on favorable terms, or at all, which would adversely affect our results of operations.**

We have historically relied on third-party bank financing to meet our seasonal cash flow requirements. On an annual basis, we prepare a forecast of seasonal working capital requirements and renew our credit facility with Wells Fargo Bank, our primary lender for more than 20 years. Disruptions in the U.S. credit markets have caused the interest rate on prospective debt financing to widen considerably and have made financing terms for borrowers less attractive, and in certain cases have resulted in the unavailability of certain types of debt financing. Continued uncertainty in the credit markets may negatively impact our ability to renew our credit facility on favorable terms or at all. If we are unable to renew our credit facility on favorable terms (including available borrowing line and the rate of interest charged thereunder), or at all, our ability to fund our operations would be impaired, which would have a material adverse effect on our results of operations.

**If management does not accurately forecast the Company's requirements for the peak summer season, the Company's results of operations could be adversely affected.**

The Company's business is highly seasonal and requires significant working capital in anticipation of and during the peak summer season. This requires management to make estimates and judgments with respect to the Company's working capital requirements during, and in anticipation of, the peak summer season. Management expends a significant amount of time in the first quarter of each year developing a stocking plan and estimating the number of temporary summer employees, the amount of raw materials, and the types of components and products that will be required during the peak season. If management does not accurately forecast the Company's requirements, the Company's results of operations could be adversely affected. For example, if management underestimates any of these requirements, Virco's ability to meet customer orders in a timely manner 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 negatively affect the Company's results of operations.

**We may require additional capital in the future, which may not be available or may be available only on unfavorable terms.**

Our capital requirements depend on many factors, including capital improvements, tooling and new product development. To the extent that our existing capital is insufficient to meet these requirements and cover any losses, we may need to raise additional funds through financings or curtail our growth and reduce our assets. Any equity or debt financing, if available at all, may be on terms that are not favorable to us. Equity financings could result in dilution to our stockholders, and the securities may have rights, preferences and privileges that are senior to those of our common

## **Table of Contents**

stock. If our need for capital arises because of significant losses, the occurrence of these losses may make it more difficult for us to raise the necessary capital.

### **An inability to protect our intellectual property could have a significant impact on our business.**

We attempt to protect our intellectual property rights through a combination of patent, trademark, copyright and trade secret laws. Our ability to compete effectively with our competitors depends, to a significant extent, on our ability to maintain the proprietary nature of our intellectual property. The degree of protection offered by the claims of the various patents, trademarks and service marks may not be broad enough to provide significant proprietary protection or competitive advantages to us, and patents, trademarks or service marks may not be issued on our pending or contemplated applications. In addition, not all of our products are covered by patents. It is also possible that our patents, trademarks and service marks may be challenged, invalidated, cancelled, narrowed or circumvented. If we are unable to maintain the proprietary nature of our intellectual property with respect to our significant current or proposed products, our competitors may be able to sell copies of our products, which could adversely affect our ability to sell our original products and could also result in competitive pricing pressures.

### **If third parties claim that we infringe upon their intellectual property rights, we may incur liability and costs and may have to redesign or discontinue an infringing product.**

We face the risk of claims that we have infringed third parties' intellectual property rights. Companies operating in the furniture industry routinely seek protection of the intellectual property for their product designs, and our principal competitors may have large intellectual property portfolios. Our efforts to identify and avoid infringing third parties' intellectual property rights may not be successful. Any claims of intellectual property infringement, even those without merit, could (i) be expensive and time-consuming to defend; (ii) cause us to cease making, licensing or using products that incorporate the challenged intellectual property; (iii) require us to redesign, reengineer, or rebrand our products or packaging, if feasible; or (iv) require us to enter into royalty or licensing agreements in order to obtain the right to use a third party's intellectual property. Such claims could have a negative impact on our sales and results of operations.

### **We could be required to incur substantial costs to comply with environmental requirements. Violations of, and liabilities under, environmental laws and regulations may increase our costs or require us to change our business practices.**

Our past and present ownership and operation of manufacturing plants are subject to extensive and changing federal, state, and local environmental laws and regulations, including those relating to discharges to air, water and land, the handling and disposal of solid and hazardous waste and the cleanup of properties affected by hazardous substances. As a result, we are involved from time to time in administrative and judicial proceedings and inquiries relating to environmental matters and could become subject to fines or penalties related thereto. We cannot predict what environmental legislation or regulations will be enacted in the future, how existing or future laws or regulations will be administered or interpreted or what environmental conditions may be found to exist. Compliance with more stringent laws or regulations, or stricter interpretation of existing laws, may require additional expenditures by us, some of which may be material. If new environmental laws and regulations are introduced and enforced domestically, but not implemented or enforced internationally, we will operate at a competitive disadvantage compared to competitors who source product primarily from international sources. In addition, in the past we have been identified as a potentially responsible party pursuant to the Comprehensive Environmental Response Compensation and Liability Act ( CERCLA ) for remediation costs associated with waste disposal sites previously used by us. In general, CERCLA can impose liability for costs to investigate and remediate contamination without regard to fault or the legality of disposal and, under certain circumstances, liability may be joint and several, resulting in one party being held responsible for the entire obligation. Liability may also include damages for harm to natural resources. We may also be subject to claims for personal injury or contribution relating to CERCLA sites. We reserve amounts for such matters when expenditures are probable and reasonably estimable.

In addition to environmental laws and regulations affecting our manufacturing activities, the Company is subject to laws and regulations related to consumer product regulation. The Company sells products that are subject to the Consumer Product Safety Improvement Act of 2008 and the California Air Resources Board rule implemented on January 1, 2009, concerning formaldehyde emissions from composite wood products. The Company has controls in

place to insure that its products meet all consumer product regulations, and a significant number of Virco products have been certified according to the GREENGUARD® Environmental Institute's stringent indoor air quality standard for children and schools.

**The Patient Protection and Affordable Care Act may increase the cost of providing medical benefits to employees, which could have a significant adverse impact on our results of operations.**

We currently provide medical, dental, and life insurance benefits to substantially all full-time employees. Recent legislation regarding health care reform may cause the cost of providing medical insurance to our employees to increase.

**Table of Contents**

We may not be able to pass the cost of increased medical costs to our customers, which could cause our costs of sales to increase and our gross profit to decline.

**We may not be able to manage our business effectively if we are unable to retain our experienced management team or recruit other key personnel.**

The success of our operations is highly dependent upon our ability to attract and retain qualified employees and upon the ability of our senior management and other key employees to implement our business strategy. We believe there are only a limited number of qualified executives in the industry in which we compete. The loss of the services of key members of our management team could seriously harm our efforts to successfully implement our business strategy.

**We are subject to potential labor disruptions, which could have a significant impact on our business.**

None of our work force is represented by unions, and while we believe that we have good relations with our work force, we may experience work stoppages or other labor problems in the future. Any prolonged work stoppage could have an adverse effect on our reputation, our vendor relations and our customers.

**Our insurance coverage may not adequately insulate us from expenses for product defects.**

We maintain product liability and other insurance coverage that we believe to be generally in accordance with industry practices. Our insurance coverage may not be adequate to protect us fully against substantial claims and costs that may arise from product defects, particularly if we have a large number of defective products that we must repair, retrofit, replace or recall.

**Volatility in the equity markets or interest rates could substantially increase our pension costs and have a negative impact on our operating results.**

We sponsor one qualified defined benefit pension plan, the Virco Employee Retirement Plan (the Employee Plan), and two nonqualified pension plans. The difference between plan obligations and assets, or the funded status of the Employee Plan, significantly affects net periodic benefit costs of our Employee Plan and our ongoing funding requirements with respect to the Employee Plan. The Employee Plan is funded with trust assets invested in a diversified portfolio of debt and equity securities and other investments. Among other factors, changes in interest rates, investment returns and the market value of plan assets can (i) affect the level of plan funding; (ii) cause volatility in the net periodic pension cost; and (iii) increase our future contribution requirements. Because the current economic environment is characterized by declining investment returns and interest rates, we may be required to make additional cash contributions to the Employee Plan and recognize further increases in our net pension cost to satisfy our funding requirements. A significant decrease in investment returns or the market value of plan assets or a significant decrease in interest rates could increase our net periodic pension costs and adversely affect our results of operations.

**Holders of approximately 40% of the shares of our stock have entered into an agreement restricting the sale of the stock.**

Certain shares of the Company's common stock received by the holders thereof as gifts from Julian A. Virtue, including shares received in subsequent stock dividends, are subject to an agreement that restricts the sale or transfer of those shares. As a result of the share ownership and representation on the board and in management, the parties to the agreement have significant influence on affairs and actions of the Company, including matters requiring stockholder approval such as the election of directors and approval of significant corporate transactions. In addition, these transfer restrictions and concentration of ownership could have the effect of impeding an acquisition of the Company.

**Our corporate documents and Delaware law contain provisions that could discourage, delay or prevent a change in control of our company.**

Provisions in our certificate of incorporation and our amended and restated bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. In addition, our certificate of incorporation provides for a staggered board of directors, whereby directors serve for three-year terms, with approximately one-third of the directors coming up for reelection each year. Having a staggered board will make it more difficult for a third party to obtain control of our board of directors through a proxy contest, which may be a necessary step in an acquisition of us that is not favored by our board of directors. We are also subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law. Under these provisions, if anyone

becomes an interested stockholder, we may not enter into a business combination with that person for three years without special approval, which could discourage a third party from making a takeover offer and could delay or prevent a change of control. For purposes of Section 203, interested stockholder means, generally, someone owning 15% or more of our outstanding voting stock or an affiliate of ours that owned 15% or more of our outstanding voting stock during the past three years, subject to certain exceptions as described in Section 203. Additionally, the Board of Directors entered into a



## **Table of Contents**

Rights Agreements pursuant to which certain preferred stock purchase rights would become exercisable when a person acquires or commences to acquire a beneficial interest of at least 20% of our outstanding common stock.

**Our stock price has historically been volatile, and investors in our common stock could suffer a decline in value.**

There has been significant volatility in the market price and trading volume of equity securities, which may be unrelated to the financial performance of the companies issuing the securities. The limited float of shares available for purchase or sale of Virco stock can magnify this volatility. These broad market fluctuations may negatively affect the market price of our common stock. Some specific factors that may have a significant effect on our common stock market price include:

actual or anticipated fluctuations in our operating results or future prospects;

our announcements or our competitors' announcements of new products;

the public's reaction to our press releases, our other public announcements and our filings with the SEC;

strategic actions by us or our competitors, such as acquisitions or restructurings;

new laws or regulations or new interpretations of existing laws or regulations applicable to our business;

changes in accounting standards, policies, guidance, interpretations or principles;

changes in our growth rates or our competitors' growth rates;

our inability to raise additional capital;

conditions of the school furniture industry as a result of changes in funding or general economic conditions, including those resulting from war, incidents of terrorism and responses to such events; and

changes in stock market analyst recommendations or earnings estimates regarding our common stock, other comparable companies or the education furniture industry generally.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

#### ***Torrance, California***

Virco leases a 560,000 sq. ft. office, manufacturing and warehousing facility located on 23.5 acres of land in Torrance, California. During the third quarter of 2008, the Company extended the lease for an additional five-year period expiring on February 28, 2015. As part of the extension, the Company received a \$600,000 tenant improvement allowance that was utilized and accounted for as capital expenditure prior to December 31, 2009. This facility also includes the corporate headquarters, the West Coast showroom, and all West Coast distribution operations.

#### ***Conway, Arkansas***

The Company owns 100 acres of land in Conway, Arkansas, containing 1,200,000 sq. ft. of manufacturing, warehousing, and office space. This facility which is equipped with high-density storage systems, features 70 dock doors dedicated to outbound freight, and has substantial yard capacity to store and stage trailers has enabled the Company to consolidate the warehousing function and implement the Assemble-to-Ship inventory stocking program. Management believes that this facility supports Virco's ability to handle increased sales during the peak delivery season and enhances the efficiency with which orders are filled.

In addition to the complex described above, the Company operates two other facilities in Conway, Arkansas. The first is a 375,000 sq. ft. fabrication facility that was acquired in 1954, and expanded and modernized over subsequent years. The Company manufactures fabricated steel and injection-molded plastic components at this facility. The

second is a 175,000 sq. ft. manufacturing facility that is used to fabricate and store compression-molded components. This building is leased under a 10-year lease expiring in March 2018. The Company sold a 150,000 sq. ft. finished goods warehouse in the third quarter of 2008. This facility was leased to a third party on a month-to-month basis until the date of sale.

**Table of Contents**

**Item 3. Legal Proceedings**

Virco has various legal actions pending against it arising in the ordinary course of business, which in the opinion of the Company, are not material in that management either expects that the Company will be successful on the merits of the pending cases or that any liabilities resulting from such cases will be substantially covered by insurance. While it is impossible to estimate with certainty the ultimate legal and financial liability with respect to these suits and claims, management believes that the aggregate amount of such liabilities will not be material to the results of operations, financial position, or cash flows of the Company.

**Item 4. Removed and Reserved**

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The NASDAQ exchange is the principal market on which Virco Mfg. Corporation (VIRC) stock is traded. As of April 4, 2011, there were approximately 296 registered stockholders according to transfer agent records. There were approximately 1,046 beneficial stockholders.

**Dividend Policy**

It is the Board of Directors' policy to periodically review the payment of cash and stock dividends in light of the Company's earnings and liquidity. During the fourth quarter of 2007 the Company initiated a quarterly dividend of \$0.025 per share. In each of 2008, 2009, and 2010 the Company paid a quarterly dividend of \$0.025 per share. Actual payment of cash dividends must be approved by the Board of Directors each quarter. Due to the timing of regularly scheduled Board of Directors meetings, declaration dates may fall in the quarter prior to the payment date, as was the case in the 2nd and 4th quarter of 2008, 2009 and 2010. The current line of credit with Wells Fargo restricts the amount of cash that can be used for stock repurchases and paying cash dividends to a maximum of \$1.75 million per year.

**Quarterly Dividend and Stock Market Information**

	Cash Dividends Declared		Common Stock Range			
	2010	2009	2010	2009		
			High	Low	High	Low
1st Quarter	\$ 0.05	\$ 0.05	\$ 4.10	\$ 3.07	\$ 3.81	\$ 1.65
2nd Quarter			3.85	2.34	3.57	2.78
3rd Quarter	0.05	0.05	3.20	2.60	3.20	2.74
4th Quarter			3.07	2.41	3.99	2.73
		19				

---

**Table of Contents****Stock Performance Graph**

The graph set forth below compares the five-year cumulative total stockholder return of the Company's common stock with the cumulative total stockholder return of (i) an industry peer group index, and (ii) the NASDAQ Market Index. The graph assumes \$100 was invested on February 1, 2006, in the Company's common stock, the NASDAQ Market Index and the companies in the peer group and assumes the reinvestment of dividends, if any.

**COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN  
AMONG VIRCO MFG. CORPORATION, NASDAQ MARKET INDEX,  
AND MORNINGSTAR INDEX**

Company/Market/Peer Group	Period Ending					
	1/31/2006	1/31/2007	1/31/2008	1/31/2009	1/31/2010	1/31/2011
Virco Mfg. Corporation	\$ 100.00	\$ 135.39	\$ 96.68	\$ 32.74	\$ 56.56	\$ 50.46
NASDAQ Market Index	\$ 100.00	\$ 107.27	\$ 104.74	\$ 65.27	\$ 95.88	\$ 121.70
Morningstar Business Equipment	\$ 100.00	\$ 126.27	\$ 101.49	\$ 60.68	\$ 84.53	\$ 115.96

The current composition of Morningstar Business Equipment is as follows: Access to Money, Inc., Acco Brands Corporation, Acme United Corporation, Advanced Growing Systems, Inc., American Locker Group, Inc., aVinci Media, Corporation, Banneker, Inc., BioAuthorize Holdings, Incorporated, Canon, Inc., Canon, Inc., ADR Champion Industries, China Stationery and Office Supply, Inc., Coinstar, Inc., Comtrex Systems Corporation, CSI Computer Specialists, Diebold Incorporated, Energy Focus, Inc., Ennis, Inc., Ergobilt INC., Global Payment Technologies, Inc., Gunther International, Ltd., Herman Miller, Inc., HNI Corporation, Hotelworks.com, Inc., Hypercom Corporation, Inscape Corporation, BKeyware Technologies, Kimball International Inc. A Share, Kimball International Inc. B Share, Knoll, Inc., Kranem Corp, Kranem Corp Common Stock, LSI Industries, Inc., Marmion Industries Corporation, New Medium Enterprise, NFinanSe, Inc., Oce NV ADR, Open Plan Systems, Inc., PAR Technology Corp., Pitney Bowes Inc., Reconditioned Systems, Inc., Ricoh, Ltd. , ADRSerefex Corporation, Smith Corona Corporation, Standard Register Company, Steelcase, Inc., Sunovia Energy Technologies, Inc., TechLite, Inc., VeriFone Systems, Inc., Virco Mfg, Corporation, Web Press Corporation, Xcellink International Incorporated, and Xerox Corporation.

**Item 6. Selected Financial Data**

The following tables set forth selected historical consolidated financial data for the periods indicated. The following data should be read in conjunction with Item 8, Financial Statements and Supplementary Data, and with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Table of Contents****Five Year Summary of Selected Financial Data**

In thousands, except per share data	2010	As Adjusted 2009	As Adjusted 2008	2007	2006
<b>Summary of Operations</b>					
Net sales	\$ 180,995	\$ 190,513	\$ 212,003	\$ 229,565	\$ 223,107
Net (loss) income (3)	\$ (17,594)	\$ (725)	\$ 2,479	\$ 22,219	\$ 7,545
Net (loss) income per share data (a) (3)					
Basic	\$ (1.25)	\$ (0.05)	\$ 0.17	\$ 1.54	\$ 0.56
Assuming dilution	(1.25)	(0.05)	0.17	1.53	0.55
Cash dividends declared per share	\$ 0.10	\$ 0.10	\$ 0.10	\$ 0.03	\$

(a) Net loss per share was calculated based on basic shares outstanding due to the anti-dilutive effect on the inclusion of common stock equivalent shares.

**Other Financial Data**

In thousands, except per share data	2010	As Adjusted 2009	As Adjusted 2008	As Adjusted 2007	2006
Total assets (3)	\$ 100,588	\$ 122,432	\$ 123,432	\$ 131,273	\$ 116,277
Working capital (3)	\$ 29,498	\$ 38,386	\$ 36,525	\$ 36,902	\$ 22,994
Current ratio (3)	2.5/1	2.7/1	2.4/1	2.1/1	1.6/1
Total long-term obligations	\$ 30,169	\$ 30,236	\$ 25,104	\$ 21,129	\$ 30,101
Stockholders' equity (3)	\$ 50,402	\$ 69,270	\$ 71,520	\$ 76,236	\$ 48,878
Shares outstanding at year-end	14,205	14,163	14,239	14,429	14,380
Stockholders' equity per share (3)	\$ 3.55	\$ 4.89	\$ 5.02	\$ 5.28	\$ 3.40

**Financial Highlights**

In thousands, except per share data	2010	As Adjusted 2009	As Adjusted 2008	As Adjusted 2007	2006
<b>Summary of Operations</b>					
Net sales	\$ 180,995	\$ 190,513	\$ 212,003	\$ 229,565	\$ 223,107
Net (loss) income (3)	\$ (17,594)	\$ (725)	\$ 2,479	\$ 22,219	\$ 7,545
Net (loss) income per share (1) (3)	\$ (1.25)	\$ (0.05)	\$ 0.17	\$ 1.54	\$ 0.55
Stockholders' equity (3)	50,402	69,270	71,520	76,236	48,878
Stockholders' equity per share (2) (3)	3.55	4.89	5.02	5.28	3.40

**Table of Contents**

In thousands, except per share data	2005	2004	2003	2002	2001
Summary of Operations					
Net sales	\$ 214,450	\$ 199,854	\$ 191,852	\$ 244,355	\$ 257,462
Net (loss) income (4)	\$ (9,574)	\$ (13,995)	\$ (23,607)	\$ 282	\$ 246
Net (loss) income per share (1) (4)	\$ (0.73)	\$ (1.07)	\$ (1.80)	\$ 0.02	\$ 0.02
Stockholder s equity (4)	39,100	49,265	62,352	82,774	90,223
Stockholder s equity per share (2)(4)	2.98	3.76	4.76	6.31	6.71

- (1) Based on average number of shares outstanding each year after giving retroactive effect to stock dividends and stock split.
- (2) Based on number of shares outstanding at year-end giving effect to stock dividends and stock split.
- (3) The historical financial data has been modified for the opening balance sheet for 2007 and for the results of operations and ending balance sheets for 2008, 2009, and 2010 to reflect our fourth quarter 2010 change in accounting principle for our method of accounting for certain of our inventory, which is discussed in further detail in Note 2 of our consolidated financial statements included in this report.
- (4) For 2003, an adjustment of \$1.6 million of income tax expense was made to reflect tax effect of minimum pension liability.

**Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations***Cautionary Statement Regarding Forward-Looking Statements*

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, including, but not limited to, availability of funding for educational institutions, statements regarding plans and objectives of management for future operations, including plans and objectives relating to products, pricing, marketing, expansion, and manufacturing processes; new business strategies; the Company s ability to continue to control costs and inventory levels; availability and cost of raw materials, especially steel and petroleum-based products; the availability and cost of labor; the potential impact of the Company s Assemble-To-Ship program on earnings; market demand; the Company s ability to position itself in the market; references to current and future investments in and utilization of infrastructure; statements relating to management s beliefs that cash flow from current operations, existing cash reserves, and available lines of credit will be sufficient to support the Company s working capital requirements to fund existing operations; references to expectations of future revenues; pricing; and seasonality.

Such statements involve known and unknown risks, uncertainties, assumptions and other factors, many of which are outside of the Company s control and difficult to forecast, that may cause actual results to differ materially from those which are anticipated. Such factors include, but are not limited to, changes in, or the Company s ability to predict, general economic conditions, the markets for school and office furniture generally and specifically in areas and with customers with which the Company conducts its principal business activities, the rate of approval of school bonds for the construction of new schools, the extent to which existing schools order replacement furniture, customer confidence, competition and other factors included in the Risk Factors section of this report.

In this report, words such as anticipates, believes, expects, will continue, future, intends, plans, estimates, potential, budgets, may, could and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof.

**Executive Overview**

Management's strategy is to position Virco as the overall value supplier of educational furniture and equipment. The markets that Virco serves include the education market (the Company's primary market), which is made up of public and private schools (preschool through 12th grade), junior and community colleges, four-year colleges and universities; trade, technical and vocational schools; convention centers and arenas; the hospitality industry, with respect to their banquet and meeting facilities; government facilities at the federal, state, county and municipal levels; and places of worship. In addition, the Company sells to wholesalers, distributors, retailers and catalog retailers that serve these same markets. These institutions are frequently characterized by extreme seasonality and/or a bid-based purchasing function. The Company's business model, which is designed to support this strategy, includes the development of several competencies to enable superior service to the markets in which Virco competes. An important element of Virco's business model is the Company's emphasis on developing and maintaining key manufacturing, warehousing,



## **Table of Contents**

distribution, installation, project management, and service capabilities. The Company has developed a comprehensive product offering for the furniture, fixtures and equipment needs of the K-12 education market, enabling a school to procure all of its FF&E requirements from one source.

Virco's product offering consists primarily of items manufactured by Virco, complemented with product sourced from other furniture manufacturers. The product offering is continually enhanced with an ongoing new product development program that incorporates internally developed product as well as product lines developed with accomplished designers. Finally, management continues to hone Virco's ability to forecast, finance, manufacture, warehouse, deliver, and install furniture within the relatively narrow delivery window associated with the highly seasonal demand for education sales. In 2010, approximately 50% of the Company's total sales were delivered in June, July, and August with an even higher portion of educational sales delivered in that period. Shipments during July and August can be as great as six times the level of shipments in the winter months. Virco's substantial warehouse space allows the Company to build adequate inventories to service this narrow delivery window for the education market. The market and operating environment for school furniture, fixtures, and equipment has been challenging during the last decade and is likely to continue to be for at least the near future. Schools suffered significant budgetary pressures from 2001 to 2005 following the dot com bust, and more recently in 2008, 2009, and 2010 as a result of the recession and severe budget deficits incurred by state and local governments.

In addition, the furniture industry in general, including the market for school furniture, has been significantly impacted by low cost competition from China. In the years 2004, 2005, and 2008 commodity prices for some of the Company's primary raw materials, particularly steel and plastic, were extremely volatile, and due to recent volatility in the commodities markets, similar volatility for the Company's raw materials is likely to continue for the near term. Because a majority of the Company's sales are generated under annual contracts (or contracts that have longer terms) in which the Company has limited ability to raise the price of its products during the term of the contract, if the costs of the Company's raw materials increase suddenly or unexpectedly, the Company cannot be certain that it will be able to implement corresponding increases in its sales prices in order to offset such increased costs. Significant cost increases in providing products during a given contract period can adversely impact operating results and have done so during prior years, especially 2004, 2005, and 2008. The Company typically benefits from any decreases in raw material costs under the contracts described above as well.

The years 2008, 2009, and 2010 were particularly challenging for the Company and the educational furniture industry in general and conditions are likely to remain challenging for the near term. The budgetary pressures placed on school budgets in these years as a result of the recession were more severe than any period in recent history. These budgetary pressures directly impacted the demand for the Company's products, as the demand for educational furniture largely depends upon: (1) available funding in a school's general operating fund and (2) the completion of bond-funded projects, which is directly impacted by the amount of bond financing issued to fund new school construction, to renovate older schools, and to fully equip new and renovated schools. Funding from bond financing reflected declines in 2008, 2009, and 2010, and school operating budgets experienced significant strain during the same period. In response to these budgetary pressures, as is traditionally the case, schools opted to retain teachers and spend less on repairs, maintenance and replacement furniture, which in turn reduced the demand for, and sales of, the Company's products.

The Company was well-positioned to weather these challenges, however, as it had maintained its reduced cost structure from prior restructurings, including a reduced workforce, wage and hiring freezes and workforce flexibility, and reacted early to the deteriorating conditions, reducing headcount through attrition, reducing production hours, and controlling inventory.

Cost reduction has been a focus of management since 2001 and the Company has achieved significant success in this arena. For example, headcount of permanent employees as of January 31, 2011, was approximately 1,050 compared to a peak of nearly 2,950 in August 2000. Factory overhead in 2010 declined by more than 40% compared to 2000. The Company accomplished this without closing a factory and while continuing to add new production processes, including flat metal forming, and other capabilities to support an ambitious product development program.

In addition, in 2008, 2009 and 2010, Virco continued to invest in new products, which positively impacted sales. For example, in 2008, the Company launched the TEXT® and Lunada® table series and in 2009 the Company introduced

Flip-Top Technology tables for computer classrooms. The Company also utilized its new flat metal forming capabilities to introduce an array of desks, returns and bookcases. Most recently, in 2010, the Company introduced, Parameter®, an invigorating collection of desks, returns and credenzas, and plans to further expand the use of our flat metal forming capabilities to produce lateral files, vertical files and mobile pedestals.

Virco also benefits from its proprietary PlanSCAPE® software and experienced PlanSCAPE managers, which allow Virco to prepare complete package solutions for the FF&E segment of bond-funded public school construction projects. PlanSCAPE software also enables the entire Virco sales force to prepare quotations for less complicated projects. PlanSCAPE project management software allows Virco's sales representatives to provide classroom-by-classroom planning documents for the budgeting, acquisition and installation of FF&E.

## **Table of Contents**

The Company anticipates that demand for furniture in the education markets may continue to decline in 2011. Although general economic conditions have improved, an anticipated reduction in federal stimulus to the states, combined with significant state and local budget deficits may adversely affect funding for education. The Company expects that completion of bond-funded school and college construction projects will be lower in 2011 than in each of 2008, 2009, and 2010. Completions of K-12 projects are anticipated to decline by approximately 8-9% and completion of college projects may increase by 4-5%. Because anticipated completions of K-12 projects are proportionally larger than college completions, and because the Company sells a much larger portion of its annual sales to the K-12 market, the market for bond-funded construction projects in which the Company competes may be smaller in 2011.

Management also anticipates reduced demand for replacement furniture due to the significant financial pressures being placed on school operating budgets. The impact of the American Recovery and Reinvestment Act of 2009 (ARRA) on furniture sales has been difficult to quantify, as many of the funds have been used to reduce layoffs of teachers and administrators. It is anticipated that the availability of federal stimulus will decrease in 2011, putting additional pressure on the operating budgets of the nation's school districts. In addition, according to the Center on Budget and Policy Priorities, at least 34 states made cuts or have proposed cuts to K-12 and early education funding in their 2011 budgets. Such cuts are likely to negatively impact the Company's performance in 2011 and for the near term.

The Company plans to maintain its core work force at current levels for the near future, supplemented with temporary labor as considered necessary in order to produce, warehouse, deliver, and install furniture during the coming summer. Because the Company has not closed any manufacturing or distribution facilities that are utilized in operations, any increase in demand for our products can be met without any required investment in physical infrastructure.

While the short-term economic conditions impacting the Company's core customer base are not positive, there are certain underlying demographics, customer responses, and changes in the competitive landscape that provide opportunities. First, the underlying demographics of the student population are stable compared to the volatility of school budgets, and the related level of furniture and equipment purchases. This volatility is attributable to the financial health of the school systems. Virco management believes that there is a pent-up demand for quality school furniture (though it is unclear when and to what extent that pent-up demand will be converted into a meaningful increase in purchases). Second, management believes that parents and voters will demand that we educate our children and make this an ongoing priority for future government spending. Third, many schools have responded to the budget strains by reducing their support infrastructure. School districts historically have operated central warehouses and professional purchasing departments in a central business office. In order to retain teaching staff, many school districts have shut down the warehouses and reduced their purchasing departments and janitorial staffs. This change provides opportunities to sell services to schools, such as project management for new or renovated schools, delivery to individual school sites rather than truckload deliveries to central warehouses, and installation of furniture in classrooms. Moreover, this change offers opportunities for Virco to promote its complete product assortment which allows one-stop shopping as opposed to sourcing furniture needs from a variety of suppliers. Fourth, many suppliers have shut down or dramatically curtailed their domestic manufacturing capabilities, making it difficult for competitors to provide custom colors or finishes during a tight seasonal summer delivery window when they are reliant upon a supply chain extending to China. Unlike its primary competitors, Virco has maintained and expanded its domestic manufacturing capabilities, recently adding flat metal forming processes to its manufacturing capabilities and bringing production into its factories of products formerly sourced from other suppliers. Virco's domestic factories are a strategic resource for providing its customers with timely delivery of a broad selection of colors, finishes, laminates, and product styles. Finally, the financial health of the competition, both manufacturers and dealers, may have been adversely impacted by the downturn in the economy, creating opportunities for suppliers that can provide dependable delivery of quality products and services. The current credit environment may make it difficult for competitors to finance the significant seasonal nature of school furniture and equipment deliveries.

During 2011 the Company also anticipates continued uncertainty and volatility in commodity costs, particularly in the areas of certain raw materials, transportation, and energy. The Company does not anticipate that this volatility will be as dramatic in 2011 as experienced in 2008, though it could be more volatile than in 2010 or 2009.

## **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 U.S. generally accepted accounting principles. 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 and related obsolescence reserves, self-insured retention for products and general liability insurance, self-insured retention for workers' compensation insurance, provision for warranty, 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

## **Table of Contents**

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 annual report on Form 10-K. Virco's critical accounting policies are as follows:

**Revenue Recognition:** The Company recognizes revenue in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 605 Revenue Recognition. Sales are recorded when title passes and collectability is reasonably assured under its various shipping terms. The Company reports sales as net of sales returns and allowances and sales taxes imposed by various government authorities.

**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 ranged from approximately 0.7% to 1.9% of accounts receivable at year-end. The allowance is evaluated using historic experience combined with a detailed review of past-due accounts. 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 is attributable to low-credit-risk governmental entities, giving Virco's receivables a historically high degree of collectability. Although many states are experiencing budgetary difficulties, it is not anticipated that Virco's credit risk will be significantly impacted by these events. 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 (determined on a first-in, first-out basis) and includes material, labor, and factory overhead. The Company maintains allowances for estimated slow moving and obsolete inventory to reflect the difference between the cost of inventory and the estimated market value. Allowances for slow moving and obsolete inventory are determined through a physical inspection of the product in connection with a physical inventory, a review of slow-moving product, and consideration of active marketing programs. The market for education furniture is traditionally driven by value, not style, and the Company has not typically incurred significant obsolescence expenses. If market conditions are less favorable than those anticipated by management, additional allowances may be required. Due to reductions in sales volume in the past years, the Company's manufacturing facilities are operating at reduced levels of capacity. The Company records the cost of excess capacity as a period expense, not as a component of capitalized inventory valuation.

On January 31, 2011, the Company elected to change its costing method for the material component of raw materials, work in process, and finished goods inventory to the lower of cost or market using the first-in first-out (FIFO) method, from the lower of cost or market using the last-in first out (LIFO) method. The labor and overhead components of inventory have historically been valued on a FIFO basis. The Company believes that the FIFO method for the material component of inventory is preferable as it conforms the inventory costing methods for all components of inventory into a single costing method and better reflects current acquisition costs of those inventories on our consolidated balance sheets. Additionally, presentation of inventory at FIFO aligns the financial reporting with the Company's borrowing base under its line of credit (see Note 3 for further discussion of the line of credit). Further, this change will promote greater comparability with companies that have adopted International Financial Reporting Standards, which does not recognize LIFO as an acceptable accounting method. In accordance with FASB ASC Topic 250, *Accounting Changes and Error Corrections*, all prior periods presented have been adjusted to apply the new accounting method retrospectively. In addition, as an indirect effect of the change in our inventory costing method from LIFO to FIFO, the Company recorded additional inventory lower of cost or market expenses and changes in deferred tax assets and income tax expense. The retroactive effect of the change in our inventory costing method, including the indirect effect of such change, increased the February 1, 2008, opening retained earnings balance by \$4.1 million, and increased our inventory and retained earnings balances by \$8.5 million and \$5.4 million as of January 31, 2009, by \$6.9 million and \$4.3 million as of January 31, 2010, and by \$7.6 million and \$4.7 million as of January 31, 2011, respectively. In addition the change in our inventory costing method, including the indirect effect of such change, increased (decreased) net income by \$1.3, \$(1.0) and \$0.4 million for the years ending January 31, 2009, 2010 and 2011,

respectively.

Self-Insured Retention: For 2008, 2009, and 2010 the Company was self-insured for product liability losses ranging up to \$250,000 per occurrence, for workers compensation losses up to \$250,000 per occurrence, and for auto liability up to \$50,000 per occurrence. The Company obtains annual actuarial valuations for the self-insured retentions.

Product liability, workers compensation, and auto reserves for known and unknown incurred but not reported ( IBNR ) losses are recorded at the net present value of the estimated losses using a discount rate ranging from 5.5% - 6.75% for 2010, 2009, and 2008. Given the relatively short term over which the IBNR losses are discounted, the sensitivity to the discount rate is not significant. Estimated workers compensation losses are funded during the insurance year and subject to retroactive loss adjustments. The Company's exposure to self-insured retentions varies depending upon the market conditions in the insurance industry and the availability of cost-effective insurance coverage. Self-insured retentions for 2011 will be comparable to the retention levels for 2010.

**Table of Contents**

**Warranty Reserve:** The Company provides a warranty against all substantial defects in material and workmanship. The Company's warranty is not a guarantee of service life, which depends upon events outside the Company's control and may be different from the warranty period. The standard warranty offered on products sold through January 31, 2005, is five years. Effective February 1, 2005, the standard warranty was increased to 10 years on products sold after February 1, 2005. The Company warranties generally provide that customers can return a defective product during the specified warranty period following purchase in exchange for a replacement product or that the Company can repair the product at no charge to the customer. The Company determines whether replacement or repair is appropriate in each circumstance. The Company uses historic data to estimate appropriate levels of warranty reserves. Because product mix, production methods, and raw material sources change over time, historic data may not always provide precise estimates for future warranty expense.

**Defined Benefit Obligations:** The Company has three defined benefit plans, the Virco Employees Retirement Plan (the Employee Plan), the Virco Important Performers Plan (the VIP Plan) and the Non-Employee Directors Retirement Plan (the Directors Plan), which provide retirement benefits to employees and outside directors. Virco discounted the pension obligations for the Employee Plan and the Directors Plan at a 5.5% and the VIP Plan at a 6.00% discount rate in 2010, discounted the pension obligations for the Employee Plan and the Directors Plan at a 5.75% and the VIP Plan at a 6.00% discount rate in 2009, and a 6.75% discount rate for all plans in 2008. Because the Company froze benefit accruals for all three plans in 2003, the assumed rate of increase in Compensation has no effect on the accounting for the plans. The Company estimated a 6.5% return on plan assets for the Employee Plan for all three years. The VIP Plan and Directors Plan are unfunded and have no plan assets. These rate assumptions can vary due to changes in interest rates, the employment market, and expected returns in the stock market. In prior years, the discount rate and the anticipated rate of return on plan assets have decreased by several percentage points, causing pension expense and pension obligations to increase. In 2008, the Company incurred significant losses on investments held in trust to fund the Employee Plan. These investment losses will cause future pension costs to increase, and will require future cash contributions to adequately fund the Employee Plan. 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. Effective December 31, 2003, the Company froze new benefit accruals under all three plans. The effect of freezing future benefit accruals minimizes the impact of future raises in compensation, but introduced a new assumption related to the plan freeze. During 2008 it was the Company's intent to resume some form of a retirement benefit when the profitability and the financial condition of the Company allowed, and the actuarial valuations assumed the plans would be frozen for one additional year. During 2009 the Company determined that the freeze would likely become permanent, and the Company recorded a plan curtailment gain of \$29,000. If the Company had assumed a permanent freeze, pension expense for 2008 would have decreased by \$145,000. The Company obtains annual actuarial valuations for all three plans.

**Deferred Tax Assets and Liabilities:** The Company recognizes deferred income taxes under the asset and liability method of accounting for income taxes in accordance with the provisions of FASB ASC Topic 740 Income Taxes. Deferred income taxes are recognized for differences between the financial statement and tax basis of assets and liabilities at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income or reversal of deferred tax liabilities during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. The Company incurred a substantial operating loss for the year ended January 31, 2011. During the fourth quarter of the year ended January 31, 2011, based on this consideration, the Company determined the realization of a majority of the net deferred tax assets no longer met the more likely than not criteria and a valuation allowance was recorded against the majority of the net deferred tax assets totaling \$14,548,000 and \$490,000 at January 31, 2011 and 2010, respectively. At January 31, 2011, the Company has net operating loss carryforwards for federal and state income tax purposes, expiring at various dates through 2032. Federal net operating losses that can potentially be carried forward totaled

approximately \$11,129,000 at January 31, 2011. State net operating losses that can potentially be carried forward totaled approximately \$32,104,000 at January 31, 2011.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ) now codified as part of FASB ASC Topic 740. ASC Topic 740 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under EITF 06-4, now codified under ASC Topic 740, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely



## **Table of Contents**

than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. ASC Topic 740 also provides guidance on derecognition, classification, interest and penalties on income taxes, and accounting in interim periods and requires increased disclosures. The Company adopted the provisions of ASC Topic 740 on February 1, 2007, the beginning of fiscal 2007. There was no material impact as a result of the implementation of ASC Topic 740.

### **Results of Operations (2010 vs. 2009)**

#### **Financial Results and Cash Flow**

As described above, on January 31, 2011, the Company elected to change its costing method for the material component of raw materials. The effect of this accounting change for the fiscal year ended January 31, 2011 was to decrease cost of sales by, and increase gross margin by, \$640,000. Net loss decreased by \$354,000. There was no effect on net cash flow from operations. The effect of this accounting change for the fiscal year ended January 31, 2010 was to increase cost of sales by, and decrease gross margin by, \$1,615,000. Net income decreased by \$1,025,000. There was no effect on net cash flow from operations. In addition, during the fourth quarter ended January 31, 2011, the Company determined the realization of a majority of the net deferred tax assets no longer met the more likely than not criteria, and an additional valuation allowance of \$14.0 million was recorded against the net deferred tax assets. After adjusting the results for the change in accounting, for the fiscal year ended January 31, 2011 and 2010, the Company incurred a pre-tax loss of \$8,587,000 on net sales of \$180,995,000 compared to pre-tax loss of \$1,451,000 on net sales of \$190,513,000 in the same period last year. Net loss per share was \$1.25 for the fiscal year ended January 31, 2011, compared to net loss per share of \$0.05 in the prior year. Cash flow provided by operations was \$5,452,000 for the fiscal year ended January 31, 2011, compared to cash flow used by operations of \$2,795,000 in the prior year.

#### **Sales**

Virco's sales decreased by 5.0% in 2010 to \$180,995,000 compared to \$190,513,000 in 2009. The decrease in sales was caused by unfavorable economic conditions that had an adverse impact on budgets for school spending. The market for school furniture, fixtures, and equipment declined, which intensified price competition for available business. Approximately 60% of the reduction was attributable to a reduction in volume with the balance attributable to reductions in price. Sales of Virco's new products, including Paramet<sup>®</sup>, Zuma<sup>®</sup>, Sage<sup>®</sup>, Metaphor<sup>®</sup>, and Text<sup>®</sup> increased in 2010 compared to 2009, but were offset by reductions in other product lines.

For 2011 the Company anticipates that the persistence of weak economic conditions may continue to cause the amount of school furniture sold to decline compared to 2010. Any such decline will place continued pressure on selling prices. The Company will continue to emphasize the value, design and color selections of its products, the value of its distribution, delivery, installation, and project management capabilities, and the value of timely deliveries during the peak seasonal delivery period. In order to increase or maintain market share during 2011, when market conditions warrant, the Company will compete based on direct prices and may reduce its prices to build or maintain its market share.

#### **Cost of Sales**

Cost of sales was 71.6% of sales in 2010 and 67.9% of sales in 2009. This increase was due to a combination of a reduction in price, as described above, combined with an increase in certain costs.

As a percentage of sales, raw material costs increased by 1.5% compared to the prior year. Steel prices increased moderately during 2010, but other commodity costs were relatively stable. Manufacturing overhead increased by approximately 1.6% of sales. The increase was attributable to a decrease in factory utilization. Production hours decreased by nearly 15% for 2010 compared to the prior year. The reduction in production levels was attributable to a reduction in unit volume, and a decision by the Company to reduce inventory levels.

The Company is beginning 2011 with approximately \$8.2 million less inventory than in 2010. In the fourth quarter of 2009, the Company manufactured more standard ATS components in order to reduce summer overtime and temporary labor costs during the summer of 2010. When the Company experienced reductions in order volumes in the second and third quarters, production levels were reduced to control inventory levels. Production levels remained low

throughout the fourth quarter, resulting is a substantial reduction in inventory levels compared to the prior year. Due to the reduced quantity of inventory at January 31, 2011, production levels and related factory overhead absorption, which vary depending upon selling volumes, are anticipated to be higher in 2011 than 2010.

During 2011 the Company anticipates continued uncertainty and volatility in commodity costs, particularly in the areas of certain raw materials, transportation, and energy. The Company does not anticipate that this volatility will be as dramatic in 2011 as experienced in 2008, but that it could be more volatile than in 2010 or 2009. For more information, please see the section below entitled Inflation and Future Change in Prices.

## **Table of Contents**

### **Selling, General and Administrative and Other Expenses**

Selling, general and administrative expenses for the fiscal year ended January 31, 2011, decreased by approximately \$2.6 million, or 4.2% from the prior year, and were 32.5% of sales as compared to 32.3% in the prior year. Freight and installation costs increased in both dollars and as a percentage of sales due to an increase in the percentage of business requiring delivery and installation. Variable selling costs declined due to a reduction in volume. G&A spending decreased due to a reduction in retirement plan expense, but was otherwise flat compared to the prior year.

For 2011 the Company has initiated a variety of cost control measures intended to reduce selling general and administrative expenses, including scheduled furlough days during federal holidays when schools are not open, and a reduction in certain fleet expenses.

Interest expense was \$50,000 less in 2010 compared to 2009 as a result of lower interest rates.

### **Provision for Income Taxes**

The Company recognizes deferred income taxes under the asset and liability method of accounting for income taxes in accordance with the provisions of ASC Topic 740, Income Taxes. Deferred income taxes are recognized for differences between the financial statement and tax basis of assets and liabilities at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income or reversal of deferred tax liabilities during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

For the fiscal year ended January 31, 2011, the Company incurred an \$8.6 million operating loss. When combined with operating results from the prior two years the Company has incurred a cumulative operating loss for the last three years. While the Company has taken measures to return to profitability, the short term outlook for the school furniture market is challenging. Based on these considerations, at January 31, 2011, the Company determined the realization of a majority of the net deferred tax assets no longer met the more likely than not criteria, and a valuation allowance was recorded against the majority of the net deferred tax assets. The Company has determined that it is more likely than not that some portion of the state net operating loss and credit carry forwards will not be realized and has provided a valuation allowance on a portion of the state net operating losses. At January 31, 2011, the Company had net operating losses carried forward for federal and state income tax purposes, expiring at various dates through 2032 if not utilized. Federal net operating losses that can potentially be carried forward totaled approximately \$11,129,000 at January 31, 2011. State net operating losses that can potentially be carried forward totaled approximately \$32,104,000 at January 31, 2011.

Because the Company has recorded a valuation allowance for the majority of deferred tax assets, the effective tax rate for 2011 may be low, with income tax being primarily attributable to alternative minimum taxes combined with income and franchise taxes as required by various states.

### **Results of Operations (2009 vs. 2008)**

#### **Financial Results and Cash Flow**

As described above, on January 31, 2011, we elected to change our costing method for the material component of raw materials. The following discussion has been modified to account for this change. In particular, all prior periods presented have been retrospectively adjusted to reflect the period-specific effects of applying the new accounting principle. The effect of this accounting change for the fiscal year ended January 31, 2010, was to increase cost of sales by, and decrease gross margin by, \$1,615,000. Net income decreased by \$1,025,000. There was no effect on net cash flow from operations. The effect of this accounting change for the fiscal year ended January 31, 2009, was to decrease cost of sales by, and increase gross margin by, \$2,088,000. Net income increased by \$1,269,000. There was no effect on net cash flow from operations. After adjusting the results for the change in accounting, for the fiscal year ended January 31, 2010, the Company incurred a net loss of \$725,000 on net sales of \$190,513,000 compared to net income of \$2,479,000 on net sales of \$212,003,000 in the prior year. The prior year results benefitted from a \$1,131,000 gain from sale of real estate offset by an impairment charge of \$2,284,000 for goodwill and other intangible assets. Results

for the year ended January 31, 2010, were not affected by similar events. Net loss per share was \$0.05 for the fiscal year ended January 31, 2010, compared to net income per share of \$0.17 in the year ended January 31, 2009.

**Sales**

Virco's sales decreased by 10.1% in 2009 to \$190,513,000 compared to \$212,003,000 in 2008. This decrease in sales was attributable to a decline in unit volume which was driven by unfavorable economic conditions experienced during 2009, offset by price increases of approximately 1%. Prices only modestly increased in 2009 as commodity prices were

## **Table of Contents**

relatively stable, and competitive conditions as a result of the weak economy made it difficult to increase prices. Sales of Virco's new products, including Sage<sup>®</sup>, Metap<sup>®</sup>forTelos<sup>®</sup>, and TEXT<sup>®</sup> increased in 2009 compared to 2008, but were offset by reductions in other product lines.

### **Cost of Sales**

Cost of sales was 67.9% of sales in 2009 and 66.7% of sales in 2008. As a percentage of sales, raw material increased by approximately 0.7% of sales in 2009. Steel prices escalated rapidly during 2008, and while more stable in 2009, remained at a higher level than the average price for 2008. Certain plastic costs increased as well. In 2009, direct labor costs as a percentage of sales were flat compared to 2008. Manufacturing overhead costs increased by approximately 0.5% of sales. Production hours in 2009 were comparable to 2008.

### **Selling, General and Administrative and Other Expenses**

Selling, general and administrative expenses for the fiscal year ended January 31, 2010, decreased by approximately \$3.0 million, or 4.6%, from the prior year, and were 32.3% of sales as compared to 30.4% in the prior year. Freight and installation costs decreased in both dollars and as a percentage of sales due to reduced selling volumes, continued focus on a tiered price structures that increased prices on small orders requiring freight and installation services, and efficiencies from implementation of a new warehouse management system. Selling expenses increased slightly in dollars and increased as a percentage of sales due to expanded selling efforts. G&A spending increased due to higher pension expense primarily attributable to amortization of investment losses incurred during 2009, but was otherwise flat compared to the prior year.

Interest expense was \$325,000 less in 2009 compared to 2008 as a result of lower interest rates.

### **Provision for Income Taxes**

At January 31, 2010, the Company had net operating losses carried forward for federal and state income tax purposes, expiring at various dates through 2029 if not utilized. Federal net operating losses that can potentially be carried forward totaled approximately \$4,524,000 at January 31, 2010. State net operating losses that can potentially be carried forward totaled approximately \$27,355,000 at January 31, 2010. The Company has determined that it is more likely than not that some portion of the state net operating loss and credit carryforwards will not be realized and has provided a valuation allowance of \$490,000 and \$927,000 on the deferred tax assets at January 31, 2010 and 2009 respectively.

### **Gain on Real Estate**

Results for 2008 included a gain on sale of real estate. During the third quarter of 2008, the Company sold a former manufacturing and distribution facility located in Conway, Arkansas. This building was not used in the Company's furniture operations and had been held as rental property. The Company recorded a gain on sale of \$1,131,000 and generated \$2,392,000 of net cash proceeds from the transaction. Results for 2009 did not include any gain / loss on disposition of real estate.

### **Goodwill Impairment**

The Company identified a single reporting unit (the Company itself) as no components have been identified beneath it. In the fourth quarter of 2008, our market capitalization decreased significantly, which decreased the calculated fair value used in the Company's annual impairment test in accordance with ASC Topic 350 Intangibles—Goodwill and Other. Based on this assessment, our management concluded that, as of January 31, 2009, the carrying value of our reporting unit (\$2,200,000) exceeded its fair value (\$0) and thus goodwill was fully impaired. Therefore, the Company recorded a pre-tax, non-cash goodwill impairment charge of \$2,200,000. We further note that after recording the impairment charge, we had no goodwill remaining on our Consolidated Balance Sheet as of January 31, 2009. For the fourth quarter of 2008 impairment test, we determined the fair value of the reporting unit based on a weighting of market capitalization analysis and a discounted cash flow analysis. The market capitalization is calculated by multiplying the share price of our common stock at the measurement date by the number of outstanding common shares and adding a control premium. A control premium was applied to the minority basis value to arrive at the reporting unit's estimated fair value on a controlling basis. In addition to these financial considerations, qualitative factors such as business descriptions, market served, and profitability were considered in our analysis. The selection and weighting of the fair value techniques may result in a higher or lower fair value. Judgment is applied in determining the weightings that are most representative of fair value. Management has performed a sensitivity

analysis on its significant assumptions and has determined that a change in its assumptions within selected sensitivity testing levels would not impact its conclusion.

## **Table of Contents**

### **Inflation and Future Change in Prices**

During 2010 the Company incurred increased costs for steel, but most other costs increased only modestly. In 2009, material costs were relatively stable. Inflation rates had a material impact on the Company in 2008, and a modest impact on the Company in 2010 and 2009. During 2008, the Company incurred a dramatic increase in the costs of steel and plastic, particularly in the second quarter. The cost of steel increased by more than 80% between the months of March and July of 2008. The Company raised prices modestly for orders received in the third quarter, but the increase was late in the year, and not adequate to compensate for the increased commodity costs. In addition, the cost of petroleum (which impacts the cost of plastic, resin, inbound freight, and utilities) increased during 2008. For 2011, the Company anticipates continued volatility in costs, particularly with respect to certain raw materials, transportation, and energy. Anticipated volatility for 2011 is not expected to be as severe as experienced in 2008. There is continued uncertainty with respect to steel and to raw material costs that are affected by the price of oil, especially plastics. Transportation costs may 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. Furthermore, as a result of current adverse economic conditions, there has been a reduction in freight carriers that compete for Virco's business. Virco expects to incur continued pressure on employee benefit costs. The Company has renewed health insurance contracts for its employees through December 2011, but costs subsequent to that date may be adversely impacted by current legislation. Virco has aggressively addressed these costs by reducing headcount, freezing pension benefits, passing on a portion of increased medical costs to employees, and hiring temporary workers who are not eligible for benefit programs. To recover the cumulative impact of increased costs, the Company raised the list prices for Virco's products in 2011 and 2008. Due to current economic conditions, the Company anticipates significant price competition in 2011, and may not be able to raise prices without risk of losing market share. The Company anticipates that the volatility of commodity costs will not be as significant in 2011 as experienced in 2008. As a significant portion of Virco's business is obtained through competitive bids, the Company is carefully considering material and transportation costs as part of the bidding process. Total material costs for 2011, as a percentage of sales, could be higher than in 2010. 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.

### **Liquidity and Capital Resources**

#### **Working Capital Requirements**

Virco addresses liquidity and capital requirements in the context of short-term seasonal requirements and 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 oblige 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 fill customer orders on a timely basis 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 the 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 (20+ years) 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. On January 31, 2011, the Company amended its revolving line of credit with Wells Fargo Bank, entering into a Amendment No. 7 thereto.



## **Table of Contents**

Available borrowing under the line ranges from \$7.5-\$45 million depending upon the period of the seasonal business cycle. The revolving line is currently set to mature on March 1, 2012.

The line of credit is secured by the substantially all of the assets of the Company and its subsidiary, including the Company's accounts receivable, inventories, equipment and real property. The credit facility with Wells Fargo Bank is subject to various financial covenants and places certain restrictions on incurrence of liens and indebtedness, capital expenditures, dividends and the repurchase of the Company's common stock. In addition, there is a clean down provision that requires the Company to reduce borrowings under the line to less than \$7.5 million for a period of 30 days each fiscal year. The Company believes that normal operating cash flow will allow it to meet the clean down requirement with no adverse impact on the Company's liquidity. Approximately \$11,116,000 was available for borrowing as of January 31, 2011.

During 2010, 2009 and 2008 the Company maintained the strength of its balance sheet and available liquidity through three primary methods. First, despite a substantial operating loss and valuation allowance against deferred tax assets in 2010, the Company recorded favorable operating cash flow of \$5,452,000. This followed operating cash flow of (\$2,795,000) in 2009 and \$11,160,000 in 2008. Second, our continued disciplines over capital expenditures resulted in depreciation expense in excess of capital expenditures by approximately \$2.35 million in 2010 and \$0.6 million in 2008. Third, the Company reduced assets employed in the business by selling a building for \$2,392,000 in 2008 and controlling levels of inventory and receivables. Management believes cash generated from operations and from the previously described sources will be adequate to meet its capital requirements in the next 12 months.

### **Long-Term Capital Requirements**

In addition to short-term liquidity considerations, the Company continually evaluates long-term capital requirements. From 1997 through 2000, the Company completed two large capital projects, which have had significant subsequent effects on cash flow. The first project was the implementation of the SAP enterprise resources planning system. The second project was the expansion and re-configuration of the Conway, Arkansas, manufacturing and distribution facility.

Upon completion of these projects, the Company dramatically reduced capital spending. During 2001-2005 capital expenditures ranged from 25%-40% of depreciation expense. Management intends to limit future capital spending until growth in sales volume fully utilizes the new plant and distribution capacity. Capital expenditures will continue to focus on new product development along with the tooling and new processes required to produce new products. The Company has established a goal of limiting capital spending to less than \$5,000,000 for 2011, which is slightly less than anticipated depreciation expense.

### **Asset Impairment**

As more fully discussed in the results of operations, the Company recorded a \$2,200,000 pre-tax, non-cash impairment to goodwill in the fourth quarter of 2008. After the impairment charge, the Company had no goodwill on its Consolidated Balance Sheet at January 31, 2011 or January 31, 2010.

In December 2003, the Company acquired certain assets of Corex Products, Inc., a manufacturer of compression-molded components, for approximately \$1 million. These assets have been transferred to the Company's Conway, Arkansas, location where they have been integrated with the Company's existing compression-molding operation. In connection with this acquisition, the Company acquired certain patents and other intangible assets. During the fourth quarter of 2008, the Company determined that it would not utilize one of the patents acquired, and took an \$84,000 pre-tax impairment charge. After the impairment charge, the Company has no intangible assets on its Consolidated Balance Sheet at January 31, 2011 or January 31, 2010.

The Company 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. The Company evaluates the potential for impaired assets on a quarterly basis. As of January 31, 2011, there has been no impairment to the long-lived assets of the Company, other than described above.

### **Contractual Obligations**

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. 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 Torrance manufacturing and distribution facility is leased under an operating lease that expires on February 28, 2015. The Company does not have any lease obligations or purchase commitments in

**Table of Contents**

excess of normal recurring obligations. Leasehold improvements and tenant improvement allowances are depreciated over the lesser of the expected life of the asset or the lease term.

Contractual Obligations  
Payments Due by Period

In thousands	Total	Less than	1-3 years	3-5	More than
		1 year		years	5 years
Long-term debt obligations	\$ 6,531	\$ 12	\$ 6,519	\$	\$
Interest on long-term debt	326		326		
Operating lease obligations	25,691	6,351	11,769	6,530	1,041
Purchase obligations	15,434	15,434			
	\$ 47,982	\$ 21,797	\$ 18,614	\$ 6,530	\$ 1,041

We may be required to make significant cash outlays related to our unrecognized tax benefits. However, due to the uncertainty of the timing of future cash flows associated with our unrecognized tax benefits, we are unable to make reasonably reliable estimates of the period of cash settlement, if any, with the respective taxing authorities.

Accordingly, unrecognized tax benefits of \$406,000 as of January 31, 2011, have been excluded from the contractual obligations table above. For further information related to unrecognized tax benefits, see Note 7, Income Taxes, to the consolidated financial statements included in this report.

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, 2011, the Company had bonds outstanding valued at approximately \$2,772,000. To the best of management's knowledge, in over 61 years of selling to schools, Virco has never had a bid or performance bond called.

The Company provides a warranty against all substantial defects in material and workmanship. In 2005 the Company extended its standard warranty from five years to 10 years. The Company's warranty is not a guarantee of service life, which depends upon events outside the Company's control and may be different from the warranty period. The Company accrues an estimate of its exposure to warranty claims based upon both product sales data, and an analysis of actual warranty claims incurred. Warranty expense increased during 2010 due to the Company's decision to replace a component on a certain style of chair. These replacements are anticipated to be completed during 2011. The replacement of this component is not related to the safety of the product and has no exposure relating to product liability reserves. At the current time, management cannot reasonably determine whether warranty claims for the upcoming fiscal year will be less than, equal to, or greater than warranty claims incurred in 2010. The following is a summary of the Company's warranty-claim activity during 2010 and 2009.

	January 31,
(In thousands)	2011      2010