NATIONAL SERVICE INDUSTRIES INC
Form 10-Q
April 15, 2002

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended February 28, 2002.

OR

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

For the transition period from ____________ to ____________.

Commission file number 1-3208.

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

Delaware	58-0364900
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1420 Peachtree Street, N.E., Atlanta, Georgia	30309-3002
(Address of principal executive offices)	(Zip Code)

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

None
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock - $1.00 Par Value 10,963,172 shares as of March 31, 2002.

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands, except share data)

	Febr
ASSETS	
Current Assets:	
Receivables, less reserves for doubtful accounts of $1,649 at February 28, 2002, and $1,798 at August 31, 2001	$
Inventories, at the lower of cost (on a first-in, first-out basis) or market	
Linens in service, net of amortization	
Deferred income taxes	
Prepayments	
Insurance receivable (Note 8)	
Other current assets	
Total Current Assets	
Property, Plant, and Equipment, at cost:	
Land	
Buildings and leasehold improvements	
Machinery and equipment	
Total Property, Plant, and Equipment	
Less: Accumulated depreciation and amortization	
Other Assets:	
Goodwill	
Other intangibles	
Insurance receivable (Note 8)	
Other	
Total Other Assets	
Net assets of discontinued operations (Note 5)	
Total Assets	$
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Current maturities of long-term debt (Note 7)	$
Notes payable (Note 7)	
Accounts payable	
Accrued salaries, commissions, and bonuses	
Current portion of self-insurance reserves	
Environmental reserve (Note 9)	
Current portion of litigation reserve (Note 8)	
Other accrued liabilities	
Total Current Liabilities	
Long-Term Debt, less current maturities (Note 7)	

Deferred Income Taxes	
Self-Insurance Reserves, less current portion	
Litigation Reserve, less current portion (Note 8)	
Other Long-Term Liabilities	
Commitments and Contingencies (Notes 8 and 9)	
Stockholders' Equity:	
Series A participating preferred stock, $.05 stated value, 500,000 shares authorized, none issued	
Preferred stock, no par value, 500,000 shares authorized, none issued	
Common stock, $1 par value, 120,000,000 shares authorized, 14,478,578 shares issued (Note 11)	
Paid-in capital	
Retained earnings	
Unearned compensation on restricted stock	
Accumulated other comprehensive income	
Less: Treasury stock, at cost (3,532,106 shares at February 28, 2002 and 4,173,299 shares at August 31, 2001)	
Total Stockholders' Equity	
Total Liabilities and Stockholders' Equity	$

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

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands, except per-share data)

	THREE MONTHS ENDED	
	February 28, 2002	February 28 2001
Sales and Service Revenues:		
Service revenues	$ 77,335	$ 79,608

Net sales of products	54,703	55,534
Total Revenues	132,038	135,142
Costs and Expenses:		
Cost of services	46,398	46,201
Cost of products sold	42,012	44,022
Selling and administrative expenses	44,033	42,579
Restructuring expense and other charges (Note 10)	(381)	--
Gain on sale of business	(379)	(2,359)
Amortization expense	432	716
Interest expense	168	439
Other (income) expense, net	(176)	227
Total Costs and Expenses	132,107	131,825
(Loss) income from continuing operations before income taxes and cumulative effect of a change in accounting principle	(69)	3,317
Income tax (benefit) expense	(28)	1,227
(Loss) income from continuing operations before cumulative effect of a change in accounting principle	(41)	2,090
Discontinued Operations (Note 5):		
Income from discontinued operations, net of tax of $7,066 in 2002, and $8,067 and $16,396 for the three and six months ended February 28, 2001, respectively	--	13,735
Costs associated with effecting the spin-off, net of tax benefit of $717	--	--
Total Discontinued Operations	--	13,735
Cumulative effect of a change in accounting principle, net of tax benefit of $10,830	--	--
Net (Loss) Income	$ (41)	$ 15,825
Basic earning per share (split adjusted):		
(Loss) earnings per share from continuing operations before cumulative effect of a change in accounting principle	$ --	$ 0.20
Discontinued operations:		
Income from discontinued operations, net of tax	--	1.34
Costs associated with effecting the spin-off, net of tax benefit	--	--
Total Discontinued Operations	--	1.34
Cumulative effect of a change in accounting principle, net of tax benefit	--	--
Net (Loss) Income	$ --	$ 1.54
Diluted earning per share (split adjusted):		
(Loss) earnings per share from continuing operations before cumulative effect of a change in accounting principle	$ --	$ 0.20

Discontinued operations:		
Income from discontinued operations, net of tax	--	1.33
Costs associated with effecting the spin-off, net of tax benefit	--	--
Total Discontinued Operations	--	1.33
Cumulative effect of a change in accounting principle, net of tax benefit	--	--
Net (Loss) Income	$ --	$ 1.53
Basic Weighted Average Number of Shares Outstanding	10,317	10,269
Diluted Weighted Average Number of Shares Outstanding	10,317	10,374

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(In thousands)

	SIX MON
	February 28, 2002
Cash Provided by (Used for) Operating Activities:	
Net (loss) income	$ (3,689)
Adjustments to reconcile net income to net cash provided by (used for) operating activities:	
Depreciation and amortization	12,530
Provision for losses on accounts receivable	643
(Gain) loss on the sale of property, plant, and equipment	(81)
Restructuring expense and other charges	5,439
Gain on the sale of business	(379)
Change in assets and liabilities, net of effect of acquisitions and divestitures:	
Receivables	(354)
Inventories and linens in service, net	6,011
Deferred income taxes	842
Prepayments and other assets	(299)
Accounts payable and accrued liabilities	(8,553)
Self-insurance reserves and other long-term liabilities	(12,217)

Net Cash (Used for) Provided by Continuing Operations	(107)
Net Cash Provided by Discontinued Operations	6,935
Net Cash Provided by Operating Activities	6,828
Cash Provided by (Used for) Investing Activities:	
Purchases of property, plant, and equipment	(10,607)
Sale of property, plant, and equipment	705
Acquisitions	(60)
Divestitures	1,062
Change in other assets	(149)
Net Cash Used for Investing Activities	(9,049)
Cash Provided by (Used for) Financing Activities:	
Borrowing of notes payable, net	9,001
Repayments of long-term debt	(411)
Treasury stock transactions, net	679
Cash dividends paid	(7,048)
Net Cash Provided by (Used for) Financing Activities	2,221
Net Change in Cash and Cash Equivalents	--
Cash and Cash Equivalents at Beginning of Period	--
Cash and Cash Equivalents at End of Period	$ --
Supplemental Cash Flow Information:	
Income taxes paid during the period	$ 3,501
Interest paid during the period	12,987
Noncash Activities:	
Treasury shares issued under long-term incentive plan	$ --
Cumulative effect of a change in accounting principle	28,432
Noncash aspects of sale of business:	
Reduction of liabilities recorded in conjunction with the 1997 sale of business	379

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NATIONAL SERVICE INDUSTRIES, INC. AND SUBSIDIARIES
(Dollar amounts in thousands, except per-share data and information contained in Note 8)

1. BASIS OF PRESENTATION

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

Certain NSI corporate assets, liabilities, and expenses have been allocated to Acuity based on an estimate of the proportion of corporate amounts allocable to Acuity, utilizing such factors as revenues, number of employees, and other relevant factors. As a result of the spin-off, the Company's financial statements have been prepared with Acuity's net assets, results of operations, and cash flows presented as discontinued operations. All historical statements have been restated to conform with this presentation. In the opinion of management, the allocations have been made on a reasonable basis.

The interim consolidated financial statements included herein have been prepared by the Company without audit and the consolidated balance sheet as of August 31, 2001 has been derived from audited statements. These statements reflect all adjustments, all of which are of a normal, recurring nature, which are, in the opinion of management, necessary to present fairly the consolidated financial position as of February 28, 2002, the consolidated results of operations for the three and six months ended February 28, 2002 and 2001, and the consolidated cash flows for the six months ended February 28, 2002 and 2001. Certain reclassifications have been made to the prior year's financial statements to conform to the current year's presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended August 31, 2001.

The results of operations for the three and six months ended February 28, 2002 are not necessarily indicative of the results to be expected for the full fiscal year because the Company's revenues and income are generally higher in the second half of its fiscal year and because of the uncertainty of general business conditions.

2. RECENT ACCOUNTING STANDARDS

NEWLY ADOPTED ACCOUNTING STANDARDS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 141 ("SFAS 141") "Business Combinations," and Statement No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 141 prospectively prohibits the pooling of interests method of accounting for business combinations initiated after June 30, 2001. SFAS 142 requires companies to cease amortizing goodwill that existed at June 30, 2001 and establishes a new method for testing goodwill for impairment on an annual basis (or an interim basis if an event occurs that might reduce the fair value of a reporting unit below its carrying value.) Any goodwill resulting from acquisitions completed after June 30, 2001 will not be amortized. SFAS 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value based approach.

The Company adopted SFAS 142 as of September 1, 2001. Summarized information for the Company's acquired intangible assets is as follows:

Acquired Intangible Assets

	February 28, 2002		August 31, 200	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Acc Amo
Amortized intangible assets				
Customer contracts	$10,249	$(3,065)	$10,215	
Other	1,433	(862)	1,428	
Total	$11,682	$(3,927)	$11,643	

The Company amortizes customer contracts over estimated useful lives of seven years. Other acquired intangible assets, consisting primarily of restrictive covenant agreements, are amortized over the lives of the agreements, which average approximately four years. The Company recorded amortization expense of $432 and $913 related to intangible assets for the three and six months ended February 28, 2002, and $417 and $834 for the three and six months ended February 28, 2001, respectively.

The changes in the carrying amount of goodwill during the period are summarized as follows:

	Textile Rental	Envelope	Total
Balance as of August 31, 2001	$ 4,162	$ 24,270	$ 28,432
Goodwill acquired during the quarter	--	--	--
Transitional impairment losses	(4,162)	(24,270)	(28,432)
Balance as of February 28, 2002	$ --	$ --	$ --

The textile rental and envelope segments each tested goodwill for impairment during the first quarter of 2002 as required by SFAS 142 upon adoption, utilizing a combination of valuation techniques including the expected present value of future cash flows, a market multiple approach and a comparable transaction approach. As a result of this valuation process as well as the application of the remaining provisions of SFAS 142, the Company recorded a pre-tax transitional impairment loss of $28,432, representing the write-off of all of the Company's existing goodwill. This write-off was reported as a cumulative effect of a change in accounting principle, on a net of tax basis, in the Company's Consolidated Statement of Income for the six months ended February 28, 2002.

Prior to the adoption of SFAS 142 in September 2001, the Company amortized goodwill over estimated useful lives ranging from 10 years to 30 years. Had the Company accounted for goodwill consistent with the provisions of SFAS 142 in prior periods, the Company's income from continuing operations and net income would have been affected as follows:

	Three Months Ended February 28,		Six Months Ended February 28,	
	2002	2001	2002	2001
Reported (loss) income from continuing operations	$ (41)	$ 2,090	$ (3,689)	$ 4,4
Add back: Goodwill amortization	--	188	--	3
Adjusted (loss) income from continuing operations	$ (41)	$ 2,278	$ (3,689)	$ 4,8
Adjusted net (loss) income	$ (41)	$ 16,013	$ (28,826)	$ 32,7
Basic earning per share:				
Reported (loss) income from continuing operations	$ --	$ 0.20	$ (0.36)	$ 0.
Add back: Goodwill amortization	--	0.02	--	0.
Adjusted (loss) income from continuing operations	$ --	$ 0.22	$ (0.36)	$ 0.
Adjusted net (loss) income	$ --	$ 1.56	$ (2.80)	$ 3.
Diluted earning per share:				
Reported (loss) income from continuing operations	$ --	$ 0.20	$ (0.36)	$ 0.
Add back: Goodwill amortization	--	0.02	--	0.
Adjusted (loss) income from continuing operations	$ --	$ 0.22	$ (0.36)	$ 0.
Adjusted net (loss) income	$ --	$ 1.54	$ (2.80)	$ 3.

3. BUSINESS SEGMENT INFORMATION

The following tables summarize the Company's business segment information from continuing operations:

THREE MONTHS ENDED FEBRUARY 28, 2002	SALES AND SERVICE REVENUES	OPERATING PROFIT (LOSS)	DEPRECIATION AND AMORTIZATION EXPENSE	C EXPE IN ACQU
Textile Rental	$ 77,335	$ 1,342	$4,071	
Envelope	54,703	649	1,800	
	132,038	1,991	5,871	
Corporate	--	(1,892)	125	
Interest expense	--	(168)	--	
Total	$132,038	$ (69)	$5,996	

THREE MONTHS ENDED FEBRUARY 28, 2001	SALES AND SERVICE REVENUES	OPERATING PROFIT (LOSS)	DEPRECIATION AND AMORTIZATION EXPENSE	C EXPE IN ACQU
Textile Rental	$ 79,608	$ 4,009	$4,121	
Envelope	55,534	863	2,431	
	135,142	4,872	6,552	
Corporate	--	(1,116)	475	
Interest expense	--	(439)	--	
Total	$135,142	$ 3,317	$7,027	

SIX MONTHS ENDED FEBRUARY 28, 2002	SALES AND SERVICE REVENUES	OPERATING PROFIT (LOSS)	DEPRECIATION AND AMORTIZATION EXPENSE	C EXPE IN ACQU
Textile Rental	$156,171	$(4,037)	$8,188	
Envelope	110,256	2,803	4,004	

	266,427	(1,234)	12,192	
Corporate	--	(4,636)	338	
Interest expense	--	(279)	--	
Total	$266,427	$(6,149)	$12,530	$

SIX MONTHS ENDED FEBRUARY 28, 2001	SALES AND SERVICE REVENUES	OPERATING PROFIT (LOSS)	DEPRECIATION AND AMORTIZATION EXPENSE	C EXPE IN ACQU
Textile Rental	$160,715	$ 7,736	$8,268	
Envelope	115,114	2,575	4,756	
	275,829	10,311	13,024	
Corporate	--	(2,367)	932	
Interest expense	--	(889)	--	
Total	$275,829	$ 7,055	$13,956	

	Total Assets	
	February 28, 2002	August 31, 2001
Textile Rental	$212,979	$231,422
Envelope	112,689	141,945
Subtotal	325,668	373,367
Corporate	124,555	124,731
Total	$450,223	$498,098

4. INVENTORIES

Major classes of inventory as of February 28, 2002 and August 31, 2001 were as follows:

February 28, August 31,

	2002	2001
Raw Materials and Supplies	$ 6,979	$ 6,716
Work-in-Process	2,261	817
Finished Goods	8,211	11,662
Total	$17,451	$19,195

5. DISCONTINUED OPERATIONS

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

As a result of the November 2001 spin-off, the Company's financial statements have been prepared with these businesses' net assets, results of operations, and cash flows presented as discontinued operations through the effective date of the Distribution, November 30, 2001. All historical statements have been restated to conform with this presentation.

Summarized financial information for discontinued operations is as follows:

	August 31, 2001
Current Assets	$ 559,116
Property, Plant, and Equipment - net	248,423
Goodwill and Other Intangibles	468,944
Other Long-Term Assets	54,092
Current Liabilities	(442,067)
Long-Term Debt, less current maturities	(373,707)
Other Long-Term Liabilities	(131,503)
Accumulated Other Comprehensive Income Items	16,998
Net Assets of Discontinued Operations	$ 400,296

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

In addition, Acuity and NSI entered into a put option agreement, whereby NSI has the option to require Acuity to purchase the property where NSI's corporate headquarters are located for a purchase price equal to 85 percent of the agreed-upon fair market value of the property. This put option will commence on June 1, 2002 and expire on May 31, 2003.

6. EARNINGS PER SHARE

The Company accounts for earnings per share using Statement of Financial Accounting Standards No. 128, "Earnings per Share." Under this statement, basic earnings per share is computed by dividing net earnings available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed similarly but reflects the dilutive effect of potential common shares, including options and restricted stock.

The following table calculates basic earnings per common share and diluted earnings per common share at February 28, and reflects the January 7, 2002 one-for-four reverse stock split further described in note 11:

	Three Months Ended February 28,		Six Mon Febr
	2002	2001	2002
Basic earnings per common share:			
(Loss) income from continuing operations before cumulative effect of a change in accounting principle	$ (41)	$ 2,090	$ (3,689)
Basic weighted average shares outstanding	10,317	10,269	10,310
Basic earnings per common share	$ --	$ 0.20	$ (0.36)
Diluted earnings per common share:			
(Loss) income from continuing operations before cumulative effect of a change in accounting principle	$ (41)	$ 2,090	$ (3,689)
Basic weighted average shares outstanding	10,317	10,269	10,310
Add: Shares of common stock assumed issued upon exercise of dilutive stock options	--	96	--
Add: Unvested restricted stock	--	9	--
Diluted weighted average shares outstanding	10,317	10,374	10,310
Diluted earnings per common share	$ --	$ 0.20	$ (0.36)

Stock options to purchase 1,485 and 1,305 shares of common stock for the three and six months ended February 28, 2002, respectively, and 744 and 759 shares of common stock for the three and six months ended February 28, 2001, respectively, were not included in the computation of diluted earnings per share because their effect would have been antidilutive.

7. LONG-TERM DEBT

Outstanding borrowings at February 28, 2002 included approximately $2,590 in notes payable at 8.5%.

In October 2001, the Company negotiated a $40,000, three-year committed credit facility with a single major US bank that became effective at the time of the spin-off. The facility contains financial covenants including a leverage ratio, a ratio of income available for fixed charges to fixed charges, and a minimum net worth. Interest rates under the facility are based on the LIBOR rate or other rates, at the Company's option. The Company will pay an annual fee on the commitment based on the Company's leverage ratio. Approximately $11,000 was outstanding under this facility at February 28, 2002.

8. LEGAL PROCEEDINGS

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

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. Most claims against the Company seek both substantial compensatory damages and punitive damages. The Company believes that many of the claims against it are without merit. The Company believes its conduct with respect to asbestos-containing insulation was consistent with recognized safety standards at the relevant times, and the Company believes there is no basis for imposing punitive damages against it in connection with asbestos claims. In addition, the Company believes that it has substantial legal defenses against many of these claims, including that the Company did not manufacture any asbestos-containing building products, that the Company did not distribute or install products at certain sites where exposure is

alleged, and that statutes of repose in some states bar the claims. However, there is no assurance that the Company will be successful in asserting defenses to these claims.

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

During the past two years, certain former members of the CCR have failed to make payments to the CCR, by reason of bankruptcy or otherwise, for their shares of certain settlement agreements the CCR had reached on behalf of its members with plaintiffs. Consequently, with respect to some settlement agreements, the CCR has been unable to make the full payments contemplated by those agreements. In some circumstances, the Company and other former members of the CCR have contributed additional funds to the CCR to permit it to make certain payments contemplated by the settlement agreements. As of February 28, 2002, the Company has contributed approximately $5.3 million to the CCR for this purpose, and it may make further such payments in the future. Payments made since August 31, 2001 have been applied against the Company's accrual for asbestos liabilities established as of August 31, 2001. Some plaintiffs who are parties to settlement agreements with the CCR that contemplate payments that the CCR has been unable to make have commenced litigation against the CCR, the Company, and other former members to recover amounts due under these settlement agreements. The Company believes that it should not be liable for settlement payments attributable to former members of the CCR, and the Company has joined a joint defense group with other former CCR members to defend these claims.

The Company believes that any amount it pays, including the $5.3 million it has already contributed to the CCR, on account of payments contemplated by settlement agreements entered into by the CCR on behalf of its members, should be covered either by the Company's insurance or by surety bonds and collateral provided by those former members who failed to meet their obligations. There can be no assurance, however, that the Company can actually recover any of these amounts. Accordingly, no insurance or other recovery with respect to these amounts has been recorded as an asset in the Company's financial statements.

The amount of the Company's liability on account of payments contemplated by settlement agreements entered into by the CCR is uncertain. The Company has included in its reserves its estimate of the Company's potential liability in this respect, but the Company's ultimate liability for these matters could be greater than estimated if more former CCR members fail to meet their obligations or if the courts determine that the Company could be liable for settlement payments that were attributable to other former CCR members.

Several significant companies that are traditional co-defendants in asbestos claims, both former members of the CCR and non-members, have sought protection under Chapter 11 of the federal bankruptcy code during the past two years. Litigation against such co-defendants generally is stayed or restricted as a result of their bankruptcy filings. The absence of these traditional defendants may increase the number of claims filed against other defendants, including the Company, and may increase the cost of resolving such claims. Due to the uncertainties surrounding the ultimate effect of these bankruptcies on remaining asbestos defendants, the effect on the amount of the Company's liabilities cannot be determined.

During the fiscal year ended August 31, 2001, the Company was served with approximately 30,000 asbestos-related claims and settled approximately 16,000 claims for an average of approximately $1,035 per claim (including approximately 200 claims that were dismissed with no payment). As of August 31, 2001, there were approximately 35,000 open claims pending against the Company (including approximately 1,000 claims that were settled in principle after February 1, 2001 but not finalized) and approximately 12,000 additional claims that were settled in principle prior to February 1, 2001 but not finalized.

During the six months ended February 28, 2002, the Company was served with approximately 4,900 asbestos-related claims and resolved approximately 14,100 claims for an average of approximately $880 per claim (including approximately 11,300 claims that were dismissed with no payment). As of February 28, 2002, there were approximately 25,800 open claims pending against the Company (including approximately 2,800 claims that were settled in principle after February 1, 2001 but not finalized) and approximately 7,900 additional claims that were settled in principle prior to February 1, 2001 but not finalized.

As of February 28, 2002 and August 31, 2001, an estimated accrual of $101.9 million and $113.4 million, respectively, for asbestos-related liabilities, before consideration of insurance recoveries, has been reflected in the accompanying financial statements, primarily in long-term liabilities. The amount of the accrual is based on the following: the Company's estimate of

indemnity payments and defense costs associated with pending and future asbestos-related claims to be paid through mid-2005; settlements agreed to but not paid as of February 28, 2002; the Company's expected payment on account of settlement obligations of defaulting CCR members; interest on settlement payments that are subject to ongoing dispute resolution with certain insurance providers; and other legal fees and expenses. The Company's estimates of indemnity payments and defense costs associated with pending and future asbestos claims are based on the Company's estimate of the number of future asbestos-related claims and the type of disease, if any, alleged or expected to be alleged in such claims, assumptions regarding the timing and amounts of settlement payments, the status of ongoing litigation and settlement initiatives, and the advice of outside counsel with respect to the current state of the law related to asbestos claims. The ultimate liability for all pending and future claims cannot be determined with certainty due to the difficulty of forecasting the numerous variables that can affect the amount of liability. There are inherent uncertainties involved in estimating these amounts, and the Company's actual costs in future periods could exceed the Company's estimates due to changes in facts and circumstances after the date of each estimate.

The Company believes that it has insurance coverage available to recover most of its asbestos-related costs. The Company has reached settlement agreements with substantially all of its relevant insurers providing for payment of substantially all asbestos-related claims (subject to retentions) up to the various policy limits, except for the Company's payments on account of settlement obligations of defaulting CCR members, as discussed above. The timing and amount of future recoveries from insurance carriers will depend on the pace of claims review and processing by such carriers and on the resolution of any remaining disputes regarding coverage under such policies. In the event the Company's insurers dispute amounts billed to them or pay on an untimely basis, the Company takes all practicable steps to secure payment, including alternative dispute resolution procedures and litigation to resolve the issues. The Company has initiated an alternative dispute resolution proceeding with one insurer to resolve outstanding insurance policy interpretation issues, to secure payment of past due amounts and to ensure that the insurer's future obligations will be met in a timely fashion. The Company believes that substantial recoveries from the insurance carriers are probable. The Company reached this conclusion after considering its prior insurance-related recoveries in respect of asbestos-related claims, existing insurance policies, settlement agreements with insurers, the apparent viability of its insurers, the advice of outside counsel with respect to the applicable insurance coverage law relating to terms and conditions of those policies, and a general assessment by the Company and its advisors of the financial condition of the relevant insurers. Accordingly, an estimated aggregate insurance recovery of $93.8 million and $95.2 million has been reflected in the accompanying financial statements as of February 28, 2002 and August 31, 2001, respectively, with respect to previously paid claims and pending and future claims estimated to be paid through mid-2005 and the other items included in the accrual of asbestos-related liabilities. Approximately $30.2 million and $28.6 million of the aggregate insurance recovery and $29.2 million and $30.5 million of the asbestos-related accrual have been classified as current assets and liabilities in the accompanying balance sheet as of February 28, 2002 and August 31, 2001, respectively.

Management continues to monitor claims activity, the status of lawsuits (including settlement initiatives), legislative developments, and costs incurred in order to ascertain whether an adjustment to the existing accruals should be made to the extent that historical experience may differ significantly from the Company's underlying assumptions. As additional information becomes available, the Company will reassess its liability and revise its estimates as appropriate. Management currently believes that, based on the factors discussed in the preceding paragraphs and taking into account the accruals reflected as of February 28, 2002, the resolution of asbestos-related uncertainties and the incurrence of asbestos-related costs net of related insurance recoveries should not have a material adverse effect on the Company's consolidated financial position or results of operations. However, as the Company's estimates are periodically re-evaluated, additional accruals to the liabilities reflected in the Company's financial statements may be necessary, and such accruals could be material to the results of the period in which they are recorded. Given the number and complexity of factors that affect the Company's liability and its available insurance, the actual liability and insurance recovery may differ substantially from the Company's estimates. No assurance can be given that the Company will not be subject to significant additional asbestos litigation and material additional liabilities. If actual liabilities significantly exceed the Company's estimates or if expected insurance recoveries become unavailable, due to insolvencies among the Company's primary or excess insurance carriers, disputes with carriers or otherwise, the Company's results of operations, liquidity and financial condition could be materially adversely affected.

The Company has been sued in two putative class actions relating to the collection from customers of National Linen Service of energy surcharges, environmental charges and sales taxes. One case was filed in the Circuit Court of Barbour County, Alabama and subsequently has been removed to the United States District Court for the Middle District of Alabama. The federal court denied the plaintiff's motion to remand the case to state court. The second case was filed in the Court of Common Pleas, Fifteenth Judicial Circuit, County of Horry, South Carolina. That case has been removed to the United States District Court for South Carolina, Florence Division. The plaintiff has filed a motion to remand which, as of April 11, 2002, had not been ruled on by the court. As of April 11, 2002, no substantive discovery has occurred in either case. Based on information currently available, it is the opinion of management that these claims are without merit and that the ultimate resolution of these legal proceedings will not have a material adverse effect on the Company's financial condition or results of operations.

9. ENVIRONMENTAL MATTERS

The Company's operations, as well as similar operations of other companies, are subject to comprehensive laws and regulations relating to the generation, storage, handling, transportation, and disposal of hazardous substances and solid and hazardous wastes and to the remediation of contaminated sites. Permits and environmental controls are required for certain of the Company's operations to limit air and water pollution, and these permits are subject to modification, renewal, and revocation by issuing authorities. The Company believes that it is in substantial compliance with all material environmental laws, regulations, and permits. On an ongoing basis, the Company incurs capital and operating costs relating to environmental compliance.

Environmental laws and regulations have generally become stricter in recent years, and the cost of responding to future changes may be substantial.

The Company's environmental reserves, which are included in current liabilities, totaled $6,789 and $7,291 at February 28, 2002 and August 31, 2001, respectively. The actual cost of environmental issues may be lower or higher than that reserved due to the difficulty in estimating such costs and potential changes in the status of government regulations.

Certain environmental laws can impose liability regardless of fault. The federal Superfund law is an example of such an environmental law. However, liability under Superfund is mitigated by the presence of other parties who will share in the costs associated with clean-up of sites. The extent of liability is determined on a case-by-case basis taking into account many factors, including the number of other parties whose status or activities also subjects them to liability regardless of fault.

The Company is currently a party to, or otherwise involved in, legal proceedings in connection with state and federal Superfund sites, one of which is located on property owned by the Company. Except for the Blydenburgh Landfill matter in New York (which is discussed below), the Company believes its liability is de minimis at each of the currently active sites which it does not own where it has been named as a potentially responsible party ("PRP") due to its limited involvement at the site and/or the number of viable PRPs. For property which the Company owns on East Paris Street in Tampa, Florida, the Company was requested by the State of Florida to clean up chlorinated solvent contamination in the groundwater beneath the property and beneath surrounding property known as Seminole Heights Solvent Site and to reimburse approximately $430 of costs already incurred by the State of Florida in connection with such contamination. The Company presented expert evidence to the State of Florida in 1998 that the Company is not the source of the contamination, and the State has referred this matter to the Environmental Protection Agency for review. At this point in time, it is not possible to quantify the extent, if any, of the Company's exposure.

In connection with the sale of certain assets, including 29 of the Company's textile rental plants in 1997, the Company has retained environmental liabilities arising from events occurring prior to the closing, subject to certain exceptions. The Company has received notice from the buyer of the textile rental plants of the alleged presence of perchloroethylene contamination on two of the properties in Texas involved in the sale. Because the Company is not the source of contamination, the Company asserted indemnification claims against the company from which it bought the properties. The prior owner is currently addressing the contamination at its expense at one of the properties, subject to a reservation of rights, and is currently reviewing the Company's claim regarding the other property. At this time, it is too early to quantify the Company's potential exposure in these matters, the likelihood of an adverse result, or the outcome of the Company's indemnification claims against the prior owner.

During the second quarter of 2001, management performed a review of the other environmental liabilities recorded in connection with the textile rental segment's 1997 uniform plants divestiture. Based on the advice of the Company's environmental experts, the Company decreased its estimates for certain environmental exposures and, as a result, reduced the related liability and recorded a gain of approximately $2,000. The gain is included in "Gain on sale of business" in the accompanying consolidated statements of income.

The State of New York has filed a lawsuit against the Company alleging that the Company is responsible as a successor to Serv-All Uniform Rental Corp. ("Serv-All") for past and future response costs in connection with the release or potential release of hazardous substances at and from the Blydenburgh Landfill in Islip, New York. The Company believes that it is not a successor to Serv-All and therefore has no liability with respect to the Blydenburgh Landfill and responded to the lawsuit accordingly. The Company has also asserted an indemnification claim against the parent of Initial Services Investments, Inc., which the Company acquired in 1992 and which had previously purchased and sold certain assets of Serv-All.

In February 2001, the federal district court in the Eastern District of New York denied the Company's motion for summary judgment on the issue of successor liability and granted the State of New York's motion for partial summary judgment, issuing a declaratory judgment that the Company is a successor to Serv-All. Subsequently, the Company and the State of New York each filed a cross-motion for summary judgment on the Company's liability under the Comprehensive Environmental Response, Compensation, and Liability Act.

On December 12, 2001, the Court granted summary judgment for the State. At a January 9, 2002 status conference, the Court verbally denied the Company's motion for summary judgment and explicitly noted that the issues presented by this case were appropriate for judicial review. The Court reiterated its denial of the Company's motion in a written order on January 10, 2002. Final judgment in the amount of $12,477 was entered against the Company on February 1, 2002. Execution of the judgment was stayed pending appeal to the Second Circuit Court of Appeals.

The Company filed a notice of appeal to the Second Circuit Court of Appeals on March 1, 2002. In its appeal, the Company asserted that the trial court erred in declaring that the Company is a successor to Serv-All, in finding that the State's claims were not barred by the statute of limitations, and in holding that the Company is jointly and severally liable for response costs.

Even if the Company were unsuccessful in its appeal to the Second Court of Appeals, the Company would have a right to seek recovery of response costs from the many other parties whose wastes were disposed of at the Landfill. At this point, it is too early to quantify the Company's potential exposure, the likelihood of an adverse result, or the outcome of the Company's indemnification claim, and thus, no accrual has been recorded related to this matter.

10. RESTRUCTURING EXPENSE AND OTHER CHARGES

During 2001, management conducted reviews of its continuing operations as part of management's strategic initiative to examine under-performing operations and to position the Company for an economic slowdown. As a result of these reviews, the Company approved a significant restructuring program and recorded a related charge of $5,014 during the fourth quarter of fiscal 2001. The accrual included severance costs of $3,087 for 367 employees of the textile rental and envelope segments, all of whom were terminated prior to the end of the fiscal year, $1,582 in exit expenses to close and consolidate facilities in the envelope segment, and $345 in losses related to the sale of two textile rental businesses. As of August 31, 2001, approximately $118 of the severance accrual had been paid to employees.

During the first quarter of fiscal 2002, the Company closed two facilities in the textile rental segment and recorded a related charge of $5,820. The charge included severance costs of $11 for four employees, all of whom were terminated prior to the end of the first quarter, and $1,396 in exit expenses to close and consolidate facilities. Exit expenses primarily include costs of lease terminations and costs to dispose of facilities. Additionally, as a further result of the closure of the two textile rental facilities, the Company recognized long-lived asset impairments totaling $4,413. Textile rental assets to be disposed of were reduced to state them at their estimated fair value less costs to sell. Assets to be disposed of primarily related to equipment located in the facilities included in the restructuring program noted above. After the charge, the remaining net book value of these assets was immaterial. Estimated fair market values were established based on an analysis of expected future cash flows.

During the second quarter of fiscal 2002, the Company recorded a reduction of restructuring and other charges of $381. Reserves of $413 were reduced primarily due to lower than originally estimated costs to prepare a facility closed in a prior year for sale. This amount was offset by additional expense of $32 related to reserves which were established during the fourth quarter of fiscal 2001 and the first quarter of fiscal 2002. The $32 of expense included a reduction of the reserve for severance costs of $159, and an increase in the reserve for exit costs of $191.

The major components of the fiscal 2001 and 2002 restructuring charges and related activity are as follows:

	Reserve, August 31, 2001	Cash Payments	Expense (Gain)	Reserve, February 28, 2002
Severance costs	$2,969	$(2,187)	$ (148)	$ 634
Exit costs	$1,582	$(1,951)	$ 1,587	$1,218

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

11. REVERSE STOCK SPLIT

On January 3, 2002, the Company's shareholders approved a one-for-four reverse stock split of NSI common stock, which began trading on a reverse split basis on January 7, 2002. As a result of the stock split, every four shares of NSI common stock were replaced with one share of NSI common stock. The reverse split did not change the number of authorized shares of NSI common stock or the par value per share of NSI common stock. All references to common stock, common shares outstanding, average numbers of common stock shares outstanding and per share amounts in these Consolidated Financial Statements and Notes to Consolidated Financial Statements prior to the effective date of the reverse stock split have been restated to reflect the one-for-four common stock reverse split on a retroactive basis.

12. RESTRICTED STOCK

In January 2002, the Company awarded 627,880 shares of restricted stock to officers, other key employees and members of the Board of Directors. The shares vest ratably in four equal annual installments beginning one year from the date of the grant. During the vesting period, the participants have voting rights and receive dividends, but the shares may not be sold, assigned, transferred, pledged or otherwise encumbered. Additionally, granted but unvested shares are forfeited upon termination of employment.

The fair value of the restricted shares on the date of the grant is amortized ratably over the vesting period. Unearned compensation on the January 2002 grant of restricted stock of $4,910 was initially recorded based on the market value of the shares on the date of grant and is generally being amortized over four years. The unamortized balance of unearned compensation on restricted stock is included as a separate component of stockholders' equity.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

National Service Industries ("NSI" or the "Company") is a diversified service and manufacturing company operating in two segments: textile rental and envelopes. The Company remained in solid financial condition at February 28, 2002. Net working capital was $76.3 million, down from $87.7 million at August 31, 2001, and the current ratio was 1.8, down slightly from 1.9 at August 31, 2001.

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 141 ("SFAS 141") "Business Combinations," and Statement No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets." SFAS 141 prospectively prohibits the pooling of interests method of accounting for business combinations initiated after June 30, 2001. SFAS 142 requires companies to cease amortizing goodwill that existed at June 30, 2001 and establishes a new method for testing goodwill for impairment on an annual basis (or an interim basis if an event occurs that might reduce the fair value of a reporting unit below its carrying value). Any goodwill resulting from acquisitions completed after June 30, 2001 will not be amortized. SFAS 142 also requires that an identifiable intangible asset that is determined to have an indefinite useful economic life not be amortized, but separately tested for impairment using a fair value based approach.

The textile rental and envelope segments each tested goodwill for impairment during the first quarter of 2002 as required by SFAS 142 upon adoption, utilizing a combination of valuation techniques including the expected present value of future cash flows, a market multiple approach and a comparable transaction approach. As a result of this valuation process, as well as the application of the remaining provisions of SFAS 142, the Company recorded a pre-tax transitional impairment loss of $28.4 million, representing the write-off of all of the Company's existing goodwill. This write-off was reported as a cumulative effect of a change in accounting principle, on a net of tax basis, in the Company's Consolidated Statement of Income for the six months ended February 28, 2002 (see Note 2 to the financial statements included in this filing).

On November 7, 2001, the Company's board of directors approved the spin-off of its lighting equipment and chemicals businesses into a separate publicly-traded company with its own management and board of directors. The spin-off was effected on November 30, 2001 through a tax-free distribution of 100% of the outstanding shares of common stock of Acuity Brands, Inc. ("Acuity"), a wholly-owned subsidiary of the Company owning and operating the lighting equipment and chemicals businesses. Each NSI stockholder of record as of November 16, 2001, the record date for the distribution, received one share of Acuity common stock for each share of NSI common stock held at that date (see Note 5 to the financial statements included in this filing).

In conjunction with the spin-off, the Company and Acuity entered into various agreements that address the allocation of assets and liabilities between them and that define their relationship after the separation, including a distribution agreement, a tax disaffiliation agreement, an employee benefits agreement, and a transition services agreement. Under the tax disaffiliation agreement, Acuity will indemnify NSI for certain taxes and liabilities that may arise related to the Distribution. The agreement also sets out each party's rights and obligations with respect to deficiencies and refunds, if any, of federal, state, local, or foreign taxes for periods before and after the Distribution. The transition services agreement provides that NSI and Acuity will provide each other services in such areas as information management and technology, employee benefits administration, payroll, financial accounting and reporting, claims administration and reporting, legal, and other areas where NSI and Acuity may need transitional assistance and support. Management believes the amounts paid or received associated with these services are representative of the fair value of the services provided.

In addition, Acuity and NSI entered into a put option agreement, whereby NSI has the option to require Acuity to purchase the property where NSI's corporate headquarters are located for a purchase price equal to 85 percent of the agreed-upon fair market value of the property. This put option will commence on June 1, 2002 and expire on May 31, 2003.

As a result of the November 2001 spin-off, the Company's financial statements have been prepared with these businesses' net assets, results of operations, and cash flows presented as discontinued operations. Accordingly, the results of operations and liquidity and capital resources information presented below reflect only the continuing operations of the Company.

On January 3, 2002, the Company's shareholders approved a one-for-four reverse stock split of NSI common stock, which began trading on a reverse split basis on January 7, 2002. As a result of the stock split, every four shares of NSI common stock were replaced with one share of NSI common stock. The reverse split did not change the number of authorized shares of NSI common stock or the par value per share of NSI common stock. All references to common stock, common shares outstanding, average numbers of common stock shares outstanding and per share amounts in these Consolidated Financial Statements, Notes to Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations prior to the effective date of the reverse stock split have been restated to reflect the one-for-four common stock reverse split on a retroactive basis.

CRITICAL ACCOUNTING POLICIES

NSI's financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of the financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. The Company reviews its estimates on a regular basis including those related to litigation, insurance receivable, environmental matters and self-insurance. The Company's estimates are based on historical experience and other assumptions management believes are reasonable under current circumstances. Actual results may differ from these estimates under different assumptions or circumstances.

In December 2001, the SEC requested that all registrants include their "critical accounting policies" in MD&A. The SEC indicated that a "critical accounting policy" is one which is both important to the portrayal of the company's financial condition and results and requires management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. NSI believes the following represent its critical accounting policies:

Litigation

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

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. Most claims against the Company seek both substantial compensatory damages and punitive damages. The Company believes that many of the claims against it are without merit. The Company believes its conduct with respect to asbestos-containing insulation was consistent with recognized safety standards at the relevant times, and the Company believes there is no basis for imposing punitive damages against it in connection with asbestos claims. In addition, the Company believes that it has substantial legal defenses against many of these claims, including that the Company did not manufacture any asbestos-containing building products, that the Company did not distribute or install products at certain sites where exposure is alleged, and that statutes of repose in some states bar the claims. However, there is no assurance that the Company will be successful in asserting defenses to these claims.

The accrual for asbestos-related liabilities, before consideration of insurance recoveries is based on the following: the Company's estimate of indemnity payments and defense costs associated with pending and future asbestos-related claims to be paid through mid-2005; settlements agreed to but not paid as of February 28, 2002; the Company's expected payment on account of settlement obligations of defaulting CCR members; interest on settlement payments that are subject to ongoing dispute resolution with certain insurance providers; and other legal fees and expenses. The Company's estimates of indemnity payments and defense costs associated with pending and future asbestos claims are based on the Company's estimate of the number of future asbestos-related claims and the type of disease, if any, alleged or expected to be alleged in such claims, assumptions regarding the timing and amounts of settlement payments, the status of ongoing litigation and settlement initiatives, and the advice of outside counsel with respect to the current state of the law related to asbestos claims. The ultimate liability for all pending and future claims cannot be determined with certainty due to the difficulty of forecasting the numerous variables that can affect the amount of liability. There are inherent uncertainties involved in estimating these amounts, and the Company's actual costs in future periods could exceed the Company's estimates due to changes in facts and circumstances after the date of each estimate. For additional information, see Note 8 to the financial statements included in this filing.

Insurance Receivable

Among the product liability claims to which the Company is subject are claims for personal injury or wrongful death arising from the installation and distribution of asbestos-containing insulation, primarily in the southeastern United States, by a previously divested business of the Company. The Company believes that it has insurance coverage available to recover most of its asbestos-related costs. The Company has reached settlement agreements with substantially all of its relevant insurers providing for payment of substantially all asbestos-related claims (subject to retentions) up to the various policy limits, except for the Company's payments on account of settlement obligations of defaulting CCR members, as discussed in Note 8 to the financial statements

included in this filing. The timing and amount of future recoveries from insurance carriers will depend on the pace of claims review and processing by such carriers and on the resolution of any remaining disputes regarding coverage under such policies. In the event the Company's insurers dispute amounts billed to them or pay on an untimely basis, the Company takes all practicable steps to secure payment, including alternative dispute resolution procedures and litigation to resolve the issues. The Company has initiated an alternative dispute resolution proceeding with one insurer to resolve outstanding insurance policy interpretation issues, to secure payment of past due amounts and to ensure that the insurer's future obligations will be met in a timely fashion. The Company believes that substantial recoveries from the insurance carriers are probable. The Company reached this conclusion after considering its prior insurance-related recoveries in respect of asbestos-related claims, existing insurance policies, settlement agreements with insurers, the apparent viability of its insurers, the advice of outside counsel with respect to the applicable insurance coverage law relating to terms and conditions of those policies, and a general assessment by the Company and its advisors of the financial condition of the relevant insurers. If expected insurance recoveries become unavailable, due to insolvencies among the Company's primary or excess insurance carriers, disputes with carriers or otherwise, the Company's results of operations, liquidity and financial condition could be materially adversely affected.

Environmental Matters

The Company's operations, as well as similar operations of other companies, are subject to comprehensive laws and regulations relating to the generation, storage, handling, transportation, and disposal of hazardous substances and solid and hazardous wastes and to the remediation of contaminated sites. Permits and environmental controls are required for certain of the Company's operations to limit air and water pollution, and these permits are subject to modification, renewal, and revocation by issuing authorities. The Company believes that it is in substantial compliance with all material environmental laws, regulations, and permits. On an ongoing basis, the Company incurs capital and operating costs relating to environmental compliance. Environmental laws and regulations have generally become stricter in recent years, and the cost of responding to future changes may be substantial.

The Company reserves for known environmental claims when payments associated with the claims become probable and the costs can be reasonably estimated. The actual cost of environmental issues may be higher than that reserved due to difficulty in estimating such costs and potential changes in the status of government regulations.

Self-Insurance

It is the Company's policy to self insure for certain insurable risks consisting primarily of physical loss to property; business interruptions resulting from such loss; and workers' compensation, employee medical, comprehensive general, and auto liability. Insurance coverage is obtained for catastrophic property and casualty exposures as well as those risks required to be insured by law or contract. Based on an independent actuary's estimate of the aggregate liability for claims incurred, a provision for claims under the self-insured program is recorded and revised annually. The actuarial estimates are subject to uncertainty from various sources, including changes in claim reporting patterns, claim settlement patterns, judicial decisions, legislation, and economic conditions.

RESULTS OF OPERATIONS

NSI generated revenue of $132.0 million and $266.4 million for the three and six months ended February 28, 2002, respectively, compared to revenue of $135.1 million and $275.8 million, respectively, in the previous year. The decrease was related to the overall softer economy and lost revenues from the closure of two envelope manufacturing facilities in the fourth quarter of fiscal 2001.

Losses from continuing operations totaled $41 thousand, or $0.00 per diluted share, for the three months ended February 28, 2002, compared to income from continuing operations of $2.1 million, or $0.20 per diluted share, for the three months ended February 28, 2001. On a year-to-date basis, net losses from continuing operations for the first six months of the current fiscal year were $3.7 million, or $0.36 per diluted share, compared to the prior year's income from continuing operations of $4.4 million, or $0.43 per diluted share. The decline in income from continuing operations primarily resulted from lower revenues, restructuring charges and higher overall labor and benefits.

Textile rental segment second quarter revenues of $77.3 million decreased 2.9 percent compared to last year's $79.6 million. On a year-to-date basis, revenues decreased $4.5 million, or 2.8 percent compared to the same prior year period. Operating profit for the second quarter was $1.3 million compared to last year's operating profit of $4.0 million. Operating profit for the second quarter included $304 thousand of gains related to previously divested businesses and a $381 thousand reduction of expense associated with ongoing restructuring plans. Last year's operating profit included $2.4 million of gains on sales of businesses. On a year-to-date basis, the textile rental segment had an operating loss of $4.0 million for the first six months of fiscal 2002 versus operating profit of $7.7 million for the first six months of fiscal 2001. Year-to-date operating profit includes restructuring expense and other charges of $5.4 million relating to the closure of two facilities and $304 thousand of gains related to previously divested businesses, whereas the operating profit for the same prior year period included $2.4 million of gains on sales of businesses. Excluding these

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items, the decline in operating profit is largely due to the impact of business travel and entertainment, increases in labor and benefit costs, and costs associated with overhead reduction programs within the business.

The restructuring charge included a reduction of severance costs of $148 thousand, and $1.6 million in exit expenses to close and consolidate facilities. Exit expenses primarily include costs of lease terminations and costs to dispose of closed facilities. Reserve reductions of $413 thousand were also recorded during the second quarter of fiscal 2002 primarily due to lower than originally estimated costs to prepare a facility closed in a prior year for sale.

Additionally, as a further result of the closure of the two textile rental facilities, the Company recognized long-lived asset impairments totaling $4.4 million. Textile rental assets to be disposed of were reduced to state them at their estimated fair value less costs to sell. Assets to be disposed of primarily related to equipment located in the facilities included in the restructuring program noted above. After the charge, the remaining net book value of these assets was immaterial. Estimated fair market values were established based on an analysis of expected future cash flows.

The envelope segment second quarter revenues of $54.7 million decreased 1.5 percent from last year's results of $55.5 million. Operating profit was $649 thousand, a decrease of $214 thousand from last year's $863 thousand profit. During the quarter, the envelope segment sold its Lyon Folder unit, recognizing a gain of approximately $75 thousand. Excluding the current year gain, and approximately $245 thousand of goodwill amortization that has been discontinued with the adoption of SFAS 142, profits decreased approximately $534 thousand. The decline in operating profits is the result of the decrease in revenue, primarily from lower courier volumes. On a year-to-date basis, the envelope segment revenues of $110.3 million decreased 4.2 percent from last year's results of $115.1 million, and operating profit of $2.8 million increased $228 thousand from last year's results of $2.6 million. Last year's results included $880 thousand of costs associated with the reorganization of the Miami, Florida facility. Excluding the current year gain of $75 thousand, the prior year reorganization costs and approximately $485 thousand of prior year goodwill amortization, which ceased upon the adoption of SFAS No. 142, profits decreased approximately $1.2 million as a result of the lower overall revenue and increased benefits costs.

Corporate expenses were $1.9 million for the first quarter compared to last year's $1.1 million. For the six months ended February 28, 2002, corporate expenses increased from $2.4 million to $4.6 million. The planned increase is representative of on-going, stand-alone corporate costs.

Net interest expense of $168 thousand and $279 thousand for the three and six months ended February 28, 2002, respectively, decreased from $439 thousand and $889 thousand for the same prior year periods, respectively, due to lower overall rates and lower interest bearing obligations. Additionally, the provision for income taxes increased to 40 percent of income from continuing operations compared to 37 percent in the prior year as a result of the loss of certain state tax benefits associated with the spin-off.

LIQUIDITY AND CAPITAL RESOURCES

Operating Activities

Continuing operations used cash of $107 thousand during the six months ended February 28, 2002 compared with cash provided of $19.9 million during the respective period of the prior year. Fiscal 2002 operating cash flow was lower because of a decrease in net income and an increase in cash used for both current and long-term liabilities, which was partially offset by an increase in cash provided by inventory and linens in service. The increase in cash used for current and long-term liabilities resulted primarily from lower days in accounts payable due to utilization of recently negotiated vendor payment terms and payments related to asbestos settlements.

Investing Activities

Investing activities used cash of $9.0 million versus $6.9 million in the prior year. The increase in spending was due mainly to increased capital spending and less cash provided by divestitures.

Capital expenditures totaled $10.6 million for the six month period compared to $8.4 million in the prior year. During the six months ended February 28, 2002, the textile rental segment invested primarily in replacing old equipment and delivery truck purchases and refurbishment. Capital expenditures in the envelope segment were primarily related to manufacturing equipment and information systems. During the six months ended February 28, 2001, capital expenditures in the envelope segment related primarily to manufacturing process improvements and information systems. The textile rental segment's expenditures were primarily attributable to building improvements, replacing old equipment and information systems.

Financing Activities

Cash provided by financing activities totaled $2.2 million during the six months ended February 28, 2002 compared to cash used of $26.0 million in fiscal 2001 primarily due to borrowing of notes payable and lower dividends. Dividend payments totaled $7.0 million, or $0.68 per share, compared with $27.1 million, or $2.64 per share, for the prior-year period.

Upon completion of the spin-off on November 30, 2001, approximately $371.3 million of long-term debt was assumed by Acuity, leaving approximately $2.8

million outstanding for the Company.

In October 2001, the Company negotiated a $40 million, three-year committed credit facility with a single major US bank that became effective at the time of the spin-off. The facility contains financial covenants including a leverage ratio, a ratio of income available for fixed charges to fixed charges, and a minimum net worth. Interest rates under the facility are based on the LIBOR rate or other rates, at the Company's option. The Company will pay an annual fee on the commitment based on the Company's leverage ratio. Approximately $11.0 million was outstanding under this facility at February 28, 2002.

Management believes anticipated cash flows from operations and the committed credit facilities are sufficient to meet the Company's planned level of capital spending and general operating cash requirements, including but not limited to cash requirements related to litigation as further described in Note 8 to the financial statements, for the next twelve months.

Subsequent to the end of the second quarter, the Company entered into an agreement to sell the property where NSI's corporate headquarters is located. The agreement provides a due diligence period through April 26, 2002, during which time the purchaser has the right to terminate the agreement without any material financial obligation. Management anticipates that the sale will occur by the end of the third quarter of fiscal 2002 and that the proceeds from the sale will be used to repay outstanding debt and to fund general corporate purposes.

Legal Proceedings

For information concerning legal proceedings, including trends and developments involving legal proceedings, see Note 8 to the financial statements included in this filing.

Environmental Matters

For information concerning environmental matters, see Note 9 to the financial statements included in this filing.

Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rates
The Company's credit line is subject to interest rate fluctuations. These fluctuations expose the Company to changes in interest expense and cash flows. The Company's variable-rate debt amounted to $11.0 million at February 28, 2002. Based on outstanding borrowings at February 28, 2002, a 10 percent adverse change in effective market interest rates would result in an immaterial amount of additional interest expense.

Commodity Price Risk
From time to time, the Company's textile rental segment enters into arrangements locking in for specified periods the prices the Company will pay for the volume of natural gas or other commodities to which the contract relates. The contracts are structured to reduce the segment's exposure to changes in the price of natural gas and relate only to portions of the Company's normal expected usage. However, these contracts also limit the benefit the segment might have otherwise received from decreases in the price of natural gas. The Company does not

believe a 10 percent adverse change in market rates of natural gas would have a material impact on its "Consolidated Balance Sheets" or "Consolidated Statements of Income."

Cautionary Statement Regarding Forward-Looking Information

This filing contains forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties. Consequently, actual results may differ materially from those indicated by the forward-looking statements. A variety of risks and uncertainties could cause the Company's actual results to differ materially from the anticipated results or other expectations expressed in the Company's forward-looking statements. The risks and uncertainties include without limitation the following: (a) the uncertainty of general business and economic conditions, interest rate changes, and fluctuations in commodity and raw material prices and; (b) unexpected developments and outcomes in the Company's legal and environmental proceedings.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

For information concerning legal proceedings, including trends and developments involving legal proceedings, see Note 8 to the financial statements included in this filing.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits - None

(b) A Form 8-K was filed on December 14, 2001 related to the completion of the distribution of the common stock of Acuity Brands, Inc. A Form 8-K was filed on January 7, 2002 related to the completion of a one-for-four reverse stock split of its common stock.

SIGNATURES

Pursuant to the requirements 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.

NATIONAL SERVICE INDUSTRIES, INC.

REGISTRANT

DATE April 15, 2002 /s/ CAROL MORGAN

CAROL MORGAN
SENIOR VICE PRESIDENT,
GENERAL COUNSEL AND SECRETARY

DATE April 15, 2002 /s/ CHESTER J. POPKOWSKI

CHESTER J. POPKOWSKI
SENIOR VICE PRESIDENT,
CHIEF FINANCIAL OFFICER AND
TREASURER