NATIONAL SERVICE INDUSTRIES INC
Form 10-K
November 29, 2001

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED AUGUST 31, 2001

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 1-3208.

NATIONAL SERVICE INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	58-0364900
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
1420 PEACHTREE STREET, N.E., ATLANTA, GEORGIA	30309-3002
(Address of principal executive offices)	(Zip Code)

(404) 853-1000
(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE SECURITIES EXCHANGE ACT OF 1934:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock ($1.00 Par Value)	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:
NONE

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 [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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. [ ]

Based on the closing price of $20.65 as quoted on the New York Stock Exchange on September 28, 2001, the aggregate market value of the voting stock held by nonaffiliates of the registrant, was $846,202,721.

The number of shares outstanding of the registrant's common stock, $1.00 par value, was 41,225,781 shares as of September 30, 2001.

DOCUMENTS INCORPORATED BY REFERENCE

LOCATION IN FORM 10-K	INCORPORATED DOCUMENT
Part III, Items 10, 11, 12, and 13	2001 Proxy Statement

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES

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PART I

ITEM 1. BUSINESS

National Service Industries, Inc. (the "Company" or "NSI") occupies leadership positions in the textile rental and envelope markets. NSI is headquartered in Atlanta, Georgia, and provides products and services throughout the United States. Of the Company's fiscal 2001 revenues of $563.3 million, the textile rental segment contributed 59 percent and the envelope segment contributed 41 percent.

On November 7, 2001, the board of directors of National Service Industries, Inc. approved the spin-off of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off will be effected on November 30, 2001 through a tax-free distribution of 100% of the outstanding shares of common stock of Acuity Brands, Inc. ("Acuity"), which is a wholly-owned subsidiary of NSI that operates the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the distribution, will receive one share of Acuity common stock for each share of NSI common stock held at that date. The historical financial statements of NSI have been restated to reflect Acuity as a discontinued operation.

The Company's principal executive offices are located at 1420 Peachtree Street, N.E., Atlanta, Georgia 30309-3002 and the telephone number is (404) 853-1000.

BUSINESS SEGMENTS

TEXTILE RENTAL

National Linen Service ("NLS") is a leading United States multi-service textile rental company, with fiscal 2001 revenues of $334.8 million. NLS serves over 50,000 customers in the dining, lodging, and healthcare industries. Its customers include restaurants, hotels, country clubs, retail stores, hospitals, clinics, and doctors' offices. Operating in 22 states, NLS delivers clean products including napkins, table and bed linens, bath towels, pillow cases, bar towels, scrubs and surgical drapery, mats, mops, and restroom supplies, and retrieves soiled linens for cleaning. NLS sells its services directly to end users through a salaried and commissioned sales force.

ENVELOPE

Atlantic Envelope Company ("AECO") is a leading United States manufacturer of custom envelopes and office products, serving the energy, finance, transportation, direct mail and package delivery markets. Products include custom business and courier envelopes, as well as specialty filing products. AECO has eight state-of-the-art manufacturing facilities located throughout the United States. AECO's customers include major airlines, banks, credit card companies and express delivery companies. Products are sold directly to end-users by a commissioned sales team. Specialty products are also sold through dealers. Revenues for fiscal 2001 totaled $228.5 million.

FINANCIAL RESULTS BY INDUSTRY SEGMENT

Sales and service revenues, operating profit (loss), total assets, and related data for each of the Company's business segments for the three years ended August 31, 2001 are included in Note 11, Business Segment Information, of the Notes to the Consolidated Financial Statements on page 41.

RAW MATERIALS

Paper comprises a significant portion of the envelope segment's material requirements. However, the Company purchases its paper from numerous suppliers and there were no significant shortages of materials during the three years ended August 31, 2001.

SEASONALITY

Financial results for any particular quarter are not necessarily indicative of results to be expected for the full year and, typically, the Company's revenues are higher in the second half of its fiscal year.

CUSTOMERS

No single customer accounted for more than 10 percent of consolidated revenues during the fiscal years ended August 31, 2001, 2000, and 1999. However, two customers of the envelope segment represented 27 percent and 18 percent of its fiscal 2001 and fiscal 2000 revenues, respectively. The loss of either customer would adversely affect the segment.

BACKLOG

Sales order backlog at August 31, 2001 and 2000 was $27.8 million and $53.7 million, respectively, in the envelope segment.

COMPETITION

While each of the Company's businesses is highly competitive, the competitive conditions and the Company's relative position and market share vary widely from business to business. Most competitors are smaller companies that frequently specialize in one industry or geographic area, which in many instances increases the intensity of competition. The principal methods of competition include price, quality, and customer responsiveness.

RESEARCH AND DEVELOPMENT

The Company conducts research and development related to present and future products for its envelope segment. Research and development expenses were immaterial during the fiscal years ended August 31, 2001, 2000, and 1999.

ENVIRONMENTAL MATTERS

Management does not anticipate that compliance with current environmental laws and regulations will materially affect the capital expenditures or results of operations of the Company or its subsidiaries during the fiscal year ending August 31, 2002. See Note 6, Commitments and Contingencies, of the Notes to the Consolidated Financial Statements on page 32.

EMPLOYMENT

As of August 31, 2001, the Company employed approximately 7,700 people.

ITEM 2. PROPERTIES

The general offices of the Company are located in Atlanta, Georgia. Because of the diverse nature of the operations and the large number of individual locations, it is neither practical nor meaningful to

describe each of the operating facilities owned or leased by the Company. The following listing summarizes the significant facility categories by business:

DIVISION	NUMBER OF FACILITIES OWNED	LEASED	NATURE OF FACILITIES
Textile Rental.............................	34	5	Linen Processing Plants
	2	27	Linen Service Centers
Envelope...................................	7	1	Manufacturing Plants
	--	2	Warehouses
	1	1	Offices
Corporate Office...........................	1	--	Corporate Headquarters

None of the Company's individual properties is considered to have a value that is significant in relation to the Company's assets as a whole. The Company believes that its properties are well maintained, are in good working condition, and are deemed to be suitable and adequate for its present needs. The Company believes that it has additional capacity available at most of the Company's production facilities and that it could significantly increase production without substantial capital expenditures.

ITEM 3. LEGAL PROCEEDINGS

See Note 6, Commitments and Contingencies, of the Notes to the Consolidated Financial Statements on page 32.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the three months ended August 31, 2001.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

National Service Industries' common stock is listed on the New York Stock Exchange under the symbol "NSI." At August 31, 2001, there were 5,647 stockholders of record. The following table sets forth the New York Stock Exchange high and low stock prices and the dividend payments for NSI's common stock for the periods indicated.

	PRICE PER SHARE*		DIVIDENDS
	HIGH	LOW	PER SHARE
2001			
First Quarter	$ 20.8125	$ 18.3125	$.33
Second Quarter	26.0200	20.5625	.33
Third Quarter	25.7000	21.5400	.33
Fourth Quarter	25.7300	20.0000	.33
2000			
First Quarter	$ 34.0000	$ 29.2500	$.32
Second Quarter	30.1875	20.5000	.33
Third Quarter	24.3750	20.3750	.33
Fourth Quarter	23.3750	18.2500	.33

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* Price per share information does not reflect any adjustment as a result of the spin-off of the Company's lighting equipment and chemicals businesses, the effectiveness of which will be November 30, 2001.

ITEM 6. SELECTED FINANCIAL DATA

	2001	2000	1999	1998	
	(Dollar amounts in thousands, except per-share dat				
OPERATING RESULTS(1)					
Revenue from Continuing Operations					
Service revenues	$ 334,820	$ 321,522	$ 309,115	$ 312,746	$
Net sales of products	228,462	225,190	204,510	161,037	
Total revenues	$ 563,282	$ 546,712	$ 513,625	$ 473,783	$
Net Income					
(Loss) income from continuing operations	$ (15,291)	$ 17,073	$ 34,918	$ 27,169	$
Discontinued operations, net of tax	42,304	82,797	89,425	81,551	
Net Income	$ 27,013	$ 99,870	$ 124,343	$ 108,720	$
PER-SHARE DATA					
Basic earnings per share(1)(2):					

(Loss) income from continuing operations...........................	$ (.37)	$ .42	$ .85	$ .64	$
Discontinued operations, net of tax.....	1.03	2.03	2.19	1.92	
Net income....................	$ .66	$ 2.45	$ 3.04	$ 2.56	$
Diluted earnings per share (1)(2):					
(Loss) income from continuing operations...........................	$ (.37)	$ .42	$ .85	$ .63	$
Discontinued operations, net of tax.....	1.03	2.03	2.18	1.90	
Net income....................	$ .66	$ 2.45	$ 3.03	$ 2.53	$
Cash dividends.........................	$ 1.32	$ 1.31	$ 1.27	$ 1.23	$
Stockholders' equity...................	$ 15.66	$ 16.37	$ 15.22	$ 13.96	$
TOTAL ASSETS(1)					
Continuing operations..................	$ 498,098	$ 398,904	$ 364,218	$ 319,690	$
Discontinued operations................	1,330,575	1,422,880	1,337,038	700,112	
Total.........................	$1,828,673	$1,821,784	$1,701,256	$1,019,802	$1,
TOTAL DEBT(1)					
Continuing operations..................	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$
Discontinued operations................	608,830	636,434	544,577	81,073	
Total.........................	$ 613,830	$ 641,434	$ 549,577	$ 86,073	$

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(1) On November 7, 2001 management approved the spin-off the Company's lighting and chemical businesses. Accordingly, the Company's results of operations have been prepared with the net assets, results of operations, and cash flows related to the lighting and chemical businesses presented as discontinued operations. Prior period amounts have been restated to conform to this presentation.

(2) In 1998, the Company adopted Financial Accounting Standard No. 128, "Earnings per Share." Prior period amounts have been restated in accordance with this statement.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

National Service Industries, Inc. is a service and manufacturing company operating in the textile rental and envelope segments.

On November 7, 2001, the board of directors of National Service Industries, Inc. approved the spin-off of its lighting equipment and chemicals businesses into a separate publicly traded company with its own management and board of directors. The spin-off will be effected on November 30, 2001 through a tax-free

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distribution of 100% of the outstanding shares of common stock of Acuity Brands, Inc. ("Acuity"), which is a wholly-owned subsidiary of NSI that operates the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the distribution, will receive one share of Acuity common stock for each share of NSI common stock held at that date.

As a result of the approval of the spin-off subsequent to August 31, 2001 but prior to the release of the Company's financial statements, the net assets and results of operations of the lighting equipment and chemicals businesses have been reflected as discontinued operations for all periods presented herein. The Company's continuing operations consist of its textile rental and envelope segments.

The following discussion should be read in conjunction with the consolidated financial statements and related notes.

The continuing operations of NSI, the textile rental and envelope segments, continued in strong financial condition at August 31, 2001. Net working capital increased to $87.7 million at August 31, 2001 as compared to $65.7 million at August 31, 2000, and the current ratio remained constant at 1.9.

LIQUIDITY AND CAPITAL RESOURCES

OPERATING ACTIVITIES

Continuing operations used cash of $29.1 million in 2001, compared with cash provided of $40.9 million in 2000 and $58.9 million in 1999. The reduction in 2001 related to a decrease in net income, an increase in prepayments and other current assets, an increase in payments related to employee medical and casualty insurance, and an increase in income tax payments. Prepayments and other current assets increased over the prior year as the Company incurred costs related to the spin-off of the lighting and chemical businesses. The increase in income tax payments relates to the resolution of various tax matters, all of which were fully accrued in prior periods. The decrease in cash provided by operating activities during 2000 primarily resulted from the decrease in net income.

INVESTING ACTIVITIES

Investing activities used cash of $24.7 million in 2001, $60.7 million in 2000, and $42.3 million in 1999. The change in fiscal 2001 investing cash flows primarily related to a decrease in capital expenditures and acquisition spending and an increase in cash provided by the sale of businesses. The change in investing cash flows during 2000 was a result of the significant increase in capital expenditures coupled with a decrease in cash provided by the sale of businesses. These items were offset somewhat by a decrease in acquisition spending during fiscal 2000.

Acquisition spending during fiscal 2001 was $5.6 million and related primarily to the textile rental segment's purchase of several plants in Florida. Prior year acquisition spending of $10.1 million also related to several small acquisitions in the textile rental segment. Acquisition spending in 1999 totaled $20.6 million ($19.8 million in cash and 26,495 shares valued at $0.8 million). In February 1999, the envelope segment acquired substantially all of Gilmore Envelope, an envelope manufacturer headquartered in Los Angeles, California, for approximately $10.6 million. The Company also made several acquisitions in the textile rental segment during fiscal 1999 for approximately $10.0 million.

Capital expenditures were $23.1 million in 2001, compared with $45.5 million in 2000 and $33.7 million in 1999. Current-year capital expenditures in the envelope segment related to manufacturing process improvements and information systems. The textile rental segment invested in building improvements, equipment upgrades, and information systems. Fiscal 2000 capital expenditures in the envelope segment primarily related to manufacturing process improvements, new folding capacity, and information systems. Prior-year expenditures in the textile rental segment related to replacing old equipment and delivery truck purchases and refurbishments. During 1999, the envelope segment invested in manufacturing process improvements, information systems, facility expansion, and new folding capacity and the textile rental segment's capital expenditures were for the implementation of new technology, production enhancements, and delivery truck purchases and refurbishments.

In 2002, capital expenditures are expected to approximate $20.3 million as the Company continues to invest capital in technology and equipment. Contractual commitments for capital spending for fiscal year 2002 approximate $4.2 million.

FINANCING ACTIVITIES

Financing activities used cash of $51.4 million, $49.5 million, and $90.2 million during 2001, 2000, and 1999, respectively. Cash used by financing activities during fiscal 2001 and 2000 primarily related to the payment of dividends offset somewhat by cash provided by Employee Stock Purchase Plan share issuances and stock option exercises. In addition to the payment of dividends, cash used by financing activities during 1999 also included the purchase of treasury shares under the Company's treasury share repurchase program which was suspended in the third quarter of fiscal 1999.

LONG-TERM DEBT AND THE SPIN-OFF

Upon completion of the spin-off on November 30, 2001, approximately $374.1 million of long-term debt will be assumed by Acuity, leaving approximately $3.0 million outstanding for the Company. The following provides a discussion of liquidity and capital resources segregated between continuing and discontinued operations.

CONTINUING OPERATIONS

In October 2001, NSI negotiated a $40.0 million, three-year committed credit facility with a single major US bank that will become effective at the time of the spin-off. The facility contains financial covenants including a leverage ratio, a ratio of income available for fixed charges to fixed charges, and a minimum net worth. Interest rates under the facility are based on the LIBOR rate or other rates, at the Company's option. The Company will pay an annual fee on the commitment based on the Company's leverage ratio. No amounts were outstanding under this facility at August 31, 2001, and it is expected that at the time of the spin-off approximately $2.0 million will be outstanding.

Outstanding borrowings at August 31, 2001 included approximately $3.0 million in notes payable at 8.5 percent and approximately $2.0 million in uncommitted credit facility borrowings at a weighted-average interest rate of 4.95 percent.

Management believes anticipated cash flows from operations and available funds from the committed credit facility are sufficient to meet the Company's planned level of capital spending and general operating cash requirements, including but not limited to any cash requirements related to litigation as further described in Note 6 to the financial statements, for at least the next twelve months.

DISCONTINUED OPERATIONS

In anticipation of the spin-off, management has, or is in the process of amending the following agreements which were in place for the Company as of August 31, 2001. The material terms of the agreements are expected to be consistent subsequent to the spin-off for Acuity, who will be the borrower.

In May 2001, the Company entered into a three-year agreement (the "Receivables Facility") to borrow, on an ongoing basis, up to $150.0 million secured by undivided interests in a defined pool of trade accounts receivable of the lighting equipment and chemical segments. At August 31, 2001, net trade accounts receivable pledged as security for the borrowings under the Receivables Facility totaled approximately $227.8 million. Outstanding borrowings under the Receivables Facility at August 31, 2001 were $105.1 million. Interest rates under the Receivables Facility vary with commercial paper rates plus an applicable margin and the interest rate was 3.90 percent at August 31, 2001. Effective at the time of the spin-off, Acuity will assume all of NSI's borrowings and other obligations under the Receivables Facility.

In July 1999, the Company entered into a $250.0 million, 364-day committed credit facility, which was renewed in June 2001 and expires in June 2002. The credit facility permits certain subsidiaries of the Company to borrow under such facility, and the Company guarantees these borrowings. Interest rates under

the credit facility are based on the LIBOR rate or other rates, at the Company's option. The Company pays an annual fee on the commitments based on the Company's credit rating for unsecured long-term public debt. Outstanding borrowings under the facility at August 31, 2001 were $105.0 million at an interest rate of 4.1 percent. No amounts were outstanding under the facility at August 31, 2000. This facility will be discontinued at the time of the spin-off.

In October 2001, NSI, on behalf of Acuity, negotiated a $240.0 million, 364-day committed credit facility with six domestic and international banks that will become effective and will replace the Company's $250.0 million credit facility at the time of the spin-off. The facility includes an option for additional lenders to enter the agreement to provide up to a total of $300.0 million of commitments. The facility contains financial covenants including a leverage ratio of total indebtedness to EBITDA and an interest coverage ratio. Interest rates under the facility are based on the LIBOR rate or other rates, at Acuity's option. Acuity will pay an annual fee on the commitment based on Acuity's credit rating for unsecured long-term public debt. The principal lighting equipment subsidiary and the principal chemicals subsidiary of Acuity are guarantors of the facility.

NSI's commercial paper program was discontinued in July 2001. Amounts outstanding under the commercial paper program were replaced by borrowings under the committed credit facility. The $236.7 million outstanding under the Company's commercial paper program at August 31, 2000 had a weighted-average interest rate of 6.8 percent.

At August 31, 2001, the Company had uncommitted lines of credit totaling $111.2 million for general operating purposes, of which $16.8 million is designated as multi-currency. Outstanding borrowings under the uncommitted credit facilities at August 31, 2001 were $24.7 million, at a weighted-average interest rate of 4.95 percent. At August 31, 2001, $74.4 million in letters of credit was outstanding, primarily under the domestic uncommitted line of credit.

In January 1999, the Company issued $160.0 million in ten-year publicly traded notes bearing a coupon rate of 6.0 percent. In August 2000, the Company issued $200.0 million in ten-year publicly traded notes bearing a coupon rate of 8.375 percent.

Management believes current cash balances, anticipated cash flows from operations, and available funds from the committed credit facilities and the uncommitted lines of credit are sufficient to meet Acuity's planned level of cash requirements for the next twelve months.

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RESULTS OF CONTINUING OPERATIONS

	YEAR ENDED AUGUST 31		
	2001	2000	1999
	(IN MILLIONS, EXCEPT PER-SHARE AMOUNTS)		
SALES AND SERVICE REVENUES:			
Textile Rental	$334.8	$321.5	$309.1
Envelope	228.5	225.2	204.5
	$563.3	$546.7	$513.6
OPERATING (LOSS) PROFIT:			
Textile Rental	$ 12.6	$ 28.2	$ 42.9
Envelope	(13.2)	5.1	17.7
	(0.6)	33.3	60.6
Corporate	(21.9)	(3.8)	(3.5)
Interest expense, net	(1.8)	(1.6)	(1.4)
	(24.3)	27.9	55.7
(LOSS) INCOME FROM CONTINUING OPERATIONS	(15.3)	17.1	34.9
INCOME FROM DISCONTINUED OPERATIONS	42.3	82.8	89.4
NET INCOME	$ 27.0	$ 99.9	$124.3
EARNINGS PER SHARE:			
Basic:			
(Loss) income from continuing operations	$ (.37)	$ .42	$ .85
Discontinued operations	1.03	2.03	2.19
Net income	$ .66	$ 2.45	$ 3.04
Diluted:			
(Loss) income from continuing operations	$ (.37)	$ .42	$ .85
Discontinued operations	1.03	2.03	2.18
Net income	$ .66	$ 2.45	$ 3.03

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National Service Industries posted revenues of $563.3 million for the fiscal year ended August 31, 2001 representing a $16.6 million increase from the prior year, primarily in the textile rental segment. Revenues in 2000 were $546.7 million, representing a 6.4 percent increase in comparison to 1999, with revenues from both segments contributing to the increase. The fiscal 2001 loss from continuing operations represents a decrease in net income of $32.4 million compared to last year. The significant decrease in operating profit during the current fiscal year related to numerous factors including a weakening economy, higher medical and casualty insurance costs, restructuring charges and asset impairments, and a charge associated with estimated uninsured settlements and other related costs associated with the Company's asbestos litigation.

TEXTILE RENTAL SEGMENT

Textile rental segment revenues, representing all of the Company's service revenues, increased 4.1 percent during 2001 to $334.8 million, as a result of additional volume associated with several new large customer accounts, price increases, and revenues associated with acquired businesses. Fiscal 2001 operating profit was $12.6 million compared to last year's operating profit of $28.2 million. Higher employee medical and casualty insurance costs, increased labor and energy costs, a sales tax audit assessment, and severance and restructuring costs, partially offset by a gain related to a reduction in the segment's environmental liabilities, were primarily responsible for the decrease in fiscal 2001 operating profit.

During the second quarter of 2001, management performed a review of the environmental liabilities recorded in connection with the textile rental segment's 1997 uniform plants divestiture. Based on the advice of the Company's environmental experts, the Company decreased its estimates for certain environmental exposures and, as a result, reduced the related liability and recorded a gain of approximately $2.1 million. The gain is included in "Gain on sale of businesses" in the accompanying "Consolidated Statements of Income."

During the fourth quarter of fiscal 2001, management took actions to better position the segment for the future. These actions included a $1.2 million pretax charge related to the termination of 216 home office and field operations employees, all of whom were terminated prior to the end of the fiscal year. None of the accrual had been paid to employees as of August 31, 2001. Additionally, the segment sold two linen facilities resulting in a pre-tax loss of $0.3 million. Management plans to close two additional facilities, whose business would continue to be serviced by other existing facilities. The cost to close these facilities is estimated to be between $6.0 million and $7.0 million. Management expects to finalize it plans and complete the transfer of business to the other existing facilities during the first quarter of fiscal 2002, at which time the Company would record these restructure costs.

The losses resulting from the restructuring activities and impairments in 2001 are included in "Restructuring expense, asset impairments, and other charges (income)" in the "Consolidated Statements of Income."

Revenues during 2000 increased 4.0 percent to $321.5 million as a result of several small acquisitions and growth in the segment's core business. Operating profit decreased $14.7 million during this period as a result of unusual gains included in 1999 results that were not repeated in 2000. The unusual gains related to the 1997 uniform plants divestiture, 1997 restructuring activities, and other gains associated with the sale of businesses. Excluding the unusual gains, fiscal 2000 operating profit increased by $3.8 million as a result of the increase in revenue, lower workers compensation expense, and productivity improvements, offset somewhat by increased fuel costs.

ENVELOPE SEGMENT

Envelope segment revenues remained essentially flat with last year as higher sales volumes to strategic partners during the first quarter were offset by lower volumes in the courier and direct mail markets throughout the remainder of the year. Operating profit decreased by $18.3 million to a loss of $13.2 million. Contributing to the fiscal 2001 loss were $10.9 million in pretax charges, which included

$4.9 million of charges associated with closing four facilities, $3.4 million for the write-off of non-performing assets, and $2.6 million for inventory obsolescence. In addition, the segment experienced higher medical and casualty insurance costs, higher raw materials costs during the first half of the year, and costs related to reorganizing the Miami, Florida manufacturing facility.

During the fourth quarter of fiscal 2001, management finalized its plans to restructure its operations to better position the segment for a continued near-term economic slowdown. Accordingly, the segment recorded a charge of $4.9 million related to its restructure activities. This charge was comprised of $1.9 million associated with terminating 151 manufacturing and salaried employees, all of whom were terminated prior to the end of the fiscal year, $1.6 million in exit expenses to close and consolidate facilities, and $1.4 million in impairments related to equipment located in the closed facilities. As of August 31, 2001, approximately $0.1 million of the accrual for severance costs had been paid to employees. Exit expenses primarily include costs of lease terminations, costs to dispose of facilities, and other union-related costs associated with closing the facilities. Impairments were recognized for those assets where the sum of the estimated undiscounted future cash flows was less than the carrying amount of the assets. Fair market values were determined based on expected future cash flows discounted at the Company's cost of capital.

Unrelated to the restructure activities discussed above, the envelope segment also recorded a charge of $3.4 million primarily related to certain costs associated with the implementation of an enterprise-wide software package. During fiscal 2001, management decided to materially alter the operating methodology of the system. This change in methodology required an extensive reconfiguration of the base software and all the processes associated with the operating system.

The losses resulting from the restructuring activities and impairments in 2001 are included in "Restructuring expense, asset impairments, and other charges (income)" and the charge related to inventory obsolescence was included in "Cost of products sold" in the "Consolidated Statements of Income."

Envelope segment revenues increased $20.7 million, or 10.1 percent, during 2000 due to acquisitions during fiscal 1999 and growth in the segment's core business. Operating profit decreased $12.6 million to $5.1 million as a result of lower average margins from prior year acquisitions and higher paper prices, labor costs, and costs associated with initiatives to improve future productivity. In addition, fiscal 1999 operating profit included a $2.0 million pretax gain on the sale of Techno-Aide/Stumb Metal Products.

CORPORATE

Allocated corporate expenses in 2001 increased $18.1 million primarily due to a $16.1 million charge during the fourth quarter largely related to an increased allocated share of asbestos-related settlements previously reached by the Center for Claims Resolution on behalf of its members for which insurance coverage is uncertain. See Note 6: Commitments and Contingencies in the Notes to the Consolidated Financial Statements for a discussion of the Company's legal proceedings. In addition, allocated corporate expenses were higher due to increased employee medical and casualty insurance costs and higher costs related to strategic and operational initiatives. Allocated corporate expenses in 2000 approximated those in 1999. Interest expense remained relatively flat during fiscal years 2001, 2000, and 1999.

As reported, corporate expenses represent an allocation of total Company corporate expenses using allocation methodologies believed reasonable by management. The Company anticipates that future corporate expenses will be higher than the allocated amounts.

ENVIRONMENTAL MATTERS

See Note 6: Commitments and Contingencies in the Notes to the Consolidated Financial Statements for a discussion of environmental matters.

OUTLOOK

Management continues to execute its strategic plan to grow internally. Fiscal 2002 sales from the existing businesses are expected to remain in line with fiscal 2001 results due to a forecasted continuing weak economy. Excluding discontinued operations and future restructuring charges, management expects the Company to earn between 15 to 20 cents per share. This forecast includes the anticipated impact of the adoption of the recent accounting standard that no longer requires companies to amortize goodwill as well as a higher tax rate of 40 percent due to the loss of certain state tax benefits. The Company is planning to close two additional linen facilities, whose business would be serviced by other existing facilities. The cost to close these facilities is expected to be between $6.0 million and $7.0 million. Additionally, the Company expects to record a pretax charge of approximately $19.0 million upon completion of the spin-off transaction.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain information contained herein constitutes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are inherently uncertain and involve risks. Consequently, actual results may differ materially from those indicated by the forward-looking statements. Statements that may be considered forward-looking include statements concerning: (a) management's expectations with regard to projected capital expenditures and future cash flows; (b) the material terms of Acuity's financing arrangements subsequent to the spin-off; (c) the timing of and estimated costs associated with management's plans to close two additional textile rental facilities; (d) the Company's expectations or beliefs with respect to the outcome and impact of environmental issues and legal proceedings on the Company's business, financial condition, or results of operations; (e) the expected benefit of management's actions to better position the textile rental and envelope businesses for the future; (f) expected future revenue and earnings per share; (g) the expected $19.0 million pretax charge associated with the spin-off transaction; (h) expectations regarding an economic slowdown; and (i) anticipated future corporate expenses. A variety of risks and uncertainties could cause the Company's actual results to differ materially from the anticipated results or other expectations expressed in the Company's forward-looking statements. The risks and uncertainties include without limitation the following: (a) the uncertainty of general business and economic conditions, including fluctuations in commodity and raw materials prices and interest rate changes; (b) unexpected developments or outcomes in the Company's legal or environmental proceedings; (c) the Company's ability to realize the anticipated benefits of strategic initiatives related to increased productivity, new product development, technological advances, cost synergies, and the achievement of sales growth across the business segments; and (d) underlying assumptions or expectations related to the spin-off transaction proving to be inaccurate or unrealized.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

DISCLOSURES ABOUT MARKET RISK

The Company believes that its exposure to market risks that may impact the "Consolidated Balance Sheets," "Consolidated Statements of Income," and "Consolidated Statements of Cash Flows" primarily relate to changing interest rates and commodity prices. The Company does not enter into derivative arrangements for trading or speculative purposes.

INTEREST RATES

The Company's credit line and fixed-rate notes are subject to interest rate fluctuations. These fluctuations expose the Company to changes in interest expense, cash flows, and the fair market value of the instruments. The Company's variable-rate debt amounted to $2.0 million at August 31, 2001. Based on outstanding borrowings at year end, a 10 percent adverse change in effective market interest rates at August 31, 2001 would result in an immaterial amount of additional interest expense.

COMMODITY PRICE RISK

From time to time, the Company's textile rental segment enters into arrangements locking in for specified periods the prices the Company will pay for the volume of natural gas to which the contract relates. The contracts are structured to reduce the segment's exposure to changes in the price of natural gas. However, these contracts also limit the benefit the segment might have otherwise received from decreases in the price of natural gas. The Company does not believe a 10 percent adverse change in market rates of natural gas would have a material impact on its "Consolidated Balance Sheets" or "Consolidated Statements of Income."

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF MANAGEMENT

NATIONAL SERVICE INDUSTRIES, INC.

The management of National Service Industries, Inc. is responsible for the integrity and objectivity of the financial information in this annual report. These financial statements are prepared in conformity with generally accepted accounting principles, using informed judgments and estimates where appropriate. Where applicable, the information in other sections of this report is consistent with the financial statements. The Company maintains a system of internal controls and accounting policies and procedures designed to provide reasonable assurance that assets are safeguarded and transactions are executed and recorded in accordance with management's authorization. The audit committee of the Board of Directors, composed entirely of outside directors, is responsible for monitoring the Company's accounting and reporting practices. The audit committee meets regularly with management, the internal auditors, and the independent public accountants to review the work of each and to assure that each performs its responsibilities. Both the internal auditors and Arthur Andersen LLP have unrestricted access to the audit committee allowing open discussion, without management's presence, on the quality of financial reporting and the adequacy of internal accounting controls.

James S. Balloun Chairman, President, and Chief Executive Officer	Brock A. Hattox Executive Vice President and Chief Financial Officer	Robert R. Burchfield Vice President and Controller

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REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of National Service Industries, Inc.:

We have audited the accompanying consolidated balance sheets of National Service Industries, Inc. (a Delaware corporation) and subsidiaries as of August 31, 2001 and 2000 and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended August 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

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

Arthur Andersen LLP

Atlanta, Georgia

November 29, 2001

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NATIONAL SERVICE INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

	AUGUST 31, 2001	AUGUST 31, 2000
	(IN THOUSANDS, EXCEPT SHARE DATA)	
ASSETS		
Current Assets:		
Receivables, less reserves for doubtful accounts of $1,798 in 2001 and $739 in 2000	$ 60,406	$ 61,291
Inventories, at the lower of cost (on a first-in, first-out basis) or market	19,195	20,723
Linens in service, net of amortization	56,910	57,162
Deferred income taxes	9,138	--
Prepayments	11,300	3,058
Insurance receivable (Note 6)	28,616	--
Other current assets	804	156
Total Current Assets	186,369	142,390
Property, Plant, and Equipment, at cost:		
Land	12,775	13,607
Buildings and leasehold improvements	57,433	58,845
Machinery and equipment	258,344	258,537
Total Property, Plant, and Equipment	328,552	330,989
Less -- Accumulated depreciation and amortization	157,507	148,958
Property, Plant, and Equipment - net	171,045	182,031
Other Assets:		
Goodwill and other intangibles (Note 1)	37,061	38,685
Insurance receivable (Note 6)	66,574	--
Other	37,049	35,798
Total Other Assets	140,684	74,483
Net assets of discontinued operations (Note 2)	400,296	455,543
Total Assets	$ 898,394	$ 854,447
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current maturities of long-term debt	$ 1,011	$ 201
Commercial paper	--	1,075
Notes payable	1,999	--
Accounts payable	28,164	26,901
Accrued salaries, commissions, and bonuses	7,050	8,905
Current portion of self-insurance reserves	3,119	2,540
Environmental reserve (Note 6)	7,291	10,125
Litigation reserve (Note 6)	30,453	1,787
Deferred income taxes	--	5,346
Other accrued liabilities	19,561	19,824

Total Current Liabilities	98,648	76,704
Long-Term Debt, less current maturities	1,990	3,724
Deferred Income Taxes	32,431	59,251
Self-Insurance Reserves, less current portion	12,477	19,394
Litigation Reserve (Note 6)	82,917	7,148
Other Long-Term Liabilities	7,303	7,016
Commitments and Contingencies (Note 6)		
Stockholders' Equity:		
Series A participating preferred stock, $.05 stated value, 500,000 shares authorized, none issued		
Preferred stock, no par value, 500,000 shares authorized, none issued		
Common stock, $1 par value, 120,000,000 shares authorized, 57,918,978 shares issued in 2001 and 2000	57,919	57,919
Paid-in capital	29,421	29,657
Retained earnings	995,537	1,022,974
Unearned compensation on restricted stock (Note 5)	(880)	--
Accumulated other comprehensive income items	(43)	(37)
	1,081,954	1,110,513
Less -- Treasury stock, at cost (16,693,197 shares in 2001 and 17,090,414 shares in 2000)	419,326	429,303
Total Stockholders' Equity	662,628	681,210
Total Liabilities and Stockholders' Equity	$ 898,394	$ 854,447

The accompanying notes to consolidated financial statements are an integral part of these balance sheets.

NATIONAL SERVICE INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF INCOME

	YEAR ENDED AUGUST 31,		
	2001	2000	1999
	(IN THOUSANDS, EXCEPT PER-SHARE DA		
Sales and Service Revenues:			
Service revenues	$334,820	$321,522	$309,1
Net sales of products	228,462	225,190	204,5
Total sales and service revenues	563,282	546,712	513,6
Costs and Expenses:			
Cost of services	192,664	183,867	180,7
Cost of products sold	183,357	177,359	154,0

Selling and administrative expenses	182,106	157,121	143,9
Amortization expense	2,807	2,411	1,8
Interest expense	1,770	1,578	1,3
Gain on sale of businesses	(2,359)	(356)	(11,2
Restructuring expense, asset impairments, and other charges (income)	26,073	--	(9,2
Other expense (income), net	1,135	(3,165)	(3,5
Total costs and expenses	587,553	518,815	457,8
(Loss) income before income tax (benefit) expense	(24,271)	27,897	55,7
Income tax (benefit) expense	(8,980)	10,824	20,8
(Loss) income from continuing operations	(15,291)	17,073	34,9
Income from discontinued operations, net of income taxes of $26,848 in 2001, $52,494 in 2000, and $53,160 in 1999 (Note 2)	42,304	82,797	89,4
Net Income	$ 27,013	$ 99,870	$124,3
BASIC EARNINGS PER SHARE			
(Loss) income from continuing operations	$ (.37)	$ .42	$.
Discontinued operations	1.03	2.03	2.
Net income	$ .66	$ 2.45	$ 3.
Basic Weighted Average Number of Shares Outstanding	41,068	40,708	40,8
DILUTED EARNINGS PER SHARE			
(Loss) income from continuing operations	$ (.37)	$ .42	$.
Discontinued operations	1.03	2.03	2.
Net income	$ .66	$ 2.45	$ 3.
Diluted Weighted Average Number of Shares Outstanding	41,068	40,727	41,0

The accompanying notes to consolidated financial statements are an integral part of these statements.

NATIONAL SERVICE INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

	COMPREHENSIVE INCOME	COMMON STOCK	PAID-IN CAPITAL	RETAINED EARNINGS	UNEARNED COMPENSATION ON RESTRICTED STOCK	ACC COMP INCO
			(IN THOUSANDS, EXCEPT SHARE AND PER-SHARE			
BALANCE, AUGUST 31, 1998		$57,919	$28,521	$ 903,974	$ --	
Comprehensive income:						
Net income	$124,343	--	--	124,343	--	

Other comprehensive income, net of tax:					
Minimum pension liability adjustment (net of tax of $4).................	9	--	--	--	--
Comprehensive income............	$124,352				
Treasury stock purchased(1)............		--	--	--	--
Stock options exercised(2)............		--	58	--	--
Treasury stock issued in connection with acquisition(3)..........		--	200	--	--
Employee Stock Purchase Plan issuances(4).......		--	276	--	--
Cash dividends of $1.27 per share paid on common stock..................		--	--	(51,856)	--
BALANCE, AUGUST 31, 1999...		57,919	29,055	976,461	--
Comprehensive income:					
Net income..............	$ 99,870	--	--	99,870	--
Other comprehensive income, net of tax:					
Minimum pension liability adjustment (net of tax of $1).................	(3)	--	--	--	--
Comprehensive income............	$ 99,867				
Stock options exercised(5)............		--	98	--	--
Treasury stock issued in connection with Long-Term Incentive Program(6)..............		--	1,245	--	--
Employee Stock Purchase Plan issuances(7).......		--	(741)	--	--
Cash dividends of $1.31 per share paid on common stock..................		--	--	(53,357)	--
BALANCE, AUGUST 31, 2000...		57,919	29,657	1,022,974	--
Comprehensive income:					
Net income..............	$ 27,013	--	--	27,013	--
Other comprehensive income, net of tax:					
Minimum pension liability adjustment (net of tax of $3).................	(6)	--	--	--	--
Comprehensive income............	$ 27,007				
Stock options					

exercised(8)............	--	(14)	--	--
Treasury stock issued in connection with Long-Term Incentive Program(9)..............	--	(963)	--	--
Restricted stock issued in connection with Long-Term Incentive Program(10).............	--	(9)	--	(1,195)
Amortization and forfeitures of restricted stock grants..................	--	--	--	315
Issuance of compensatory stock options...........	--	1,855	--	--
Employee Stock Purchase Plan issuances(11)......	--	(1,105)	--	--
Cash dividends of $1.32 per share paid on common stock..........	--	--	(54,450)	--
BALANCE, AUGUST 31, 2001...	$57,919	$29,421	$ 995,537	$ (880)

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(1) 1,153,099 shares, (2) 21,357 shares, (3) 26,495 shares, (4) 112,835 shares, (5) 29,350 shares, (6) 176,033 shares, (7) 153,955 shares, (8) 1,945 shares, (9) 183,124 shares, (10) 47,920 shares, (11) 164,228 shares.

The accompanying notes to consolidated financial statements are an integral part of these statements.

NATIONAL SERVICE INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEAR ENDED AUGUST 31,		
	2001	2000	1999
	(IN THOUSANDS)		
CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES			
Net (loss) income from continuing operations.............	$ (15,291)	$ 17,073	$ 34,918
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization.........................	27,633	25,227	22,526
Provision for losses on accounts receivable...........	2,345	2,125	906
Loss (gain) on the sale of property, plant, and equipment...	996	(1,098)	(1,168)
Gain on sale of businesses............................	(2,359)	(356)	(11,220)
Restructuring expense, asset impairments, and other charges (income)..................................	26,073	-	(9,291)
Change in assets and liabilities net of effect of acquisitions and divestitures --			
Receivables..	(1,484)	(4,126)	(5,046)

Inventories and linens in service, net	786	1,940	(1,478)
Deferred income taxes	(41,304)	(1,343)	35,695
Prepayments and other current assets	(13,946)	93	(2,309)
Accounts payable and accrued liabilities	(5,358)	2,000	(1,062)
Self-insurance reserves and other long-term liabilities	(7,228)	(648)	(3,585)
Net Cash (Used for) Provided by Continuing Operations	(29,137)	40,887	58,886
Net Cash Provided by Discontinued Operations	105,187	69,296	72,970
Net Cash Provided by Operating Activities	76,050	110,183	131,856
CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES			
Purchases of property, plant, and equipment	(23,053)	(45,485)	(33,730)
Sale of property, plant, and equipment	1,289	1,948	3,619
Sale of businesses	4,888	-	11,962
Acquisitions	(5,596)	(10,130)	(19,762)
Change in other assets	(2,182)	(7,026)	(4,390)
Net Cash Used for Investing Activities	(24,654)	(60,693)	(42,301)
CASH PROVIDED BY (USED FOR) FINANCING ACTIVITIES			
Issuance (purchase) of treasury stock, net	3,054	3,867	(38,390)
Cash dividends paid	(54,450)	(53,357)	(51,856)
Net Cash Used for Financing Activities	(51,396)	(49,490)	(90,246)
Net Change in Cash and Cash Equivalents	--	--	(691)
Cash and Cash Equivalents at Beginning of Year	--	--	691
Cash and Cash Equivalents at End of Year	$ --	$ --	$ --
Supplemental Cash Flow Information:			
Income taxes paid during the year	$ 68,348	$ 66,705	$ 40,799
Interest paid during the year	45,186	43,977	15,660
Noncash Investing and Financing Activities:			
Treasury shares issued under long-term incentive plan	$ 3,637	$ 5,667	$ --

The accompanying notes to consolidated financial statements are an integral part of these statements.

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NATIONAL SERVICE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT SHARE AND PER-SHARE DATA OR AS OTHERWISE INDICATED)

NOTE 1: SUMMARY OF ACCOUNTING POLICIES

DESCRIPTION OF BUSINESS

The Company's continuing operations are in two business segments -- textile rental and envelope -- each of which is a leading competitor in its respective market. The textile rental segment provides linens and dust control products to healthcare, lodging, and dining customer segments in the United States. The envelope segment produces business and specialty envelopes and office products in the United States. The envelope segment's customers include major airlines, banks, credit card companies and express delivery companies.

REVENUE RECOGNITION

The Company records revenues as products are shipped or as services are rendered.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and all subsidiaries after elimination of significant intercompany transactions and accounts.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. In particular, as further discussed in Note 6: Commitments and Contingencies, the Company has made significant estimates related to the ultimate resolution of numerous asserted and unasserted claims, as well as the ultimate reimbursement for these claims from its insurers. Actual results could differ from those estimates.

CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS

Cash in excess of daily requirements is invested in time deposits and marketable securities and is included in the accompanying balance sheets at market value. The Company considers time deposits and marketable securities purchased with an original maturity of three months or less to be cash equivalents. Investments purchased with a maturity of more than three months and less than a year are considered short-term investments. There were no short-term investments at August 31, 2001 and 2000, and all cash balances have been attributed to discontinued operations.

CONCENTRATIONS OF CREDIT RISK

Concentrations of credit risk with respect to receivables are limited due to the wide variety of customers and markets using the Company's products and services, as well as their dispersion across many different geographic areas. As a result, as of August 31, 2001, the Company does not consider itself to have any significant concentrations of credit risk.

INVENTORIES AND LINENS IN SERVICE

Inventories are valued at the lower of cost (on a first-in, first-out basis) or market and consisted of the following at August 31, 2001 and 2000:

	2001	2000
Raw materials and supplies	$ 6,716	$ 5,477
Work in progress	817	585

Finished goods	11,662	14,661
	$19,195	$20,723

Linens in service are recorded at cost and are generally amortized over their estimated useful lives of 15 to 50 months.

GOODWILL AND OTHER INTANGIBLES

The following table summarizes net goodwill and intangible assets including the useful life associated with each as of August 31:

	2001	2000	USEFUL LIFE (IN YEARS)
Goodwill	$28,432	$29,648	10-30
Customer lists	7,866	7,964	7
Other	763	1,073	3-5
	$37,061	$38,685	

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. An impairment loss is recognized when the undiscounted future cash flows estimated to be generated by the asset are not sufficient to recover the unamortized balance of the asset. An impairment loss would be recognized based on the difference between the carrying value of the asset and the estimated fair value, which would be determined based on either the discounted future cash flows or other appropriate fair value methods. If the asset being tested for recoverability was acquired in a business combination, intangible assets and goodwill resulting from the acquisition that are related to the asset are included in the assessment. The Company also evaluates the amortization periods assigned to its intangible assets to determine whether events or circumstances warrant revised estimates of useful lives.

DEPRECIATION

For financial reporting purposes, depreciation is determined principally on a straight-line basis using estimated useful lives of plant and equipment (33 years for buildings and 3 to 16 years for machinery and equipment) while accelerated depreciation methods are used for income tax purposes. Leasehold improvements are amortized over the life of the lease or the useful life of the improvement, whichever is shorter.

RESEARCH AND DEVELOPMENT

Research and development costs are expensed as incurred. Research and development expenses amounted to $749, $536, and $415 during 2001, 2000, and 1999, respectively.

POSTRETIREMENT HEALTHCARE AND LIFE INSURANCE BENEFITS

Substantially all of the Company's retiree medical plans are financed entirely by retiree contributions; therefore, the Company has no liability in connection with them. Several programs provide limited retiree life insurance and medical benefits. The liability for these plans is not material.

POSTEMPLOYMENT BENEFITS

Statement of Financial Accounting Standards ("SFAS") No. 112, "Employers' Accounting for Postemployment Benefits," requires the accrual of the estimated cost of benefits provided by an employer to former or inactive employees after employment but before retirement. The Company's accrual, which is not material, relates primarily to severance agreements and the liability for life insurance coverage for certain eligible employees.

OTHER EXPENSE (INCOME), NET

Other expense (income), net, is comprised primarily of gains or losses resulting from the sale of fixed assets.

FREIGHT BILLED TO CUSTOMERS AND FREIGHT EXPENSE

In September 2000, the Emerging Issues Task Force ("EITF") reached a final consensus on EITF 00-10, "Accounting for Shipping and Handling Fees and Costs." Specifically, EITF 00-10 addresses how the seller of goods should classify amounts billed to a customer for shipping and handling. The EITF concluded that amounts billed to a customer in a sale transaction related to shipping and handling represents revenues earned for the goods provided and should be classified as revenue. The Company adopted EITF 00-10 in fiscal 2001. Historically, the Company netted certain shipping and handling revenues charged to customers in selling and administrative expenses, and such amounts have been reclassified for all periods presented. The adoption of EITF 00-10 resulted in an increase in sales and a corresponding increase in selling and administrative expenses of $4,383, $3,242, and $2,781 for the fiscal years ended August 31, 2001, 2000, and 1999, respectively, with no impact on net income. The Company includes freight expense in selling and administrative expenses. Freight expense amounted to $8,574, $8,232 and $6,945 in fiscal 2001, 2000, and 1999, respectively.

ACCOUNTING STANDARDS YET TO BE ADOPTED

In July 2001, the FASB issued Statement No. 141 ("SFAS 141"), "Business Combinations," and Statement No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 141 eliminates pooling of interest accounting and requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. SFAS 142 eliminates the amortization of goodwill and certain other intangible assets and requires the Company to evaluate goodwill for impairment on an annual basis by applying a fair value test. SFAS 142 also requires that an identifiable intangible asset which is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value-based approach.

The Company will adopt SFAS 142 effective September 1, 2001. As a result, the amortization of existing goodwill and intangibles with indefinite useful lives will cease on August 31, 2001, which will result in an estimated decrease in amortization expense of approximately $975 during fiscal 2002. However, the Company will be required to test its goodwill and intangibles with indefinite useful lives for impairment under the new standard beginning in the first quarter of fiscal 2002, which could have an adverse effect on the Company's future results of operations if these assets are deemed impaired.

NATIONAL SERVICE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

RECLASSIFICATIONS

Certain prior period amounts in the financial statements and notes have been reclassified to conform with the 2001 presentation.

NOTE 2: DISCONTINUED OPERATIONS

On November 7, 2001, the Company's board of directors approved the spin-off of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off will be effected on November 30, 2001 through a tax-free distribution of 100% of the outstanding shares of common stock of Acuity Brands, Inc. ("Acuity"), a wholly-owned subsidiary of the Company operating the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the distribution, will receive one share of Acuity common stock for each share of NSI common stock held at that date.

As a result of the November 2001 spin-off, the Company's August 31, 2001 financial statements have been prepared with these businesses' net assets, results of operations, and cash flows presented as discontinued operations. All historical statements have been restated to conform with this presentation.

Summarized financial information for discontinued operations is as follows (in thousands):

	AUGUST 31,	
	2001	2000
Current Assets	$ 559,116	$ 620,979
Property, Plant, and Equipment -- net	248,423	245,028
Goodwill and Other Intangibles	468,944	497,324
Other Long-Term Assets	54,092	59,549
Current Liabilities	(442,067)	(465,594)
Long-Term Debt, less current maturities	(373,707)	(380,518)
Other Long-Term Liabilities	(131,503)	(133,966)
Accumulated other comprehensive income items	16,998	12,741
Net assets of discontinued operations	$ 400,296	$ 455,543

A summary of the operating results of the discontinued operations is as follows:

	YEAR ENDED AUGUST 31,		
	2001	2000	1999

Sales	$1,982,700	$2,023,644	$1,701,568
Income before provision for income taxes	$ 69,152	$ 135,291	$ 142,585
Provision for income taxes	26,848	52,494	53,160
Net income	$ 42,304	$ 82,797	$ 89,425

In conjunction with the spin-off, the Company and Acuity will enter into various agreements that address the allocation of assets and liabilities between them and that define their relationship after the separation, including a distribution agreement, a tax disaffiliation agreement, an employee benefits agreement, and a transition services agreement.

In addition, Acuity and NSI will enter into a put option agreement, whereby NSI will have the option to require Acuity to purchase the property where NSI's corporate headquarters are located for a purchase price

equal to 85 percent of the agreed-upon fair market value of the property. This put option will commence on June 1, 2002 and expire on May 31, 2003.

NOTE 3: PENSION AND PROFIT SHARING PLANS

The Company has several pension plans covering hourly and salaried employees. Benefits paid under these plans are based generally on employees' years of service and/or compensation during the final years of employment. The Company makes annual contributions to the plans to the extent indicated by actuarial valuations. Plan assets are invested primarily in equity and fixed income securities.

The following tables reflect the status of the Company's pension plans at August 31, 2001 and 2000:

	2001	2000
CHANGE IN BENEFIT OBLIGATION:		
Benefit obligation at beginning of year	$53,542	$53,018
Service cost	1,482	1,637
Interest cost	4,270	3,862
Actuarial loss	5,784	872
Benefits paid	(4,210)	(5,946)
Other	(1,136)	99
Benefit obligation at end of year	$59,732	$53,542
CHANGE IN PLAN ASSETS:		
Fair value of plan assets at beginning of year	$82,323	$80,510
Actual return on plan assets	1,185	7,427
Employer contributions	199	42
Employee contributions	144	290
Benefits paid	(4,210)	(5,946)
Other	(691)	--

Fair value of plan assets at end of year	$78,950	$82,323
FUNDED STATUS:		
Funded status	$19,218	$28,781
Unrecognized actuarial loss	14,399	3,715
Unrecognized transition asset	(1,577)	(2,209)
Unrecognized prior service cost	1,287	1,194
Prepaid pension expense	$33,327	$31,481
AMOUNTS RECOGNIZED IN THE CONSOLIDATED BALANCE SHEETS CONSIST OF:		
Prepaid benefit cost	$34,465	$32,466
Accrued benefit liability	(1,485)	(1,331)
Intangible asset	279	287
Accumulated other comprehensive income	68	59
Prepaid pension expense	$33,327	$31,481

The projected benefit obligation and accumulated benefit obligation for defined benefit pension plans with accumulated benefit obligations in excess of plan assets were $915 and $816, respectively, as of August 31, 2001, and $1,485 and $754, respectively, as of August 31, 2000.

Components of net periodic benefit cost for the fiscal years ended August 31, 2001, 2000, and 1999 included the following:

	2001	2000	1999
Service cost	$ 1,482	$ 1,637	$ 1,914
Interest cost	4,270	3,862	3,885
Expected return on plan assets	(7,653)	(7,506)	(7,831)
Amortization of prior service cost	90	83	86
Amortization of transitional asset	(625)	(837)	(862)
Recognized actuarial loss	346	212	10
Net periodic pension benefit	$(2,090)	$(2,549)	$(2,798)

Weighted average assumptions in 2001 and 2000 included the following:

	2001	2000
Discount rate	7.75%	8.25%
Expected return on plan assets	9.50%	9.50%
Rate of compensation increase	4.40%	4.70%

It is the Company's policy to adjust, on an annual basis, the discount rate used to determine the projected benefit obligation to approximate rates on high-quality, long-term obligations.

The Company also has profit sharing and 401(k) plans to which both employees and the Company contribute. At August 31, 2001, assets of the 401(k) plans included shares of the Company's common stock with a market value of approximately $3,670. The Company recorded expense related to these plans of $822 in 2001, $438 in 2000, and $221 in 1999.

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NATIONAL SERVICE INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 4: LONG-TERM DEBT AND LINES OF CREDIT

Long-term debt at August 31, 2001 and 2000, consisted of the following:

	2001		2000	
	CONTINUING OPERATIONS	DISCONTINUED OPERATIONS	CONTINUING OPERATIONS	DISCONTINUED OPERATIONS
6% notes due February 2009 with an effective rate of 6.04%, net of unamortized discount of $310 in 2001 and $351 in 2000	$ --	$159,690	$ --	$159,649
8.375% notes due August 2010 with an effective rate of 8.398%, net of unamortized discount of $219 in 2001 and $244 in 2000	--	199,781	--	199,756
4.3% to 8.5% other notes, payable in installments to 2026	3,001	14,593	3,925	21,113
	3,001	374,064	3,925	380,518
Less -- Amounts payable within one year included in current liabilities	1,011	357	201	--
	$1,990	$373,707	$3,724	$380,518

Future annual principal payments of long-term debt are as follows:

FISCAL YEAR	CONTINUING OPERATIONS	DISCONTINUED OPERATIONS
2002	$1,011	$ 357
2003	1,102	341
2004	888	2,687
2005	--	--
2006	--	--

2007 and beyond...	--	370,679
	$3,001	$374,064

Upon completion of the spin-off in November 2001, approximately $374,064 of long-term debt will be assumed by Acuity, leaving approximately $3,001 outstanding for the Company. The following provides a discussion of long-term debt segregated between continuing and discontinued operations.

CONTINUING OPERATIONS

Outstanding borrowings at August 31, 2001 included approximately $3,001 in notes payable at 8.5 percent and $1,999 in uncommitted credit facility borrowings at a weighted-average interest rate of 4.95 percent.

DISCONTINUED OPERATIONS

In anticipation of the spin-off, management has amended, or is in the process of amending, the following agreements which were in place for NSI as of August 31, 2001. The material terms of the agreements are expected to be consistent subsequent to the spin-off for Acuity, who will be the borrower.

In May 2001, NSI entered into a three-year agreement (the "Receivables Facility") to borrow, on an ongoing basis, up to $150,000 secured by undivided interests in a defined pool of trade accounts receivable of the lighting equipment and chemical segments. At August 31, 2001, net trade accounts receivable pledged as security for the borrowings under the Receivables Facility totaled $227,754. Outstanding borrowings under the Receivables Facility at August 31, 2001 were $105,100. Interest rates under the Receivables Facility vary with commercial paper rates plus an applicable margin and the interest rate was 3.90 percent at August 31, 2001. Effective at the time of the spin-off, Acuity will assume all of NSI's borrowings and other obligations under the Receivables Facility.

In July 1999, NSI entered into a $250,000, 364-day committed credit facility, which was renewed in June 2001 and expires in June 2002. The credit facility permits certain subsidiaries of NSI to borrow under such facility, and NSI guarantees these borrowings. Interest rates under the credit facility are based on the LIBOR rate or other rates, at NSI's option. NSI pays an annual fee on the commitments based on NSI's credit rating for unsecured long-term public debt. Outstanding borrowings under the facility at August 31, 2001 were $105,000 at an interest rate of 4.1 percent. No amounts were outstanding under the facility at August 31, 2000. This facility will be discontinued at the time of the spin-off.

In October 2001, NSI, on behalf of Acuity, negotiated a $240,000, 364-day committed credit facility with six domestic and international banks that will become effective and will replace the Company's $250,000 credit facility at the time of the spin-off. The facility includes an option for additional lenders to enter the agreement to provide up to a total of $300,000 of commitments. The facility contains financial covenants including a leverage ratio of total indebtedness to EBITDA and an interest coverage ratio. Interest rates under the facility are based on the LIBOR rate or other rates, at Acuity's option. Acuity will pay an annual fee on the commitment based on Acuity's credit rating for unsecured long-term public debt. The principal lighting equipment subsidiary and the principal chemicals subsidiary of Acuity are guarantors of the facility.

NSI's commercial paper program was discontinued in July 2001. Amounts outstanding under the commercial paper program were replaced by borrowings under the committed credit facility. The $236,706 outstanding under the Company's commercial paper program at August 31, 2000 had a weighted-average interest rate of 6.8 percent.

At August 31, 2001, NSI had complimentary uncommitted lines of credit totaling $111,169 for general operating purposes, of which $16,779 is designated as multi-currency. Outstanding borrowings under the uncommitted credit facilities at August 31, 2001 were $24,666, at a weighted-average interest rate of 4.95 percent. At August 31, 2001, $74,390 in letters of credit was outstanding, primarily under the domestic uncommitted line of credit.

In January 1999, NSI issued $160,000 in ten-year publicly traded notes bearing a coupon rate of 6.0 percent. In August 2000, NSI issued $200,000 in ten-year publicly traded notes bearing a coupon rate of 8.375 percent. The fair values of the $160,000 and $200,000 notes, based on quoted market prices, were approximately $152,016 and $219,380, respectively, at August 31, 2001. Excluding the $160,000 and $200,000 notes, long-term debt recorded in the accompanying balance sheets approximates fair value based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities.

NOTE 5: COMMON STOCK AND RELATED MATTERS

SHARES AUTHORIZED

In January 1999, the stockholders approved an amendment to the Corporation's Restated Certificate of Incorporation to increase the Corporation's authorized shares of common stock from 80,000,000 to

120,000,000. The additional shares will be available for potential acquisitions, stock dividends and splits, and other purposes determined by the Board of Directors to be in the best interests of the Corporation.

SHAREHOLDER RIGHTS PLAN

The Company has a shareholder rights plan under which one preferred stock purchase right is presently attached to and trades with each outstanding share of the Company's common stock. The plan, which was to have expired May 19, 1998, was amended in December 1997 and extended to May 19, 2008.

The rights become exercisable and transferable apart from the common stock (a) on the date that a person or group announces that they have acquired 15 percent or more of the Company's common stock or (b) ten days after a person or group makes an unsolicited offer to acquire beneficial ownership of, or the right to obtain beneficial ownership of, 15 percent or more of the Company's common stock (unless such date is extended by the Board of Directors) or (c) 20 business days before the date on which a business combination is reasonably expected to be consummated involving a person who, if the business combination is consummated, has or would acquire beneficial ownership of, or the right to obtain beneficial ownership of, 15 percent or more of the Company's common stock and that person has directly or indirectly nominated a director of the Company at the time the business combination is considered. The rights are not triggered if the Board of Directors is notified that reaching the trigger threshold was inadvertent and divestiture of sufficient stock is thereafter made. Once exercisable, each right entitles the holder to purchase one one-thousandth share of Series A Participating Preferred Stock at an exercise price of $160, subject to adjustment to prevent dilution. The rights have no voting power and, until exercised, no dilutive effect on net income per common share. The rights expire on May 19, 2008, and are redeemable under certain circumstances.

If a person acquires 15 percent ownership, except in an offer approved under the plan by a majority of the nonemployee directors, each right not owned by the acquirer or related parties will entitle its holder to purchase, at the right's exercise price, common stock or common stock equivalents having a market value immediately prior to the triggering of the right of twice that exercise price. In addition, after an acquirer obtains 15 percent ownership, if the Company is involved in certain mergers, business combinations, or asset sales, each right not owned by the acquirer or related persons will entitle its holder to purchase, at the right's exercise price, shares of common stock of the other party to the transaction having a market value immediately prior to the triggering of the right of twice that exercise price.

PREFERRED STOCK

The Company has 1,000,000 shares of preferred stock authorized, 500,000 of which have been reserved for issuance under the shareholder rights plan. No shares of preferred stock had been issued at August 31, 2001 and 2000.

EARNINGS PER SHARE

The following table represents a reconciliation of basic and diluted earnings per share at August 31:

	2001	2000	1999
Basic weighted average shares outstanding (thousands)	41,068	40,708	40,899
Add: Shares of common stock assumed issued upon exercise of dilutive stock options (thousands)	--	19	194
Diluted weighted average shares outstanding (thousands)	41,068	40,727	41,093
(Loss) income from continuing operations	$(15,291)	$ 17,073	$ 34,918
Income from discontinued operations, net of tax	42,304	82,797	89,425
Net income	$ 27,013	$ 99,870	$124,343
Earnings per Share:			
Basic:			
(Loss) income from continuing operations	$ (.37)	$ .42	$ .85
Income from discontinued operations	1.03	2.03	2.19
Net income	$ .66	$ 2.45	$ 3.04

Diluted:			
(Loss) income from continuing operations	$ (.37)	$ .42	$ .85
Income from discontinued operations	1.03	2.03	2.18
Net income	$ .66	$ 2.45	$ 3.03

STOCK-BASED COMPENSATION

In 1990, stockholders approved the National Service Industries, Inc. Long-Term Incentive Program for the benefit of officers and other key employees. There were 1,750,000 treasury shares reserved for issuance under the program.

In 1997, stockholders approved the National Service Industries, Inc. Long-Term Achievement Incentive Plan for the benefit of officers and other key employees. On January 5, 2000, the stockholders approved an amendment to the plan which, in addition to other modifications, increased the number of shares authorized for issuance under the plan from 1,750,000 to 5,750,000. Treasury shares have been reserved for issuance under the plan.

Aspiration Achievement Incentive Awards were granted annually beginning in September 1996 under the Long-Term Achievement Incentive Plan. Shares may be earned and issued to participants based on a level of achievement of performance over three-year performance cycles. Amounts (credited) charged to compensation expense for 2001, 2000 and 1999 were approximately ($328), $500 and $1,100, respectively. During fiscal 2001 and 2000, 183,124 and 176,033 shares were issued under the award for the performance cycles ended August 31, 2000 and 1999, respectively. In addition, during fiscal 2001 certain participants elected to receive at-the-money options in lieu of cash or share awards. As a result, $1,855 previously accrued was reclassified to paid in capital. No shares were issued under this award as of August 31, 1999.

Generally, the stock options granted under both long-term incentive programs become exercisable in four equal annual installments beginning one year from the date of the grant.

In January 1993, stockholders approved the National Service Industries, Inc. 1992 Nonemployee Directors' Stock Option Plan. The stock options granted under that plan become exercisable one year from the date of the grant. There were 100,000 treasury shares reserved for issuance under the plan. During fiscal 2001, 2000, and 1999 15,000, 16,500 and 11,000 options were granted, respectively, under this plan.

Under all stock option plans, the options expire ten years from the date of the grant and have an exercise price equal to the fair market value of the Company's stock on the date of the grant. At August 31, shares available for grant as options under all plans were 2,336,144 in 2001, 3,517,152 in 2000, and 694,279 in 1999, less shares required for the payment of outstanding Aspiration Achievement Incentive Awards (approximately 270,644 at August 31, 2001).

Stock option transactions for the stock option plans and stock option agreements during the years ended August 31, 2001, 2000, and 1999 were as follows:

	OUTSTANDING		EXERCISABLE	
	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at August 31, 1998.......	1,744,646	$34.74	876,721	$29.05
Granted...........................	665,250	35.24		
Exercised.........................	(21,357)	27.71		
Cancelled.........................	(122,955)	39.24		
Outstanding at August 31, 1999.......	2,265,584	$34.78	1,110,084	$31.30
Granted...........................	1,144,598	$27.51		
Exercised.........................	(29,350)	27.44		
Cancelled.........................	(27,533)	32.14		
Outstanding at August 31, 2000.......	3,353,299	$32.40	1,752,011	$32.28
Granted...........................	1,874,163	$19.38		
Exercised.........................	(1,945)	19.75		
Cancelled.........................	(693,130)	31.26		
Outstanding at August 31, 2001.......	4,532,387	$27.17	2,188,543	$31.15
Range of option exercise prices:				
Officers and other key employees --				
$19.31 -- $29.72 (average life -- 8.1 years)...........	3,026,371	$22.46	1,013,152	$24.83
$29.72 -- $41.61 (average life -- 5.5 years)...........	1,094,016	$34.63	860,641	$34.56
$41.61 -- $46.63 (average life -- 5.9 years)...........	339,000	$44.35	255,250	$44.35
Nonemployee directors --				
$22.13 -- $30.98 (average life -- 5.9 years)...........	46,000	$25.99	32,500	$27.42
$35.40 -- $44.25 (average life -- 4.7 years)...........	27,000	$39.49	27,000	$39.49

During fiscal 1997, the Company adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." Accordingly, no compensation cost has been recognized for these stock option plans. Had compensation cost for the Company's stock option plans been determined based on the fair value at the grant date for awards in fiscal years 2001, 2000, and 1999, consistent with the provisions of SFAS No. 123, the total Company's net income and earnings per share would have been reduced to the following pro forma amounts:

	2001	2000	1999

Pro Forma Information:			
Net income	$21,452	$94,166	$120,141
Basic earnings per share	$ .52	$ 2.31	$ 2.94
Diluted earnings per share	$ .52	$ 2.31	$ 2.92

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model. The weighted average grant date fair value of options was $5.25, $9.18, and $13.70, respectively.

The following weighted average assumptions were used to estimate fair value:

	2001	2000	1999
Dividend yield	3.5%	2.6%	2.6%
Expected volatility	26.6%	24.4%	36.2%
Risk-free interest rate	5.8%	6.9%	5.2%
Expected life of options	10 years	10 years	10 years
Turnover rate	5.0%	5.0%	5.0%

EMPLOYEE STOCK PURCHASE PLAN

In 1998, stockholders approved the National Service Industries, Inc. Employee Stock Purchase Plan for the benefit of eligible employees. Under the plan, employees may purchase, through payroll deduction, the Company's common stock at a 15 percent discount. Shares are purchased quarterly at 85 percent of the lower of the fair market value of the Company's common stock on the first business day of the quarterly plan period or on the last business day of the quarterly plan period. There were 1,500,000 treasury shares reserved for purchase under the plan, of which 1,054,698 shares remain available for purchase at August 31, 2001.

RESTRICTED STOCK

In October 2000, the Company awarded 256,800 shares of restricted stock to officers and other key employees under the National Service Industries, Inc. Long-Term Achievement Incentive Plan. The shares are granted in 20 percent increments when the Company's stock price equals or exceeds certain stock price targets ranging from $22.14 to $38.50 for thirty consecutive calendar days. The shares vest ratably in four equal annual installments beginning one year from the date of grant. During the vesting period, the participants have voting rights and receive dividends, but the shares may not be sold, assigned, transferred, pledged or otherwise encumbered. If the stock price targets are not reached on or before the fifth anniversary of the award date, the corresponding shares are not granted. Additionally, granted but unvested shares are forfeited upon termination of employment, unless certain retirement criteria are met.

The fair value of the restricted shares on the date of grant is amortized ratably over the vesting period. In January 2001, the first stock price target was achieved and 51,260 restricted shares were granted. Unearned compensation of $1,195 on restricted stock was recorded in fiscal 2001 based on the market value of the shares on the date of grant and is generally being amortized over four years. The unamortized balance of unearned compensation on restricted stock is included as a separate component of stockholders' equity.

The preceding information with regards to stock based compensation related to the Company as a whole. Certain balances have been allocated to discontinued operations using allocation methodologies believed to be reasonable by management.

NOTE 6: COMMITMENTS AND CONTINGENCIES

SELF-INSURANCE

It is the Company's policy to self insure for certain insurable risks consisting primarily of physical loss to property; business interruptions resulting from such loss; and workers' compensation, comprehensive general, and auto liability. Insurance coverage is obtained for catastrophic property and casualty exposures as well as those risks required to be insured by law or contract. Based on an independent actuary's estimate of the aggregate liability for claims incurred, a provision for claims under the self-insured program is recorded and revised annually.

The activity in the self-insurance liability for each of the years ended August 31 was as follows:

	2001	2000	1999
Reserve, beginning of period	$ 21,934	$24,005	$ 27,116
Expense	10,944	5,216	2,684
Payments	(17,282)	(7,287)	(5,795)
Reserve, end of period	$ 15,596	$21,934	$ 24,005

LEASES

The Company leases certain of its buildings and equipment under noncancelable lease agreements. Minimum lease payments under noncancelable leases related to continuing operations for years subsequent to August 31, 2001, are as follows: 2002 -- $2,955; 2003 -- $2,255; 2004 -- $1,926; 2005 -- $1,595; 2006 -- $1,596; after 2006 -- $5,735.

Total rent expense was $5,582 in 2001, $4,524 in 2000, and $4,236 in 1999.

LITIGATION

The Company is subject to various legal claims arising in the normal course of business out of the conduct of its current and prior businesses, including patent infringement and product liability claims. Based on information currently available, it is the opinion of management that the ultimate resolution of pending and threatened legal proceedings will not have a material adverse effect on the Company's financial condition or results of operations. However, in the event of unexpected future developments, it is possible that the ultimate resolution of such matters, if unfavorable, could have a material adverse effect on the Company's results of operations in a particular future period. The Company reserves for legal claims when payments associated with the claims become probable and the costs can be reasonably estimated for financial statement purposes. While management believes that its reserves are appropriate based on information currently available, the actual costs of resolving pending and future legal claims against the Company may differ substantially from the amounts reserved.

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. Most claims against the

Company seek both substantial compensatory damages and punitive damages. The Company believes that many of the claims against it are without merit. The Company believes its conduct with respect to asbestos containing insulation was consistent with recognized safety standards at the relevant times, and the Company believes there is no basis for imposing punitive damages against it in connection with asbestos claims. In addition, the Company believes that it has substantial legal defenses against many of these claims, including that the Company did not manufacture any asbestos-containing building products, that the Company did not distribute or install products at certain sites where exposure is alleged, and that statutes of repose in some states bar the claims. However, there is no assurance that the Company will be successful in asserting defenses to these claims.

Prior to February 1, 2001, the Center for Claims Resolution (the "CCR") handled the processing and settlement of claims on behalf of the Company and retained local counsel for the defense of claims. Pursuant to a written agreement among CCR members, the Company was responsible for varying percentages of defense and liability payments on a claim-by-claim basis for each claim in which it was named in accordance with predetermined sharing formulae. Substantially all of the Company's portion of those payments were paid directly by the Company's insurers. Since February 1, 2001, the Company has begun to retain trial counsel directly, rather than through the CCR, to defend asbestos-related claims against the Company and has engaged another outside consultant to provide claims processing and administration services for asbestos-related claims. Now that it is no longer a member of the CCR, the Company intends to be more vigorous in defending asbestos-related claims and will seek to dismiss without any settlement payment claims arising in jurisdictions or involving worksites where the Company did not distribute or install asbestos-containing products.

During the past two years, some members or former members of the CCR have failed, by reason of bankruptcy or otherwise, to make payments to the CCR for their shares of certain settlement agreements the CCR had reached on behalf of its members with plaintiffs. Consequently, with respect to some settlement agreements, the CCR has been unable to make the full payments contemplated by those agreements. In some circumstances, the Company and other members of the CCR have contributed additional funds to the CCR to permit it to make certain payments contemplated by the settlement agreements. The Company has contributed approximately $500,000 to the CCR for this purpose, and it may make further such payments in the future. Some plaintiffs who are parties to settlement agreements with the CCR that contemplate payments that the CCR has been unable to make have commenced litigation against the CCR, the Company, and other members to recover amounts due under these settlement agreements. The Company believes that it should not be liable for settlement payments attributable to other members or former