

LANDSTAR SYSTEM INC

Form 10-Q

May 05, 2006

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

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the quarterly period ended April 1, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-21238

**LANDSTAR SYSTEM, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**06-1313069**  
(I.R.S. Employer  
Identification No.)

**13410 Sutton Park Drive South, Jacksonville, Florida**

(Address of principal executive offices)

**32224**

(Zip Code)

**(904) 398-9400**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one)  
Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No

The number of shares of the registrant's common stock, par value \$0.01 per share, outstanding as of the close of business on April 28, 2006 was 58,967,759.

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**PART I**

Item 1. Financial Statements

The interim consolidated financial statements contained herein reflect all adjustments (all of a normal, recurring nature) which, in the opinion of management, are necessary for a fair statement of the financial condition, results of operations, cash flows and changes in shareholders' equity for the periods presented. They have been prepared in accordance with Rule 10-01 of Regulation S-X and do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. Operating results for the thirteen weeks ended April 1, 2006 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 30, 2006.

These interim financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-K.

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LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

(Unaudited)

	April 1, 2006	Dec. 31, 2005
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 49,401	\$ 29,398
Short-term investments	20,496	20,693
Trade accounts receivable, less allowance of \$5,439 and \$4,655	437,286	534,274
Other receivables, including advances to independent contractors, less allowance of \$4,444 and \$4,342	21,644	11,384
Deferred income taxes and other current assets	17,797	21,106
<b>Total current assets</b>	<b>546,624</b>	<b>616,855</b>
Operating property, less accumulated depreciation and amortization of \$71,501 and \$68,561	85,449	89,131
Goodwill	31,134	31,134
Other assets	29,821	28,694
<b>Total assets</b>	<b>\$ 693,028</b>	<b>\$ 765,814</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Cash overdraft	\$ 23,995	\$ 29,829
Accounts payable	146,141	164,509
Current maturities of long-term debt	12,250	12,122
Insurance claims	31,923	27,887
Other current liabilities	62,579	65,149
<b>Total current liabilities</b>	<b>276,888</b>	<b>299,496</b>
Long-term debt, excluding current maturities	91,735	154,851
Insurance claims	32,244	37,840
Deferred income taxes	18,471	17,938
Shareholders Equity		
Common stock, \$0.01 par value, authorized 160,000,000 shares, issued 64,391,342 and 64,151,902 shares	644	642
Additional paid-in capital	90,043	84,532
Retained earnings	415,425	392,549
Cost of 5,579,583 and 5,344,883 shares of common stock in treasury	(232,301)	(221,776)
Accumulated other comprehensive loss	(74)	(211)
Note receivable arising from exercise of stock options	(47)	(47)

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Total shareholders' equity	273,690	255,689
Total liabilities and shareholders' equity	\$ 693,028	\$ 765,814

See accompanying notes to consolidated financial statements.

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LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
Revenue	\$ 610,042	\$ 502,212
Investment income	379	539
Costs and expenses:		
Purchased transportation	458,250	377,578
Commissions to agents	47,011	39,126
Other operating costs	12,068	8,698
Insurance and claims	11,552	13,125
Selling, general and administrative	35,836	31,815
Depreciation and amortization	4,093	3,962
Total costs and expenses	568,810	474,304
Operating income	41,611	28,447
Interest and debt expense	1,850	937
Income before income taxes	39,761	27,510
Income taxes	15,411	10,692
Net income	\$ 24,350	\$ 16,818
Earnings per common share	\$ 0.41	\$ 0.28
Diluted earnings per share	\$ 0.41	\$ 0.27
Average number of shares outstanding:		
Earnings per common share	58,901,000	60,396,000
Diluted earnings per share	59,919,000	61,765,000
Dividends paid per common share	\$ 0.025	

See accompanying notes to consolidated financial statements.



LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 24,350	\$ 16,818
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of operating property	4,093	3,962
Non-cash interest charges	44	44
Provisions for losses on trade and other accounts receivable	1,892	1,617
Gains on sales and disposals of operating property	(158)	(248)
Deferred income taxes, net	276	(418)
Stock-based compensation	1,411	1,512
Changes in operating assets and liabilities:		
Decrease in trade and other accounts receivable	84,836	33,391
Decrease in other assets	2,738	4,302
Decrease in accounts payable	(18,368)	(20,294)
Increase (decrease) in insurance claims	(1,560)	2,529
Decrease in other liabilities	(2,016)	(910)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>97,538</b>	<b>42,305</b>
<b>INVESTING ACTIVITIES</b>		
Net change in other short-term investments	1,448	(1,111)
Sales and maturities of long-term investments	10,328	1,500
Purchases of long-term investments	(11,701)	(1,309)
Purchases of operating property	(668)	(739)
Proceeds from sales of operating property	415	1,582
<b>NET CASH USED BY INVESTING ACTIVITIES</b>	<b>(178)</b>	<b>(77)</b>
<b>FINANCING ACTIVITIES</b>		
Increase (decrease) in cash overdraft	(5,834)	723
Proceeds from repayment of notes receivable arising from exercises of stock options		275
Dividends paid	(1,474)	
Proceeds from exercises of stock options	2,376	2,975
Excess tax benefit on stock option exercises	1,694	935
Borrowings on revolving credit facility		2,000
Principal payments on long-term debt and capital lease obligations	(62,988)	(2,755)
Purchases of common stock	(11,131)	(34,947)
<b>NET CASH USED BY FINANCING ACTIVITIES</b>	<b>(77,357)</b>	<b>(30,794)</b>



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Increase in cash and cash equivalents	20,003	11,434
Cash and cash equivalents at beginning of period	29,398	61,684
Cash and cash equivalents at end of period	\$ 49,401	\$ 73,118

See accompanying notes to consolidated financial statements.

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LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
Thirteen Weeks Ended April 1, 2006  
(Dollars in thousands)  
(Unaudited)

	Common Stock		Add 1		Treasury Stock at Cost		Accumulated Other Comprehensive Income		Note Receivable Arising from Exercise of Stock Options	Total
	Shares	Amount	Paid-In Capital	Retained Earnings	Shares	Amount	(Loss)			
Balance December 31, 2005	64,151,902	\$ 642	\$ 84,532	\$ 392,549	5,344,883	\$ (221,776)	\$ (211)	\$ (47)	\$ 255,689	
Net income				24,350					24,350	
Dividends paid				(1,474)					(1,474)	
Purchases of common stock					249,300	(11,131)			(11,131)	
Stock based compensation expense			1,411						1,411	
Exercises of stock options, including excess tax benefit	239,440	2	4,068						4,070	
Incentive compensation paid in common stock			32		(14,600)	606			638	
Change in other comprehensive income on available-for-sale investments, net of income taxes							137		137	
Balance April 1, 2006	64,391,342	\$ 644	\$ 90,043	\$ 415,425	5,579,583	\$ (232,301)	\$ (74)	\$ (47)	\$ 273,690	

See accompanying notes to consolidated financial statements.

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LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The consolidated financial statements include the accounts of Landstar System, Inc. and its subsidiary, Landstar System Holdings, Inc., and reflect all adjustments (all of a normal, recurring nature) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. The preparation of the consolidated financial statements requires the use of management's estimates. Actual results could differ from those estimates. Landstar System, Inc. and its subsidiary are herein referred to as "Landstar" or the "Company".

(1) Share-Based Payments

Prior to 2006, the Company accounted for share-based payment plans in accordance with Accounting Principal Board Opinion No. 25, Accounting for Stock Issued to Employees ( "APB 25" ), and related interpretations. Under APB 25, no stock-based compensation was reflected in net income from stock options granted as all options granted had an exercise price equal to the fair market value of the underlying common stock on the date of grant. On January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R ( "FAS 123R" ), Share-Based Payment. The Company adopted FAS 123R using the modified retrospective method. Amounts for prior periods have been adjusted to reflect the adoption of FAS 123R.

Retrospective Application

Under the modified retrospective method, compensation cost is recognized in the financial statements beginning January 1, 2006, based on the requirements of FAS 123R for all share-based payments granted after that date, and based on the requirements of FAS 123 for all unvested awards granted prior to the effective date of FAS 123R. In addition, results for prior periods have been retrospectively adjusted utilizing the pro forma disclosures in those prior financial statements. The unaudited Balance Sheet as of December 31, 2005, reflects the adoption of FAS 123R as follows: (1) retained earnings has been reduced by \$20,421,000, representing cumulative share-based compensation expense, net of related income tax benefits, for stock options granted from 1995 through 2005, (2) additional paid-in-capital has been increased by \$23,475,000, representing cumulative share-based compensation expense and reduced by income tax benefits realized excluding tax benefits in excess of recognized compensation costs ( "excess tax benefits" ), for stock options granted from 1995 through 2005, and (3) deferred tax assets have been increased by \$3,054,000 representing the estimated future tax benefits attributable to share-based compensation expense expected to be realized.

As a result of the FAS 123R retroactive application, for the thirteen weeks ended March 26, 2005, net income was reduced by \$1,060,000, and earnings per common share and diluted earnings per share were each reduced by \$.02.

Prior to the adoption of FAS 123R, under APB 25, the Company was required to record tax benefits realized from share-based payment arrangements as an operating cash flow. However, FAS 123R requires that excess tax benefits be recorded as a financing cash inflow and corresponding operating cash outflow. The change in presentation of tax benefits from share-based payment arrangements results in a decrease in cash from operating activities and an increase in cash from financing activities of the same amount and does not impact the Company's overall cash position. In the accompanying unaudited Consolidated Statements of Cash Flows for thirteen week period ended April 1, 2006, the Company realized tax benefits of \$1,694,000 in excess of recognized compensation cost and reported that amount as a cash outflow from operating activities and a cash inflow from financing activities. In addition, the cash flow presentation for the thirteen weeks ended March 26, 2005, has been adjusted to conform to the current year presentation.

Share-based payment arrangements

At April 1, 2006, the Company had two employee stock option plans and one stock option plan for members of its Board of Directors (the "Plans" ). The Plans have been approved by the Company's shareholders and are further described below. Amounts recognized in the financial statements with respect to these Plans are as follows (in thousands):

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
Total cost of share-based payment plans during the period	\$ 1,411	\$ 1,512
Amount of related income tax benefit recognized in income	467	452
Net cost of share based payment plans during the period	\$ 944	\$ 1,060

#### Employee and director stock option plans

Under the 1993 Stock Option Plan, as amended, the Compensation Committee of the Board of Directors was authorized to grant options to Company employees to purchase up to 4,460,000 shares of common stock. Under the 2002 Employee Stock Option Plan, the Compensation Committee of the Board of Directors was authorized to grant options to Company employees to purchase up to 6,400,000 shares of common stock. Under the 1994 Directors' Stock Option Plan, as amended (the "DSOP"), options to purchase up to 420,000 shares of common stock were authorized to be granted to outside members of the Board of Directors upon election or re-election to the Board of Directors. Effective May 15, 2003, no further grants will be made under the DSOP. Also, no further grants will be made under the 1993 Stock Option Plan as it has expired.

Options granted under the Plans become exercisable in either three or five equal annual installments commencing on the first anniversary of the date of grant or vest 100% four and one-half years from the date of grant or 100% on the fifth anniversary from the date of grant, subject to acceleration in certain circumstances. All options granted under the Plans expire on the tenth anniversary of the date of grant. Under the Plans, the exercise price of each option equals the fair market value of the Company's common stock on the date of grant. At April 1, 2006, there were 7,062,372 shares of the Company's common stock reserved for issuance upon exercise of options granted and to be granted under the Plans.

The fair value of each option grant on its grant date was calculated using the Black-Scholes option pricing model with the following assumptions for grants made in 2006 and 2005: risk-free interest rate of 4.75% and 4.5% in 2006 and 2005, respectively, expected lives of 4.5 years and 5 years in 2006 and 2005, respectively, a dividend yield of 0.3% in 2006 and no dividend yield in 2005. The expected volatility used in calculating the fair market value of stock options granted was 34% and 31% in 2006 and 2005, respectively. The Company utilizes historical data, including exercise patterns and employee departure behavior, in estimating the term options will be outstanding. Expected volatility was based on historical volatility and other factors, such as expected changes in volatility arising from planned changes to the Company's business, if any. The risk-free interest rate was based on the yield of zero coupon U.S. Treasury bonds for terms that approximated the term of the options granted.

#### Summary details for plan stock options

Information regarding the Company's stock options is as follows:

	Number of Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (000s)
Options outstanding at December 31, 2005	2,794,652	\$ 19.07		
Granted	629,000	\$ 43.60		
Exercised	(239,440)	\$ 9.93		

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Forfeited/expired

Options outstanding at April 1, 2006	3,184,212	\$	24.60	7.6	\$	62,479
Options exercisable at April 1, 2006	1,263,006	\$	15.58	6.3	\$	36,177

The weighted average grant date fair value of stock options granted during the thirteen week periods ended April 1, 2006 and March 26, 2005 was \$15.32 and \$12.78, respectively.

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The total intrinsic value of stock options exercised during the thirteen week periods ended April 1, 2006 and March 26, 2005 was \$8,221,000 and \$8,659,000, respectively.

As of April 1, 2006, there was \$17,627,000 of total unrecognized compensation cost related to non-vested stock options granted under the plans. The compensation cost related to these non-vested options is expected to be recognized over a weighted average period of 2.6 years.

(2) Dividends on Common Stock

On February 28, 2006, the Company paid cash dividends of \$0.025 per common share to stockholders of record on February 14, 2006.

(3) Income Taxes

The provisions for income taxes for the 2006 and 2005 thirteen week periods were based on estimated full year combined effective income tax rates of approximately 38.8% and 38.9%, respectively, which are higher than the statutory federal income tax rate primarily as a result of state income taxes, the meals and entertainment exclusion and non-deductible stock-based compensation.

(4) Earnings Per Share

Earnings per common share amounts are based on the weighted average number of common shares outstanding and diluted earnings per share amounts are based on the weighted average number of common shares outstanding plus the incremental shares that would have been outstanding upon the assumed exercise of all dilutive stock options.

The following table provides a reconciliation of the average number of common shares outstanding used to calculate earnings per share to the average number of common shares and common share equivalents outstanding used in calculating diluted earnings per share (in thousands):

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
Average number of common shares outstanding	58,901	60,396
Incremental shares from assumed exercises of stock options	1,018	1,369
Average number of common shares and common share equivalents outstanding	59,919	61,765

For the thirteen week periods ended April 1, 2006 and March 26, 2005, there were 599,000 and 470,000, respectively, of options outstanding to purchase shares of common stock excluded from the calculation of diluted earnings per share because they were antidilutive.

(5) Additional Cash Flow Information

During the 2006 thirteen week period, Landstar paid income taxes and interest of \$2,985,000 and \$2,375,000, respectively. During the 2005 thirteen week period, Landstar paid income taxes and interest of \$536,000 and \$1,048,000, respectively. Landstar did not acquire operating property by entering into capital leases in the 2006 thirteen week period. Landstar acquired operating property by entering into capital leases in the amount of \$4,297,000 in the 2005 thirteen week period.

## (6) Segment Information

The following tables summarize information about Landstar's reportable business segments as of and for the thirteen weeks ended April 1, 2006 and March 26, 2005 (in thousands):

	Thirteen Weeks Ended April 1, 2006				
	Carrier	Global Logistics	Insurance	Other	Total
External revenue	\$ 428,313	\$ 173,425	\$ 8,304		\$ 610,042
Investment income			379		379
Internal revenue	11,856	360	5,939		18,155
Operating income	40,571	8,727	6,676	\$ (14,363)	41,611
Goodwill	20,496	10,638			31,134

	Thirteen Weeks Ended March 26, 2005				
	Carrier	Global Logistics	Insurance	Other	Total
External revenue	\$ 371,043	\$ 123,696	\$ 7,473		\$ 502,212
Investment income			539		539
Internal revenue	5,884	350	6,590		12,824
Operating income	31,031	5,166	4,092	\$ (11,842)	28,447
Goodwill	20,496	10,638			31,134

## (7) Comprehensive Income

The following table includes the components of comprehensive income for the thirteen week periods ended April 1, 2006 and March 26, 2005 (in thousands):

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
Net income	\$ 24,350	\$ 16,818
Unrealized holding gains (losses) on available-for-sale investments, net of income taxes	137	(78)
Comprehensive income	\$ 24,487	\$ 16,740

Accumulated other comprehensive loss at April 1, 2006 of \$74,000 represents the unrealized holding loss on available-for-sale investments of \$116,000, net of income benefits of \$42,000.

## (8) Commitments and Contingencies

At April 1, 2006, Landstar had \$27,219,000 of letters of credit outstanding under the Company's revolving credit facility and \$39,054,000 of letters of credit secured by investments held at the Company's insurance segment. The short-term investments of \$20,496,000 combined with \$20,745,000 of the non-current portion of investment grade bonds included in other assets at April 1, 2006, provide collateral for the \$39,054,000 of letters of credit issued to guarantee payment of insurance claims.

On November 1, 2002, the Owner Operator Independent Drivers Association, Inc. ( OOIDA ) and six individual independent contractors who provide truck capacity to the Company under exclusive lease arrangements ( BCO Independent Contractors ) and collectively with OOIDA, the Plaintiffs ) filed a putative class action complaint (the Complaint ) in the United States District Court for the Middle District of Florida (the Court ) in Jacksonville, Florida, against the Company. The Complaint alleges that certain aspects of the Company's motor carrier leases with its BCO



Independent Contractors violate certain federal leasing regulations and seeks injunctive relief, an unspecified amount of damages and attorney's fees. On March 8 and June 4, 2004, the Court dismissed all claims of one of the six individual Plaintiffs on the grounds that the ICC Termination Act (the Act) is not applicable to leases signed bef