

STERLING CONSTRUCTION CO INC

Form 10-K/A

November 10, 2005

Table of Contents

**FORM 10-K/A
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2004

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
Commission file number: 0-19450

STERLING CONSTRUCTION COMPANY, INC.
(Exact name of registrant as specified in its charter)

Delaware
State or other jurisdiction of incorporation or
organization

25-1655321
I.R.S. Employer Identification Number

2751 Centerville Road Suite 3131
Wilmington, Delaware
Address of principal executive offices

19803
Zip Code

Registrant's telephone number, including area code: **(281) 821-9091**

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

None

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

Title of each class

Common Stock, \$0.01 par value per share

Preferred Shares Purchase Rights

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 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

Indicate by check mark whether the registrant is an accelerated filer (as defined by Exchange Act Rule 12b-2).
Yes No

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Aggregate market value at June 30, 2004 of the voting stock held by non-affiliates of the registrant: \$15,557,732.

At March 1, 2005 the registrant had 7,399,681 shares of common stock outstanding

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the Registrant's definitive proxy statement for the annual meeting of shareholders to be held on May 19, 2005, which proxy statement will be filed no later than 120 days after the close of the Registrant's fiscal year ended December 31, 2004.

TABLE OF CONTENTS

PART I

Item 1. Business

Item 2. Properties

Item 3. Legal Proceedings

Item 4. Submission of Matters to a Vote of Security Holders

Item 4A. Executive Officers of the Company

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Item 6. Selected Financial Data

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 7(A). Quantitative and Qualitative Disclosure about Market Risk

Item 8. Financial Statements and Supplementary Data

Item 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Item 9(A) Controls and Procedures

Item 9(B). Other Information

PART III

ITEMS 10-14

PART IV

Item 15 Exhibits, Financial Statement Schedules, And Reports

SIGNATURES

Consent of Grant Thornton LLP

Section 302 Certification of Patrick T. Manning, CEO

Section 302 Certification of Maarten D. Hemsley, CFO

Certification of CEO and CFO

Table of Contents

Explanatory Note

This Amendment No. 1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004 is being filed primarily to clarify certain items related to the purchase of the minority interest in Sterling Houston Holdings, Inc. (the Put Transaction), to reclassify the accretion of interest in 2003 and 2002 as a non-cash item in the cash flow statement and to clarify the effectiveness of its internal controls at December 31, 2004.

PART I

Item 1. Business

Cautionary Statement

This Report on Form 10-K contains certain forward-looking statements that involve risks and uncertainties. The cautionary statements contained in this Report should be read as being applicable to all related forward-looking statements wherever they appear in this Report. The Company's actual results in the future could differ materially from those discussed here. Important factors that could cause or contribute to such differences include those discussed in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report.

Company Website

The Company maintains a website at www.sterlingconstructionco.com and makes available free of charge on or through its website, access to its latest Annual Report on Form 10-K, recent Quarterly Reports on Form 10-Q, any amendments to those filings, recent press releases, its Code of Ethics, and Audit Committee Charter together with other filings related to shareholdings. The website content is available for informational purposes only. The website should not be relied upon for investment purposes nor is it incorporated by reference into this Form 10-K.

Business

Sterling Construction Company, Inc. (Sterling or the Company) owns two subsidiaries (i) Sterling Houston Holdings, Inc., a heavy civil construction company based in Houston, Texas (the Construction Segment or SHH) and (ii) Steel City Products, Inc., a distributor of automotive accessories, non-food pet supplies and lawn and garden products based in Pittsburgh, Pennsylvania (the Distribution Segment or SCPI).

Further information on the businesses of the Company's operating segments is discussed below. Financial information for the segments is set forth in Note 13 to the consolidated financial statements of the Company.

Business Strategy

The Company seeks to increase long-term stockholder value by expanding profit opportunities through winning and executing more contracts and larger ones in its core construction business. This requires the continued investment in a growing staff of professional engineers and construction crews and the addition of capital equipment. Acquisitions are also part of management's growth strategy and acquisition candidates are regularly evaluated. In general, the Company is seeking acquisitions that would be accretive and have management who will continue to direct the operations of the acquired enterprise. While an acquisition that would expand the scope, either functionally and/or geographically, of the current business would be desirable, management has and will continue to consider other transactions that meet the aforementioned financial and management criteria. The Company's tax loss carryforwards are an important corporate asset and the protection and utilization of the losses is expected to assist in increasing shareholder values for the next several years. Stockholder value is measured by increases in shareholders' equity and by the appreciation of the value of the outstanding common stock over a period of years. In addition, the Company measures its success by the ability to attract and maintain experienced and capable employees and to maintain high ethical standards.

Table of Contents

The Construction Segment

Operations

SHH specializes in municipal and state contracts for the construction and paving of highways, building of bridges, installing water and sewer mains, light rail infrastructure projects and similar activities.

Raw Materials

The principal raw materials used in SHH's business include structural steel, concrete and aggregate. These and other raw materials and components which are used and are necessary in the construction business are generally available from numerous sources. Factors such as price and availability of transportation for these raw materials may limit supply at some times. SHH does not foresee shortages in these raw materials in the near term that would have a material adverse effect on the business.

Seasonality

SHH's operations can be materially affected by poor weather conditions, so that generally less construction is completed in the winter months. In particular, significant rainfall can cause construction delays adversely affecting revenues and margins on contracts in progress.

Customer Base

Most of SHH's revenues are generated in the Houston municipal market, which includes the City of Houston, the Houston Metropolitan Transit Authority and Harris County. (See Note 13)

In addition to its established operations in Houston, SHH has operations in the Dallas/Fort Worth and San Antonio markets and undertakes contracts for the State of Texas in each of its markets and elsewhere within the State. SHH also occasionally undertakes projects for private developers and corporate customers.

Most contracts are subject to a competitive public tender process.

There are no foreign revenues.

The table set forth in Note 13 to the consolidated financial statements shows contract revenues generated from SHH's largest customers which accounted for more than 10% of revenues in fiscal 2004, 2003 and 2002.

Contract Backlog

At December 31, 2004, SHH's backlog of construction contracts totaled \$232 million, the largest year-end backlog in SHH's history, and an increase of 65% compared with December 31, 2003. Of this amount, approximately \$160 million is scheduled to be completed within fiscal 2005, and approximately \$72 million in fiscal 2006 and beyond. SHH expects to add further contracts during 2005 for construction during the year and in the future. Through mid-March 2005, the Company announced new contract wins individually exceeding \$5 million with an aggregate value of \$55.5 million.

Competition

The typical public contract selection process is by sealed bid with the lowest bidder winning in a public selection process. Management undertakes a significant due diligence process in preparing each bid. Participants must post bid bonds for up to 10% of the amount bid, and on successful bids must post performance bonds for 100% of the contract amount. Contracts are priced for labor, sub-contracting, equipment use and materials against detailed specifications provided by the customer.

Table of Contents

SHH's competitors include large national and regional construction companies as well as smaller contractors. Management is unable to determine the relative size of most competitors, which are privately-owned, but believes that SHH is one of the larger participants in its marketplace, and the largest contractor in Houston that is engaged in municipal civil construction work.

SHH's size relative to its many smaller competitors in the municipal construction market gives it several advantages, including greater flexibility to manage its backlog so as to maximize its manpower and equipment resources, and the cost effective purchasing of materials, insurance and bonds. Since SHH owns and maintains most of the equipment required for its contracts and has the experienced manpower to handle many types of municipal civil construction, it is able to bid competitively on many categories of contracts, especially complex multi-task projects. In its successful effort to penetrate the state highway market, where most competitors are large, regional contractors, and individual contracts tend to be larger than the Company's municipal work and involve many specialized skills, SHH acquired the Kinsel heavy highway construction business (Kinsel) in September 2002. By fiscal 2004 state highway work had come to represent 33.0% of Construction Segment revenues, compared with 18.6% and 7.7% in fiscal 2003 and 2002, respectively.

Regulation

Management does not anticipate that existing or known pending environmental legislation or other regulations will require major capital expenditures or will adversely affect its operations. However, in the last two years, environmental issues have adversely impacted the rate at which certain highway contracts have been let in the Houston market.

Employees

At December 31, 2004, SHH employed approximately 750 persons, of whom 29 were employed in the headquarters in Houston. Most of the others are field personnel. No SHH employees are represented by a labor union. Senior SHH executives, including Patrick T. Manning (also Chief Executive Officer of Sterling) and Joseph P. Harper, Sr. (also President of Sterling) have many years of service with SHH and are employed under long-term contracts, which were renewed during fiscal 2004.

SHH's business is dependent upon a readily available workforce of both field and supervisory personnel. SHH does not anticipate any shortage of labor in the near term, but has no assurance that it will be able to continue to attract sufficient numbers of new employees to support its growth in the future.

The Distribution Segment

Operations

Since its founding in 1947 SCPI has distributed automotive accessories, now including functional and decorative car and truck accessories, car care products, chemicals and car repair and maintenance items. In fiscal 1996, SCPI expanded its merchandise selection to include non-food pet supplies and in fiscal 2000 added lawn and garden products. Sales in fiscal 2004 of pet supplies and lawn and garden products represented approximately 16.5% and 16.6%, respectively, of SCPI's total sales. SCPI's automotive and pet distribution operations are conducted from leased facilities in McKeesport, Pennsylvania and its lawn and garden operations are conducted from leased facilities in Glassport, Pennsylvania.

Many of SCPI's largest customers transmit their own orders directly to SCPI's warehouse; nevertheless, SCPI continues to provide personal service to many customers, which involves visits by its sales personnel to customers stores to count and re-order merchandise. Since most orders are generated electronically and are shipped within a few days of receipt, the size of SCPI's order backlog is not relevant to an understanding of the business. Shipments are either made directly to each of the customers' stores or are packed for onward shipment to stores via the retailers distribution centers. SCPI also provides price ticketing and associated services to those of its customers that request such services.

Table of Contents

Sources of Supply

SCPI acquires its merchandise from a large number of suppliers, the largest of which accounted for 13.5% of its purchases for fiscal 2004. Many of the products sold by SCPI carry nationally advertised brand names, but because of the diversity and number of suppliers and products carried, the business is not generally dependent on the continued availability of individual products or continued dealings with existing supply sources. From time to time, market or seasonal conditions may affect the availability of certain merchandise, but not to the extent that the Company believes would materially impact its business.

Steel City Products generally carries in inventory only those products that its customers have identified as necessary for their own merchandising needs and does not acquire significant quantities of other merchandise.

Seasonality

SCPI's automotive and lawn and garden businesses are seasonal, being slowest in the early winter months than at other times of the year. In anticipation of higher sales volume in the spring and summer, SCPI carries higher inventories of these products beginning in the winter months. As is customary in the automotive aftermarket and in the lawn and garden products business, some suppliers allow extended payment terms to SCPI for such inventory build-ups.

SCPI's pet supply business is less subject to seasonality, but usually experiences increased sales in the fourth quarter of the year.

SCPI's needs for working capital are affected by these seasonal fluctuations and other factors (see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources).

Customer Base

SCPI's customers include supermarket chains, drug stores, general merchandise retail chains, automotive specialty stores, hardware stores, variety stores, some smaller garden centers and other automotive accessory distributors. Most customers are based in the northeastern United States, although stores operated by some customers are located outside of that area, and since 2000 SCPI has been selling to the West Coast distribution facility of one of its major customers (See Note 13). There are no foreign sales.

SCPI's customers are continually affected by changes in the retail environment, including the competitive pressures facing regional mass merchandisers and the growing influence of national automotive and pet specialty chains. These have led to fluctuations in the level of business that SCPI enjoys with individual customers. Some customers have changed their buying practices to acquire certain merchandise direct from manufacturers rather than through distributors such as SCPI.

In its efforts to offset these trends, SCPI has in recent years added new customers, especially in the supermarket and drug store sectors, has expanded its product offerings to certain customers, has enlarged the territory that it serves and has introduced new categories of products. Management believes that these efforts have resulted in a more diverse and financially secure customer base.

None of SCPI's business is based on government contracts and there are no long-term sales contracts with any customers.

Competition

The distribution business for automotive parts and accessories, non-food pet supplies and lawn and garden products is highly competitive, with several similar companies operating in SCPI's market place, and many of SCPI's suppliers also offering their products directly to retailers. Management is unable to quantify SCPI's relative

Table of Contents

size in relation to its competitors, but believes it is one of the largest independent distributors of automotive accessories in the Northeastern United States. In recent years, a number of significant competitors of SCPI have gone out of business and some of SCPI's customers have chosen to purchase some products directly from manufacturers. SCPI competes on the basis of its management's merchandise expertise, the breadth of merchandise offered, price, levels of service, order fill rates and order turnaround times. Management believes that SCPI's long history, good reputation, experienced management, product selection, pricing, and traditionally high service levels and order fill rates, enable it to compete favorably with other distributors and direct sales by manufacturers.

Regulation

SCPI's management does not anticipate that existing or known pending environmental legislation or other regulations will require major capital expenditures or will adversely affect its operations.

Employees

SCPI employs approximately 50 persons, of which about 40 are employed in the headquarters office and distribution facility in McKeesport and the Glassport distribution facility. The others are field personnel. Senior executives, including the Chairman of the Board of Directors, Bernard H. Frank (a founder of Steel City Products), the President and Chief Executive Officer, Terrance W. Allan and the Vice President of Sales, Patrick Nicholson, have many years of service with SCPI. Mr. Allan is employed under a long-term contract.

Warehouse and certain office employees of SCPI are represented by Local 636 of the International Brotherhood of Teamsters. SCPI has experienced generally good labor relations and no significant labor disputes have affected its business for many years. The union contract was extended in 2003 to December 1, 2005.

Item 2. Properties

SHH owns a 15,000 sq. ft. headquarters building in Houston located on a seven-acre parcel on which its equipment repair center is also located. It also leases small offices in Grand Prairie and San Antonio, Texas.

SCPI operates its automotive and pet supply businesses from a leased, 67,000 square-foot building located in an industrial park in McKeesport, Pennsylvania. With the addition of the lawn and garden distribution business in 2000, SCPI leased an additional 43,000 sq. ft. of warehouse space located in an industrial park in nearby Glassport, Pennsylvania.

Item 3. Legal Proceedings

The Company is involved in certain claims and lawsuits occurring in the normal course of business. Management, after consultation with outside legal counsel, does not believe that the outcome of these actions would have a material impact on the financial statements of the Company. (See Note 15)

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.

Item 4A. Executive Officers of the Company

Executive officers of the Company are as follows:

| Name | Age | Position |
|-----------------------|-----|---|
| Patrick T. Manning | 59 | Chairman of the Board and Chief Executive Officer of the Company; President and Chief Executive Officer of SHH |
| Joseph P. Harper, Sr. | 59 | President, Chief Operating Officer and Director of the Company; Treasurer of SHH |

Table of Contents

| Name | Age | Position |
|--------------------|-----|--|
| Maarten D. Hemsley | 55 | Chief Financial Officer and Director of the Company; Chief Financial Officer of SCPI |
| Roger M. Barzun, | 63 | Vice President, Secretary and General Counsel of the Company |
| Terrance W. Allan | 53 | President and Chief Executive Officer of SCPI |

Patrick T. Manning. Mr. Manning joined SHH in 1971 and led its move from Detroit, Michigan into the Houston market in 1978. He is currently SHH's President and Chief Executive Officer. Mr. Manning has served on a variety of construction industry committees, including the Gulf Coast Trenchless Association and the Houston Contractors Association, where he served as a member of the Board of Directors and as President from 1987 to 1993. He attended Michigan State University from 1969 to 1972. Mr. Manning has served as Chairman of the Board and Chief Executive Officer of Sterling since July 2001, when the Company increased its equity investment in SHH to 80.1% (the Sterling Transaction).

Joseph P. Harper, Sr. Mr. Harper has been employed by SHH since 1972 and has performed both estimating and project management functions as well as his primary role as SHH's Treasurer. Mr. Harper has served as President and Chief Operating Officer of the Company since the completion of the Sterling Transaction in July 2001. Mr. Harper also serves as a director of SCPI.

Maarten D. Hemsley. Mr. Hemsley has been an employee and/or director of the Company or SCPI in various capacities since 1988. Mr. Hemsley served as President, Chief Operating Officer and Chief Financial Officer of the Company until July 2001, and currently serves as Chief Financial Officer of both Sterling and SCPI. Since January 2001, Mr. Hemsley has also been a consultant to (and since May 2002 an employee of) JO Hambro Capital Management Limited, an investment management company based in the United Kingdom as Fund Manager of Leisure & Media Venture Capital Trust, plc, and recently as a principal of its Trident Private Equity II investment fund.. Mr. Hemsley is a director of Tech/Ops Sevcon, Inc., a public company that manufactures electronic controls, of XN Checkout Holdings plc, a United Kingdom public company that provides electronic sales solutions to the restaurant, pub and hotel markets, and of a number of privately-held companies in the United Kingdom.

Roger M. Barzun. Mr. Barzun has been Vice President, Secretary and General Counsel of the Company since August 1991 and was a Senior Vice President from May 1994 until July 2001. Mr. Barzun has been a lawyer since 1968 and is a member of the New York and Massachusetts bars.

Terrance W. Allan. Mr. Allan has been an officer of SCPI for more than the last five years. He was appointed President of SCPI in May 2000 and its Chief Executive Officer in May 2002.

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

Prior to February 12, 2004, the Company's Common Stock traded on the OTC Bulletin Board, under the symbol STCS.OB. On February 12, 2004, the Company's stock commenced trading on the American Stock Exchange under the symbol STV.

The following table sets forth the high and low bid prices by fiscal quarter for the Company's common stock for fiscal years 2004 and 2003.

| | Fiscal 2004 | | Fiscal 2003 | |
|-----------|----------------|---------------|----------------|---------------|
| | Quarterly High | Quarterly Low | Quarterly High | Quarterly Low |
| Quarter 1 | \$8.94 | \$ 3.60 | \$1.95 | \$ 1.16 |
| Quarter 2 | \$4.60 | \$ 2.99 | \$2.80 | \$ 1.55 |
| Quarter 3 | \$6.33 | \$ 3.02 | \$4.45 | \$ 2.20 |
| Quarter 4 | \$6.34 | \$ 4.32 | \$5.35 | \$ 2.75 |

Table of Contents

In its first quarter through March 15, 2005, the Company's stock has ranged from a low of \$5.13 to a high of \$7.28. Such quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

There were approximately 3,600 holders of record of the Company's common stock on March 1, 2005.

No cash dividends were declared or paid in fiscal years 2004, 2003 or 2002. The Company does not anticipate the declaration of cash dividends in the foreseeable future. The ability of the Company's operating subsidiaries, SHH and SCPI, to upstream funds to Sterling for payment of dividends is limited by their respective bank credit agreements.

On December 22, 2004, 1,794,627 shares were issued in connection with the exercise of the Put in which the Company purchased the remaining 19.9% of SHH. (See Note 4).

Table of Contents**Item 6. Selected Financial Data**

The following table sets forth selected financial and other data of Sterling Construction Company, Inc. and subsidiaries and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, which follows, and the Consolidated Financial Statements and related Notes (amounts in thousands, except per share data).

| | Fiscal 2004 December 31, 2004 | Fiscal 2003 December 31, 2003 | Fiscal 2002 December 31, 2002 (Restated) | Fiscal 2001 December 31, 2001 (c)(d) (ten months) | Fiscal 2000 February 28, 2001(a)(d) |
|--|--|--|--|--|---|
| Operating results: | | | | | |
| Revenues | \$ 154,178 | \$ 169,532 | \$ 134,317 | \$ 66,121 | \$ 20,694 |
| Income (loss) from continuing operations before minority interest and income taxes | \$ 4,697 | \$ 8,924 | \$ 4,345 | \$ (1,965) | \$ (7,044) |
| Minority interest (e) | (962) | (1,627) | (873) | (647) | |
| Current income tax expense | (186) | (246) | (14) | (14) | (27) |
| Deferred income tax benefit (expense) (b) | 2,104 | (1,632) | (106) | | |
| Income (loss) from continuing operations | 5,653 | 5,419 | 3,352 | (2,626) | (7,071) |
| Income from discontinued operations (a) | | | | | 399 |
| Net income (loss) | \$ 5,653 | \$ 5,419 | \$ 3,352 | \$ (2,626) | \$ (6,672) |
| Basic and diluted per share amounts: | | | | | |
| Basic earnings (loss) per share from continuing operations | \$ 1.06 | \$ 1.06 | \$ 0.66 | \$ (0.52) | \$ (1.43) |
| Basic earnings per share from discontinued operations | \$ | \$ | \$ | \$ | \$ 0.09 |
| Basic earnings (loss) per share | \$ 1.06 | \$ 1.06 | \$ 0.66 | \$ (0.52) | \$ (1.34) |
| Basic weighted average shares outstanding | 5,343 | 5,090 | 5,062 | 5,056 | 4,943 |
| Diluted earnings (loss) per share from continuing operations | \$ 0.81 | \$ 0.84 | \$ 0.56 | \$ (0.52) | \$ (1.43) |
| Diluted earnings per share from discontinued operations | \$ | \$ | \$ | \$ | \$ 0.09 |

| | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|
| Diluted earnings (loss) per share | \$ 0.81 | \$ 0.84 | \$ 0.56 | \$ (0.52) | \$ (1.34) |
| Diluted weighted average shares outstanding | 7,028 | 6,488 | 6,102 | 5,056 | 4,943 |
| Cash dividends declared | \$ (0.00) | \$ (0.00) | \$ (0.00) | \$ (0.00) | \$ (0.00) |
| Balance sheet statistics: | | | | | |
| Total assets | \$ 89,544 | \$ 75,578 | \$ 72,757 | \$ 59,138 | \$ 16,507 |
| Long-term obligations | \$ 22,012 | \$ 19,958 | \$ 34,323 | \$ 30,241 | \$ 4,633 |
| Book value per share of common stock | \$ 4.77 | \$ 3.24 | \$ 2.14 | \$ 1.21 | \$ (2.01) |

(a) Upon completion of the sale of Dowling's Fleet Services, Inc. in fiscal 2000, the Company recorded income of \$399,000.

(b) In December 2001, the Company recorded a deferred tax asset that exceeded its valuation allowance (see Note 8 to the Consolidated Financial Statements).

(c) In November 2001, the Board of Directors of the Company voted to change its fiscal year end from the last day of February to December 31. Accordingly, results for fiscal 2001 are for the ten month period

March 1 to
December 31,
2001.

- (d) In July 2001, the Company increased its percentage ownership in SHH from 12% to 80.1%. The original investments were recorded using the cost method. The subsequent acquisition in July 2001 resulted in step-acquisition treatment of the original investments. Fiscal 2000 has been restated to reflect this treatment.
- (e) Minority interest represented the 19.9% of SHH not owned by the Company until December 2004.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

As discussed in ITEM 1. BUSINESS above, the Company operates primarily as a heavy civil construction company based in Houston, Texas under the trade name Texas Sterling Construction. The Company's distribution business is conducted in Pittsburgh, Pennsylvania under the name Steel City Products.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Management's estimates, judgments and assumptions are continually evaluated based on available information and experience, however, actual amounts could differ from those estimates. The Company's significant accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements.

Certain of the Company's accounting policies require higher degrees of judgment than others in their application. These include the recognition of revenue and earnings from construction contracts and the valuation of long-term assets. Management evaluates all of its estimates and judgments on an on-going basis.

Revenue Recognition: The Company uses the percentage of completion accounting method for construction contracts in accordance with the American Institute of Certified Public Accountants Statement of Position 81-1,

Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Revenue and earnings on construction contracts are recognized on the percentage of completion method in the ratio of costs incurred to estimated final costs. Provisions are recognized in the statement of income for the full amount of estimated losses on uncompleted contracts whenever evidence indicates that the estimated total cost of a contract exceeds its estimated total revenue.

Factors that can contribute to changes in estimates of contract profitability include, without limitation, site conditions that differ from those assumed in the original bid to the extent that contract remedies are unavailable, the availability and skill level of workers in the geographic location of the project, the availability and proximity of materials, the accuracy of the original bid, inclement weather and timing and coordination issues inherent in all projects, including design/build. Contract cost consists of direct costs on contracts, including labor and materials, subcontractor costs, direct overhead and equipment expense (primarily depreciation, fuel, maintenance and repairs). Depreciation is provided using straight-line methods for construction equipment. Contract cost is recorded as incurred and revisions in contract revenue and cost estimates are reflected in the accounting period when known. If the Company projects a loss on a project the estimated loss is immediately recognized. Claims for additional contract revenue are recognized if it is probable that the claim will result in additional revenue and the amount can be reliably estimated. The foregoing as well as weather, stage of completion and mix of contracts at different margins may cause fluctuations in gross profit achieved in different accounting periods and these fluctuations may be significant.

A significant portion of the Construction Segment's revenues is derived from contracts that are fixed unit price under which the Company is committed to provide materials or services required by a project at fixed unit prices (for example, dollars per cubic yard of concrete or per cubic yards of earth excavated). All government contracts and many of the Company's other contracts provide for termination of the contract for the convenience of the party contracting with the Company, with provisions to pay the Company for work performed through the date of termination.

The construction industry is highly competitive and lacks firms with dominant market power. The majority of the Company's business involves construction contracts obtained through competitive bidding. The volume and profitability of the Company's construction work depends to a significant extent upon the general state of the economy of Texas, especially in the Houston area, the volume of work available to contractors and competitors

Table of Contents

levels of backlog. The Company's construction operations could be adversely affected by labor stoppages or shortages, adverse weather conditions, economic downturns, shortages of supplies or government actions.

Valuation of Long-Term Assets: Long-lived assets, which include property, equipment and acquired identifiable intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment evaluations involve management estimates of useful asset lives and future cash flows. Actual useful lives and cash flows could be different from those estimated by management and this could have a material effect on operating results and financial position. Additionally, the Company had goodwill with a value of approximately \$13 million at December 31, 2004, which must be reviewed for impairment at least annually in accordance with Statement of Financial Accounting Standards No. 142 (SFAS 142). The impairment testing required by SFAS 142 requires considerable judgment and there can be no assurance that an impairment charge will not be required in the future. The Company completed its annual impairment review for goodwill effective October 1, 2004 and it did not reveal impairment of goodwill.

Deferred Taxes: Deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts and tax bases of assets and liabilities. The Company regularly reviews its deferred tax assets for recoverability and establishes a valuation allowance based upon projected future taxable income and the expected timing of the reversals of existing temporary differences. As a result of this review and the related SHH acquisition, in fiscal 2001 the Company reduced the valuation allowance against the deferred tax asset related to the estimated utilization of the net operating loss carryforwards. Due to the operating profitability of the Company and the expiration of loss carryforwards, in fiscal 2004, 2003 and 2002, the valuation allowance was reduced by \$18.9 million, \$4.9 million and \$1.5 million, respectively.

Liquidity and Capital Resources

At SHH, the level of working capital varies principally as a result of changes in the levels of cost and estimated earnings in excess of billings, of billings in excess of cost and estimated earnings and levels of retention and the timeliness of payment of receivables by its customers. SHH's cash requirements are also impacted by its needs for capital equipment, which have generally been financed from cash flow or from borrowings under its line of credit.

At SCPI, the level of working capital varies primarily with the amounts of inventory carried, which can change seasonally, the size and timeliness of payment of receivables due from customers and the amount of credit extended by suppliers. SCPI's working capital needs not financed by suppliers have been financed from cash flow and borrowings, principally under its line of credit.

Contractual Obligations

Fixed, noncancelable obligations of the Company at December 31, 2004 are as follows (in thousands):

| | Total | Payments due by period | | | |
|-----------------------------|-----------|------------------------|-------------------|-------------------|----------------------|
| | | Less than one year | One - three years | Four - five years | More than five years |
| Debt | \$ 16,954 | \$ 3,625 | \$ 13,329 | | |
| Capital leases | 58 | 25 | 23 | 10 | |
| Operating leases | 1,604 | 555 | 1,049 | | |
| Related party notes | 11,349 | 3,593 | 3,878 | 3,878 | |
| Other long-term liabilities | 1,018 | 123 | 246 | 246 | 403 |
| | \$ 30,983 | \$ 7,921 | \$ 18,525 | \$ 4,134 | \$ 403 |

To assure the material prices and sub-contracting costs used in tendering bids for construction contracts, the Company obtains firm quotations from its suppliers and sub-contractors, and is therefore rarely exposed to any price or availability risk on contracts in backlog. Such agreements do not include any quantity guarantees, so that the

Table of Contents

Company has no obligation for materials or sub-contract services beyond those required to complete the respective contracts.

The Company's obligations for interest are not included in the table above, as these amounts vary according to the levels of debt outstanding at any time. Interest on the Company's Revolving Lines of Credit is paid monthly and fluctuates with the balances outstanding during the year, as well as fluctuations in interest rates. In Fiscal 2004 such interest was approximately \$700,000. The Company also pays interest on a quarterly basis on its related party debt, as discussed further below, which amounts are expected to be approximately \$1.2 million in the next year, an aggregate of \$1.6 million for the one to three year period, and an aggregate of \$579,000 in the four to five year period. All other debt is expected to have interest of approximately \$60,000, \$120,000 and \$120,000 in the periods above.

Exercise of the Put

As part of the Sterling Transaction, the Company granted certain selling shareholders a Put option for the 19.9% of SHH stock owned by them, pursuant to which they had the right to sell the remaining SHH shares to the Company at a date of their choosing between July 2004 and July 2005 at a minimum price of \$105 per SHH share. The price of the Put was to be based on a multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) for the 12 months immediately preceding the Put exercise date. The Company recorded the fair value of the Put as a \$4.1 million liability on the effective date of the Sterling Transaction, July 18, 2001. From the date of the transaction through the date of exercise the Put liability increased by \$1.5 million to \$5.6 million.

The Put was exercised on July 19, 2004 and a compilation of the results for the 12 months preceding the exercise date was performed, with the result that the purchase price was determined to be approximately \$15.0 million. The Put transaction was finalized in November 2004 and settled in December reflecting the terms of a Put Restructuring Agreement entered into in September 2003, The Put price was satisfied by cash of approximately \$2.4 million (derived from borrowings on available long-term bank facilities), five-year notes of approximately \$6.4 million, and the balance through the issuance of approximately 1,569,000 shares of the Company's common stock at an agreed value of \$4.00 per share, representing a premium to the market at the time of exercise. At the date the terms of the agreement were settled, the stock was recorded at the fair value of \$5.14. (See Note 4)

Financing

At December 31, 2004 and 2003, the Company's debt consisted of (in thousands):

| | 2004 | 2003 |
|---|-----------|-----------|
| Related party notes: | | |
| Subordinated debt | \$ | \$ 1,500 |
| Subordinated zero coupon notes | | 3,216 |
| Convertible subordinated notes | | 560 |
| Management/director notes | 3,590 | 1,795 |
| Management notes issued upon put settlement | 6,354 | |
| NASCIT loan | 1,405 | 1,997 |
| | 11,349 | 9,068 |
| SHH revolver | 13,329 | 6,568 |
| SCPI revolver | 3,625 | 2,660 |
| Insituform notes | | 563 |
| Mortgage payable | 1,018 | 1,141 |
| Equipment notes and capital leases | 58 | 58 |
| | \$ 29,379 | \$ 20,058 |

Related Party Debt

Table of Contents*Subordinated Debt*

As part of the Sterling Transaction, certain shareholders of SHH were issued subordinated promissory notes by SHH in the aggregate amount of \$6 million in payment for certain of their SHH shares. These notes were repaid over three years through September 30, 2004 in equal quarterly installments and carried interest at 12% per annum.

Subordinated Zero Coupon Notes/NASCIT Loan

The Sterling Transaction was funded in part through the sale of zero coupon notes combined with the issuance of zero coupon notes to certain selling shareholders of SHH. Warrants for Sterling common stock were issued in connection with the zero coupon notes and are exercisable for ten years from closing at \$1.50 per share. The zero coupon notes were discounted at a rate of 12%, maturing four years from the date of closing of the Sterling Transaction, subject to earlier payment in the event the SHH Put was exercised before such date. Employee selling shareholders of SHH received an aggregate face value of \$3.8 million in zero coupon notes, in which Mr. Manning and Mr. Harper received zero coupon notes in the face amount of \$799,000 and \$1.0 million, respectively and warrants for 63,498 shares and 81,301 shares, respectively. North Atlantic Smaller Companies Investment Trust (NASCIT), an investor in SHH, received a note in the face amount of \$4 million. In December 2003, a prepayment of \$1.3 million was made on the zero coupon note issued to NASCIT in consideration of the forgiveness of six months interest on such notes.

The Put was exercised in July 2004, which triggered payment of the zero coupon notes. Upon settlement of the Put in December 2004, the employee selling shareholders received a cash payment of \$783,000 utilizing funding from long term borrowings under SHH's line of credit. Of the balance, \$901,000 was converted into 225,326 shares of common stock at an agreed value of \$4.00 per share, which represented a premium to the market price on the date of exercise. The stock was recorded on the date the terms were settled at a fair value of \$5.14. The remaining \$1.9 million was converted into new five-year notes at 12%, with principal and interest payable quarterly beginning March 31, 2005. NASCIT received a cash payment of \$834,000, with the balance of \$1.4 million converted into a new five-year note at 12% interest, with principal and interest payable quarterly beginning March 31, 2005 (See Note 14).

Management/Director Notes

Notes with an aggregate face amount of \$1.3 million issued in connection with the October 1999 purchase of the second equity tranche of shares of SHH were restructured as part of the Sterling Transaction. Of the total, notes for \$800,000 were issued to several members of Sterling's management, including Joseph P. Harper, since elected the Company's President. Notes totaling approximately \$559,000 were due to Robert Davies, the Company's former Chairman and Chief Executive Officer, and, through a participation agreement, Maarten Hemsley, formerly the Company's President and now its Chief Financial Officer. In consideration for the extension of the maturity dates of these notes, the face amounts were increased in July 2001 by an aggregate of approximately \$342,000. Furthermore, certain amounts owed by the Company to Messrs. Davies and Hemsley aggregating approximately \$355,000 were converted into notes. All such notes were to mature over four years, unless maturity was triggered by the exercise of the Put, and carried interest at 12% per year. Principal and interest may be paid only from defined cash flow of Sterling and SCPI, or from proceeds of any sale of SCPI's business. In December 2003, prepayments of accrued interest and principal were made to certain of these noteholders. Mr. Harper received prepayment totaling \$86,000 and Mr. Davies received prepayment totaling \$411,000. Mr. Hemsley declined any prepayment of his notes.

Pursuant to a Restructuring Agreement entered into in September 2003, when the Put was exercised in July 2004, triggering payment of the Management/Director notes, one half of the balance of the notes was paid in cash utilizing funding from long term borrowings under the SHH line of credit, with the remainder converted into new five-year notes at 12% interest, amortized quarterly beginning March 31, 2005. Mr. Davies, Mr. Harper, Mr. Hemsley and Mr. Manning received cash payments of \$166,876, \$1,045,764, \$208,397 and \$460,458, respectively.

Convertible Subordinated Notes

Table of Contents

In December 2001, in conjunction with an amendment to the SCPI Revolver and in order to strengthen SCPI's working capital position through the purchase of additional inventory, Sterling obtained funding of \$500,000 principally from members of management and directors (including Messrs. Frickel (a director of the Company), Harper and Hemsley, who loaned \$155,000, \$100,000 and \$25,000, respectively) (the Convertible Subordinated Notes). In January 2002, two other members of management, including Bernard Frank funded a further \$60,000, which was used for general corporate purposes. The notes evidencing these advances were convertible at any time prior to the maturity date into the Company's common stock at a price of \$2.50 per share and otherwise matured and were payable in full in December 2004. Interest at an annual rate of 12% was payable monthly. The notes were senior to debt issued in connection with the Sterling Transaction. All notes were converted at the election of their holders into common stock on December 31, 2004.

Other Related-Party Debt

In January 2003, members of management of the Company and of SHH (including Messrs. Harper and Hemsley) further funded SCPI with a \$250,000 short-term loan to reduce SCPI's vendor payables. Interest on the notes was payable monthly at the annual rate of 10%. The notes, which are subordinated to the SCPI Revolver, matured in July 2003, but were extended beyond that date with the granting of a guarantee by SHH, and an increase in the interest rate to 12% per annum, effective January 2004. The notes were repaid in three installments in January and February 2005.

SHH Revolver and SCPI Revolver

In conjunction with the Sterling Transaction, SHH entered into a three-year agreement providing for a bank revolving line of credit with a maximum line of \$13.0 million, subject to a borrowing base (the SHH Revolver). The line of credit carries interest at prime, subject to achievement of certain financial targets and is secured by the equipment of SHH and guarantees by the parent company. In December 2004, SHH entered into an amendment of the agreement providing for a maximum line of \$17 million with a maturity date of May 1, 2007, under substantially the same terms as the original loan. The agreement was finalized in February 2005. SHH paid a fee of \$15,000 in connection with the increase in the line and the renewal. At December 31, 2004, the balance on the SHH Revolver was \$13.3 million, with an effective rate of interest of 5.25% and availability under the line of credit was \$671,000. The balance at the end of the year included borrowing of approximately \$5.0 million in late December to fund the settlement of the Put and related payments. SHH is required to maintain financial covenants of debt, current and cash flow coverage ratios, and at December 31, 2004 SHH was in compliance with these covenant requirements.

Management believes that the SHH Revolver will provide adequate funding for SHH's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006.

In July 2001 SCPI entered into an agreement for a bank revolving line of credit in the amount of \$5.0 million, subject to a borrowing base (the SCPI Revolver). In fiscal 2002, the line of credit was further amended to extend the term to May 2004 and to remove certain limitations on borrowing and in fiscal 2003, the interest rate was reduced to prime plus 1% and the maturity date extended to December 2004. In March 2004, the line was extended until May 31, 2006. The credit agreement continues to mandate that SCPI utilize a lockbox arrangement with the lender and the agreement further provides that the lender may accelerate the maturity date of the SCPI Revolver if a material adverse change occurs in SCPI's business. Because of these arrangements, the Company reports the SCPI Revolver as a current liability. At December 31, 2004, the outstanding balance on the Revolver was \$3.6 million and the effective rate of interest was 6.25%. SCPI had no excess availability on its line of credit at December 31, 2004. The SCPI Revolver is secured by the assets of SCPI and is subject to the maintenance of a fixed charge coverage ratio covenant. At December 31, 2004, SCPI was in compliance with its financial covenant.

Management believes that the SCPI Revolver will continue to provide adequate funding for SCPI's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006, assuming no material deterioration in current sales or profit margins.

Table of Contents**SHH Mortgage**

In June 2001, SHH completed the construction of a new headquarters building on land adjacent to its existing equipment repair facility in Houston. The building was financed principally through an additional mortgage of \$1.1 million on the land and facilities, at an interest rate of 7.75% per annum, repayable over 15 years. The new mortgage is cross-collateralized with an existing mortgage on the land and facilities which was obtained in 1998 in the amount of \$500,000, repayable over 15 years with an interest rate of 9.3% per annum.

Insituform Note

In September 2002, a wholly owned subsidiary of SHH acquired the Kinsel Heavy Highway construction business from a subsidiary of Insituform Technologies. The transaction was financed through the issuance of two unsecured two-year notes aggregating \$1.5 million to Insituform, with the balance funded through additional borrowings under the SHH Revolver. The Insituform Notes bore interest at 9% and were payable in quarterly installments plus accrued interest through September 2004.

Capital Expenditures

Capital expenditures made by Sterling and its subsidiaries during fiscal 2004 totaled \$3.6 million, consisting almost exclusively of heavy construction equipment at SHH.

Tax Loss Carry-forwards

At December 31, 2004, Sterling had the benefit of net operating tax loss carry-forwards (the Tax Benefits) of approximately \$38.9 million, which expire in the years 2005 through 2020 and, in the event of no change of control as discussed below, which are expected to shelter most income of Sterling and its subsidiaries from federal income taxes for several years. A change in control of Sterling exceeding 50% in any three-year period may lead to the loss of the majority of the Tax Benefits. In order to reduce the likelihood of such a change of control occurring, Sterling's Certificate of Incorporation includes restrictions on the registration of transfers of stock resulting in, or increasing, individual holdings exceeding 4.5% of Sterling's common stock. Shareholdings over 5% resulting from the Sterling Transaction, and changes thereto resulting from the shares issued pursuant to the exercise of the Put, were approved by the Company's Board following receipt of required opinions that these did not adversely affect the availability of the Tax Benefits.

Since the regulations governing the Tax Benefits are highly complex and may be changed from time to time, and since Sterling's attempts to reduce the likelihood of a change of control occurring may not be successful, management is unable to determine the likelihood of the continued availability of the Tax Benefits. However, management believes that the Tax Benefits are currently available in full and intends to take all appropriate steps to help ensure that they remain available. Should the Tax Benefits become unavailable to Sterling, most of its future income and that of any consolidated affiliate would not be shielded from federal taxation, thus reducing funds otherwise available for corporate purposes (see Note 8 to the Consolidated Financial Statements). In fiscal 2004, approximately \$42 million of tax losses expired unused.

Cash Flows

Cash flows for the past three years are summarized as follows (in thousands):

| | December 31, 2004 | December 31, 2003 | December 31, 2002 |
|---------------------------------|----------------------|----------------------|----------------------|
| Cash and cash equivalents | \$ 3,518 | \$ 2,765 | \$ 2,406 |
| Net cash provided by (used in): | | | |
| Operating activities | 2,937 | 17,799 | 5,106 |
| Investing activities | (5,843) | (4,280) | (6,902) |

Table of Contents

| | December 31, 2004 | December 31, 2003 | December 31, 2002 |
|------------------------------|----------------------|----------------------|----------------------|
| Financing activities | 3,659 | (13,160) | 1,318 |
| Capital expenditures | (3,589) | (4,350) | (4,346) |
| Working capital, December 31 | 15,754 | 6,488 | 11,747 |

In fiscal 2004, cash provided by operations decreased by \$14.9 million compared with fiscal 2003. The decrease was due to lower income from operations which decreased from \$15.8 million to \$9.6 million, combined with a net increase in working capital of \$8.7 million, which was principally due to changes in working capital employed for construction contracts, as follows:

Contracts receivable decreased in 2004 by \$0.3 million compared with an increase of \$4.3 million in 2003. The substantial increase in 2003 was due to higher levels of retainage on certain contracts.

Costs and estimated earnings in excess of billings on uncompleted contracts increased by \$4.6 million in 2004 compared with a decrease of \$1.5 million in 2003. The substantial increase in costs in excess in 2004 was due to timing differences on several significant contracts.

Billings in excess of costs and estimated earnings on uncompleted contracts decreased in 2004 by \$5.3 million, compared with an increase of \$6.2 million in 2003. These changes resulted principally from the receipt in 2003 of mobilization payments from customers to assist in the start-up of some larger projects, which were applied during 2004 as work on those contracts progressed.

Net cash provided by operations for fiscal 2003 was \$17.8 million, an increase of \$12.7 million compared with prior year. The increase was due to improved operating results, combined with increases in billings in excess of costs and estimated earnings, and to increases in other accrued expenses, offset by decreases in vendor payables and increases in contracts receivable and inventories.

Cash used in investing activities increased in fiscal 2004 by approximately \$1.6 million compared with the prior year. The increase was due to the purchase of the remaining 19.9% of SHH by the Company in December 2004. Capital expenditures in fiscal 2004 were lower than fiscal 2003 by approximately \$761,000. Capital expenditures by the Company consist primarily of purchases of construction equipment.

In fiscal 2003, cash used in investing activities decreased by approximately \$2.6 million, due principally to the acquisition of the Kinsel business in fiscal 2002.

Cash provided by financing activities increased substantially in 2004 compared with 2003. The increase was due to higher borrowings on the SHH Revolver, which funded \$5 million in December to settle the Put transaction. Certain loans to shareholders of \$1.5 million and the loans to Insituform of \$563,000 for the funding of the Kinsel transaction in fiscal 2002 were repaid.

Financing activities used approximately \$13.2 million of cash in fiscal 2003, due in part to the reduction of the SHH revolver from \$14 million at the end of fiscal 2002 to \$6.6 million at the end of fiscal 2003. Also in fiscal 2003, the KTI Loan was repaid in the amount of \$1.2 million, and prepayments of \$2 million were made on debt maturing in 2005.

Management does not believe that inflation has had a material negative impact on the Company's operations or financial results during recent years. However, in fiscal 2004 increases in oil prices adversely affected the costs of operating the construction fleet and certain abnormal increases in steel prices have had an adverse effect on the Construction Segment's profitability.

The Company did not have any off-balance sheet arrangements at December 31, 2004 or December 31, 2003.

Results of Operations

Operations include SHH (the Construction Segment) and SCPI, (the Distribution Segment). SHH is a heavy civil construction company based in Houston, Texas that specializes in municipal and state contracts for highway paving, bridge, water and sewer and light rail. SCPI, through its operating division, Steel City Products, is

Table of Contents

headquartered in McKeesport, Pennsylvania, and distributes automotive accessories, non-food pet supplies and lawn and garden products.

The Company measures its performance principally through its operating profit. In addition to the Company's audited consolidated financial statements presented in accordance with generally accepted accounting principles (GAAP), management sometimes uses non-GAAP measures, including Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) that it believes are appropriate to enhance an overall understanding of the Company's financial performance and future prospects. Non-GAAP measures, which are adjusted to exclude certain costs from the comparable GAAP measures of net income, are considered among the indicators management uses as a basis of evaluating financial performance as well as for forecasting future periods. In addition, the Put price was determined as a multiple of EBITDA, and certain management bonuses are calculated according to EBITDA. For these reasons, management believes the non-GAAP measure of EBITDA can be useful to investors, potential investors and others.

Although EBITDA is not a recognized measurement under GAAP, management believes that the presentation of EBITDA is useful to investors because it is frequently used by securities analysts, investors and other interested parties in the evaluation of companies in the construction industry. In addition, management believes that EBITDA is useful in evaluating operating performance compared to that of other companies in the industry because the calculation of EBITDA generally eliminates the effects of financings, income taxes and the accounting effects of acquisitions, items that may vary for different companies for reasons unrelated to overall operating performance. EBITDA has certain material limitations associated with its use as compared to net income. These limitations are primarily due to the exclusion of certain amounts that are material to the Company's consolidated results of operations, as follows:

EBITDA does not include interest expense. Because the Company has borrowed money in order to finance its operations, interest expense is a necessary element of costs and the Company's ability to generate revenue. Therefore any measure that excludes interest expense or operating lease expense has this material limitation.

EBITDA does not include income tax expense. Because the payment of taxes is a necessary element of the Company's operations, any measure that excludes income tax expense has this material limitation.

EBITDA does not include depreciation and amortization expense. Because the Company uses capital assets, depreciation is a necessary element of costs and the Company's ability to generate revenue. Therefore any measure that excludes depreciation and amortization expense has this material limitation.

EBITDA may differ from the EBITDA calculations of other companies in its industry, limiting its usefulness as a comparative measure, and therefore has this material limitation.

Because of these limitations, EBITDA should not be considered a measure of discretionary cash available to the Company to invest in the growth of its business. We compensate for these limitations by relying primarily on our GAAP results and using adjusted EBITDA only supplementally. The presentation of this additional information is not meant to be considered in isolation or as a substitute for financial statements prepared in accordance with GAAP.

Consolidated revenues and operating profit for fiscal 2004 decreased 9% and 40% respectively, from the exceptional levels that were achieved in fiscal 2003.

(\$ thousands)

| Fiscal 2004 | Construction | Distribution | Corporate | Total |
|----------------------------|--------------|--------------|-----------|-----------|
| Revenues | \$132,478 | \$21,700 | | \$154,178 |
| Gross profit | 13,261 | 3,237 | | 16,498 |
| Operating income (loss) | 7,088 | 827 | (1,524) | 6,391 |
| Net income | | | | \$ 5,653 |
| Add back: | | | | |

Table of Contents

(\$ thousands)

| Fiscal 2004 | Construction | Distribution | Corporate | Total |
|-------------------------------|--------------|--------------|-----------|------------|
| Interest | | | | 1,695 |
| Taxes | | | | (1,918) |
| Depreciation and amortization | | | | 4,628 |
| EBITDA | | | | \$ 10,058 |
| Fiscal 2003 | Construction | Distribution | Corporate | Total |
| Revenues | \$ 149,006 | \$ 20,526 | | \$ 169,532 |
| Gross profit | 17,825 | 3,055 | | 20,880 |
| Operating income (loss) | 12,258 | 576 | (1,837) | 10,997 |
| Net income | | | | \$ 5,419 |
| Add back: | | | | |
| Interest | | | | 2,074 |
| Taxes | | | | 1,878 |
| Depreciation and amortization | | | | 4,807 |
| EBITDA | | | | \$ 14,178 |

Fiscal Year Ended December 31, 2004 (Fiscal 2004) Compared with Fiscal Year Ended December 31, 2003 (Fiscal 2003)**Construction**

As expected, contract revenues in fiscal 2004 decreased from the record levels in fiscal 2003. State highway business generated \$39 million in revenues in 2004, an increase of 50% compared with the prior year. SHH has begun to successfully compete for and work on much larger multi-year jobs. Business with the City of Houston and Harris County decreased in fiscal 2004, due to the completion of several large projects in 2003. Poor weather, especially in the second and fourth quarters of 2004, significantly reduced the number of available workdays on many of the Construction Segment's contracts.

Gross profit was \$13.3 million, or 10.0% of contract revenues, compared with gross profit in the prior year of \$17.8 million, or 12.0% of contract revenues. The decrease was due to the lower revenues and resulting higher fixed cost absorption rates, and to the mix of contracts in process, as many with higher margins were completed in fiscal 2003.

SHH reported operating income of \$7.1 million compared with operating profit of \$12.2 million in the prior year, principally due to the lower revenues and to the hiring of additional project managers and additional personnel in 2004.

A combination of lower gross margins due to bad weather and some construction problems encountered on contracts in the Dallas market, together with higher expenses, adversely affected the Construction Segment in the fourth quarter of fiscal 2004.

Contract backlog at December 31, 2004 was \$232 million, of which \$160 million is expected to be completed within fiscal 2005 and approximately \$72 million in fiscal 2006 and beyond.

Distribution

Sales in fiscal 2004 for the Distribution segment totaled \$21.7 million, an increase of \$1.1 million, or 5.7% from fiscal 2003. Additional sales of new products and product lines to existing customers increased automotive accessories sales by approximately \$800,000. Sales of pet supplies increased by approximately \$400,000 due to increased promotional orders to existing customers. Sales of lawn and garden products decreased by approximately \$100,000.

Gross profit was \$3.2 million, an increase of approximately \$200,000, or 6% from the prior year. Margins on pet supplies increased due to the higher sales volumes. Although sales of lawn and garden products decreased,

Table of Contents

margins on these items increased due to the mix of products. Margins on automotive accessories remained comparable with the prior year.

Operating profit in the current year was \$827,000, compared with \$576,000 in the prior year. The increase was due to the increased gross profit and to reductions in bad debt expense in the current year.

Corporate

Corporate expenses decreased by \$313,000 in fiscal 2004 compared with the prior year. In 2003, the Company had increased its liability for the Put in anticipation of its exercise in 2004, resulting in a charge of \$1.0 million. Offsetting this in fiscal 2004 were expense increases due to the listing of the Company's stock on the American Stock Exchange and subsequent hiring of a public relations firm (\$100,000); increased legal expenses related to the Put (\$80,000) and to non-cash items such as deferred compensation expense related to options issued (\$80,000) and to the conversion of certain of the zero coupon notes into stock at the settlement of the Put (\$257,000).

In the fourth quarter of fiscal 2004, the reduced profitability of the Construction Segment resulted in a pre-tax consolidated loss of \$140,000.

Interest and Taxes

Interest expense decreased by \$379,000 in fiscal 2004 compared with the prior year. In April 2003, the Company paid in full a \$1.0 million note to KTI, Inc., and principal payments were made on the subordinated debt. The subordinated debt was paid in full in September 2004.

The Company annually reviews its deferred tax loss carryforwards based on its estimate of future operating results. In fiscal 2004, the Company evaluated its potential future operating results and decreased its deferred tax valuation allowance, estimating that fewer tax loss carryforwards would expire unused, resulting in a deferred tax credit of \$2.1 million to its results of operations. In 2003, based on the Company's estimate of future operating results, the Company recorded deferred income tax expense of \$1.6 million at the expected rate of 34%, reduced by the utilization of net operating loss carryforwards against current taxable income. The Company's federal income taxes are largely sheltered by the use of net operating loss carryforwards.

Fiscal Year Ended December 31, 2003 (Fiscal 2003) Compared with Fiscal Year Ended December 31, 2002 (Fiscal 2002)

Consolidated revenues and net income increased by 26.2% and 14.8%, respectively, from fiscal 2002. The increase in earnings resulted in a 7.7% increase in diluted earnings per share over fiscal 2002 results.

(\$ thousands)

| Fiscal 2003 | Construction | Distribution | Corporate | Total |
|-------------------------------|--------------|--------------|-----------|------------|
| Revenues | \$ 149,006 | \$ 20,526 | | \$ 169,532 |
| Gross profit | 17,825 | 3,055 | | 20,880 |
| Operating income (loss) | 12,258 | 576 | (1,837) | 10,997 |
| Net income | | | | \$ 5,419 |
| Add back: | | | | |
| Interest | | | | 2,074 |
| Taxes | | | | 1,878 |
| Depreciation and amortization | | | | 4,807 |
| EBITDA | | | | \$ 14,178 |

Table of Contents

| Fiscal 2002 | Construction | Distribution | Corporate | Total |
|----------------------------------|--------------|--------------|-----------|------------|
| Revenues | \$ 111,747 | \$ 22,570 | | \$ 134,317 |
| Gross profit | 12,812 | 3,653 | | 16,465 |
| Operating income (loss) | 7,086 | 1,039 | (1,137) | 6,988 |
| Net income (restated) | | | | \$ 3,352 |
| Add back: | | | | |
| Interest | | | | 2,643 |
| Taxes | | | | 120 |
| Depreciation and amortization | | | | 3,985 |
| EBITDA | | | | \$ 10,100 |

Construction

Contract revenues in fiscal 2003 totaled \$149 million, an increase of \$37 million, or 33% compared with fiscal 2002. The increase was due to higher revenues on municipal contracts and the effect of the full year revenues generated by the addition of contracts acquired with the Kinsel business, enhanced by generally favorable weather conditions, which permitted faster average completion of contracts.

Gross profit was \$17.8 million, or 12% of contract revenues, compared with gross profit in the prior year of \$12.8 million, or 11.5% of contract revenues. The increase of \$5 million was due primarily to the revenue increase and favorable market conditions.

As a result of the increased gross profit, SHH reported operating profit of \$12.2 million, compared with \$7.1 million in fiscal 2002.

Contract backlog at December 31, 2003 was approximately \$141 million, an increase of approximately \$3 million from the prior year. Of the \$141 million, \$107 million was scheduled to be completed in fiscal 2004, and \$34 million was scheduled to be completed in fiscal 2005 and beyond.

Distribution

Sales in fiscal 2003 for the Distribution segment totaled \$20.5 million, a decrease of \$2 million, or 9% from fiscal 2002. The decrease was due primarily to the loss of Ames business in the prior year, which totaled approximately \$3.0 million in fiscal 2002. Although sales of automotive products and pet supplies decreased by \$3 million, sales of lawn and garden products increased by \$1.2 million, due to sales to a new customer and to increased sales to existing customers.

Gross profit was \$3.0 million, a decrease of approximately \$600,000, or 16% from the prior year. The decrease was principally the result of the lower sales volumes, however margins on pet supplies increased in fiscal 2003, as such sales to Ames in the prior year were at lower gross margin.

Operating profit in fiscal 2003 was \$576,000, compared with \$1,039,000 in the prior year. The decrease was due to the lower sales volumes and reduced gross profit.

Corporate

Corporate expenses increased by \$700,000 due to an increase of \$480,000 in the expense related to the Put, which was exercised during fiscal 2004. The increased Put liability reflected the strong operating results at SHH. In addition, the Company recorded expense of \$287,000 related to variable option expense for option grants after June 2000 and before adoption of SFAS 123 in January 2003.

Interest and Taxes

The Company's interest expense decreased by \$569,000 in fiscal 2003 compared with fiscal 2002 due to the payment over the year on the subordinated shareholder notes, and to lower average balances throughout the year on the revolving line of credit at SHH, resulting in reduced interest expense.

Table of Contents

The Company recorded deferred tax expense of \$1.6 million at the expected rate of 34%, offset by the utilization of net operating loss carryforwards against current taxable income. In December, 2002, the Company evaluated and decreased its deferred tax valuation allowance, thereby reducing tax expense to \$106,000. The Company's federal income taxes are largely sheltered through the use of net operating loss carryforwards.

Risk Factors

SHH measures its performance within the construction industry through the bidding process and the number, size and expected profitability of contracts obtained throughout the year. The Company is subject to various risks and uncertainties. Many factors affect the bidding climate, such as economic downturns, the amount of local, state and federal government funds available for infrastructure upgrade and new construction, as well as the number of bidders in the market and the prices at which they are prepared to bid, which are in turn affected by such bidders' profitability and contract backlogs. Factors outside the bidding climate include: (a) weather conditions such as precipitation and temperature, which can result in significant variability in quarterly revenues and earnings, particularly in the first and fourth fiscal quarters; (b) the availability of bonding, the absence of which would adversely affect the Company's ability to obtain new contracts; (c) the price of oil, (d) the price and availability of steel and other construction materials, which can significantly fluctuate and impact operating expense and (e) the availability of qualified field and supervisory personnel. While in recent years the Company has reported significant growth in revenues and profitability, there can be no assurance that it will be able to continue to achieve revenue and profit growth.

The distribution industry has been adversely affected by suppliers that offer products directly to retailers, precluding the need for a distributor. SCPI has been able to maintain its presence in the distribution industry by offering new product lines and by competing through product selection, distribution services, order fill rates, short turnaround times and breadth of merchandise offered but there can be no assurance that it will be able to continue to do so.

Certification

This Annual Report on Form 10-K has been certified by Patrick T. Manning, Chief Executive Officer of the Company, and by Maarten D. Hemsley, Chief Financial Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code) and the certification is attached as Exhibit 32.0.

Item 7(A). Quantitative and Qualitative Disclosure about Market Risk

The Company and its subsidiaries are exposed to certain market risks from transactions that are entered into during the normal course of business. Sterling's primary market risk exposure is related to interest rate risk. The Company manages its interest rate risk by attempting to balance its exposure between fixed and variable rates while attempting to minimize its interest costs. An increase of 1% in the market rate of interest would have increased the Company's interest expense in fiscal 2004 by approximately \$30,000.

Financial derivatives are used as part of the overall risk management strategy. These instruments are used to manage risk related to changes in interest rates. The portfolio of derivative financial instruments consists of interest rate swap agreements. Interest rate swap agreements are used to modify variable rate obligations to fixed rate obligations, thereby reducing the exposure to higher interest rates. Amounts paid or received under interest rate swap agreements are accrued as interest rates change with the offset recorded in interest expense.

The Company applies Statement of Financial Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Under SFAS No. 133, the Company's interest rate swaps have not been designated as hedging instruments; therefore changes in fair value are recognized in current earnings.

Table of Contents

Because the Company derives no revenues from foreign countries or otherwise has no obligations in foreign currency, the Company experiences no foreign currency exchange rate risk.

Item 8. Financial Statements and Supplementary Data

| | |
|---|----|
| Report of Independent Registered Public Accounting Firm | 21 |
| Consolidated Balance Sheets: December 31, 2004 and December 31, 2003 | 22 |
| Consolidated Statements of Operations for the fiscal periods ended December 31, 2004, December 31, 2003 and December 31, 2002 | 23 |
| Consolidated Statement of Stockholders' Equity for the fiscal periods ended December 31, 2004, December 31, 2003 and December 31, 2002 | 24 |
| Consolidated Statements of Cash Flows for the fiscal periods ended December 31, 2004, December 31, 2003 and December 31, 2002 | 25 |
| Notes to Consolidated Financial Statements | 27 |
| Schedule II Valuation and Qualifying Accounts | 58 |

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Sterling Construction Company, Inc.

We have audited the accompanying consolidated balance sheets of Sterling Construction Company, Inc. and its subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity, and cash flows for the three years in the period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (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. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Sterling Construction Company, Inc. and its subsidiaries as of December 31, 2004 and December 31, 2003 and the results of their operations and their cash flows for the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule II is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole. As discussed in Note 2 to the Consolidated Financial Statements, the Company restated its financial statements for the years ended December 31, 2003 and 2002 due to a misclassification of its release of an income tax valuation allowance between deferred income tax benefit and accumulated paid-in capital.

/s/ Grant Thornton LLP

Houston, Texas

March 11, 2005

Table of Contents**STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS****December 31, 2004 and 2003****(Dollar amounts in thousands, except per share data)**

| | 2004 | Restated 2003 |
|---|-----------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,518 | \$ 2,765 |
| Contracts receivable | 26,250 | 26,504 |
| Costs and estimated earnings in excess of billings | 5,884 | 1,281 |
| Trade accounts receivable, less allowance of \$1,015 and \$1,013, respectively | 2,361 | 1,919 |
| Inventories | 4,525 | 4,842 |
| Deferred tax asset | 3,986 | 1,452 |
| Other | 1,554 | 1,436 |
| Total current assets | 48,078 | 40,199 |
| Property and equipment, net | 21,227 | 22,380 |
| Goodwill | 12,863 | 7,809 |
| Deferred tax asset | 6,493 | 4,527 |
| Other assets | 883 | 663 |
| | 20,239 | 12,999 |
| Total assets | \$ 89,544 | \$ 75,578 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | 18,189 | 14,439 |
| Billings in excess of cost and estimated earnings | 4,477 | 9,742 |
| Short-term debt | 3,625 | 2,660 |
| Short-term debt, related parties | 3,593 | 2,310 |
| Current maturities of long term obligations | 149 | 708 |
| Other accrued expenses | 2,291 | 3,852 |
| Total current liabilities | 32,324 | 33,711 |
| Long-term obligations: | | |
| Long-term debt | 13,329 | 6,568 |
| Long-term debt, related parties | 7,755 | 6,758 |
| Put liability | | 5,578 |
| Other long-term obligations | 928 | 1,054 |
| | 22,012 | 19,958 |
| Minority interest | | 5,273 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, par value \$0.01 per share; authorized 1,000,000 shares, none issued | 74 | 51 |
| Common stock, par value \$0.01 per share; authorized 14,000,000 shares, 7,378,681 | | |

| | | |
|--|-----------|-----------|
| and 5,139,900 shares issued | | |
| Additional paid-in capital | 80,688 | 67,770 |
| Deferred compensation expense | (161) | (139) |
| Accumulated deficit | (45,392) | (51,045) |
| Treasury stock, at cost, 207 common shares | (1) | (1) |
| Total stockholders' equity | 35,208 | 16,636 |
| | \$ 89,544 | \$ 75,578 |

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

Table of Contents**STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS****December 31, 2004, 2003 and 2002**

(Dollar amounts in thousands, except per share data)

| | 2004 | 2003 | Restated 2002 |
|---|------------|------------|------------------|
| Contract revenues | \$ 132,478 | \$ 149,006 | \$ 111,747 |
| Distribution revenues | 21,700 | 20,526 | 22,570 |
| | 154,178 | 169,532 | 134,317 |
| Cost of contract revenues earned | 119,217 | 131,181 | 98,935 |
| Cost of goods sold, including occupancy, buying and warehouse expenses | 18,463 | 17,471 | 18,917 |
| Selling and administrative expenses, net | 9,990 | 9,650 | 9,218 |
| Provision for doubtful accounts | 116 | 232 | 259 |
| Interest expense, net of interest income | 1,695 | 2,074 | 2,643 |
| | 149,481 | 160,608 | 129,972 |
| Income before minority interest and income taxes | 4,697 | 8,924 | 4,345 |
| Minority interest | 962 | 1,627 | 873 |
| Income before income taxes | 3,735 | 7,297 | 3,472 |
| Income taxes: | | | |
| State income tax expense | 17 | 10 | 14 |
| Current income tax expense | 169 | 236 | |
| Deferred income tax (benefit) expense | (2,104) | 1,632 | 106 |
| Total income tax (benefit) expense | (1,918) | 1,878 | 120 |
| Net income | \$ 5,653 | \$ 5,419 | \$ 3,352 |
| Basic net income per share | \$ 1.06 | \$ 1.06 | \$ 0.66 |
| Weighted average number of shares outstanding used in computing basic per share amounts | 5,342,847 | 5,089,849 | 5,061,598 |
| Diluted net income per share | \$ 0.81 | \$ 0.84 | \$ 0.56 |
| Weighted average number of shares outstanding used in computing diluted per share amounts | 7,027,682 | 6,488,376 | 6,101,515 |

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

25

Table of Contents

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
For the years ended December 31, 2004, 2003 and 2002
(Dollars in thousands)

| | Common Stock | Deferred Compensation Expense | Additional Paid-in Capital | Accumulated Deficit | Treasury Stock | Total |
|--|-----------------|-------------------------------------|----------------------------------|------------------------|-------------------|-----------|
| Balance at December 31, 2001 | \$ 50 | | \$ 65,900 | (\$59,816) | (\$1) | \$ 6,133 |
| Stock issued upon option exercise | * | | 9 | | | 9 |
| Reduction of valuation allowance - deferred tax asset (restated) | | | 1,332 | | | 1,332 |
| Net income (restated) | | | | 3,352 | | 3,352 |
| Balance at December 31, 2002 (restated) | 50 | 0 | 67,241 | (56,464) | (1) | 10,826 |
| Stock issued upon option exercise | 1 | | 108 | | | 109 |
| Stock options granted | | (439) | 439 | | | 0 |
| Deferred compensation expense | | 300 | | | | 300 |
| Write off of discounted warrants | | | (18) | | | (18) |
| Net income | | | | 5,419 | | 5,419 |
| Balance at December 31, 2003 (restated) | 51 | (139) | 67,770 | (51,045) | (1) | 16,636 |
| Stock issued upon option exercise | 2 | | 403 | | | 405 |
| Stock options granted | | (403) | 403 | | | 0 |
| Deferred compensation expense | | 381 | | | | 381 |
| Conversion of debt to stock | 5 | | 1,714 | | | 1,719 |
| Shares issued upon settlement of put | 16 | | 8,051 | | | 8,067 |
| Privatization of SCPI | | | (49) | | | (49) |
| Reduction of valuation allowance-deferred tax asset | | | 2,396 | | | 2,396 |
| Net income | | | | 5,653 | | 5,653 |
| Balance at December 31, 2004 | \$ 74 | (\$161) | \$ 80,688 | (\$45,392) | (\$1) | \$ 35,208 |

*rounds to less than one thousand

The accompanying notes are an integral part of this consolidated financial statement

26

Table of Contents

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2004, 2003 and 2002
(Dollar amounts in thousands)

| | 2004 | 2003 | Restated 2002 |
|---|----------|----------|------------------|
| Cash flows from operating activities: | | | |
| Income from operations | \$ 5,653 | \$ 5,419 | \$ 3,352 |
| Adjustments to reconcile income from operations to net cash provided by operating activities: | | | |
| Depreciation and amortization | 4,628 | 4,807 | 3,855 |
| Bad debt expense | 116 | 232 | 259 |
| Loss (gain) on sale of property and equipment | 4 | (11) | (47) |
| Deferred tax expense (benefit) | (2,104) | 1,632 | 106 |
| Deferred compensation expense | 381 | 300 | |
| Minority interest in net earnings of subsidiary | 962 | 1,627 | 873 |
| Increase in put liability | | 1,001 | 521 |
| Accretion of zero coupon notes | | 744 | 761 |
| Other changes in operating assets and liabilities, net of effect from acquisitions: | | | |
| (Increase) decrease in accounts receivable | (558) | 944 | (1,391) |
| Decrease (increase) in contracts receivable | 254 | (4,286) | (7,023) |
| Decrease (increase) in inventories | 317 | (1,464) | 748 |
| (Increase) decrease in costs and estimated earnings in excess of billings on uncompleted contracts | (4,603) | 1,512 | (1,061) |
| (Increase) decrease in prepaid expense and other assets | (420) | (1,548) | 331 |
| Increase (decrease) in trade payables | 3,750 | (195) | 2,364 |
| (Decrease) increase in billings in excess of costs and estimated earnings on uncompleted contracts | (5,265) | 6,201 | (472) |
| Increase in accrued compensation and other liabilities | (178) | ,884 | 1,930 |
| Net cash provided by operating activities | 2,937 | 17,799 | 5,106 |
| Cash flows from investing activities: | | | |
| Net cash paid upon acquisition of Kinsel business | | | (2,662) |
| Net cash paid upon acquisition of SHH minority interest | (2,446) | | |
| Additions to property and equipment | (3,589) | (4,350) | (4,346) |
| Proceeds from sale of property and equipment | 192 | 70 | 106 |
| Net cash used in investing activities | (5,843) | (4,280) | (6,902) |

The accompanying notes are an integral part of this consolidated financial statement

Table of Contents

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2004, 2003 and 2002
(Dollar amounts in thousands)
(Continued)

| | 2004 | 2003 | Restated 2002 |
|--|-----------|-----------|------------------|
| Cash flows from financing activities: | | | |
| Cumulative daily drawdowns-revolvers | 126,393 | 101,864 | 84,674 |
| Cumulative daily reductions of revolvers | (118,666) | (109,948) | (81,221) |
| Additions to long-term obligations | | 702 | 895 |
| Repayments under long-term obligations | (4,681) | (6,137) | (3,039) |
| Proceeds from issuance of short-term debt | | 250 | |
| Fair value of induced conversion of debt to equity | 257 | | |
| Effect of SCPI reverse stock split | (49) | | |
| Issuance of common stock, pursuant to options | 405 | 109 | 9 |
| Net cash (used in) provided by financing activities: | 3,659 | (13,160) | 1,318 |
| Net increase (decrease) in cash and cash equivalents | 753 | 359 | (478) |
| Cash and cash equivalents at beginning of period | 2,765 | 2,406 | 2,884 |
| Cash and cash equivalents at end of period | \$ 3,518 | \$ 2,765 | \$ 2,406 |
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during period for: | | | |
| Interest | \$ 2,097 | \$ 1,943 | \$ 2,316 |
| Income taxes | \$ 14 | \$ 10 | |
| Supplemental disclosure of non-cash financing activities: | | | |
| Capital lease obligations for new equipment | \$ 26 | | \$ 32 |
| Additional common stock was issued upon the conversion of \$560 of convertible debt in 2004 | | | |
| Additional common stock was issued upon the conversion of \$901 of zero coupon notes in 2004 | | | |
| <i>The accompanying notes are an integral part of these consolidated financial statements.</i> | | | |

Table of Contents

**STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Summary of Business and Significant Accounting Policies

Basis of Presentation:

Sterling Construction Company, Inc. (Sterling or the Company) owns two subsidiaries; Sterling Houston Holdings, Inc., (Construction or SHH) and Steel City Products, Inc. (Distribution or SCPI).

The accompanying consolidated financial statements include the accounts of subsidiaries in which the Company has a greater than 50% ownership interest and all significant intercompany accounts and transactions have been eliminated in consolidation. For all years presented, the Company had no subsidiaries with ownership interests less than 50%.

Organization and business:

The Company s operations at December 31, 2004 consisted of two businesses, Construction and Distribution. Construction comprises SHH, a heavy civil construction company based in Houston that specializes in municipal and state contracts for highway paving, bridge, water and sewer, and light rail, and its subsidiaries. Distribution comprises SCPI, a wholesale distributor operating under the trade name Steel City Products which principally sells automotive accessories, primarily to drug and supermarket retailers, discount retail chains, hardware and automotive stores, based mainly in the Northeastern United States. SCPI also distributes non-food pet supplies and lawn and garden products.

Use of Estimates:

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain of the Company s accounting policies require higher degrees of judgment than others in their application. These include the recognition of revenue and earnings from construction contracts under the percentage of completion method, the valuation of long-term assets, estimates for the use of the Company s net operating loss carryforwards and the allowance for doubtful accounts. Management evaluates all of its estimates and judgments on an on-going basis.

Revenue Recognition:

Construction

The Company s primary business since July 2001 has been as a general contractor in the State of Texas where it engages in various types of heavy civil construction projects for both public and private owners. Credit risk is minimal with public (government) owners since the Company ascertains that funds have been appropriated by the governmental project owner prior to commencing work on public projects. However, most public contracts are subject to termination at the election of the government although, in the event of termination, the Company is entitled to receive the contract price on completed work and reimbursement of termination-related costs. Credit risk with private owners is minimized because of statutory mechanics liens, which give the Company high priority in the event of lien foreclosures following financial difficulties of private owners.

Revenues are recognized on the percentage-of-completion method, measured by the percentage of costs incurred to date to estimated total costs for each contract.

Table of Contents

Contract costs include all direct material, labor, subcontract and other costs and those indirect costs related to contract performance, such as indirect salaries and wages, equipment repairs and depreciation, insurance and payroll taxes. Administrative and general expenses are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability, including those arising from contract penalty provisions and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. An amount equal to costs attributable to contract claims is included in revenues when realization is probable and the amount can be reliably estimated.

The asset, Costs and estimated earnings in excess of billings on uncompleted contracts represents revenues recognized in excess of amounts billed. The liability Billings in excess of costs and estimated earnings on uncompleted contracts represents billings in excess of revenues recognized.

Distribution

Revenue is recognized when all of the following criteria are met:

Persuasive evidence of an arrangement exists

Delivery has occurred or service has been rendered

The seller's price to the buyer is fixed or determinable, and

Collectibility is reasonably assured.

Cash and Cash Equivalents:

The Company considers all highly liquid investments with maturities of three months or less to be cash equivalents. Included in cash and cash equivalents at December 31, 2004 and 2003 are uninsured temporary cash investments of \$6.0 million and \$9,000 in a money market fund stated at fair value. Additionally, the Company had at December 31, 2004 and 2003 \$54,000 and \$7.5 million, respectively, of cash balances in excess of the Federal Deposit Insurance Corporation insured limits. For the years ended December 31, 2004, 2003 and 2002, the Company recorded interest income of \$9,000, \$17,000 and \$6,000, respectively, which is netted in interest expense in the financial statements.

Contracts Receivable:

Contracts receivable are based on contracted prices. Based upon a review of outstanding contracts receivable, historical collection information and existing economic conditions, management has determined that all contracts receivable at December 31, 2004 and 2003 are fully collectible, and accordingly, no allowance for doubtful accounts against contracts receivable is required. Contracts receivable are written off based on individual credit evaluation and specific circumstances of the customer, when such treatment is warranted.

Accounts Receivable:

The Company maintains an allowance for doubtful accounts of its Distribution Segment, which is reviewed periodically based on customer credit history reports. The Company believes it conservatively estimates its doubtful accounts. Due to the bankruptcy filings of certain customers, the allowance for doubtful accounts increased by \$172,000 in fiscal 2003. The allowance increased in 2004 by \$2,000. Credit for returns is not deemed to be significant.

Retainage:

Many of the contracts under which the Company performs work contain retainage provisions. Retainage refers to that portion of revenue earned by the Company but held for payment by the customer pending satisfactory completion of the project. Unless reserved, the Company assumes that all amounts retained by customers under such provisions are fully collectible. Retainage on active contracts is classified as a current asset regardless of the term of the contract. Retainage is generally collected within one year of the completion of a contract. Retainage was approximately \$9.5 million and \$12.4 million at December 31, 2004 and December 31, 2003, respectively, of which

Table of Contents

\$1.3 million is expected to be collected beyond 2005. At December 31, 2003, retainage expected to be collected beyond 2004 was \$3.8 million.

Inventories:

The Company's inventories are stated at the lower of cost as determined by the first-in first-out (FIFO) method, or market.

Property and Equipment:

Property and equipment are stated at cost. Depreciation and amortization are computed using the straight-line method. The estimated useful lives used for computing depreciation and amortization are as follows:

| | |
|--|--|
| Building and improvements | 15-39 years |
| Construction equipment | 5-15 years |
| Leasehold improvements | 3-10 years, depending on the term of the lease |
| Transportation equipment | 5 years |
| Office furniture, warehouse equipment and vehicles | 3-10 years |

Depreciation expense was approximately \$4.5 million, \$4.8 million and \$3.8 million in fiscal years 2004, 2003 and 2002.

Deferred Loan Costs:

Deferred loan costs represent loan origination fees paid to the lender and related professional fees. These fees are amortized over the term of the loan. Amortization expense for fiscal years 2004, 2003 and 2002 was \$82,000, \$102,000 and \$151,000, respectively.

Goodwill:

Goodwill represents the excess of the cost of companies acquired over the fair value of their net assets at the dates of acquisition.

The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS 142). SFAS 142 requires that: (1) goodwill and indefinite lived intangible assets are no longer amortized, (2) goodwill is tested for impairment at least annually at the reporting unit level, (3) the amortization period of intangible assets with finite lives is no longer be limited to forty years, and (4) intangible assets deemed to have an indefinite life are tested for impairment at least annually using a one step process.

The first step in the impairment test of goodwill is to identify a potential impairment by comparing the fair value to the reported value of each reporting unit. The second step of the goodwill impairment test measures the amount of the impairment loss, if any, and is recorded in the consolidated statements of operations during the period in which the test is performed.

Intangible assets that have finite lives continue to be subject to amortization. In addition, the Company must evaluate the remaining useful life each reporting period to determine whether events and circumstances warrant a revision of the remaining period of amortization. If the estimate of an intangible assets remaining life is changed, the remaining carrying amount of the intangible asset is amortized prospectively over that revised remaining useful life.

Table of Contents

The amounts recorded by the Company for goodwill are as follows (dollars in thousands):

| | Construction Segment | Distribution Segment | Total |
|-----------------------------------|-------------------------|-------------------------|-----------|
| Balance, January 1, 2003 | \$ 7,681 | \$ 128 | \$ 7,809 |
| Impairment losses | | | |
| Balance, January 1, 2004 | \$ 7,681 | \$ 128 | \$ 7,809 |
| Purchase of SHH minority interest | 5,054 | | 5,054 |
| Impairment losses | | | |
| Balance, December 31, 2004 | \$ 12,735 | \$ 128 | \$ 12,863 |

The Company performed impairment testing on both reporting segments as of October 1, 2004. The analysis indicated no impairment of the Company's recorded goodwill for either reporting segment.

Equipment Under Capital Leases:

The Company accounts for capital leases, which transfer substantially all the benefits and risks incident to the ownership of the property to the Company, as the acquisition of an asset and the incurrence of an obligation. Under this method of accounting, the recorded value of the leased asset is amortized principally using the straight-line method over its estimated useful life and the obligation, including interest thereon, is amortized over the life of the lease. Depreciation expense on leased equipment and the related accumulated depreciation is included with that of owned equipment.

Shipping and Handling Costs:

Shipping costs are recorded in cost of goods sold. Expenses incurred for handling goods in preparation for shipment to customers totaled \$772,000, \$753,000 and \$875,000 during fiscal years 2004, 2003 and 2002, respectively. These expenses are primarily related to warehouse personnel.

Federal and State Income Taxes:

Sterling accounts for income taxes using an asset and liability approach. Deferred tax liabilities and assets are recognized for the future tax consequences of events that have already been recognized in the financial statements or tax returns. Net deferred tax assets are recognized to the extent that management believes that realization of such benefits is considered more likely than not. Changes in enacted tax rates or laws may result in adjustments to the recorded deferred tax assets or liabilities in the period that the tax law is enacted (see Note 8).

Stock-Based Compensation:

Effective January 1, 2003, the Company adopted SFAS No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure* which amends SFAS Statement No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company transitioned utilizing the prospective method for options granted after January 1, 2003. Stock option expense for options granted in fiscal 2004 was \$36,000 and for options granted in fiscal 2003 was \$13,000.

Prior to adoption of SFAS 148, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (dollars in thousands, except per share data).

Table of Contents

| | Fiscal year ended December 31, 2004 | Fiscal year ended December 31, 2003 | Fiscal year ended December 31, 2002 |
|---|--|--|--|
| Net income, as reported | \$ 5,653 | \$ 5,419 | \$ 3,352 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 381 | 300 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (117) | (64) | (50) |
| Proforma net income | \$ 5,917 | \$ 5,655 | \$ 3,302 |
| Basic and diluted net income per share: | | | |
| Basic, as reported | \$ 1.06 | \$ 1.06 | \$.066 |
| Diluted, as reported | \$ 0.81 | \$ 0.84 | \$ 0.56 |
| Proforma, basic | \$ 1.10 | \$ 1.11 | \$ 0.66 |
| Proforma, diluted | \$ 0.84 | \$ 0.87 | \$ 0.55 |

The Company recorded compensation expense of approximately \$315,000 and \$288,000 in the fiscal 2004 and 2003, respectively related to options granted between June 2000 and January 2003 under option plans that were subject to variable option accounting. The Board of Directors amended these plans in March 2004 with the result that the market price at which these options are measured as compensation expense throughout their vesting periods was fixed at the date of such amendment.

Earnings Per Share:

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is the same as basic but assumes the exercise of convertible subordinated debt securities and includes dilutive stock options and warrants using the treasury stock method. The following table reconciles the numerators and denominators of the basic and diluted per common share computations for net income for the fiscal years 2004, 2003 and 2002 (in thousands, except per share data):

| | Fiscal 2004 | Fiscal 2003 | Fiscal 2002 |
|--|----------------|----------------|----------------|
| Numerator: | | | |
| Net income | \$ 5,653 | \$ 5,419 | \$ 3,352 |
| Interest on convertible debt, net of tax | 44 | 44 | 44 |
| Net income before interest on convertible debt | \$ 5,697 | \$ 5,463 | \$ 3,396 |
| Denominator: | | | |
| Weighted average common shares outstanding basic | 5,343 | 5,090 | 5,062 |
| Shares for convertible debt | | 224 | 224 |
| Shares for dilutive stock options and warrants | 1,685 | 1,174 | 816 |
| Weighted average common shares outstanding and assumed conversions diluted | 7,028 | 6,488 | 6,102 |

| | | | | | | |
|------------------------------------|----|------|----|------|----|------|
| Basic earnings per common share: | | | | | | |
| Net income per common share | \$ | 1.06 | \$ | 1.06 | \$ | 0.66 |
| Diluted earnings per common share: | | | | | | |
| Net income per common share | \$ | 0.81 | \$ | 0.84 | \$ | 0.56 |

Table of Contents

At December 31, 2002 there were 410,601 options not included in the shares for the dilutive stock options and warrants as they would have been antidilutive. No options were considered antidilutive at December 31, 2004 and 2003.

Derivatives:

Financial derivatives, consisting of interest rate swap agreements, are used as part of the overall risk management strategy to manage the risk related to changes in interest rates. Interest rate swap agreements are used to modify variable rate obligations to fixed rate obligations, thereby reducing the exposure to higher interest rates. Amounts paid or received under interest rate swap agreements are accrued as interest rates change with the offset recorded in interest expense.

The Company applies Statement of Financial Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Under SFAS No. 133, the Company's interest rate swaps have not been designated as hedging instruments; therefore changes in fair value are recognized in current earnings.

Put Liability and Exercise of the Put

As part of the Sterling Transaction (see Note 4), the Company granted certain selling shareholders (the Selling Shareholders) a Put option for the remaining 19.9% of SHH stock owned by them, pursuant to which they had the right to sell the remaining SHH shares to the Company at a date of their choosing between July 2004 and July 2005 at a minimum price of \$105 per SHH share. The price of the Put was based on a multiple of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) for the twelve months immediately preceding the Put exercise date. The Company recorded the fair value of the Put as a \$4.1 million liability on the effective date of the Sterling Transaction, July 18, 2001. The fair value of the Put was reviewed quarterly and changes were reflected as components of pre-tax earnings. In fiscal 2002, the Company recorded approximately \$520,000 as expense related to the change in the fair value of the Put and the liability increased to approximately \$4.6 million. In the fourth quarter of fiscal 2003, exceptionally strong earnings during 2003 increased the likelihood that the Put would be exercised in 2004. Accordingly, based on an independent valuation of SHH, an updated estimate of the Put price was established in December 2003 and the Put liability was increased by \$1.0 million. At the end of each of the quarters ended March 31, 2004 and June 30, 2004, the Company evaluated the fair value of the Put and determined that no adjustment was necessary, as the Put value was determined to be the difference between the fair value of 19.9% of SHH and the expected exercise price. Therefore, any increase in the expected Put exercise price, being driven by an increase in SHH's EBITDA, reflected an underlying proportional increase in the fair value of SHH. In addition, the final computation of the Put price was based on a 12 month lookback of EBTIDA at SHH. This lookback was not completed until November 2004, and therefore, no adjustment was made to the Put liability in March and June 2004.

Recent Accounting Pronouncements:

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)) which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25) and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure, as was allowed under APB 25, will no longer be an alternative.

SFAS 123(R) must be adopted in interim periods beginning after June 15, 2005. The Company accounts for its stock-based compensation under the fair value method, and does not believe adoption of SFAS No. 123(R) will have a material effect on its financial position or results of operations.

Table of Contents*Reclassifications:*

Certain prior years' balances have been reclassified to conform to current year presentation.

2. Restatement of 2002 Results

Management's review of the valuation of the deferred tax asset in 2004 led to the discovery of a misclassification in the 2002 deferred tax valuation allowance between deferred income tax benefit and accumulated paid-in capital. The following have been restated to reflect this misclassification, (dollar amounts in thousands, except per share data):

| | Original 10-K filing | Adjustment | Adjusted Balance |
|---|-------------------------|------------|---------------------|
| 2003 Balance sheet | | | |
| Additional paid in capital | 66,400 | 1,370 | 67,770 |
| Accumulated deficit | (49,675) | (1,370) | (51,045) |
| 2002 Income statement | | | |
| Deferred tax credit | (1,264) | 1,370 | 106 |
| Net income | 4,722 | (1,370) | 3,352 |
| Earnings per share, basic | \$ 0.93 | (\$0.27) | \$ 0.66 |
| Earnings per share, diluted | \$ 0.78 | (0.22) | \$ 0.56 |
| Statement of stockholders' equity | | | |
| Reduction of valuation allowance-deferred tax asset | (38) | 1,370 | 1,332 |
| Net income | 4,722 | (1,370) | 3,352 |
| 2002 Cash flow statement | | | |
| Income from operations | 4,722 | (1,370) | 3,352 |
| Deferred tax benefit | (1,264) | 1370 | 106 |

3. Property and Equipment

Property and equipment are summarized as follows (in thousands):

| | December 31, 2004 | December 31, 2003 |
|--|-------------------------|----------------------|
| Construction equipment | \$ 26,550 | \$ 24,367 |
| Transportation equipment | 4,406 | 4,174 |
| Buildings | 1,488 | 1,488 |
| Leasehold improvements | 402 | 402 |
| Office furniture, warehouse equipment and vehicles | 1,462 | 1,378 |
| Land | 182 | 182 |
| | 34,490 | 31,991 |
| Less accumulated depreciation | (13,263) | (9,611) |
| | \$ 21,227 | \$ 22,380 |

Warehouse equipment financed under capital leases amounted to \$132,647 and \$106,402 at December 31, 2004 and December 31, 2003, respectively and accumulated depreciation related to such leased assets was \$81,835 and \$57,930.

4. Investment in Affiliated Company (*Sterling Transaction*)

Table of Contents

In July 2001, the Company completed the Sterling Transaction, in which it increased its equity ownership in SHH from 12% to 80.1%. SHH is a heavy civil construction company based in Houston that specializes in municipal and state contracts for highway paving, bridge, water and sewer, and light rail.

Total consideration for the increase in equity was \$24.6 million, including the Company's previous investment in SHH of \$3.5 million, and consisted of (a) cash payment of \$9.9 million, (b) conversion of a \$1.3 million SHH subordinated note receivable into Sterling equity, (c) issuance of subordinated notes and warrants, and (d) the sale and issuance of the Company's common stock. For accounting purposes, the value of the 1,124,536 shares of common stock sold was determined based on the average price of the Company's common shares over the 5-day period before and after the closing date.

As part of the Sterling Transaction, the Company granted the Selling Shareholders a Put option for the remaining 19.9% of SHH stock owned by them, pursuant to which they had the right to sell the remaining SHH shares to the Company at a date of their choosing between July 2004 and July 2005 at a minimum price of \$105 per SHH share. The Company recorded the fair value of the Put as a \$4.1 million liability at July 18, 2001. The fair value of the Put was reviewed quarterly and changes were reflected as components of pre-tax earnings. In fiscal 2002, the Company recorded approximately \$520,000 as expense related to the change in the fair value of the Put and the liability increased to approximately \$4.6 million. Strong earnings in fiscal 2003 increased the likelihood that the Put would be exercised in 2004. Accordingly, based on an independent valuation of SHH in the fourth quarter of fiscal 2003, the Company recorded an additional \$1.0 million expense related to the change in the fair value of the Put. At December 31, 2003, the Put liability was approximately \$5.6 million.

Effective July 19, 2004, the Selling Shareholders exercised the Put.

The purchase price of the SHH shares was to be computed as a multiple of SHH's EBITDA for the twelve months preceding the exercise, with a minimum price of \$12 million. Accordingly, a compilation of the financial statements of SHH for the period from July 2003 through June 2004 was completed in November 2004 as a result of which the purchase price was fixed at \$15.0 million. Settlement of the Put transaction occurred on December 22, 2004, following which the Company owned 100% of SHH.

The Put price was satisfied by cash of approximately \$2.4 million (derived from borrowings on available long-term bank facilities), five-year notes of approximately \$6.4 million, and the balance through the issuance of approximately 1,569,000 shares of the Company's common stock at a negotiated value of \$4.00 per share to determine the number of shares to be issued in the transaction, which represented a premium to the market price on the date of exercise in July. At the date the terms were settled and announced, November 13, 2004, the common stock was recorded at a fair value of \$5.14 per share. The cash owed to the selling shareholders and the notes issued in connection with the Put accrued interest from November 13, 2004 until the date of closing, December 22, 2004.

The final settlement of the Put transaction resulted in an increase of approximately \$5.1 million to the Company's reported amount of goodwill related to SHH. The Company determined that there were no adjustments to the fair value of the underlying value of the assets and liabilities of SHH, as book value approximated market value in all material aspects.

The following table summarized the estimated fair values of the assets acquired and liabilities assumed at the date the terms of the Put were settled (in thousands):

At November 13, 2004

| | |
|-------------------------------------|----------|
| Current assets | \$ 7,600 |
| Property, plant and equipment (net) | 4,000 |
| Goodwill | 5,100 |
| Total assets acquired | 16,700 |
| Current liabilities | (4,200) |
| Long-term liabilities | (3,200) |
| Total liabilities assumed | (7,400) |
| Put liability | \$ 5,800 |

Purchase price

36

\$ 15,100

Table of Contents

The settlement of the Put triggered the repayment of approximately \$7.9 million of the Company's debt owed to management and others who funded the Sterling Transaction in 2001. The Company paid this amount as well through a combination of cash of approximately \$2.4 million (from borrowings on available long-term bank facilities), issuance of five-year notes of approximately \$4.7 million and the balance through the issuance of approximately 225,000 shares of the Company's common stock, at a fair value of \$5.14 per share.

The following table reflects the settlement of the Put as if it had been completed at the beginning of each respective period of fiscal 2004, 2003 and 2002, even though, by its terms, the Put was not exercisable before July 19, 2004 (dollar amounts in thousands, except per share data):

| | Fiscal year ended December 31, 2004 | Proforma Adjustment | Proforma fiscal year ended December 31, 2004 |
|--|--|------------------------|---|
| Total revenues | \$ 154,178 | | \$ 154,178 |
| Operating profit | 6,391 | | 6,391 |
| Interest expense, net of interest income | 1,695 | 344(b) | 2,039 |
| Minority interest | 962 | (962)(c) | |
| Net income | \$ 5,653 | 408 | \$ 6,061 |
| Weighted average shares, basic | 5,343 | | 5,343 |
| Earnings per share, basic | \$ 1.06 | | \$ 1.13 |
| Weighted average shares, diluted | 7,028 | | 7,028 |
| Earnings per share, diluted | \$ 0.81 | | \$ 0.86 |
| | | | Proforma fiscal |
| | Fiscal year ended December 31, 2003 | Proforma adjustment | year ended December 31, 2003 |
| Total revenues | \$ 169,532 | | \$ 169,532 |
| Operating profit | 10,998 | 1,001(a) | 11,999 |
| Interest expense, net of interest income | 2,074 | 359(b) | 2,433 |
| Minority interest | 1,627 | (1,627)(c) | |
| Net income | \$ 5,419 | 4,147 | \$ 9,566 |
| Weighted average shares, basic | 5,090 | 1,794(d) | 6,885 |
| Earnings per share, basic | \$ 1.06 | | \$ 1.39 |
| Weighted average shares, diluted | 6,488 | 1,794(d) | 8,282 |
| Earnings per share, diluted | \$ 0.84 | | \$ 1.16 |

Table of Contents

| | Fiscal year ended December 31, 2002 (Restated) | Proforma adjustment | Proforma fiscal year ended December 31, 2002 |
|--|---|------------------------|---|
| Total revenues | \$ 134,317 | | \$ 134,417 |
| Operating profit | 6,988 | 521(a) | 7,509 |
| Interest expense, net of interest income | 2,643 | 484(b) | 3,127 |
| Minority interest | 873 | (873)(c) | |
| Net income | \$ 3,352 | 601 | \$ 3,953 |
| Weighted average shares, basic | 5,062 | 1,794(d) | 6,856 |
| Earnings per share, basic | \$ 0.66 | | \$ 0.58 |
| Weighted average shares, diluted | 6,103 | 1,794(d) | 7,897 |
| Earnings per share, diluted | \$ 0.56 | | \$ 0.50 |

Notes:

(a) Reverses the increase of \$1.0 million in 2003 and \$521,000 in the Put liability during 2002

(b) Additional interest expense related to the issuance of new notes offset by a decrease in interest expense related to existing notes repaid or replaced as part of the transaction

(c) Minority interest expense is eliminated

(d) Reflects the issuance of 1.8 million of shares of common stock in part satisfaction of the Put consideration and certain notes.

5. Line of Credit and Long-Term Obligations

Long-term obligations consist of the following (in thousands):

| | December 31, 2004 | December 31, 2003 |
|---|-------------------------|-------------------------|
| SHH Revolving Credit Agreement, due May 2007 | \$ 13,329 | \$ 6,568 |
| Subordinated debt, due quarterly through September 2004 | | 1,500 |
| Subordinated zero coupon notes | | 5,213 |
| SCPI Revolving Credit Agreement, due May, 2006 | 3,625 | 2,660 |
| Other related party debt | 250 | 1,795 |
| Mortgage payable, due monthly through June 2016 | 1,018 | 1,141 |
| Insituform Notes due quarterly through September 2004 | | 563 |
| Convertible subordinated notes, due December 2004 | | 560 |
| Management/director notes due December 2009 | 3,341 | |
| NASCIT five year-note, due December 2009 | 1,405 | |
| Management notes issued at settlement of the Put, due December 2009 | 6,353 | |
| Other | 58 | 58 |
| | 29,379 | 20,058 |
| Less current portion | (6,243) | (5,678) |

| | | | | |
|-----------------------|----|--------|----|--------|
| Net long-term portion | \$ | 23,136 | \$ | 14,380 |
|-----------------------|----|--------|----|--------|

Related Party Notes

Subordinated Debt

As part of the Sterling Transaction, certain shareholders of SHH were issued subordinated promissory notes by SHH in the aggregate amount of \$6 million in payment for certain of their SHH shares. These notes were repaid over three years through September 30, 2004 in equal quarterly installments and carried interest at 12% per annum.

Subordinated Zero Coupon Notes

The Sterling Transaction was funded in part through the sale of zero coupon notes combined with the issuance of zero coupon notes to certain selling shareholders of SHH. Warrants for Sterling common stock were issued in connection with the zero coupon notes and are exercisable for ten years from closing at \$1.50 per share.

Table of Contents

The zero coupon notes were discounted at a rate of 12%, maturing four years from the date of closing of the Sterling Transaction, subject to earlier payment in the event the SHH Put was exercised before such date. Employee selling shareholders of SHH received an aggregate face value of \$3.8 million in zero coupon notes, in which Mr. Manning and Mr. Harper received zero coupon notes in the face amount of \$799,000 and \$1.0 million, respectively and warrants for 63,498 shares and 81,301 shares, respectively. North Atlantic Smaller Companies Investment Trust (NASCIT), an investor in SHH, received a note in the face value of \$4 million. In December 2003, a prepayment of \$1.3 million was made on the zero coupon note issued to NASCIT in consideration of the forgiveness of six months interest on such notes. Accretion on the zero coupon notes was \$617,000 and \$744,000 in fiscal 2004 and 2003, respectively.

The Put was exercised in July 2004, which triggered repayment of the zero coupon notes. Upon settlement of the Put in December 2004, the Employee selling shareholders received a cash payment of \$783,000 utilizing funding from long term borrowings under SHH's line of credit. Of the balance, \$901,000 was converted into 225,326 shares of common stock, and the remaining \$1.9 million was converted into new five-year notes at 12%, with principal and interest payable quarterly beginning March 31, 2005. NASCIT received a cash payment of \$834,000, with the balance of \$1.4 million converted into a new five-year note at 12% interest, with principal and interest payable quarterly beginning March 31, 2005. The NASCIT loan has been classified as a current liability at December 31, 2004 (see Note 14)

Management/Director Notes

Notes with an aggregate face amount of \$1.3 million issued in connection with the October 1999 purchase of the second equity tranche of shares of SHH were restructured as part of the Sterling Transaction. Of the total, notes for \$800,000 were issued to several members of Sterling's management, including Joseph P. Harper, since appointed the Company's President. Notes totaling approximately \$559,000 were due to Robert Davies, the Company's former Chairman and Chief Executive Officer, and, through a participation agreement, Maarten Hemsley, formerly the Company's President and now its Chief Financial Officer. In consideration for the extension of the maturity dates of these notes, the face amounts were increased in July 2001 by an aggregate of approximately \$342,000. Furthermore, certain amounts owed by the Company to Messrs. Davies and Hemsley aggregating approximately \$355,000 were converted into notes. All such notes mature over four years, unless maturity is triggered by the exercise of the Put, and carry interest at 12% per year. Principal and interest may be paid only from defined cash flow of Sterling and SCPI, or from proceeds of any sale of SCPI's business. In December 2003, prepayments of accrued interest and principal were made to certain of these noteholders. Mr. Harper received prepayment totaling \$86,000 and Mr. Davies received prepayment totaling \$411,000. Mr. Hemsley declined any prepayment of his notes.

Pursuant to a Restructuring Agreement entered into in September 2003, when the Put was exercised in July 2004, triggering payment of the Management/Director notes, one half of the balance of the notes was paid in cash utilizing funding from long term borrowings under the SHH line of credit, with the remainder converted into new five-year notes at 12% interest, payable quarterly beginning March 31, 2005. Mr. Davies, Mr. Harper, Mr. Hemsley and Mr. Manning received cash payments of \$166,876, \$1,045,764, 208,397 and \$460,458, respectively.

Convertible Subordinated Notes

In December 2001, in conjunction with an amendment to the SCPI Revolver and in order to strengthen SCPI's working capital position through the purchase of additional inventory, Sterling obtained funding of \$500,000 principally from members of management and directors (including Messrs. Frickel, Harper and Hemsley, who loaned \$155,000, \$100,000 and \$25,000, respectively) (the Convertible Subordinated Notes). In January 2002, two other members of management, including Bernard Frank funded a further \$60,000, which was used for general corporate purposes. The notes evidencing these advances were convertible at any time prior to the maturity date into the Company's common stock at a price of \$2.50 per share and otherwise mature and are payable in full in December 2004. Interest at an annual rate of 12% was payable monthly. The notes are senior to debt issued in connection with the Sterling Transaction. All notes were converted at the election of their holders into common stock on December 31, 2004.

Table of Contents*Other Related-Party Debt*

In January 2003, members of management of the Company and of SHH (including Messrs. Harper and Hemsley) further funded SCPI with a \$250,000 short-term loan to reduce SCPI's vendor payables. Interest on the notes was payable monthly at the annual rate of 10%. The notes, which are subordinated to the SCPI Revolver, matured in July 2003, but were extended beyond that date with the granting of a guarantee by SHH, and an increase in the interest rate to 12% per annum, effective January 2004. The notes were repaid in three installments in January and February 2005.

SHH Revolver and SCPI Revolver

In conjunction with the Sterling Transaction, SHH entered into a three-year agreement providing for a bank revolving line of credit with a maximum line of \$13.0 million, subject to a borrowing base (the SHH Revolver). The line of credit carries interest at prime, subject to achievement of certain financial targets and is secured by the equipment of SHH and guarantees by the parent company. In December 2004, SHH entered into an amendment of the agreement providing for a maximum line of \$17 million with a maturity date of May 1, 2007, under substantially the same terms as the original loan. The amendment was finalized in February 2005. SHH paid a fee of \$15,000 in connection with the increase in the line and the renewal. At December 31, 2004, the balance on the SHH Revolver was \$13.3 million with an effective rate of interest of 5.25% and availability under the line of credit was \$671,000. The balance at the end of the year included borrowing of approximately \$5.0 million in late December to fund the settlement of the Put and related payments. SHH is required to maintain financial covenants of debt, current and cash flow coverage ratios, and at December 31, 2004 SHH was in compliance with these covenant requirements.

Management believes that the SHH Revolver will provide adequate funding for SHH's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006.

In July 2001 SCPI entered into an agreement for a bank revolving line of credit in the amount of \$5.0 million, subject to a borrowing base (the SCPI Revolver). In fiscal 2002, the line of credit was further amended to extend the term to May 2004 and to remove certain limitations on borrowing and in fiscal 2003, the interest rate was reduced to prime plus 1% and the maturity date extended to December 2004. In March 2004, the line was extended until May 31, 2006. The credit agreement continues to mandate that SCPI utilize a lockbox arrangement with the lender and the agreement further provides that the lender may accelerate the maturity date of the SCPI Revolver if a material adverse change occurs in SCPI's business. Because of these arrangements, the Company reports the SCPI Revolver as a current liability. At December 31, 2004, the outstanding balance on the Revolver was \$3.6 million and the effective rate of interest was 6.25%. SCPI had no excess availability on its line of credit at December 31, 2004. The SCPI Revolver is secured by the assets of SCPI and is subject to the maintenance of a fixed charge coverage ratio covenant. At December 31, 2004, SCPI was in compliance with its financial covenant.

Management believes that the SCPI Revolver will continue to provide adequate funding for SCPI's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months through March 31, 2006, assuming no material deterioration in current sales or profit margins.

SHH Mortgage

In June 2001, SHH completed the construction of a new headquarters building on land adjacent to its existing equipment repair facility in Houston. The building was financed principally through an additional mortgage of \$1.1 million on the land and facilities, at an interest rate of 7.75% per annum, repayable over 15 years. The new mortgage is cross-collateralized with an existing mortgage on the land and facilities which was obtained in 1998 in the amount of \$500,000, repayable over 15 years with an interest rate of 9.3% per annum.

Insituform Note

Table of Contents

In September 2002, a wholly owned subsidiary of SHH acquired the Kinsel Heavy Highway construction business from a subsidiary of Insituform Technologies. The transaction was financed through the issuance of two unsecured two-year notes aggregating \$1.5 million to Insituform, with the balance funded through additional borrowings under the SHH Revolver. The Insituform Notes bore interest at 9% and were payable in quarterly installments plus accrued interest through September 2004.

Other Debt

The Company acquired certain warehouse and computer equipment through capital leases, usually with five-year lease terms, with expirations ranging from September 2003 through October 2007. Equipment financed under capital leases totaled \$106,402 at December 31, 2003.

Maturity of Debt

The Company's long-term obligations mature during each fiscal year as follows (in thousands):

| | |
|-------------|-----------|
| Fiscal Year | |
| 2005 | \$ 6,243 |
| 2006 | 2,355 |
| 2007 | 15,683 |
| 2008 | 2,322 |
| 2009 | 2,297 |
| Thereafter | 479 |
| | \$ 29,379 |

6. Financial Instruments

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments* defines the fair value of financial instruments as the amount at which the instrument could be exchanged in a current transaction between willing parties.

Due to their near-term maturities, the carrying amounts of accounts receivable and accounts payable are considered equivalent to fair value. As the interest rates on the SHH Revolver and SCPI Revolver are variable, their fair value approximates their carrying value.

The Company's other debt is to management and directors, as to which book value is considered to be equal to fair value. As these notes are subordinated to the Company's lines of credit, they are subject to a greater degree of risk. Management believes that the 12% interest rate approximates market rates of interest for similar subordinated debt.

SHH has two mortgages, at 7.75% and 9.3% which contain pre-payment penalties. The amount of future cash flows was discounted using SHH's borrowing rate on its Revolver. At December 31, 2004 and December 31, 2003, the carrying value of the mortgages was \$1.0 million and \$1.1 million, respectively. At December 31, 2004 and December 31, 2003, the fair value of the mortgages was \$1.2 million and \$1.3 million, respectively.

SHH has two interest rate swap agreements, which are adjusted quarterly to their fair value.

The Company does not have any material off-balance sheet financial instruments.

7. Derivative Financial Instruments

During fiscal 2002, in connection with certain long-term debt, SHH entered into two interest rate swap agreements to manage exposure to fluctuations in interest rates on a portion of the loan balances.

Table of Contents

Under the interest rate swap agreements, the Company exchanged variable rate interest on a portion of the loan balances, equal to a notional amount of \$3,000,000 each, with fixed rates of 5.87% and 6.57%.

During the years ended December 31, 2004 and December 31, 2003, SHH recorded a fair value adjustment of \$119,600 and \$34,955 to adjust the carrying amounts of derivatives to reflect their face values of \$23,181 and \$142,801, respectively.

8. Income Taxes and Deferred Tax Asset

At December 31, 2004, Sterling had the benefit of net operating tax loss carry-forwards (the Tax Benefits) of approximately \$38.9 million, which expire in the years 2005 through 2021 and which shelter most income of Sterling and its subsidiaries from federal income taxes for several years. A change in control of Sterling exceeding 50% in any three-year period may lead to the loss of the majority of the Tax Benefits. In order to reduce the likelihood of such a change of control occurring, Sterling's Certificate of Incorporation includes restrictions on the registration of transfers of stock resulting in, or increasing, individual holdings exceeding 4.5% of the Company's common stock.

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

| | December 31, 2004 | | December 31, 2003 | |
|--|-------------------|-----------|-------------------|-----------|
| | Current | Long Term | Current | Long Term |
| ASSETS | | | | |
| Net operating loss carryforwards | \$ 4,541 | \$ 8,685 | \$ 15,747 | \$ 12,448 |
| Accrued compensation | 490 | | | |
| Reserve for bad debts | 345 | | 324 | |
| Other | | 8 | | 46 |
| | 5,376 | 8,693 | 16,071 | 12,494 |
| LIABILITIES | | | | |
| Depreciation of property and equipment | | 2,200 | | 2,343 |
| Net asset before valuation allowance | 5,376 | 6,493 | 16,071 | 10,151 |
| Less: valuation allowance | (1,390) | | (14,619) | (5,624) |
| Net asset | \$ 3,986 | \$ 6,493 | \$ 1,452 | \$ 4,527 |

During fiscal years 2004 and 2003, the valuation allowance decreased by \$18.9 and \$4.9 million due to the following (in thousands):

| | Fiscal 2004 | Fiscal 2003 |
|--|-------------|-------------|
| Utilization of net operating loss carryforwards previously reserved against current taxable income | \$ | \$ 1,816 |
| Reassessment of valuation allowance based on future taxable income forecasts: | | |
| Effects on income statement | 3,787 | (319) |
| Effects on additional paid in capital | 2,396 | |
| Expiration of net operating loss carryforwards | 12,670 | 3,444 |
| | \$ 18,853 | \$ 4,941 |

As a result of the acquisition of SHH in fiscal 2001, the Company evaluated and decreased the valuation allowance on its net deferred tax asset. Management believes that more likely than not, the deferred assets will be

realized based on future earnings of both SHH and SCPI.

Fluctuations in market conditions and trends and other changes in the Company's earnings base, such as subsidiary acquisitions and disposals, warrant periodic management reviews of the recorded tax asset to determine if an increase or decrease in the recorded valuation allowance is necessary to change the tax asset to an amount that management believes will more likely than not be realized.

Table of Contents

In fiscal 1990, SCPI underwent a quasi-reorganization. As a result of this quasi-reorganization, any subsequent recognition of net operating loss carryforwards generated before the quasi-reorganization resulted in an adjustment to paid-in capital. At February 28, 2001, the Company had approximately \$147 million in net operating losses generated before the quasi-reorganization. Of this amount, approximately \$18 million had previously been recognized and then subsequently re-reserved, resulting in a charge to earnings of approximately \$6.1 million in prior years. During fiscal 2001, most of these net operating loss carryforwards were either utilized to offset current taxable income or the valuation allowance was reduced based on the evaluation of the deferred tax assets when accounting for the SHH acquisition. At December 31, 2004, the Company has approximately \$4 million of net operating losses that are fully reserved that relate to the period prior to the quasi-reorganization. Any subsequent reduction in the valuation allowance related to the loss carryforwards would result in an adjustment to paid-in capital.

The deferred tax effects of temporary differences are not significant, and current income taxes payable represent state income taxes and federal alternative minimum tax.

The income tax provision differs from the amount using the statutory federal income tax rate of 34% applied to income or loss from continuing operations, for the following reasons (in thousands):

| | December 31, 2004 | Fiscal Year Ended December 31, 2003 | December 31, 2002 |
|--|----------------------|--|----------------------|
| Tax expense at the U.S. federal statutory rate | \$ 1,270 | \$ 2,484 | \$ 1,176 |
| State income tax expense, net of refunds and federal benefits | 17 | 10 | 14 |
| Utilization of net operating loss carryforwards against current taxable income | | (1,816) | |
| (Decrease) increase in deferred tax asset valuation allowance | (3,787) | 319 | (1,572) |
| Non-deductible costs | 558 | 873 | 504 |
| Other | 24 | 8 | (16) |
| Income tax (benefit) expense | \$ (1,918) | \$ 1,878 | \$ 106 |

The availability of the net operating tax loss carry-forwards may be adversely affected by future ownership changes of Sterling; at this time, such changes cannot be predicted. Sterling's estimated net operating tax loss carry-forwards at December 31, 2004 expire as follows (in thousands):

| | |
|-------------|-----------|
| Fiscal Year | |
| 2005 | \$ 13,358 |
| 2008 | 153 |
| 2010 | 1,466 |
| 2011 | 2,094 |
| 2017 | 3,098 |
| 2018 | 874 |
| Thereafter | 17,857 |
| | \$ 38,900 |

9. Costs and Estimated Earnings and Billings on Uncompleted Contracts

Costs and estimated earnings and billings on uncompleted contracts at December 31, 2003 are as follows (in thousands):

43

Table of Contents

| | Fiscal year ended December 31, 2004 | Fiscal year ended December 31, 2003 |
|--|---|---|
| Costs incurred and estimated earnings on uncompleted contracts | \$ 95,840 | \$ 99,732 |
| Billings on uncompleted contracts | (94,433) | (108,193) |
| | \$ 1,407 | \$ (8,461) |

Included in accompanying balance sheets under the following captions:

| | Fiscal year ended December 31, 2004 | Fiscal year ended December 31, 2003 |
|---|--|--|
| Costs and estimated earnings in excess of billings on uncompleted contracts | \$ 5,884 | \$ 1,281 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | (4,477) | (9,742) |
| | \$ 1,407 | \$ (8,461) |

10. Stock Options and Warrants**Options**

In fiscal 1991, the Board of Directors granted options to purchase 194,388 shares of the Company's common stock to key employees and to certain members of the Board of Directors. The exercise price of the options, which was equal to the market value of the stock at the date of the grant, was \$2.75.

In fiscal 1994, the Board of Directors and shareholders approved two stock option plans, the 1994 Omnibus Stock Plan (the "1994 Omnibus Plan") and the 1994 Non-Employee Director Stock Option Plan (the "Director Plan"). Under both plans, the exercise price of options granted may not be less than the fair market value of the common stock on the date of the grant and the term of the grant may not exceed ten years.

The 1994 Omnibus Plan initially provided for the issuance of a maximum of 350,000 shares of the Company's common stock pursuant to the grant of incentive stock options to employees of Sterling and its subsidiaries and the grant of non-qualified stock options, stock or restricted stock to employees, consultants, directors and officers of Sterling and its subsidiaries. Subsequently, the number of options available under the plan was increased to 1,150,000 shares. The options generally vest over a four-year period and expire ten years from the date of the grant.

The Director Plan (a "formula plan") provided for the issuance of up to 100,000 shares of common stock pursuant to options granted to directors who were not employees of the Company. The plan provided that on every May 1, each non-employee director holding office on such date would automatically receive a fully-exercisable, fully vested, ten-year option to purchase 3,000 shares at the market value on such date. Each director's options expire upon such director's resignation. Options covering the final 7,000 shares that remained under the plan were issued in May 2001.

In December 1998, the Board of Directors approved the 1998 Omnibus Stock Plan (the "1998 Omnibus Plan"). Under the 1998 Omnibus Plan, the exercise price of the options granted may not be less than the fair market value of the common stock on the date of grant and the term of the grant may not exceed ten years. The 1998 Omnibus Plan provides for the issuance of 700,000 shares. Stock options granted under the plan generally vest over a three-year period.

In fiscal 2001, the shareholders ratified the 1998 Omnibus Stock Plan and the Board of Directors approved the 2001 Stock Incentive Plan (the "2001 Stock Incentive Plan"). The 2001 Stock Incentive Plan provides for the issuance of incentive stock awards for up to 500,000 shares of common stock, under which stock options may be granted at an

exercise price not less than the fair market value of the common stock on the date of grant. The Company's and its subsidiaries' officers, employees, directors, consultants and advisors are eligible to be granted awards under the plan. Stock options generally vest over time and can be exercised no more than 10 years after the date of the grant. The plan also provides for stock grants, but none have been made as of December 31, 2004.

Table of Contents

Beginning in 1998 and as part of the Sterling Transaction in 2001, certain options granted to Messrs. Davies and Hemsley were extended beyond the normal expiration date under a standstill agreement. At the time of the standstill agreement, the fair value of the stock was lower than the option exercise price.

The following tables summarize the activity under the five plans:

| | 1991 Plan | | Director Plan | | 1994 Omnibus Plan | |
|-----------------------|-----------|---------------------------------|-----------------------|---------------------------------|---------------------------|---------------------------------|
| | Shares | Weighted average exercise price | Shares | Weighted average exercise price | Shares | Weighted average exercise price |
| Outstanding at 12/01: | 128,573 | \$ 2.58 | 87,502 | \$ 1.77 | 866,284 | \$ 1.46 |
| Granted | | | | | | |
| Exercised | | | | | (13,500) | \$ 1.07 |
| Expired/forfeited | (29,157) | \$ 2.00 | | | (30,000) | \$ 1.68 |
| Outstanding at 12/02: | 99,416 | \$ 2.75 | 87,502 | \$ 1.77 | 822,784 | \$ 1.46 |
| Granted | | | | | | |
| Exercised | (14,996) | \$ 2.75 | | | (50,000) | \$ 2.75 |
| Expired/forfeited | | | | | (2,400) | \$ 1.35 |
| Outstanding at 12/03: | 84,420 | \$ 2.75 | 87,502 | \$ 1.77 | 770,384 | \$ 1.48 |
| Granted | | | | | | |
| Exercised | | \$ 2.75 | (37,170) | \$ 1.83 | (162,192) | \$ 1.95 |
| Expired/forfeited | | | (3,000) | \$ 2.75 | (29,996) | \$ 2.42 |
| Outstanding at 12/04: | 84,420 | \$ 2.75 | 47,332 | \$ 1.67 | 578,196 | \$ 1.29 |
| | | | | | | |
| | | | 1998 Omnibus Plan (a) | | 2001 Stock Incentive Plan | |
| | | | Shares | Weighted average exercise price | Shares | Weighted average exercise price |
| Outstanding at 12/01: | | | 540,500 | \$ 0.54 | 97,400 | \$ 1.50 |
| Granted | | | 10,000 | \$ 1.50 | 55,900 | \$ 1.73 |
| Expired/forfeited | | | | | | |
| Outstanding at 12/02: | | | 550,500 | \$ 0.55 | 153,300 | \$ 1.58 |
| Granted | | | | | 60,800 | \$ 3.05 |
| Exercised | | | (10,000) | \$ 0.50 | | |
| Expired/forfeited | | | | | | |
| Outstanding at 12/03: | | | 540,500 | \$ 0.56 | 214,100 | \$ 2.00 |
| Granted | | | | | 157,800 | \$ 3.10 |
| Exercised | | | (20,375) | \$ 1.05 | 420 | \$ 2.04 |
| Expired/forfeited | | | (1,500) | \$ 1.00 | (7,180) | \$ 1.82 |
| Outstanding at 12/04: | | | 518,625 | \$ 0.54 | 364,300 | \$ 2.48 |

- (a) Of the options to purchase 600,000 shares granted in fiscal 1999, one third were immediately exercisable, one third vested in December 1999 and one third vested in December 2000. The option to purchase 41,000 shares granted in fiscal 2000 vest over a four year period, with one quarter of the total being immediately exercisable.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2004:

Table of Contents

| Range of exercise price per share | Number of shares | Options outstanding | Weighted average exercise price per share | Options exercisable | Weighted average exercise price per share |
|-----------------------------------|------------------|---|---|---------------------|---|
| | | Weighted average remaining contractual life (years) | | Number of shares | |
| \$0.50 - \$0.88 | 885,532 | 8.01 | \$ 0.67 | 885,532 | \$ 0.67 |
| \$1.00 - \$1.50 | 214,025 | 5.85 | \$ 1.27 | 195,925 | \$ 1.25 |
| \$1.73 - \$2.00 | 61,600 | 6.60 | \$ 1.77 | 31,041 | \$ 1.80 |
| \$2.75 - \$3.38 | 431,716 | 5.97 | \$ 2.93 | 229,617 | \$ 2.80 |
| | 1,592,873 | | \$ 1.41 | 1,342,115 | \$ 1.13 |

At December 31, 2003, options to purchase 1,547,250 shares were exercisable at a weighted average exercise price of \$1.24 per share.

The weighted average fair value per share of all options granted during fiscal 2004, 2003 and 2002 was \$2.55, \$2.49 and \$1.45, respectively.

The pro forma adjustments were calculated using the Black-Scholes option pricing model using the following assumptions in each year:

| | Fiscal 2004 | Fiscal 2003 | Fiscal 2002 |
|-------------------------|-------------|-------------|-------------|
| Risk free interest rate | 4.00% | 4.00% | 4.00% |
| Expected volatility | 78.0% | 77.0% | 79.0% |
| Expected life of option | 10.0 years | 10.0 years | 10.0 years |
| Expected dividends | None | None | None |

Warrants

As part of the Sterling Transaction in July 2001, warrants attached to zero coupon notes were issued to certain members of SHH management, to NASCIT and to KTI. These ten-year warrants to purchase shares of the Company's common stock at \$1.50 per share were exercisable 54 months from the issue date; following settlement of the Put, the exercise date was changed (see Note 14). In April 2003, the KTI Loan was prepaid, and as part of the consideration for the prepayment, 394,302 warrants were cancelled. At December 31, 2004 and 2003, 850,000 warrants were outstanding. At December 31, 2002 there were 1,244,302 warrants outstanding.

11. Employee Benefit Plan

The Company and its subsidiaries maintain defined contribution profit-sharing plans covering substantially all persons employed by the Company and its subsidiaries, whereby employees may contribute a percentage of compensation, limited to maximum allowed amounts under the Internal Revenue Code. The Plan provides for discretionary employer contributions, the level of which, if any, may vary by subsidiary and is determined annually by each company's Board of Directors. The Company matched \$328,000, \$244,000 and \$217,000 in contributions for the years ended December 31, 2004, December 31, 2003 and December 31, 2002, respectively.

12. Operating Leases

In December 1997, SCPI entered into an operating lease for its warehouse with an initial term that expired January 1, 2003, with one additional five-year renewal option. SCPI exercised its renewal option in late 2002. The lease requires minimum rental payments of \$247,000 through December 2005, increasing to \$259,000 per annum through December 2007, and payment by SCPI of certain expenses such as liability insurance, maintenance and other operating costs. With the addition of lawn and garden business in fiscal 2001, SCPI entered into a lease agreement for additional warehouse and office space with an initial term of seven years, expiring December 2007, with one three-year renewal option.

Operations of SHH are conducted from an owned building in Houston, Texas. SHH also leases incidental office space in Fort Worth, Texas and in San Antonio, Texas on month to month agreements.

Through the acquisition of the Kinsel Business in September 2002, SHH acquired several equipment operating leases, with balances on the lease terms ranging from several months to approximately two years.

Table of Contents

Minimum annual rentals for all operating leases having initial non-cancelable lease terms in excess of one year are as follows (in thousands):

| | |
|--------------------------------------|----------|
| Fiscal Year | |
| 2005 | 555 |
| 2006 | 533 |
| 2007 | 516 |
| Thereafter | |
| Total future minimum rental payments | \$ 1,604 |

Total rent expense for all operating leases amounted to approximately \$614,000, \$795,000 and \$428,000 in fiscal years 2004, 2003 and 2002, respectively.

13. Segment Information

The Company operates two segments of business. SHH, or Construction, is primarily a heavy civil construction company based in Houston, Texas that specializes in municipal and state highway contracts for paving, bridge, water and sewer and light rail projects. Sterling also operates SCPI or Distribution, a wholesale distributor based in Pittsburgh, Pennsylvania.

Each of the Construction Segment and the Distribution Segment is managed by its own decision makers and comprises different customers, suppliers and employees. The operating profitability of the Construction Segment is reviewed by its Treasurer, Joseph P. Harper, to determine its financial needs. Terry Allan, Chief Executive Officer of SCPI and Maarten Hemsley, the Company's Chief Financial Officer, review the operating profitability of the Distribution Segment and its working capital needs to allocate financial resources. Allocation of resources among the Company's operating segments is determined by Messrs. Harper and Hemsley.

The following table reflects the Company's two operating segments (in thousands):

| Fiscal 2004 | | | | Consolidated |
|--|--------------|--------------|-----------|--------------|
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 132,478 | \$ 21,700 | | \$ 154,178 |
| Operating profit (loss) | 7,088 | 827 | (1,524) | 6,391 |
| Interest expense, net | | | | 1,695 |
| Income before minority interest and income taxes | | | | 4,697 |
| Minority interest expense | | | (962) | (962) |
| Net income | | | | 5,653 |
| Depreciation and amortization | \$ 4,536 | \$ 89 | \$ 3 | \$ 4,628 |
| Segment assets | \$ 59,225 | \$ 7,737 | \$ 22,582 | \$ 89,544 |
| Capital expenditures | \$ 3,570 | \$ 35 | \$ 9 | \$ 3,614 |
| Fiscal 2003 | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 149,006 | \$ 20,526 | | \$ 169,532 |
| Operating profit (loss) | 12,258 | 576 | (1,836) | 10,998 |
| Interest expense, net | | | | 2,074 |

| | | | | |
|--|-----------|----------|-----------|-----------|
| Income before minority interest and income taxes | | | | 8,924 |
| Minority interest expense | | | (1,627) | (1,627) |
| Net income | | | | 5,419 |
| Depreciation and amortization | \$ 4,687 | \$ 118 | \$ 2 | \$ 4,807 |
| Segment assets | \$ 55,248 | \$ 7,118 | \$ 13,212 | \$ 75,578 |
| Capital expenditures | \$ 4,341 | \$ 9 | \$ | \$ 4,350 |

47

Table of Contents

| | | | | | |
|--|--------------|--------------|-----------|--|--------------|
| Fiscal 2002 | | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | | Total |
| Revenues | \$ 111,747 | \$ 22,570 | | | \$ 134,317 |
| Operating profit (loss) | 7,086 | 1,039 | (1,137) | | 6,988 |
| Interest expense, net | | | | | 2,643 |
| Income before minority interest and income taxes | | | | | 4,345 |
| Minority interest expense | | | (873) | | (873) |
| Net income (restated) | | | | | \$ 3,352 |
| Depreciation and amortization | \$ 3,703 | \$ 149 | \$ 3 | | \$ 3,855 |
| Segment assets | \$ 49,442 | \$ 6,906 | \$ 16,409 | | \$ 72,757 |
| Capital expenditures | \$ 4,242 | \$ 101 | \$ 3 | | \$ 4,346 |

The following table shows contract revenues generated from SHH's largest customers which accounted for more than 10% of consolidated revenues (dollars in thousands):

| | Fiscal 2004 | | Fiscal 2003 | | Fiscal 2002 | |
|--|-------------------|---------------|-------------------|---------------|-------------------|---------------|
| | December 31, 2004 | | December 31, 2003 | | December 31, 2002 | |
| | Contract Revenues | % of Revenues | Contract Revenues | % of Revenues | Contract Revenues | % of Revenues |
| City of Houston | \$16,512 | 12.5% | \$58,441 | 39.2% | \$26,044 | 23.3% |
| Texas State Department of Transportation | \$44,461 | 33.6% | \$28,412 | 19.1% | * | * |

* represents less than 10% of revenues

The following table shows sales to SCPI's customers that individually accounted for more than 10% of SCPI's sales during any of the latest three fiscal years (dollars in thousands):

| | Fiscal Year 2004 | | Fiscal Year 2003 | | Fiscal Year 2002 | |
|-----------------|-------------------|------------|-------------------|------------|-------------------|------------|
| | December 31, 2004 | | December 31, 2003 | | December 31, 2002 | |
| | Sales | % of Sales | Sales | % of Sales | Sales | % of Sales |
| Kroger | \$4,082 | 19% | \$3,242 | 16% | \$3,591 | 16% |
| Warehouse Sales | \$3,768 | 17% | \$3,784 | 18% | \$3,711 | 16% |
| Giant Eagle | \$3,487 | 16% | \$3,245 | 16% | \$2,959 | 13% |

14. Subsequent Event

In February 2005, The Board approved a change in the date that all outstanding warrants would first become exercisable, from January 2006 to January 2005 and an agreement was reached between the Company, NASCIT and certain holders of debt issued to the Selling Shareholders, as well as Messrs. Davies and Hemsley (the Noteholders), whereby NASCIT would exercise all its warrants in March 2005, providing a payment to the Company of approximately \$484,000. That amount will be utilized to fund a principal repayment to NASCIT on March 31, 2005. The other Noteholders agreed to defer certain principal payments otherwise due to them in March and June 2005, sufficient to facilitate the repayment of all of NASCIT's note. As a result of this agreement the Company will benefit

by a reduced interest cost of approximately \$112,000 in fiscal 2005.

15. Commitments and Contingencies

Employment Agreements

Table of Contents

Messrs. Harper and Manning and certain other officers of SHH have employment agreements with a subsidiary of SHH which provide for payments of annual salary and benefits if the executive's employment is terminated without cause.

SCPI has an employment agreement with Mr. Allan that provides for payments of annual salary and certain benefits if his employment is terminated without cause.

Self-Insurance

SHH is self-insured for employee health claims. Its policy is to accrue the estimated liability for known claims and claims that have been incurred but not reported through December 31, 2004. The Company has obtained reinsurance coverage for the policy period from June 1, 2004 through May 31, 2005 as follows:

Specific excess reinsurance coverage for medical and prescription drug claims in excess of \$40,000 with a maximum lifetime reimbursable of \$468,000.

Aggregate reinsurance coverage for medical, dental and prescription drug claims with a plan year maximum of \$1,000,000 for claims in excess of approximately \$818,000 which is estimated claims cost based on the number of employees.

For the twelve months ended December 31, 2004, SHH incurred approximately \$803,000 in expenses related to this plan, compared with \$769,000 in fiscal 2003 and \$848,000 in fiscal 2002.

Guarantees

The Company typically indemnifies contract owners for claims arising during the construction process and carries insurance coverage for such claims, which in the past have not been material in nature.

Litigation

The Company is involved in certain claims and lawsuits occurring in the normal course of business. Management, after consultation with outside legal counsel, does not believe that the outcome of these actions would have a material impact on the financial statements of the Company. In 2003, Ames filed a preference claim against SCPI, which the Company believes is largely without merit. The Company does not believe that the liability for any successful preference action by Ames could exceed the amount due to the Company by Ames on its post-petition administrative claim, which has been largely written-off. Accordingly, the Company does not believe that the outcome of the Ames matters will have a material impact on the Company's financial condition.

16. Minority Interest

During fiscal 1993, the cumulative dividends on SCPI's Series A Preferred Stock exceeded SCPI's net income for that year, thus creating a loss attributable to SCPI's common stockholders in excess of the minority interest, and accordingly, the Company reduced to zero the minority interest related to SCPI. In October 2003, the Board of Directors of SCPI approved a 1 for 300,000 share reverse stock split of SCPI's common stock. The transaction was approved by the Company; SCPI's majority shareholder. In March 2004 the reverse stock split of SCPI's common stock was completed with the result that the Company is SCPI's sole shareholder.

From July 2001 to December 2004, the Company had an 80.1% investment in SHH. A minority interest liability of \$5.3 million was reflected in the consolidated balance sheet for fiscal year 2003. In December 2004, the Company purchased the remaining 19.9% of SHH. Minority interest expense of \$962,000, \$1,627,000, and \$873,000 is reflected in the consolidated results of operations for fiscal years 2004, 2003 and 2002, respectively.

17. Related Party Transactions

Table of Contents

In October 1999, certain shareholders of SHH exercised their right to sell a second tranche of equity securities to Oakhurst Technology, Inc. (a wholly owned subsidiary of the Company) (OTI) thereby increasing the Company's consolidated equity ownership of SHH from 7% to 12%. The equity purchase was financed through the issuance of two notes. One of these notes reflecting loans in the amount of \$559,000, was issued to Mr. Davies (the First Note) in which Mr. Hemsley had a participation of \$116,000. The second of the notes in the amount of \$800,000 (the Manning Note) was issued to James D. Manning, the brother of Patrick T. Manning and one of the SHH shareholders who sold SHH equity securities to OTI. The First Note provided for interest at 14% payable quarterly and was due in October 2000, however, no interest payments were made and the First Note was not repaid in October 2000. In connection with the July 2001 transaction in which the Company increased its ownership of SHH to 80.1%, (the Sterling Transaction), accrued unpaid interest in the amount of \$134,000 on the First Note was added to the principal, the maturity date of the First Note was extended to July 2005, and the interest rate was reduced to 12%. In connection with the Sterling Transaction, the Company also issued an additional four-year 12% promissory note to each of Messrs. Hemsley (\$136,421) and Davies (\$250,623) (the Second Notes) to repay certain amounts due to them from the Company or OTI, including deferred compensation, the fee (and related interest) owed to them in connection with the acquisition of the second tranche of SHH equity in October 1999, the fee due in July 2001 to them in connection with the Sterling Transaction and a fee for the extension of the First Note.

In connection with the Sterling Transaction, the maturity date of the Manning Note also was extended to July 2005 and the interest rate was reduced from 14% to 12%. In consideration for the extension of the maturity date and interest rate reduction, Mr. James D. Manning received a zero coupon promissory note due in July 2005 with principal and interest payable at maturity in the aggregate amount of \$187,000. Interest and principal on the First Note, the Second Notes and the Manning Note are payable prior to maturity only to the extent of cash available to Sterling for these payments and as permitted by institutional lenders to Sterling or its subsidiaries.

After the Sterling Transaction, Mr. Harper and another officer of SHH purchased \$300,000 and \$100,000, respectively, of the Manning Note from Mr. James D. Manning. As a result, Mr. Harper now holds a separate note in the principal amount of \$300,000, an officer of TSC holds a separate note in the principal amount of \$100,000, and Mr. James D. Manning holds a note in the principal amount of \$400,000, in each case, on the same terms and conditions as the Manning Note.

In September 2003, the First Note, the Manning Note and the Second Notes were amended to provide for a maturity date that is the date the Company is required to purchase the remaining shares of SHH if the holders of those shares exercise their rights to sell such shares to the Company, and to provide for payment of those notes with a combination of cash and five-year notes of the Company.

In December 2003 prepayments of accrued interest and principal were made to certain of these noteholders. Mr. Harper received a prepayment totaling \$86,000 and Mr. Davies received a prepayment totaling \$411,000. Mr. Hemsley declined any prepayment of his notes.

In July 2004, the remaining shareholders of SHH exercised their right to sell their shares of SHH to the Company (the Put) for consideration (paid in December 2004) consisting of a combination of cash (funded through long-term borrowings), stock and five-year notes of the Company bearing interest at an annual rate of 12%. The exercise of the Put triggered the acceleration of the maturity of the other debt issued in July 2001. Those obligations were satisfied in December 2004 through a payment of cash, the issuance of some stock and the issuance of the same form of five-year notes. The cash paid and shares and notes issued were as follows:

| Name | Cash | Shares | Five-year Notes |
|-----------------------|--------------|---------------|----------------------------|
| Patrick T. Manning | \$ 460,458 | 135,474 | \$ 365,831 |
| James D. Manning | \$ 660,649 | 218,357 | \$ 2,124,633 |
| Joseph P. Harper, Sr. | \$ 1,045,764 | 345,437 | \$ 3,020,201 |
| Maarten D. Hemsley | \$ 208,397 | | \$ 207,504 |
| Robert M. Davies | \$ 166,876 | | \$ 518,641 |

Mr. James D. Manning is employed by an operating subsidiary of SHH under a three-year employment agreement that commenced January 1999 and that was extended for an additional three-year term in July 2001 and

Table of Contents

again in July 2004 pursuant to which he receives an annual salary of \$75,000 plus \$75.00 per hour for each hour worked in excess of 1,000 hours during any calendar year. In addition, he is entitled to receive incentive compensation up to 100% of his base pay if certain financial goals are met. In fiscal 2004, he earned his maximum bonus of \$50,000. The employment agreement limits the ability of Mr. Manning to compete for a period of two years after he ceases to be an employee if he terminates his employment without good cause or SHH terminates his employment for good cause, and for a period of one year after he ceases to be an employee if he terminates his employment for good reason or SHH terminates his employment without good cause; provided that these non-competition obligations may be avoided by Mr. Manning if SHH terminates the employment agreement other than for good cause.

Since March 2001 Mr. Hemsley has provided consulting services to (and since May 2002 has been an employee of) J O Hambro Capital Management Limited as Fund Manager of Leisure & Media Venture Capital Trust plc, and recently as a principal of its Trident Private Equity II investment fund, neither of which funds were or are an investor in the Company or any of its affiliates.

In December 2001, in order to strengthen SCPI's working capital position, Sterling obtained funding in the amount of \$500,000 from members of management and directors, including Messrs. Frickel, Harper and Hemsley, who loaned \$155,000, \$100,000 and \$25,000, respectively. The notes, which ranked senior to debt incurred in the Sterling Transaction, bore interest at 12%, payable monthly. The notes were convertible into shares of common stock of the Company at a conversion price of \$2.50 per share at any time prior to the maturity date in December 2004. All holders of these notes converted their debt into common stock on December 31, 2004.

In January 2003 certain members of management, including Messrs. Harper (\$70,000) and Hemsley (\$25,000), loaned an aggregate of \$250,000 to SCPI for working capital. Under the original terms of the loan, interest at an annual rate of 10% was paid monthly, with a maturity date of July 2003. The maturity date was later extended to December 2003 with the addition of a guarantee by Sterling and was extended again to July 2004 with an increase in the interest rate to 12%. These notes were repaid in three installments in January and February 2005.

In July 2001, Mr. Frickel was elected to the Board of Directors. He is President of R.W. Frickel Company, P.C., an accounting firm based in Michigan that performs certain accounting and tax services for SHH. Fees paid or accrued to R.W. Frickel Company for fiscal 2004 and fiscal 2003 were approximately \$82,000 and \$60,000, respectively.

18. Quarterly Financial Information**(Unaudited)**

(Dollar amounts in thousands, except per share data)

| | March 31 | June 30 | September 30 | December 31 | Total |
|--|-----------|-----------|--------------|-------------|------------|
| Fiscal 2004 quarter ended | | | | | |
| Revenues | \$ 32,309 | \$ 34,743 | \$ 45,674 | \$ 41,452 | \$ 154,178 |
| Gross profit | 3,625 | 5,477 | 4,641 | 2,755 | 16,498 |
| Income (loss) before minority interest and taxes | 630 | 2,869 | 1,338 | (140) | 4,697 |
| Net income | \$ 268 | \$ 1,624 | \$ 716 | \$ 3,045 | \$ 5,653 |
| Net income per share, basic: | \$ 0.05 | \$ 0.31 | \$ 0.13 | \$ 0.57 | \$ 1.06 |
| Net income per share, diluted: | \$ 0.04 | \$ 0.23 | \$ 0.10 | \$ 0.44 | \$ 0.81 |

| | March 31 | June 30 | September 30 | December 31 | Total |
|---|-----------|-----------|--------------|-------------|------------|
| Fiscal 2003 quarter ended | | | | | |
| Revenues | \$ 41,698 | \$ 49,311 | \$ 41,376 | \$ 37,147 | \$ 169,532 |
| Gross profit | 4,716 | 5,299 | 5,803 | 5,062 | 20,880 |
| Income before minority interest and taxes | 2,121 | 2,834 | 2,889 | 1,080 | 8,924 |
| Net income | \$ 1,196 | \$ 1,572 | \$ 2,292 | \$ 359 | \$ 5,419 |

Edgar Filing: STERLING CONSTRUCTION CO INC - Form 10-K/A

| | | | | | |
|--------------------------------|---------|---------|---------|---------|---------|
| Net income per share, basic: | \$ 0.24 | \$ 0.31 | \$ 0.45 | \$ 0.06 | \$ 1.06 |
| Net income per share, diluted: | \$ 0.20 | \$ 0.25 | \$ 0.34 | \$ 0.05 | \$ 0.84 |

51

Table of Contents**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

Item 9(A). Controls and Procedures

The Company maintains disclosure controls and procedures, as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended (the Exchange Act), that are designed to ensure that information required to be disclosed in the Company's reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer, President and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. In designing and evaluation the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluation the cost benefit relationship of possible controls and procedures.

The Company's Chief Executive Officer and Chief Financial Officer (its principal executive officer and principal financial officer, respectively) have evaluated the effectiveness of the Company's disclosure controls and procedures as of December 31, 2004. Based on their evaluation, the principal executive officer and principal financial officer concluded that the Company's controls and procedures were not effective at December 31, 2004 for the reasons stated below.

Changes in Internal Controls

Subsequent to the issuance of the Company's financial statement for the quarter ended September 30, 2004, the Company's management determined that borrowings under the SCPI Revolver should have been classified as short-term in the consolidated balance sheets. As a result, the condensed balance sheets as of March 31, 2004, June 30, 2004 and September 30, 2004 were restated and related disclosures were added. Management has implemented a formal loan review process and has established a control to ensure that debt is properly classified in the financial statements.

Item 9(B). Other Information

Effective January 1, 2005, the fee structure for non-employee directors was changed to provide for meeting of Stockholders): fees and to add an annual fee for the Chairman of the Compensation Committee as summarized in the table below:

Annual fees:

| | |
|--|---|
| All Directors | \$7,500 |
| All Directors (effective at the Annual Meeting of Stockholders): | A ten-year option to purchase 5,000 shares of the Company's common stock at the market price on the date of grant and vesting in full on the date of grant. |

Additional Annual Fees:

| | |
|--|---------|
| Chairman of the Audit Committee | \$7,500 |
| Chairman of the Compensation Committee | \$2,500 |

Meeting fees:

| | |
|--|---------|
| Regularly scheduled in-person Board meeting | \$1,250 |
| Regularly scheduled telephonic Board meeting | \$1,000 |
| Other telephonic meeting: | \$500 |
| Audit committee meeting | \$750 |
| Compensation committee meeting | \$750 |

Table of Contents

In addition, all directors are reimbursed for their reasonable out-of-pocket expenses incurred in attending meetings of the Company's board and board committees.

Table of Contents

PART III

ITEMS 10-14

The information required by Part III of this Form 10-K will be included in the Company's definitive proxy materials for its 2005 Annual Meeting of Shareholders, to be filed with the Security and Exchange Commission and is hereby incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules, And Reports

(a) Documents filed as a part of this report.

1. Financial Statements:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets: December 31, 2004 and December 31, 2003

Consolidated Statements of Operations for the fiscal periods ended

December 31, 2004, December 31, 2003, and December 31, 2002

Consolidated Statements of Stockholders' Equity for the fiscal periods ended

December 31, 2004, December 31, 2003 and December 31, 2002

Consolidated Statements of Cash Flows for the fiscal periods ended

December 31, 2004, December 31, 2003, and December 31, 2002

Notes to Consolidated Financial Statements

2. The following Financial Statement Schedules for the fiscal periods ended December 31, 2004, December 31, 2003 and December 31, 2002 are submitted herewith:

Schedule II Valuation and Qualifying Accounts

All other schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or the notes thereto.

3. Exhibits

| Exhibit No. | Description |
|-------------|--|
| 2.1 | Agreement and Plan of Merger dated as of May 20, 1991 (filed as Appendix A to the Proxy Statement/Prospectus dated April 16, 1991 of the Company and Steel City Products, Inc.) (SEC Commission file number 0-2572). |
| 2.2 | Transaction Agreement, dated as of July 18, 2001, by and among Oakhurst Company, Inc., Sterling Construction Company and Certain Stockholders of Sterling Construction Company (filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended May 31, 2001). |
| 3.1 | Restated and Amended Certificate of Incorporation (filed as Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended August 31, 1996). |
| 3.2 | By-laws, as amended through January 13, 1998 (filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 1998). |

Table of Contents

| Exhibit No. | Description |
|-------------|--|
| 4.1 | Certificate of Designations of Series A Junior Participating Preferred Stock dated as of February 10, 1998 (filed as Exhibit 4.2 to the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 1998). |
| 4.2 | Warrant to Purchase Common Stock of Oakhurst Company, Inc. issued to KTI, Inc., dated July 3, 2001 (filed as Exhibit B to Exhibit 10.26 to the Company's Annual Report on Form 10-K405 for the fiscal year ended February 21, 2001). |
| 4.3# | Form of Warrant to Purchase Common Stock of Oakhurst Company, Inc., dated July 18, 2001 (filed as Exhibit 4.3 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.2 | The 1994 Omnibus Stock Plan with form of option agreement (filed as Exhibit 10.13 to the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 1995 [SEC Commission file number 0-19450]). |
| 10.3# | The 1994 Non-Employee director Stock Option Plan with form of option agreement (filed as Exhibit 10.13 to the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 1995 [SEC Commission file number 0-19450]). |
| 10.5 | Rights Agreement, dated as of December 29, 1998 between Oakhurst Company, Inc. and American Stock Transfer and Trust Company, including the form of Certificate of Designation, the form of Rights Certificate and the Summary of Rights attached thereto as Exhibits A, B and C, respectively filed as Exhibit 99.1 to the Company's Registration Statement on Form 8-A filed on January 5, 1999. |
| 10.6# | Amendment to the 1994 Omnibus Stock Plan, amended as of December 18, 1998 (filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 1999). |
| 10.10# | Subordinated Promissory Note, dated July 18, 2001, by Sterling Construction Company to Patrick T. Manning. (filed as Exhibit 10.10 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.11# | Subordinated Promissory Note, dated July 18, 2001, by Sterling Construction Company to Joseph P. Harper, Sr. (filed as Exhibit 10.11 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.12# | Subordinated Promissory Note, dated July 18, 2001, by Oakhurst Company, Inc. to Patrick T. Manning. (filed as Exhibit 10.12 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.13# | Subordinated Promissory Note, dated July 18, 2001, by Oakhurst Company, Inc. to Joseph P. Harper, Sr. (filed as Exhibit 10.13 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.14# | Secured Promissory Note, dated July 19, 2001, by Oakhurst Technology, Inc. to Joseph P. Harper, Sr. (filed as Exhibit 10.143 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |

10.15# Subordinated Promissory Note, dated July 19, 2001, by Oakhurst Company, Inc. to Joseph P. Harper, Sr. (filed as Exhibit 10.15 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001).

55

Table of Contents

| Exhibit No. | Description |
|-------------|--|
| 10.16# | Secured Promissory Note, dated October 18, 1999, by Oakhurst Technology, Inc. to Robert M. Davies, (filed as Exhibit 10.16 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.17# | Amendment to Secured Promissory Note dated October 18, 1999, dated July 13, 2001, by and between Oakhurst Technology, Inc. and Robert M. Davies. (filed as Exhibit 10.17 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.18# | Subordinated Promissory Note, dated July 13, 2001, by Oakhurst Company, Inc. to Robert M. Davies. (filed as Exhibit 10.18 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.19# | Amendment No. 1 to Subordinated Promissory Note dated July 13, 2001, dated July 19, 2001, by and between Oakhurst Company, Inc. and Robert M. Davies. (filed as Exhibit 10.19 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.20# | Subordinated Promissory Note, dated July 13, 2001, by Oakhurst Company Inc. to Maarten D. Hemsley. (filed as Exhibit 10.20 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.21# | Amendment No. 1 to Subordinated Promissory Note dated July 13, 2001, dated July 19, 2001, by and between Oakhurst Company, Inc. and Maarten D. Hemsley. (filed as Exhibit 10.21 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.22# | Amended and Restated Executive Employment Agreement, dated July 18, 2001, by and between Sterling Construction Company and Patrick T. Manning. (filed as Exhibit 10.22 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.23# | Amended and Restated Executive Employment Agreement, dated July 18, 2001, by and between Sterling Construction Company and Joseph P. Harper, Sr. (filed as Exhibit 10.23 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.24# | Executive Employment Agreement, dated July 18, 2001, by and between Oakhurst Company, Inc. and Patrick T. Manning. (filed as Exhibit 10.24 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.25# | Executive Employment Agreement, dated July 18, 2001, by and between Oakhurst Company, Inc. and Joseph P. Harper, Sr. (filed as Exhibit 10.25 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001). |
| 10.26# | Employment Agreement, dated May 1, 2000, by and between Sterling Construction Company and Terrance W. Allan (filed as Exhibit 10.25 to the Company's Annual Report on Form 10-K405 for the fiscal year ended February 28, 2001). |
| 10.27 | Subordinated Promissory Note, dated July 18, 2001, by Oakhurst Company, Inc. to North Atlantic Smaller Companies Investment Trust Plc. (filed as Exhibit 10.27 to the Company's Transition Report on |

Form 10-K for the ten months ended December 31, 2001).

- 10.28 Oakhurst Group Tax Sharing Agreement, dated July 18, 2001, by and among Oakhurst Company, Inc., Sterling Construction Company, Steel City Products, Inc., and such other companies set forth therein. (filed as Exhibit 10.28 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001).

Table of Contents

| Exhibit No. | Description |
|-------------|---|
| 10.29 | Securities Purchase Agreement, dated as of July 18, 2001, by and among JO Capital Management Ltd A/C A, JO Capital Management Ltd A/C B, JO Capital Management Ltd A/C C, Orynx International Growth Fund Limited, Invesco English & International Trust Plc, North Atlantic Small Companies Investment Trust Plc, Oakhurst Company, Inc. and Sterling Construction Company (filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended May 31, 2001). |
| 10.30# | Stock Pledge Agreement, dated July 19, 2001, by and between Oakhurst Company, Inc. and Joseph P. Harper, Sr. (filed as Exhibit 10.30 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002). |
| 10.31 | Amended and Restated Revolving Credit Loan Agreement, dated July 18, 2001, between Comerica Bank-Texas and Sterling Construction Company (filed as Exhibit 10.31 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |
| 10.32 | Amendment to Amended and Restated Revolving Credit Loan Agreement, effective July 18, 2001, between Comerica Bank-Texas and Sterling Construction Company (filed as Exhibit 10.32 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2001) |
| 10.33 | Credit Agreement, dated as of July 13, 2001, by and between National City Bank of Pennsylvania and Steel City Products, Inc. (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended May 31, 2001). |
| 10.34 | Amendment to Revolving Credit Agreement, dated September 12, 2001 between National City Bank of Pennsylvania and Steel City Products, Inc. (filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended May 31, 2001). |
| 10.35 | Amendment No. 2 to Revolving Credit Agreement, effective December 13, 2001 between National City Bank of Pennsylvania and Steel City Products, Inc. (filed as Exhibit 10.35 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |
| 10.36 | Convertible Subordinated Note, dated December 31, 2001, by Sterling Construction Company, Inc. to Robert W. Frickel. (filed as Exhibit 10.36 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |
| 10.37 | Convertible Subordinated Note, dated December 31, 2001, by Sterling Construction Company, Inc. to Joseph P. Harper, Sr. (filed as Exhibit 10.37 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |
| 10.38 | Convertible Subordinated Note, dated December 31, 2001, by Sterling Construction Company, Inc. to Maarten D. Hemsley. (filed as Exhibit 10.38 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |
| 10.39 | Convertible Subordinated Note, dated January 2, 2002, by Sterling Construction Company, Inc. to Bernard Frank. (filed as Exhibit 10.39 to the Company's Transition Report on Form 10-K for the ten months ended December 31, 2002) |

- 10.40 Purchase Agreement between Insituform Technologies, Inc. and Texas Sterling Construction, L.P. dated September 23, 2002 (filed as Exhibit 10.40 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2002).
- 10.41 Put Restructuring Agreement dated September 25, 2003 (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2003).

Table of Contents

| Exhibit No. | Description |
|-------------|--|
| 10.42# | Executive Employment Agreement dated as of July 2004 by and between Patrick T. Manning and Sterling Construction Company, Inc. (filed as exhibit 99.1 to the Company's 8k dated March 23, 2005) |
| 10.43# | Executive Employment Agreement dated as of July 2004 by and between Joseph P. Harper, Sr. and Sterling Construction Company, Inc. (filed as exhibit 99.2 to the Company's 8k dated March 23, 2005) |
| 10.44 | Promissory Note dated November 13, 2004 by and between Patrick T. Manning and Sterling Construction Company, Inc. |
| 10.45 | Promissory Note dated November 13, 2004 by and between Joseph P. Harper, Sr. and Sterling Construction Company, Inc. |
| 10.46 | Promissory Note dated December 22, 2004 by and between Patrick T. Manning and Sterling Construction Company, Inc. |
| 10.47 | Promissory Note dated December 22, 2004 by and between Joseph P. Harper, Sr. and Sterling Construction Company, Inc. |
| 10.48 | Promissory Note dated December 22, 2004 by and between Robert M. Davies and Sterling Construction Company, Inc. |
| 10.49 | Promissory Note dated December 22, 2004 by and between Maarten D. Hemsley and Sterling Construction Company, Inc. |
| 10.49 | Promissory Note dated December 22, 2004 by and between North American Smaller Companies Investment Trust and Sterling Construction Company, Inc. |
| 10.50 | The 1998 Stock Option Plan; forms of option agreements |
| 10.51 | The 2001 Stock Incentive Plan; forms of option agreements |
| 16 | Deloitte & Touche LLP letter to Securities and Exchange Commission dated October 1, 2001 (filed as Exhibit 16 to Form 8-K/A, filed October 5, 2001.) |
| 21 | Subsidiaries at December 31, 2004: Steel City Products, Inc. Delaware Oakhurst Management Corporation Texas Sterling Houston Holdings, Inc. Delaware |
| 23.1* | Consent of Grant Thornton LLP to the incorporation by reference of the filings on Form S-8 dated May 14, 2002. |
| 31.1* | Section 302 Certification of Patrick T. Manning, Chief Executive Officer |
| 31.2* | Section 302 Certification of Maarten D. Hemsley, Chief Financial Officer |
| 32.0* | |

Certification of Patrick T. Manning, Chief Executive Officer, and Maarten D. Hemsley, Chief Financial Officer.

#Management contract or compensatory plan or arrangement.

*Filed herewith

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**STERLING CONSTRUCTION
COMPANY, INC.**

Dated: November 10, 2005

By: /s/ Patrick T. Manning
Patrick Manning, Chief Executive
Officer
(duly authorized officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signatures | Titles | Date |
|--|---|-------------------|
| /s/ Patrick T. Manning Patrick T. Manning | Chairman of the Board Chief Executive Officer (principal executive officer) Director | November 10, 2005 |
| /s/ Maarten D. Hemsley Maarten D. Hemsley | Chief Financial Officer (principal financial and accounting officer) Director | November 10, 2005 |
| /s/ Joseph P. Harper, Sr. Joseph P. Harper, Sr. | President, Director | November 10, 2005 |
| /s/ John D. Abernathy John D. Abernathy | Director | November 10, 2005 |
| /s/ Robert M. Davies Robert M. Davies | Director | November 10, 2005 |
| /s/ Robert W. Frickel Robert W. Frickel | Director | November 10, 2005 |
| /s/ Christopher H.B. Mills Christopher H.B. Mills | Director | November 10, 2005 |

Table of Contents**SCHEDULE II****STERLING CONSTRUCTION COMPANY, INC. AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS****(Dollars in thousands)**

| Column A | Column B | Column C | Column D | Column E | |
|---|--------------------------------|-------------------------------|--------------------------------------|------------------------|--------------------------|
| Description | Balance at beginning of period | Charged to costs and expenses | Charges to other accounts - describe | Deductions describe(A) | Balance at end of period |
| Allowance for doubtful accounts deducted from trade accounts receivable: Years ended: | | | | | |
| December 31, 2004 | \$ 1,013 | 116(C) | | 114 | \$ 1,015 |
| December 31, 2003 | \$ 841 | 232(B) | | 60 | \$ 1,013 |
| December 31, 2002 | \$ 588 | 259(C) | | 6 | \$ 841 |

(A) Amounts were deemed uncollectible

(B) Relates to the bankruptcy filing of Penn Traffic and Hutchins, customers of SCPI

(C) Relates to the bankruptcy of Ames, a customer of SCPI