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CALLOWAYS NURSERY INC  
Form 10-K405  
December 21, 2001

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended September 30, 2001

Commission File No. 0-19305

CALLOWAY'S NURSERY, INC.  
(Exact name of registrant as specified in its charter)

Texas  
(State or other jurisdiction of  
incorporation or organization)

75-2092519  
(IRS Employer  
Identification Number)

4200 Airport Freeway  
Fort Worth, Texas 76117-6200  
817.222.1122  
(Address, zip code and telephone number of principal executive offices)

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

Common Stock, \$.01 par value

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 other information statements incorporated by reference in Part III of this Form 10-K.

As of December 14, 2001, Registrant had outstanding 6,284,563 shares of Common Stock. The aggregated market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Stock on December 14, 2001 as reported on the Nasdaq Stock Market, was approximately \$4,200,000.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for Registrant's 2002 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-K.

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ABOUT CALLOWAY'S NURSERY, INC.

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At the largest retail nursery chain in Texas, all of us feel a responsibility to our customers to provide timely information about the care and nurturing of quality plants and the proper use and enjoyment of the related products we sell. In fact, all of the companies that are part of the Calloway's Nursery, Inc. ("the Company") family are known for treating each of our customers with caring respect. Satisfaction is guaranteed.

Our management team consists of professionals that have worked together for most of the time that the Company has been in operation. This hard-working team of specialists enables each area of our Company to evolve and upgrade its services and products continuously. And by taking advantage of available technology we are especially responsive to the ever-changing demands of the market.

Because we hold the largest number of shares in our Company, the Company's team's interests are tightly aligned with those of every shareholder.

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ABOUT OUR OPERATIONS

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Founded in 1986, the Company has become the largest lawn and garden retailer in Texas.

We opened the first four retail stores in 1987. Since that time, we have grown to twenty retail stores: seventeen Calloway's Nursery retail stores in the Dallas-Fort Worth market ("Calloway's Nursery") and three Cornelius Nurseries retail stores in the Houston market ("Cornelius Nurseries").

We have added two established growing operations for the production of living plants: Miller Plant Farms in 1997 and Turkey Creek Farms in 1999.

Near the end of fiscal 1999 we acquired Cornelius Nurseries, Inc. (the "Cornelius Acquisition"), which included Cornelius Nurseries and Turkey Creek Farms, as well as the Wholesale Landscape Distributors wholesale operations in Houston and Austin ("WLD"). Fiscal 2000 was the first year that the operations acquired in the Cornelius Acquisition were included in the Company's results of operations.

During Fiscal 2001 we decided to discontinue the wholesale aspects of our operations, which have been a part of the wholesale and growing segment. We sold all of the WLD operations in October 2001. We have also repositioned Turkey Creek Farms to grow plant material exclusively for our retail stores, thus discontinuing our wholesale sales to unrelated third parties. We completed the sale of excess inventory at Turkey Creek Farms by December 2001. In connection with that decision, we incurred a loss from discontinued operations of \$3,687,000, or \$.59 per diluted share in Fiscal 2001.

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RETAIL

CALLOWAY'S NURSERY  
CORNELIUS NURSERIES

We operate twenty retail stores: seventeen Calloway's stores in the Dallas-Fort Worth and three Cornelius Nurseries stores in Houston. Our locations are

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selected on the basis of demographic data, traffic patterns and shopping habits. All Calloway's Nursery and Cornelius Nurseries stores are Company-operated. We lease twelve of the Calloway's Nursery store locations and own the other five. We own all three Cornelius Nurseries store locations.

We focus on quality and breadth of selection in bedding plants and nursery stock, complemented by other related garden products such as soil amendments and fertilizers. Apart from Christmas, approximately two-thirds of our annual retail sales are derived from living plants. The remaining one-third is made up of products that primarily relate to their care and nurturing.

All Calloway's Nursery and Cornelius Nurseries stores sell Christmas merchandise. The Cornelius Nurseries stores have developed a stronger and more financially beneficial focus on Christmas than have the Calloway's Nursery stores.

The quality selection of living plants and garden products found throughout all Calloway's Nursery and Cornelius Nurseries retail stores offer our customers appropriate living plants, while informing them about the care and additional products that may be required to provide the best results with their selections. Our staff is known for treating customers with respect and guaranteeing their satisfaction.

Living plants are ecologically sound investments that cleanse the air and replenish the earth's oxygen and more. We believe that the living plants we sell do more than just benefit our customers with decoration. They provide spiritual and physical buffers against the stresses of urban life.

We seek to maintain balance with our natural habitat by informing our customers as to the manner they may use our products in harmony with the environment.

### GROWING

#### MILLER PLANT FARMS

In 1997 the Company acquired an established facility for the production of living plants - Miller Plant Farms. This growing facility was developed by Mike Miller, who has continued to manage the facility since it was acquired by the Company. Miller Plant Farms produces roses, ground covers, caladiums, perennials, hollies and flowering shrubs. Miller Plant Farms allows the Company to provide its customers with the very best selection and value in top-quality living plants. Since its acquisition, Miller Plant Farms has been providing the Calloway's Nursery stores with first quality products in the appropriate quantities at the appropriate time.

Founder Mike Miller is Past President of the International Plant Propagation Society - Southern Region; Past President of Northeast Texas Nursery Growers Association; and Past Director of the Texas Nursery and Landscape Association ("TNLA") Region III. He is a Texas Certified Nursery Professional and received his BS in Horticulture from Kansas State University in 1974.

#### TURKEY CREEK FARMS

The Cornelius family began Turkey Creek Farms in 1951 to meet the demand for quality nursery-grown products in Texas. At the time of the Cornelius Acquisition, Turkey Creek Farms was primarily a wholesale business.

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During fiscal 2001 Turkey Creek Farms was repositioned as a growing operation similar to Miller Plant Farms. Turkey Creek Farms has become an additional source for first quality plant material to enhance the offering of our twenty retail stores. Turkey Creek Farms is expected to generate greater sales volumes in 2002 to the Company's twenty retail stores than it generated in 2001 through sales to both the Company's stores and unaffiliated third party customers.

Turkey Creek Farms continues to be professionally managed by Tom Henry. A Texas Certified Nursery Professional and a member of the International Plant Propagation Society, Tom Henry received his BS with a double major in Agriculture and Business from Stephen F. Austin State University in 1989.

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### ABOUT OUR INDUSTRY

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Texas is the third largest retail market in the United States for lawn and garden center "green goods" and the third largest producer of green goods for the retail and landscape markets in the United States.

According to the Texas Comptroller's research Division, Texas retailers of ornamental nursery products reported sales of \$1.6 billion in 1999. During the past ten years, sales by nursery retailers have increased by 26%. This increase has occurred despite the proliferation of retailers such as Home Depot, Lowe's and Wal-Mart that do not separately report their sales of nursery products.

Wholesale green goods produced in Texas are sold primarily in Texas. The state offers varying climates and soils allowing a broad range of plant production. Reported wholesale sales of ornamental nursery products in Texas have increased by 45% during the past ten years.

Two geographic areas where green goods production is predominant are Houston (the location of Turkey Creek Farms) and Tyler (the location of Miller Plant Farms). In the Houston area, mild weather, high humidity and a long growing season combine to make conditions favorable for production of a wide variety of ornamental and blooming plants. In Tyler, climatic cycles, soils and water make production of roses and woody evergreens favorable.

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### EXECUTIVE OFFICERS OF THE REGISTRANT

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JIM ESTILL, 54, is Chairman of the Board, President and Chief Executive Officer. Along with John Cosby and John Peters, Jim co-founded the Company in 1986. Prior to that, Jim worked with Sunbelt Nursery Group, as President and Chief Executive Officer. Jim received his BBA in Finance from Texas Christian University in 1969, and his MBA from TCU in 1977. A Texas Master Certified Nursery Professional, Jim is Vice-Chairman of the Texas Certified Nursery Professional Committee, Member of the Nursery/Floral Advisory Committee of the Texas Department of Agriculture and Past Chairman of the TNLA Education and Research Foundation.

STERLING CORNELIUS, 79, is President of Cornelius Nurseries, Inc., and a Director of the Company. Sterling has been with Cornelius Nurseries since his father founded the business in 1937, except for the period 1941-1945, when he served in the U.S. Navy during World War II. Sterling is a recognized leader in the nursery industry, having been President of the TNLA, President of the Houston Landscape Nurserymen's Association, Chairman of the Drafting Committee -

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Texas Certified Nursery Professional Manual and Examination, Member of the Board of Trustees of the Texas Agricultural Lifetime Leadership Board, and a member of the Texas Certified Nurserymen's Professional Committee. He is the only two-time recipient of the ARP Award - the highest honor that TNLA can bestow on one of its members. Sterling is also active in many community efforts, including past membership on the Board of Directors of the Houston Chamber of Commerce and the President's Council of Houston Baptist University.

JOHN COSBY, 58, is Vice President, Secretary and a Director. John, along with Jim Estill and John Peters, co-founded the Company in 1986. He developed all of Calloway's Nursery retail store locations, including site selection and development, as well as lease and acquisition negotiations. Prior to 1986, John worked at Sunbelt Nursery Group, serving as Vice President -- Corporate Development and at Pier 1 Imports as Real Estate Manager. John received his BBA in Management from Texas Wesleyan College in 1969 and his MBA in Management from the University of Dallas in 1983. A Certified Master Mediator, John is Past Chairman of Optical Federal Credit Union, and Past President of the Dispute Resolution Services of Tarrant County.

JOHN PETERS, 50, is Vice President and Director of the Company. John, along with Jim Estill and John Cosby, co-founded the Company in 1986. He developed the original staff into a team of industry professionals. He has primary responsibility for operations, distribution, human resources and administration. Prior to 1986, John worked with Sunbelt Nursery Group as Senior Vice President of Operations, where he was responsible for operations of all subsidiaries, including more than 100 stores in five states, and two growing operations. John attended Texas Christian University. A Texas Master Certified Nursery Professional, John is Past Chairman of the TNLA.

DAN REYNOLDS, 44, is Vice President, Chief Financial Officer and Assistant Secretary. Dan joined the Company in 1990, where he developed its financial, operating and merchandising decision-support systems. His responsibilities include all financial and management reporting, treasury management, credit facilities, corporate and shareholder records, SEC and stock market compliance, public, media and investor relations, risk management and budgeting. Dan also oversees design, development, implementation and review of all transactional and decision-support systems. Prior to 1990, Dan worked with Atmos Energy Corporation as Financial Systems Manager and KPMG LLP as Supervising Senior Accountant. Dan received his BBA in Accounting from the University of Texas at Arlington. A Certified Public Accountant, Dan is Past President of the Fort Worth Chapter of Financial Executives Institute.

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SAM WEGER, 51, is Vice President of Merchandising. Sam began with the Company in retail store management in 1987 with the opening of the first stores. He has primary responsibility for the administration of planning, procurement and replenishment of all merchandise lines. Prior to 1987, Sam was Landscape Designer with Odessa Nursery. He has also been Co-Owner of Lessmon-Weger Garden Center in Colby, Kansas. Sam received his BBA in Political Science and Education from Fort Hays State University. A Texas Master Certified Nursery Professional, Sam is a Director of the TNLA, Past President of TNLA, Region 5, and Past Chairman of the TNLA Education Committee.

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### ABOUT OUR CHALLENGES

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Like any business, we face certain challenges. The biggest challenges are:

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The nursery business is highly competitive in the United States. In the Dallas, Fort Worth and Houston markets, we compete for the loyalty of our customers with large "mass merchants" such as Home Depot, Lowe's, Kmart, Wal-Mart, and several grocery store chains that sell plants, flowers, seeds and other gardening products. Most of these other chains have longer operating histories and considerably greater financial, marketing and sales resources than does the Company. Dallas, Fort Worth and Houston are also home to many independent garden centers.

For us to succeed in this environment, we must consistently and dependably represent to our customers a clearly superior value.

Our business is seasonal. About 40% of our annual sales occur in the third fiscal quarter, which is our most profitable quarter. Fiscal 2000 was the first year for which sales from the operations acquired in the Cornelius Acquisition were included.

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### CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Form 10-K Report contains forward-looking statements. We are including this cautionary statement for the express purpose of providing the Company with the protections of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to all forward-looking statements. Several important factors, in addition to the specific factors discussed in connection with such forward-looking statements individually, could affect future results and could cause those results to differ materially from those expressed in the forward-looking statements contained in this Report.

Our expected future results, products and service performance or other non-historical facts are forward-looking and reflect our current perspective on existing trends and information. These statements involve risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, among others, the seasonality of our business, geographic concentration, the impact of weather and other growing conditions, the ability to manage growth, the impact of competition, the ability to obtain future financing, government regulations, market risks associated with variable-rate debt, the costs and benefits of discontinuing certain operations, and other risks and uncertainties defined from time to time in our Securities and Exchange Commission filings.

Therefore, each reader of this report is cautioned to consider carefully the risk factors listed above, as well as any specific factors discussed with a forward-looking statement in this Report and disclosed in our filings with the Securities and Exchange Commission, as such risks and factors, in some cases, have affected, and in the future (together with other factors) could affect, our ability to implement our business strategy and may cause actual results to differ materially from those contemplated by the statements expressed in this Report.

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### ITEM 2. PROPERTIES

The typical Calloway's Nursery (Dallas and Fort Worth markets) and Cornelius Nurseries (Houston market) retail store is located in a high-traffic shopping area. All are free standing stores. The typical Calloway's Nursery retail store consists of a building (approximately 10,000 square feet), a greenhouse (approximately 12,000 square feet) and an outdoor nursery yard (approximately 40,000 square feet). Though each Cornelius Nurseries retail store has a somewhat different configuration, they are about the same overall size as a Calloway's Nursery retail store.

As of September 30, 2001 we operated seventeen Calloway's Nursery retail stores. We own the land and buildings at five locations. The other twelve locations are leased under the terms of long-term leases. All three of the Cornelius Nurseries retail stores are owned by the Company.

We own two nursery growing facilities. Miller Plant Farms, near Tyler, Texas (approximately 80 acres), and Turkey Creek Farms, north of Houston (approximately 160 acres).

We lease our corporate office, which is located in an office building in Fort Worth, Texas. We also lease a warehouse/distribution center in Fort Worth, Texas.

### ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

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## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED SHAREHOLDER MATTERS

Our common stock has been traded on the Nasdaq National Market under the symbol CLWY since the initial public offering on June 26, 1991. The following table sets forth the high, low and closing price information for each quarter of the most recent five fiscal years:

	High	Low	Close
	-----	-----	-----
FISCAL YEAR 1997			
First Quarter	\$1.063	\$ .719	\$ .750
Second Quarter	.938	.688	.813
Third Quarter	1.094	.688	1.063
Fourth Quarter	1.375	1.000	1.281
	-----	-----	-----
FISCAL YEAR 1998			
First Quarter	2.063	1.094	1.375
Second Quarter	2.875	1.313	2.844
Third Quarter	3.125	1.875	2.250
Fourth Quarter	2.313	.938	1.188



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FISCAL YEAR 1999			
First Quarter	1.375	1.000	1.125
Second Quarter	1.500	1.125	1.313
Third Quarter	2.000	1.250	1.375
Fourth Quarter	1.563	1.125	1.125
FISCAL YEAR 2000			
First Quarter	1.438	.938	1.188
Second Quarter	1.500	.969	1.375
Third Quarter	1.500	.813	1.188
Fourth Quarter	1.750	1.125	1.375
FISCAL YEAR 2001			
First Quarter	1.750	1.063	1.250
Second Quarter	1.625	1.141	1.188
Third Quarter	1.600	1.000	1.300
Fourth Quarter	\$1.390	\$ .850	\$ .940

The closing price of the common stock on December 14, 2001, as reported by Nasdaq, was \$1.02. As of December 14, 2001 there were approximately 500 shareholders of record, and approximately 1,800 beneficial shareholders.

We have never paid cash dividends on common stock. We intend to retain earnings for further development of the business and, therefore, do not intend to pay cash dividends on common stock in the foreseeable future.

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ITEM 6. SELECTED FINANCIAL DATA

The following table of selected financial data should be read in conjunction with the Consolidated Financial Statements included in Item 8, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in Item 7. Comparability of the Statement of Operations data for 2001 and 2000, and the Balance Sheet data for 2001, 2000 and 1999, was impacted by the Cornelius Acquisition. In addition, the Statement of Operations data reflects the discontinuance of the wholesale operations.

SELECTED FINANCIAL DATA  
(Amounts in millions, except per share amounts)

o	STATEMENT OF OPERATIONS DATA	2001	2000	1999	1998	1997
	Net sales	\$ 43.5	\$ 44.6	\$ 30.4	\$ 27.1	\$ 26.2
	Income (loss) from continuing operations	\$ 1.6	\$ 2.0	\$ .4	\$ (.3)	\$ 1.7
	Net income (loss)	\$ (2.1)	\$ 1.7	\$ .4	\$ (.3)	\$ 1.7
	Income (loss) per common share from continuing operations:					
	Basic	\$ .20	\$ .32	\$ .07	\$ (.05)	\$ .33
	Diluted	\$ .20	\$ .30	\$ .07	\$ (.05)	\$ .33
	Net income (loss) per common share:					
	Basic	\$ (.40)	\$ .26	\$ .07	\$ (.05)	\$ .33

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Diluted \$ (.39) \$ .25 \$ .07 \$ (.05) \$ .33

BALANCE SHEET DATA	2001	2000	1999	1998	1997
Total assets	\$ 27.3	\$ 31.0	\$ 26.3	\$ 14.7	\$ 13.1
Long-term obligations	8.6	9.8	9.0	3.0	1.8
Redeemable preferred stock	\$ 2.2	\$ 1.9	\$ 1.9	--	--

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

INTRODUCTION

In September 1999 we completed the Acquisition of Cornelius Nurseries, Inc. and affiliated companies (the "Cornelius Acquisition"). The results of operations for fiscal 2000 and fiscal 2001 include the Cornelius Acquisition, while the results of operations for fiscal 1999 and prior years do not.

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations that had been a part of its wholesale and growing segment (see Note 21 to Consolidated Financial Statements). Accordingly, the following discussion of results of operations has been separated into (i) Continuing Operations and (ii) Discontinued Operations.

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RESULTS OF OPERATIONS

CONTINUING OPERATIONS

YEAR ENDED SEPTEMBER 30, 2001 COMPARED WITH YEAR ENDED SEPTEMBER 30, 2000

Income from Continuing Operations Before Income Taxes for 2001 was lower than it was for 2000 (when we had our most profitable year of operations since becoming a public company in 1991).

[PERFORMANCE GRAPH]

INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE  
INCOME TAXES  
(\$ thousands)

2001	2000	1999	1998	1997
2,363	3,290	799	(327)	767

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Sales declined 2.5% from 2000. Strong Sales during the spring season were not enough to offset slower Sales during the fall and winter seasons, which saw consumer demand for nursery products reduced due to unfavorable weather for gardening.

[PERFORMANCE GRAPH]

SALES  
(\$ millions)

2001	2000	1999	1998	1997
----	----	----	----	----
43.5	44.6	30.4	27.1	26.2

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Gross Margin (Gross Profit as a percentage of net Sales) declined to 49.5% in 2001 from 51.1% for 2000. The 2000 Gross Margin was the highest in the Company's history, a result of strong Sales that kept stock loss and markdowns to a minimum. The 2001 Gross Margin was more consistent with the 1999 Gross Margin of 49.3%, which was achieved under similar market conditions.

[PERFORMANCE GRAPH]

GROSS MARGIN  
% of sales

2001	2000	1999	1998	1997
----	----	----	----	----
49.5%	51.1%	49.3%	45.1%	47.3%

Operating Expenses decreased 4.0%. The decrease was primarily the result of fewer bonuses paid due to the reduction in Income from Continuing Operations for 2001 compared to 2000.

Occupancy Expenses decreased by 3.1%. The decrease was primarily due to a reduction in accrued property taxes. The real properties added in the Cornelius Acquisition are Company-owned instead of leased. Occupancy Expenses do not include the Depreciation and Amortization or Interest Expenses related to the cost of Company-owned facilities.

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Advertising Expenses increased 12.7%. The increase was primarily due to increased newspaper and radio advertising done to stimulate consumer demand during the 2001 spring season.

Depreciation and Amortization was flat, with a 0.4% increase.

Interest Expense increased 7.9%, primarily due to increased seasonal borrowings under the Company's revolving credit lines.

Interest Income decreased 55.0%, due to lower levels of Cash maintained during the year.

YEAR ENDED SEPTEMBER 30, 2000 COMPARED WITH YEAR ENDED SEPTEMBER 30, 1999

Income from Continuing Operations Before Income Taxes was higher for 2000 than it was for 1999. We had our most profitable year of operations since becoming a public company in 1991.

Sales increased 47.0% over 1999, marking the fifth consecutive year that sales have risen. Most of the increase was a result of adding the Cornelius Nurseries retail stores from the Cornelius Acquisition.

Gross Margin improved to 51.1% for 2000 from 49.3% for 1999. The increase was primarily due to reduced stock loss and markdowns.

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Operating Expenses increased 48.3%. Substantially all of the increase was due to the Cornelius Acquisition.

Occupancy Expenses increased 0.4%. The percentage increase was much lower than the percentage increase in Sales because substantially all of the real properties added in the Cornelius Acquisition are Company-owned instead of leased. Occupancy Expenses do not include the Depreciation and Amortization or Interest Expenses related to the cost of Company-owned facilities.

Advertising Expenses decreased 2.3%. We changed the media mix in the Dallas-Fort Worth markets to optimize our Advertising budget. Those savings were more than the Advertising Expenses needed for the Houston market.

Depreciation and Amortization increased 29.6%. The increase was attributable to the assets added in the Cornelius Acquisition.

Interest Expense increased 224.6%, primarily due to the debt incurred to finance the Cornelius Acquisition.

Interest Income decreased 23.8%, due to lower levels of Cash maintained during the year.

DISCONTINUED OPERATIONS

YEAR ENDED SEPTEMBER 30, 2001 COMPARED WITH YEAR ENDED SEPTEMBER 30, 2000

Sales decreased 6%. The decrease in sales was primarily attributed to continued pressure from lower cost wholesalers.

Gross Margin declined from 32% for fiscal 2000 to 13% for fiscal 2001. The decline was a result of the substantial decline in sales, through June 30, 2001,

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which caused excessive quantities of inventory that had to be marked down to lower of cost or market.

Expenses declined 29%. The decline was a result of reduced expenses needed to support the reduced volume of sales.

The aforementioned factors caused the Loss before Income Taxes to increase from approximately \$0.5 million for fiscal 2000 to approximately \$1.2 million for fiscal 2001.

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### LIQUIDITY AND CAPITAL RESOURCES

#### CASH FLOWS FROM OPERATING ACTIVITIES

Cash Flows Used for Operating Activities were \$1,754,000 for fiscal 2001, compared to Cash Flows Provided by Operating Activities of \$2,979,000 for fiscal 2000. The decline was primarily attributed to (i) the payment of approximately \$1.5 million of income taxes in 2001 that were accrued in 2000, and (ii) increase in income taxes receivable of approximately \$1.2 million related to the carry back of the 2001 net operating loss (see Note 8 to Consolidated Financial Statements).

#### CASH FLOWS FROM INVESTING ACTIVITIES

Cash Flows Used for Investing Activities decreased to \$458,000 for fiscal 2001 from \$1,791,000 for fiscal 2000. During fiscal 2000 we opened one new retail Store; none were opened during fiscal 2001.

#### CASH FLOWS FROM FINANCING ACTIVITIES

Cash Flows Used for Financing Activities were \$187,000 for fiscal 2001 compared to Cash Flows Provided by Financing Activities of \$467,000 for fiscal 2000. We borrowed \$750,000 during fiscal 2000 to acquire the Land to construct a new retail store. The only significant borrowings during fiscal 2001 were to refinance existing long-term debt to obtain lower, fixed interest rates and longer maturities.

In October 1999 we redeemed 5,798 shares of Preferred Stock for a cash payment of \$158,500. The redeemed Preferred Stock had a redemption value of \$579,800 and a carrying amount of \$274,000. Thus, the remaining redemption amount of the Preferred Stock was reduced to \$3,420,200.

We anticipate that cash flows from operations and the \$5,000,000 revolving line of credit arrangement (see Note 7 to Consolidated Financial Statements) will be sufficient to meet all working capital needs.

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### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("Statement") No. 141, Business Combinations and Statement No. 142, Goodwill and Other Intangible Assets. Statement 141 requires that the purchase method of accounting be used for all business

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combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. Statement 141 also specifies criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. Statement 142 requires that goodwill and intangible assets with indefinite lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of Statement 142. Statement 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with Statement 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, which has been superceded by Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which is effective for fiscal years beginning after December 15, 2001.

The Company is required to adopt, and has adopted, the provisions of Statement 141 immediately. Statement 142 is effective for fiscal years beginning after December 15, 2001. The Company intends to adopt Statement 142 as of October 1, 2002. Goodwill and intangible assets acquired in business combinations completed before July 1, 2001 will continue to be amortized prior to the adoption of Statement 142.

Statement 141 will also require, upon adoption of Statement 142, that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and to make any necessary reclassification in order to conform to the new criteria in Statement 141 for recognition apart from goodwill.

Upon adoption of Statement 142 the Company will be required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of Statement 142 within the first interim period.

Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

As of October 1, 2002 the Company expects to have unamortized goodwill in the amount of \$632,000 that will be subject to the transition provisions of Statements 141 and 142. Amortization expense related to goodwill was \$108,000 for the fiscal year ended September 30, 2001. Because of the extensive effort that will be needed to comply with adopting Statements 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on the Company's consolidated financial statements at the date of this report, including whether any transitional impairment losses will be required to be recognized as the cumulative effect of a change in accounting principle.

In August 2001 the FASB issued Statement 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Statement 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. Statement 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a

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comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Statement 144 requires companies to separately report discontinued operations and extends that reporting to a component of an entity that either has been disposed of (by sale, abandonment, or in a distribution to owners) or is classified as held for sale. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company is required to adopt Statement 144 as of October 1, 2002. Management does not expect the adoption of Statement 144 to have a material impact on the Company's consolidated financial statements because the impairment assessment under Statement 144 is largely unchanged from Statement 121.

### ITEM 7.A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to certain market risks, including fluctuations in interest rates. We do not enter into transactions designed to mitigate such market risks, nor do we enter into any transactions in derivative securities for trading or speculative purposes. As of September 30, 2001, we had no foreign exchange contracts or options outstanding.

We manage our interest rate risk by balancing (a) the amount of variable-rate long-term debt with (b) the amounts due under long-term leases, which typically have fixed rental payments that do not fluctuate with interest rate changes. For our variable-rate debt, interest rate changes generally do not affect the fair market value of such debt, but do impact future operations and cash flows, assuming other factors are held constant.

At September 30, 2001 the Company had variable rate long-term debt of \$3.4 million, out of total long-term debt of \$9.4 million. Holding other variables, such as debt levels, constant, a one percentage point increase in interest rates would be expected to have an estimated impact on income before income taxes and cash flows for next year of approximately \$34,000 for the variable-rate long-term debt.

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by Item 8 are included in a separate section of this Report. The index is included under Item 14.

### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item with regard to executive officers is included in Part I of this Report. The other information required by this item is incorporated by reference from the Company's Proxy Statement.

### ITEM 11. EXECUTIVE COMPENSATION

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The information required by this item is incorporated by reference from the Company's Proxy Statement.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this item is incorporated by reference from the Company's Proxy Statement.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference from the Company's Proxy Statement.

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## PART IV

### ITEM 14. EXHIBITS, FINANCIAL STATEMENTS, SCHEDULES, AND REPORTS ON FORM 8-K

#### (a) (1) FINANCIAL STATEMENTS

Independent Auditors' Report - KPMG LLP

Consolidated Balance Sheets - September 30, 2001 and 2000

Consolidated Statements of Operations - Years Ended September 30, 2001, 2000 and 1999

Consolidated Statements of Shareholders' Equity - Years Ended September 30, 2001, 2000 and 1999

Consolidated Statements of Cash Flows - Years Ended September 30, 2001, 2000 and 1999

Notes to Consolidated Financial Statements

#### (a) (2) SCHEDULES

Schedules, for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are omitted because they either are not required under the related instructions, are inapplicable, or the required information is shown in the consolidated financial statements or notes thereto.

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#### (a) (3) EXHIBITS

- (3) (a) Restated Articles of Incorporation of the Registrant. (Exhibit (3) (a)) (1)
- (b) Form of Bylaws of the Registrant. (Exhibit (3) (b)) (1)



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- (c) Amendment to Bylaws Adopted on May 19, 1993. (Exhibit (3(c))(1))
- (4) (a) Specimen Stock Certificate. (Exhibit (4)(a)(1))  
(b) Form of Shareholder Rights Plan. (Exhibit (4)(b)(1))
- (10) (a) Form of Employment Agreement dated July 3, 1991 between the Registrant and James C. Estill. (Exhibit (10)(a))(1)  
(b) Form of Employment Agreement dated July 3, 1991 between the Registrant and John T. Cosby. (Exhibit (10)(b))(1)  
(c) Form of Employment Agreement dated July 3, 1991 between the Registrant and John S. Peters. (Exhibit (10)(c))(1)  
(d) Left blank intentionally.  
(e) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and each of James C. Estill and John T. Cosby. (Exhibit (10)(g))(1)  
(f) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and John S. Peters. (Exhibit (10)(h))(1)  
(g) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and each of Robert E. Glaze and Dr. Stanley Block. (Exhibit (10)(i))(1)  
(h) Extension of Employment Agreement between the Registrant and James C. Estill dated July 2, 1996. (Exhibit (10)(m))(2)  
(i) Extension of Employment Agreement between the Registrant and John T. Cosby dated July 2, 1996. (Exhibit (10)(n))(2)  
(j) Extension of Employment Agreement between the Registrant and John S. Peters dated July 2, 1996. (Exhibit (10)(o))(2)  
(k) Employment Agreement between the Registrant and C. Sterling Cornelius dated September 21, 1999.(9)  
(l) Extension of Employment Agreement between the Registrant and James C. Estill dated May 9, 2001. (Exhibit (10)(p))(3)  
(m) Extension of Employment Agreement between the Registrant and John T. Cosby dated May 9, 2001. (Exhibit (10)(q))(3)  
(n) Extension of Employment Agreement between the Registrant and John S. Peters dated May 9, 2001. (Exhibit (10)(r))(3)  
(o) Calloway's Nursery, Inc. Vice President of Merchandising Profit Improvement Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(s))(3)  
(p) Calloway's Nursery, Inc. Profit Improvement Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(t))(3)  
(q) Calloway's Nursery, Inc. Monthly Sales Gain Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(u))(3)
- (21) (a) Subsidiaries of the Registrant.(3)
- (23) (d) Consent of KPMG LLP.(3)
- (99) (a) Calloway's Nursery, Inc. Stock Purchase Plan. (Exhibit (28))(4)
- (99) (b) Calloway's Nursery, Inc. 1991 Stock Option Plan. (Exhibit (10)(d))(1)

- (99) (c) Calloway's Nursery, Inc. 1995 Stock Option Plan for Independent Directors. (Exhibit (99)(c))(5)
- (99) (d) Calloway's Nursery, Inc. 1997 Stock Option Plan. (Exhibit A)(6)
- (99) (e) Calloway's Nursery, Inc. 1998 Stock Option Plan. (Exhibit A)(7)
- (99) (f) Calloway's Nursery, Inc. 1999 Stock Option Plan. Exhibit A)(8)
- (99) (g) Cornelius Nurseries, Inc. and Turkey Creek Farms, Inc. Combined

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- Financial Statements as of and for the years ended September 30, 1998 and 1997. (Exhibit 99.1) (9)
- (99) (h) Calloway's Nursery, Inc. and Subsidiaries Unaudited Pro Forma Condensed Financial Information as of June 30, 1999 and for the nine month period ended June 30, 1999 and for the year ended September 30, 1998. (Exhibit 99.2) (8)
- (99) (i) Calloway's Nursery, Inc. 2000 Stock Option Plan. (10)
- (99) (j) Form of Calloway's Nursery, Inc. 2001 Stock Option Plan. (3)
- (99) (k) Calloway's Nursery, Inc. 1996 Stock Option Plan. (Exhibit A) (11)

-----

(1) Incorporated by reference to the Exhibit shown in parenthesis to Registration Statement No. 33-40473 on Form S-1, and amendments thereto, filed by the Company with the Securities and Exchange Commission and effective June 26, 1991.

(2) Incorporated by reference to the Exhibit shown in parenthesis to the Company's form 10-Q Report for the quarter ended June 30, 1996.

(3) Filed herewith.

(4) Incorporated by reference to the Exhibit shown in parenthesis to Registration Statement No. 33-46170 on Form S-8, and amendments thereto, filed by the Company with the Securities and Exchange Commission and effective March 3, 1992.

(5) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Form 10-K Report for the fiscal year ended September 30, 1995.

(6) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1998 Annual Meeting of Shareholders.

(7) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1999 Annual Meeting of Shareholders.

(8) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 2000 Annual Meeting of Shareholders.

(9) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Form 8-K Report filed October 1, 1999.

(10) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders.

(11) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1997 Annual Meeting of Shareholders.

(b) REPORTS ON FORM 8-K

None.

### 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.

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CALLOWAY'S NURSERY, INC.

By:

/s/ James C. Estill  
-----

James C. Estill, President and  
Chief Executive Officer

/s/ Daniel G. Reynolds  
-----

Daniel G. Reynolds, Vice  
President and Chief Financial  
Officer

Dated: December 20, 2001

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

Name -----	Title -----	Date -----
/s/ James C. Estill ----- James C. Estill	Director	December 20, 2001
/s/ John T. Cosby ----- John T. Cosby	Director	December 20, 2001
/s/ John S. Peters ----- John S. Peters	Director	December 20, 2001
/s/ Dr. Stanley Block ----- Dr. Stanley Block	Director	December 20, 2001
/s/ C. Sterling Cornelius ----- C. Sterling Cornelius	Director	December 20, 2001
/s/ Daniel R. Feehan ----- Daniel R. Feehan	Director	December 20, 2001
/s/ Timothy J. McKibben ----- Timothy J. McKibben	Director	December 20, 2001

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The Board of Directors and Shareholders  
 Calloway's Nursery, Inc.:

We have audited the accompanying consolidated balance sheets of Calloway's Nursery, Inc. and subsidiaries as of September 30, 2001 and 2000, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended September 30, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Calloway's Nursery, Inc. and subsidiaries as of September 30, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended September 30, 2001, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Fort Worth, Texas  
 November 16, 2001

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
 CONSOLIDATED BALANCE SHEETS  
 (amounts in thousands, except share and per share amounts)  
 ASSETS

	SEPTEMBER 30, 2001	SEPT
	-----	-----
Cash and cash equivalents	\$ 279	\$
Accounts receivable	433	
Inventories	6,042	
Prepays and other assets	230	
Deferred income taxes, current	55	
Income taxes receivable	1,180	
Current assets of discontinued operations	2,847	
	-----	-----
Total current assets	11,066	
Property and equipment, net	13,888	
Goodwill, net of accumulated amortization of \$1,233 and \$1,125,		

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respectively	740	
Deferred income taxes	1,301	
Other assets	266	
Noncurrent assets of discontinued operations	--	
	-----	-----
Total assets	\$ 27,261	\$
	=====	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Accounts payable	\$ 2,128	\$
Accrued expenses	1,534	
Income taxes payable	--	
Notes payable, current	730	
Current portion of long-term debt	732	
Deferred income taxes, current	187	
Current liabilities of discontinued operations	2,304	
	-----	-----
Total current liabilities	7,615	
Deferred rent payable	929	
Long-term debt, net of current portion	8,646	
	-----	-----
Total liabilities	17,190	
	-----	-----
Commitments and contingencies		
Non-Voting Acquisition Preferred Stock with mandatory redemption provisions; par value \$.01 per share; 40,000 shares authorized; 40,000 shares issued and 34,202 shares outstanding	2,180	
Shareholders' equity:		
Voting convertible preferred stock; par value \$.625 per share; 3,200,000 shares authorized; no shares issued or outstanding	--	
Preferred stock; par value \$.01 per share; 9,960,000 shares authorized; no shares issued or outstanding	--	
Common stock; par value \$.01 per share; 30,000,000 shares authorized; 6,498,346 and 6,237,760 shares issued, respectively; 6,248,346 and 5,987,760 shares outstanding, respectively	65	
Additional paid-in capital	9,610	
Retained earnings (accumulated deficit)	(388)	
	-----	-----
	9,287	
Less: treasury stock, at cost (250,000 common shares)	(1,396)	
	-----	-----
Total shareholders' equity	7,891	
	-----	-----
Total liabilities and shareholders' equity	\$ 27,261	\$
	=====	=====

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(amounts in thousands, except per share amounts)

YEAR ENDED                      YEAR ENDED                      Y

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	SEPTEMBER 30, 2001	SEPTEMBER 30, 2000	SE
Net sales	\$ 43,494	\$ 44,619	\$
Cost of goods sold	21,957	21,839	
Gross profit	21,537	22,780	
Operating expenses	12,959	13,501	
Occupancy expenses	2,638	2,721	
Advertising expenses	1,583	1,404	
Depreciation and amortization	906	902	
Interest expense	1,124	1,042	
Interest income	(36)	(80)	
Total expenses	19,174	19,490	
Income from continuing operations before income taxes	2,363	3,290	
Income tax expense	812	1,300	
Income from continuing operations	1,551	1,990	
Discontinued operations:			
Loss from discontinued operations, net of tax benefits of \$416, \$202, and \$--	(794)	(323)	
Loss on disposal of discontinued operations, net of tax benefit of \$1,515, \$--, and \$--	(2,893)	--	
Loss from discontinued operations	(3,687)	(323)	
Net income (loss)	(2,136)	1,667	
Accretion of preferred stock	(303)	(261)	
Retirement of preferred stock	--	115	
Net income (loss) attributable to common shareholders	\$ (2,439)	\$ 1,521	\$
Weighted average number of common shares outstanding			
Basic	6,107	5,823	
Diluted	6,290	6,002	
Basic net income (loss) per common share			
Income from continuing operations	\$ .20	\$ .32	\$
Loss from discontinued operations	(.60)	(.06)	
Net income (loss)	\$ (.40)	\$ .26	\$
Diluted net income (loss) per common share			
Income from continuing operations	\$ .20	\$ .30	\$
Loss from discontinued operations	(.59)	(.05)	
Net income (loss)	\$ (.39)	\$ .25	\$

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

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(amounts in thousands)

	Common Stock		Additional	Retained	Treasury
	Shares	Amount	Paid-in	Earnings	Stock
	-----	-----	-----	(Accumulated	-----
			Capital	Deficit)	
	-----	-----	-----	-----	-----
Balance as of September 30, 1998	5,736	\$ 57	\$ 8,666	\$ 139	\$ (1,396)
Issuance of common stock	205	2	261	--	--
Net income	--	--	--	391	--
	-----	-----	-----	-----	-----
Balance as of September 30, 1999	5,941	59	8,927	530	(1,396)
Issuance of common stock	297	3	361	--	--
Net income	--	--	--	1,667	--
Accretion of preferred stock	--	--	--	(261)	--
Retirement of preferred stock	--	--	--	115	--
	-----	-----	-----	-----	-----
Balance as of September 30, 2000	6,238	62	9,288	2,051	(1,396)
Issuance of common stock	260	3	322	--	--
Net loss	--	--	--	(2,136)	--
Accretion of preferred stock	--	--	--	(303)	--
	-----	-----	-----	-----	-----
Balance as of September 30, 2001	6,498	\$ 65	\$ 9,610	\$ (388)	\$ (1,396)
	=====	=====	=====	=====	=====

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(amounts in thousands)

	Year Ended	Year
	September 30,	Ended
	2001	September
	-----	-----
Cash flows from operating activities:		
Net income (loss)	\$ (2,136)	\$
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Loss from discontinued operations (net of tax)	794	
Loss on disposal of discontinued operations (net of tax)	2,893	
Depreciation and amortization	906	
Gains on property sales	--	
Deferred income taxes	61	
Stock compensation	140	
(Increase) decrease (net of effects from acquisition) in:		
Accounts receivable	(183)	
Inventories	(199)	

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Income taxes receivable	(1,180)
Prepaid expenses and other assets	7
Increase (decrease) (net of effects from acquisition) in:	
Accounts payable	(1,074)
Accrued expenses	(138)
Income taxes payable	(1,518)
Deferred rent payable	(127)
	-----
Net cash flows provided by (used for) operating activities	(1,754)
	-----
Cash flows from investing activities:	
Additions to property and equipment	(458)
Acquisition of Cornelius Nurseries	--
Proceeds from property sales	--
	-----
Net cash flows used for investing activities	(458)
	-----

Continued on Page F-6

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
CONTINUED  
(amounts in thousands)

	Year Ended September 30, 2001	Ye Sep
	-----	---
Cash flows from financing activities:		
Proceeds from issuance of common stock	185	
Proceeds from issuance of long-term debt	3,769	
Net borrowings (repayments) under revolving line of credit	675	
Repayments of long-term debt	(4,716)	
Lease payments under capital lease	(100)	
Bank overdraft	--	
Payment of debt issuance costs	--	
Retirement of preferred stock	--	
	-----	---
Net cash flows provided by (used for) financing activities	(187)	
	-----	---
Net increase (decrease) in cash and cash equivalents from continuing operations	(2,399)	
	-----	---
Net increase (decrease) in cash and cash equivalents from discontinued operations	2,265	
	-----	---
Net increase (decrease) in cash and cash equivalents	(134)	
	-----	---



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Cash and cash equivalents at beginning of year	413	
	-----	---
Cash and cash equivalents at end of year	\$ 279	\$
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest	\$ 1,124	\$
Income taxes	\$ 1,518	

In 1999 the Company issued non-dividend preferred stock with mandatory redemption provisions with a fair value of \$1,890, and assumed accounts payable of \$845, in exchange for certain assets relating to the Cornelius Acquisition.

In 2000 the Company redeemed 5,798 shares of Preferred Stock for a cash payment of \$159. The redeemed Preferred Stock had a redemption value of \$580 and a carrying amount of \$274. In 2001 and 2000 the carrying amount of the Preferred Stock was accreted by \$303 and \$261, respectively to a carrying amount of \$2,180 and \$1,877 at September 30, 2001 and 2000, respectively.

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

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 1 - ORGANIZATION AND NATURE OF THE COMPANY

Calloway's Nursery, Inc. and Subsidiaries (the "Company") has been engaged in the retail, and wholesale and growing segments of the nursery business. The Company opened its first three retail stores in 1987.

The Company derives the majority of its revenues from sales to consumers of living plants and related products. No single product or customer accounts for a material portion of its revenues.

In September 1999 the Company acquired certain assets of Cornelius Nurseries, Inc. and two affiliated entities ("the Cornelius Acquisition"). The Cornelius Acquisition added three retail stores in the Houston market, a growing operation near Houston and two wholesale distribution centers (one in Houston and one near Austin).

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its wholesale and growing segment (see Note 21). The Company has three wholly owned subsidiaries:

Calloway's Nursery of Texas, Inc. -- operates the Company's Calloway's retail stores in the Dallas-Fort Worth area.

Miller Plant Farms, Inc. - is the Company's growing facility near Tyler, Texas.

Cornelius Nurseries, Inc. -- operates three Cornelius retail stores in the Houston market, and the growing operation near Houston.

Economic, weather and other circumstances that may exist from time-to-time in

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these areas can have a significant impact on the Company's results of operations.

All significant intercompany accounts and transactions have been eliminated.

### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of these financial statements.

Revenue recognition - The Company recognizes revenue when the customer takes possession of the merchandise.

Accounts receivable - The Company's accounts receivable are primarily related to credit card transactions. The Company's retail Stores accept MasterCard, VISA, American Express and Discover. No allowance for doubtful accounts is considered necessary since substantially all amounts are collected within five business days.

Inventories - Inventories are stated at the lower of cost or market, with cost being determined principally on a first-in, first-out basis.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Property and equipment - Property and equipment are capitalized at cost and depreciated using the straight-line method over the estimated useful lives of the various classes of assets. Leasehold improvements are amortized on a straight-line basis over the lease term. Expenditures for normal maintenance and repairs are expensed as incurred. The cost of property and equipment sold or otherwise retired, and the related accumulated depreciation and amortization, are removed from the accounts and any resultant gain or loss is included in operating results. The useful lives for purposes of calculating depreciation and amortization are as follows:

Leasehold improvements	Term of lease
Land improvements	15 years
Buildings	33 years
Furniture and fixtures	5 years
Vehicles	3 years

The Company reevaluates the propriety of the carrying amounts of its properties as well as the amortization periods when events and circumstances indicate that impairment may have occurred. Recoverability of assets to be held and used is measured by the comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Management believes that no impairment has occurred and that no reduction of the estimated useful lives is warranted.

Net income (loss) per share - Basic EPS is computed by dividing income (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that

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could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings or loss of the entity.

Income taxes - Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date.

Intangibles - Goodwill is being amortized on a straight-line basis over 20 years. The Company assesses the recoverability of this goodwill by determining whether the amortization of the goodwill balance over its remaining life can be recovered through undiscounted future operating cash flows. The amount of goodwill impairment, if any, is measured based on projected discounted future operating cash flows using a discount rate reflecting the Company's average cost of funds. The assessment of the recoverability of goodwill will be impacted if estimated future operating cash flows are not achieved. Management believes no impairment has occurred.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Cash equivalents - For purposes of the consolidated statements of cash flows, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Stock Based Compensation - The Company sponsors a stock-based compensation plan for its employees and directors. The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, in accounting for its fixed plan stock options. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. See Note 11 for pro forma disclosures that show the effect on the Company's net income (loss) and net income (loss) per share as if the Company had adopted the cost recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("SFAS 123").

Use of Estimates - 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. Actual results could differ from those estimates.

The amount of the valuation allowance related to deferred tax assets at September 30, 2001 and 2000 has been estimated based on the weight of available evidence at September 30, 2001 and 2000. Such estimate could change in the future based on the occurrence of one or more future events.

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Fair Value of Financial Instruments - The carrying values of the Company's financial instruments, other than long-term debt, approximate fair values due to the short maturities of such instruments. The Company's borrowings, if recalculated based on current interest rates, would not differ significantly from the amounts recorded at September 30, 2001 and 2000.

Reclassifications - Certain amounts for 1999 and 2000 have been reclassified to conform to the 2001 presentation of the Discontinued Operations.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Recent Accounting Pronouncements

In June 2001 the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("Statement") No. 141, Business Combinations and Statement No. 142, Goodwill and Other Intangible Assets. Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. Statement 141 also specifies criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. Statement 142 requires that goodwill and intangible assets with indefinite lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of Statement 142. Statement 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with Statement 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, which has been superceded by Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which is effective for fiscal years beginning after December 15, 2001.

The Company is required to adopt, and has adopted, the provisions of Statement 141 immediately. Statement 142 is effective for fiscal years beginning after December 15, 2001. The Company intends to adopt Statement 142 as of October 1, 2002. Goodwill and intangible assets acquired in business combinations completed before July 1, 2001 will continue to be amortized prior to the adoption of Statement 142.

Statement 141 will also require, upon adoption of Statement 142, that the Company evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and to make any necessary reclassification in order to conform to the new criteria in Statement 141 for recognition apart from goodwill.

Upon adoption of Statement 142 the Company will be required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of Statement 142 within the first interim period.

Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

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As of October 1, 2002 the Company expects to have unamortized goodwill in the amount of \$632,000 that will be subject to the transition provisions of Statements 141 and 142. Amortization expense related to goodwill was \$108,000 for the fiscal year ended September 30, 2001. Because of the extensive effort that will be needed to comply with adopting Statements 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on the Company's consolidated financial statements at the date of this report, including whether any transitional impairment losses will be required to be recognized as the cumulative effect of a change in accounting principle.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In August 2001 the FASB issued Statement 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Statement 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. Statement 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Statement 144 requires companies to separately report discontinued operations and extends that reporting to a component of an entity that either has been disposed of (by sale, abandonment, or in a distribution to owners) or is classified as held for sale. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

The Company is required to adopt Statement 144 as of October 1, 2002. Management does not expect the adoption of Statement 144 to have a material impact on the Company's consolidated financial statements because the impairment assessment under Statement 144 is largely unchanged from Statement 121.

#### NOTE 3 - CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following (amounts in thousands):

	September 30, 2001	September 30, 2000
	-----	-----
Money market fund	\$ 2	\$ 1
Demand deposit accounts	246	376
Petty cash	31	36
	-----	-----
	\$ 279	\$ 413
	=====	=====

#### NOTE 4 - INVENTORIES

Inventories consist of the following (amounts in thousands):

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	September 30, 2001	September 30, 2000
	-----	-----
Finished goods	\$ 3,921	\$ 4,757
Work in process	1,884	1,021
Supplies	237	65
	-----	-----
	\$ 6,042	\$ 5,843
	=====	=====

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 - PROPERTY AND EQUIPMENT

Property and equipment consist of the following (amounts in thousands):

	September 30, 2001	September 30, 2000
	-----	-----
Land	\$ 7,028	\$ 7,159
Land improvements	1,012	1,005
Leasehold improvements	1,138	1,121
Buildings	5,463	5,412
Furniture, fixtures and equipment	3,208	2,625
Vehicles	575	569
Construction in Process	--	14
Less: accumulated depreciation and amortization	(4,536)	(3,677)
	-----	-----
	\$ 13,888	\$ 14,228
	=====	=====

NOTE 6 - ACCRUED EXPENSES

Accrued expenses consist of the following (amounts in thousands):

	September 30, 2001	September 30, 2000
	-----	-----
Accrued salaries and related taxes and expenses	\$ 910	\$ 631
Accrued bonuses	20	324
Accrued property taxes	429	549
Accrued sales and use taxes	175	168
	-----	-----
	\$ 1,534	\$ 1,672
	=====	=====

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 7 - NOTES PAYABLE AND LONG-TERM DEBT

The Company entered into a \$5,000,000 revolving line of credit arrangement with a bank that matures on May 31, 2002 and is collateralized by inventory, accounts receivable and certain real property. The line of credit was established to supplement sources available to meet the Company's seasonal working capital needs. At September 30, 2001 and 2000 the outstanding balances were \$730,000 and \$55,000, respectively, and the unused available credit was \$4,270,000 and \$4,945,000, respectively. The interest rate is variable, tied to the bank's current prime lending rate. The interest rate was 5.5% at September 30, 2001.

Long-term debt consists of the following (amounts in thousands):

Description -----	September 30, 2001 -----	September 30, 2000 -----	Matures -----	Interest -----
1. Term loan, financial institution	\$ 1,053	\$ 4,625	September 2004	Variable
2. Term loan, financial institution	359	409	December 2006	Variable
3. Term loan, financial institution	853	889	August 2012	Variable (
4. Term loan, financial institution	241	270	July 2007	Variable (
5. Term loan, financial institution	939	1,003	October 2003	Variable
6. Term loan, financial institution	972	1,008	March 2015	Fixed 8
7. Term loan, financial institution	1,157	1,199	April 2015	Fixed 8
8. Term loan, financial institution	1,176	750	November 2020	Fixed 1
9. Term loan, financial institution	2,492	--	December 2015	Fixed 8
Capital lease	--	100	September 2001	N/A
Other	136	172		
	-----	-----		
Totals	9,378	10,425		
Less: amounts due within one year	(732)	(555)		
	-----	-----		
	\$ 8,646	\$ 9,870		
	=====	=====		

At September 30, 2000 the term loan described in (1) in the above table included amounts related to discontinued operations for 2000, which were refinanced in 2001.

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Maturities of long-term debt are as follows (amounts in thousands):

Year Ending September 30,	
2002	\$ 732
2003	696
2004	1,405
2005	1,965
2006	704
Thereafter	3,876
	-----
	\$ 9,378
	=====

At September 30, 2001 the Company was in compliance with all of its loan covenants.

### NOTE 8 - INCOME TAXES

Total income taxes for the years ended September 30, 2001, 2000 and 1999 were allocated as follows:

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Ended September 30, 1999
	-----	-----	-----
Income from continuing operations	\$ 812	\$ 1,300	\$ 408
Discontinued operations	(1,931)	(202)	--
	-----	-----	-----
	\$ (1,119)	\$ 1,098	\$ 408
	=====	=====	=====

Components of income tax expense (benefit) attributable to continuing operations consist of the following (amounts in thousands):

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Ended September 30, 1999
	-----	-----	-----
Current expense			
Federal	\$ 751	\$ 1,495	\$ 8
State	--	265	109
	-----	-----	-----
Total current	751	1,760	117
	-----	-----	-----
Deferred expense (benefit):			
Federal	61	(460)	291
	-----	-----	-----
Total deferred	61	(460)	291
	-----	-----	-----
Total expense	\$ 812	\$ 1,300	\$ 408
	=====	=====	=====



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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The differences between the Company's effective tax rate and the federal statutory tax rate of 34%, as applied to income from continuing operations before income taxes, for the fiscal years ended September 30, 2001, 2000 and 1999 are as follows (amounts in thousands):

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Ended September 30, 1999
	-----	-----	-----
Income tax expense at statutory rate	\$ 803	\$ 1,119	\$ 272
State income tax, net of federal benefit	--	175	72
Amortization of goodwill	37	37	37
Other, net	(28)	(31)	27
	-----	-----	-----
Total income tax expense	\$ 812	\$ 1,300	\$ 408
	=====	=====	=====
Effective tax rate	34.4%	39.5%	51.1%

Significant components of the Company's deferred tax assets and liabilities as of September 30, 2001 and 2000 are as follows (amounts in thousands):

	September 30, 2001	September 30, 2000
	-----	-----
Deferred tax liabilities:		
Basis difference in inventories	\$ --	\$ (118)
Gain on disposal of assets	(187)	--
	-----	-----
Total deferred tax liabilities	(187)	(118)
	-----	-----
Deferred tax assets:		
Deferred rent	353	390
State net operating loss carryforward	66	--
Inventory capitalization	55	--
Assets marked to market	203	203
Basis difference in property and equipment	679	755
	-----	-----
Total deferred tax assets	1,356	1,348
	-----	-----
Net deferred tax asset	\$ 1,169	\$ 1,230
	=====	=====

Management has determined that it is more likely than not that the Company's deferred tax assets will be realized; therefore, no valuation allowance was

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necessary as of September 30, 2001, 2000 and 1999. In assessing the need for a valuation allowance, management has considered future reversals of existing taxable temporary differences and future taxable income exclusive of such reversing differences. Positive evidence considered includes the Company's history of income from continuing operations before income taxes, and the availability of its existing net operating loss carryforwards. At September 30, 2001 the Company has net operating loss carryforwards of approximately \$178,000 for state income tax purposes.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 9 - SHAREHOLDERS' EQUITY

During 2001, 2000 and 1999, the Company issued shares of common stock to the Calloway's Nursery, Inc. Stock Purchase Plan (see Note 12) and upon the exercise of stock options (see Note 11), receiving proceeds as follows (amounts in thousands):

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Ended September 30, 1999
	-----	-----	-----
Number of shares issued	260	297	205
Proceeds	\$ 185	\$ 240	\$ 147
Compensation expense	140	124	116
	-----	-----	-----
	\$ 325	\$ 364	\$ 263
	=====	=====	=====

#### NOTE 10 - COMMON STOCK PURCHASE RIGHTS

Effective July 1991, the Company adopted a shareholder rights plan ("Rights Plan") that entitles each registered shareholder to one common share purchase right ("Right") per common share held. The Rights attach to all certificates representing outstanding shares of common stock; no separate Rights certificates have been distributed. The terms of the Rights Plan provide that in the event of an unapproved tender to acquire 20 percent or more of the Company's common stock, the Right holders, except as noted below, can purchase common stock at 50% of the then current market price. The Rights Plan also provides that all Rights held by parties to the unapproved tender shall be null and void; thus, such party cannot participate in the discounted purchase of common stock. The Rights are redeemable, at the Company's option, at any time at \$.01 per Right.

#### NOTE 11 - STOCK OPTION PLANS AND STOCK-BASED COMPENSATION

The Company's stock option plans provide for the awarding of incentive stock options to employees and non-qualified stock options to employees and independent directors. The employee plans are administered by the Compensation Committee of the Board of Directors, which consists entirely of independent directors. The independent director stock options are initially granted on a formula basis. Additional nonqualified stock options are provided to independent directors on an individual grant basis. All options are exercisable according to

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predetermined vesting schedules (all options vest within three years of the date of the grant) and remain in effect for ten years from the date of the grant. An aggregate of 2,267,000 shares of common stock have been reserved for issuance under the Company's stock option plans, including 302,000 shares in connection with the Company's 2000 Stock Option Plan that was approved in fiscal 2001.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As permitted by SFAS 123, the Company applies Accounting Principles Board (APB) Opinion 25 and related interpretations in accounting for its stock option plans. Accordingly, no expense has been recognized for its stock option plans, as the exercise price equals the stock price on the date of grant. Had compensation expense been determined for stock options granted based on the "fair value" at grant dates provided for in SFAS 123, the Company's pro forma net income (loss) and diluted net income (loss) per share for 2001, 2000 and 1999 would approximate the amounts below (amounts in thousands, except per share amounts):

	Year Ended September 30, 2001 -----	Year Ended September 30, 2000 -----	Year Ended September 30, 1999 -----
Net income (loss)	\$ (2,292)	\$ 1,667	\$ 326
Net income (loss) per share	\$ (.41)	\$ .25	\$ .06

The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future amounts. The pro forma amounts were estimated using the Black Scholes option-pricing model with the following assumptions:

	Year Ended September 30, 2001 -----	Year Ended September 30, 2000 -----	Year Ended September 30, 1999 -----
Weighted average expected life (years)	10	N/A	10
Expected volatility	90.75%	--	88.21%
Expected dividends	None	--	None
Risk free interest rate	5.68%	--	5.88%
Weighted average fair value of options granted	\$ 1.2763	N/A	\$ 1.0174

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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The following table summarizes activity in the stock option plans for the three years ended September 30, 2001:

	Shares	Weighted Average Exercise Price
	-----	-----
September 30, 1998	921,500	\$ 1.075
Granted	64,000	1.156
Exercised	400	1.000
Forfeited	--	--
Expired	--	--
	-----	-----
September 30, 1999	985,100	1.0806
Granted	--	--
Exercised	--	--
Forfeited	31,400	1.0645
Expired	--	--
	-----	-----
September 30, 2000	953,700	1.0800
Granted	122,000	1.4380
Exercised	3,500	1.0000
Forfeited	4,300	1.1163
Expired	--	--
	-----	-----
September 30, 2001	1,067,900	\$ 1.1221
	=====	=====
Exercisable, September 30, 2001	1,027,900	\$ 1.1220

The following table summarizes information regarding stock options outstanding at September 30, 2001:

Range of Exercise Prices	Options Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Prices	Options Exercisable	Weighted Average Exercise Prices
-----	-----	-----	-----	-----	-----
\$0.875 to \$1.188	938,900	4.6	\$ 1.0438	930,900	\$ 1.0428
\$1.189 to \$6.125	129,000	8.6	1.6923	97,000	1.7762
	-----	-----	-----	-----	-----
	1,067,900	5.1	\$ 1.1221	1,027,900	\$ 1.1120
	=====	=====	=====	=====	=====

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 - STOCK PURCHASE PLAN

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In 1992, the Company's Board of Directors and shareholders adopted a Stock Purchase Plan (the "Stock Purchase Plan"). The Stock Purchase Plan is designed to provide employees and directors with the opportunity to acquire an ownership interest in the Company and thereby provide those who will be responsible for the continued growth of the Company with a more direct concern about its welfare and a common interest with the Company's other shareholders. The Stock Purchase Plan is not subject to the Employee Retirement Income Security Act of 1974.

All employees who have attained the age of majority in the state of their residence and have completed 60 days of full-time employment with the Company, and all independent members of the Board of Directors, are eligible to participate in the Stock Purchase Plan. Participants may elect to have payroll deductions of a maximum of 10% of their compensation each pay period. The Company matches up to 100% of such deductions based upon the participant's years of continuous participation in the Stock Purchase Plan. Funds deducted from a participant's pay and contributions made by the Company to the Stock Purchase Plan on behalf of a participant (all of which is invested for the benefit of the participant) are taxable to the participant as wages or compensation for services. The Company contributions for the years ended September 30, 2001, 2000 and 1999 were \$140,000, \$124,000 and \$116,000, respectively.

### NOTE 13 - 401(K) PLAN

On January 1, 1999 the Company initiated a 401(k) plan for its employees. The 401(k) plan provides employees with a way to save and invest for their retirement. The Company does not provide matching contributions for the 401(k) plan.

### NOTE 14 - INDEMNITY AGREEMENTS

The Company has entered into indemnity agreements with members of the Board which, to the extent permitted under applicable law, indemnify such persons against all expenses, judgments, fines and penalties incurred in connection with the defense or settlement of actions brought against them by reason of the fact that they are or were directors or officers of the Company or assumed certain responsibilities while directing the Company.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In addition, the Company has entered into indemnity agreements with two officers of the Company that provide additional indemnification for all liabilities and expenses in respect of certain lease obligations of the Company that have been personally guaranteed by such officers. If the Company fails to indemnify either of the officers as required in the indemnity agreement or if either of these officers are terminated for any reason as an employee of the Company, the Company will provide the terminated officer with one or more bank letters of credit to cover an aggregate of \$4,000,000 of such liability; however, the Company shall not be obligated to provide letters of credit aggregating more than \$4,000,000 to these two officers.

### NOTE 15 - COMMITMENTS AND CONTINGENCIES

As of September 30, 2001 the Company leased twelve retail stores under noncancellable operating leases. The leases expire in various years through 2013. The leases generally contain renewal options for periods ranging from 5 to 15 years and require the Company to pay all executory costs (such as property taxes, maintenance and insurance). Rental payments include minimum rentals plus

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contingent rentals based on sales. The Company has not had to pay contingent rentals to date and does not expect to in the future.

Future minimum lease payments under noncancellable operating leases as of September 30, 2001 are as follows (amounts in thousands):

Year Ending September 30,	
2002	\$ 2,000
2003	1,645
2004	1,630
2005	1,187
2006	1,001
Thereafter	2,322
	-----
	\$ 9,785
	=====

Rental expense for operating leases during the fiscal years ended September 30, 2001, 2000 and 1999 was approximately \$2.1 million, \$2.1 million, and \$2.2 million, respectively.

There are various claims and pending actions incident to the business operations of the Company. In the opinion of management, the Company's potential liability in all pending actions and claims, in the aggregate, will not have a material adverse effect on the Company's financial position, results of operations or liquidity.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 16 - NET INCOME (LOSS) PER SHARE

A reconciliation between the weighted average shares outstanding used in the basic and diluted net income (loss) per share computations is as follows (in thousands, except per share amounts):

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Ended September 30, 1999
	-----	-----	-----
Net income (loss)	\$ (2,136)	\$ 1,667	\$ 391
Accretion of preferred stock	(303)	(261)	--
Retirement of preferred stock	--	115	--
	-----	-----	-----
Net income (loss) attributable to common shareholders	\$ (2,439)	\$ 1,521	\$ 391
	=====	=====	=====
Weighted average shares outstanding			
- basic	6,107	5,823	5,579
Effective of dilutive securities:			

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Assumed exercise of stock options	183	179	179
	-----	-----	-----
Weighted average shares outstanding			
- diluted	6,290	6,002	5,758
	=====	=====	=====
Net income (loss) per share:			
Basic	\$ (.40)	\$ .26	\$ .07
Diluted	\$ (.39)	\$ .25	\$ .07

For the years ended September 30, 2001 and 2000, 129,000 and 7,000 options respectively, were excluded from the diluted EPS computation because they would have been antidilutive.

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 17 - SELECTED QUARTERLY DATA (UNAUDITED)

Amounts (except share data) are expressed in thousands:

	FIRST QUARTER		SECOND QUARTER		THIRD QUARTER	
	2001	2000	2001	2000	2001	2000
Net Sales	\$ 9,912	\$ 10,882	\$ 7,423	\$ 9,454	\$ 20,251	\$
Gross Profit	4,684	5,096	3,564	4,572	10,760	
Income (loss) from continuing operations	(178)	31	(618)	86	3,319	
Net income (loss)	\$ (231)	\$ (227)	\$ (605)	\$ (120)	\$ (315)	\$
Income (loss) per share						
Basic						
Continuing operations	\$ (.04)	\$ .01	\$ (.11)	\$ --	\$ .53	\$
Discontinued operations	(.01)	(.04)	--	(.03)	(.59)	
	(.05)	(.03)	(.11)	(.03)	(.06)	
Diluted						
Continuing operations	(.04)	(.01)	(.11)	--	.53	
Discontinued operations	(.01)	(.04)	--	(.03)	(.59)	
	\$ (.05)	\$ (.03)	\$ (.11)	\$ (.03)	\$ (.06)	

In the third quarter of 2001 the Company recorded a loss from discontinued operations of \$3,674,000 (see Note 21).

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 18 - ACQUISITION OF CORNELIUS NURSERIES

On September 21, 1999 the Company completed the Cornelius Acquisition.

The Cornelius Acquisition, recorded under the purchase method of accounting, included the purchase of substantially all of the inventories and property, plant and equipment of Cornelius for cash of approximately \$8.5 million and \$4.0 million redemption value of non-dividend, preferred stock with a mandatory redemption after five years.

The purchase price totaled approximately \$11.8 million as follows (amounts in thousands):

Cash	\$ 8,500
Preferred stock, non-dividend, mandatory redemption after five years, \$4.0 million redemption value, at estimated fair value	1,890
Accounts payable	845
Acquisition costs	551
	-----
Total purchase price	\$ 11,786
	=====

The purchase price was allocated to assets acquired and liabilities assumed based on estimated fair market values at the date of the acquisition. Since the fair market value of assets acquired and liabilities assumed exceeded the purchase price, the resulting excess was allocated proportionately to reduce the carrying amounts of noncurrent assets, resulting in assets being recorded as follows (amounts in thousands):

Inventories	\$ 6,500
Property and equipment	5,286
	-----
Total assets	\$ 11,786
	=====

### NOTE 19 - PREFERRED STOCK WITH MANDATORY REDEMPTION PROVISIONS

On September 21, 1999 the Company issued 40,000 shares of Non-Voting Acquisition Preferred Stock (the "Preferred Stock"), \$.01 par value, in connection with the Cornelius Acquisition. The Preferred Stock has a liquidation preference of \$100 per share and no voting rights, except as otherwise required by law. The Company may, at any time prior to September 21, 2004, redeem any portion or all of the outstanding shares of Preferred Stock for \$100 per share. Any unredeemed shares outstanding at September 21, 2004 must be redeemed for \$100 per share.

The Preferred Stock was recorded at its estimated fair value of approximately \$1,890,000. The carrying amount of the Preferred Stock will be accreted at each balance sheet date to its redemption amount using the interest method. The resulting increase in the carrying amount of the Preferred Stock will reduce net income attributable to common shareholders or increase net loss attributable to common shareholders.

In October 1999 the Company redeemed 5,798 shares of Preferred Stock for a cash



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payment of \$158,500. The redeemed Preferred Stock had a redemption value of \$579,800 and a carrying amount of \$274,000.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 20 - SEGMENT INFORMATION

Through June 2001 the Company had two reportable segments: (i) retail, and (ii) wholesale and growing. On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations that had been a part of its wholesale and growing segment. Accordingly, the following segment information reflects the aforementioned two segments, as well as elimination of the wholesale operations from Consolidated Sales, Income from Continuing Operations before Income Taxes, Total Assets, Interest Income, Interest Expense and Depreciation and Amortization Expense. For future periods, the Company will have two reportable segments as follows: (i) retail, and (ii) growing.

The Company aggregates its individual retail stores because they are all managed in a similar way, they serve a similar type of customer, they use similar methods to distribute their products and services, they carry similar product lines, and they use similar marketing approaches. For example, the retail stores sell plants, garden supplies and other merchandise, primarily to individuals, on a cash-and-carry basis, at each retail store.

Likewise, the Company aggregates its two growing operations. These operations are distinguished from the retail segment, but are similar to each other, in the way they are managed, in the type of customer they serve, in the methods they use to produce and ship their products, in the product lines they carry, and in the way they market their products. For example, the growing segment operations sell plants to the Company's retail stores, and ship goods via truck to the retail stores.

The reporting segments follow the same accounting policies used for the Company's consolidated financial statements and described in the summary of significant accounting policies (see Note 2). Management evaluates a segment's performance based upon income before income taxes. Intersegment sales or transfers are recorded based upon prevailing market prices.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following is a tabulation of business segment information for each of the past three years. Intersegment elimination information is included to reconcile segment data to the consolidated financial statements. Amounts are in thousands:

	Year Ended September 30, 2001	Year Ended September 30, 2000	Year Septe 1
--	-------------------------------------	-------------------------------------	--------------------

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REVENUES

From external customers				
Retail	\$	43,385	\$	44,523
Growing		109		96
		-----		-----
Totals		43,494		44,619
		-----		-----
From other operating segments				
Retail		--		--
Growing		1,944		1,887
		-----		-----
Totals		1,944		1,887
		-----		-----
Intersegment Eliminations		(1,944)		(1,887)
		-----		-----
Total consolidated net sales	\$	43,494	\$	44,619
		=====		=====
		-----		-----
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES				
Retail	\$	2,113	\$	2,984
Growing		250		306
		-----		-----
Total consolidated income from continuing operations before income taxes	\$	2,363	\$	3,290
		=====		=====
		-----		-----
TOTAL ASSETS				
Retail	\$	21,973	\$	22,292
Growing		2,441		1,141
		-----		-----
Totals	\$	24,414	\$	23,433
		=====		=====
		-----		-----
INTEREST INCOME				
Retail	\$	36	\$	80
Growing		--		--
		-----		-----
Totals	\$	36	\$	80
		=====		=====
		-----		-----
INTEREST EXPENSE				
Retail	\$	1,023	\$	992
Growing		101		50
		-----		-----
Totals	\$	1,124	\$	1,042
		=====		=====
		-----		-----
DEPRECIATION AND AMORTIZATION EXPENSE				
Retail	\$	891	\$	887
Growing		15		15
		-----		-----
Totals	\$	906	\$	902
		=====		=====
		-----		-----

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 21 - DISCONTINUED OPERATIONS

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its wholesale and growing segment. The Company plans to exit its wholesale operations by the end of December 2001. Specifically, the Company ceased in an orderly fashion production and marketing of plants and related products grown or purchased for sale to wholesale customers, including other nursery retailers and landscape contractors. The wholesale operation included the wholesale growing operations of Turkey Creek Farms as well as the wholesale landscape distribution centers ("WLD") in Austin and Houston. At Turkey Creek Farms, the Company will exclusively grow plants for sale at its retail stores. The adopted disposal plan includes: (i) the sale of the Turkey Creek Farms wholesale inventories to unaffiliated customers, and (ii) the sale of the WLD operations as an ongoing business to an unaffiliated third party.

The Company has incurred operating losses and negative cash flows in the wholesale operations for most of the last two fiscal years. The continued pressure from lower cost wholesalers has impacted the profitability and competitive position of these operations. The Company has concluded that market conditions today and for the foreseeable future are such that these operations are likely to remain uncompetitive. Additionally, incremental future investments would not generate sufficient income to recover the cost of such investments.

The Company recorded a loss on disposal of discontinued operations of approximately \$2.9 million (net of income taxes) in the fiscal year ended September 30, 2001 to cover the expected cash and non-cash costs of the discontinued operations. The loss includes the write down to estimated net realizable value of the investment in facilities and equipment, inventory, and accounts receivable, as well as the accrual of anticipated operating losses during the period after the date the disposal plan was adopted, through the date the disposition is completed.

Prior to this decision, the Company grew plants for sale to external customers in addition to plants grown for sale in its retail stores. The Company intends to grow a greater amount of plants that are solely for sale in its retail stores.

The sale of the WLD operations was completed in October 2001 and indebtedness related to the WLD real property was paid off. The Turkey Creek Farms wholesale inventory has proceeded since August 2001, and is expected to be completely sold or otherwise disposed of by the end of December 2001.

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### CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Following is a summary of the asset and liabilities of the discontinued wholesale operations as of the applicable periods (amounts in thousands):

September 30, 2001	September 30, 2000
-----	-----

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Cash	\$	41	\$	--
Accounts receivable		717		818
Inventories		1,458		6,089
Property and equipment		631		--
		-----		-----
Current assets of discontinued operations	\$	2,847	\$	6,907
		=====		=====
Noncurrent assets of discontinued operations	\$	--	\$	637
		=====		=====
Accounts payable	\$	693	\$	799
Accrued expenses		495		250
Current portion of long-term debt		1,116		--
		-----		-----
Current liabilities of discontinued operations	\$	2,304	\$	1,049
		=====		=====

The property and equipment of the discontinued wholesale operations is classified as a current asset at September 30, 2001 since it was sold in October 2001. In addition, the debt related to such property is also classified as current at September 30, 2001 since it was paid off in October 2001 with the proceeds from the sale.

Following is a summary of the operating results of the discontinued wholesale operations for the applicable periods (amounts in thousands):

	Year ended September 30, 2001	Year ended September 30, 2000
	-----	-----
Sales	\$ 7,414	\$ 7,886
Cost of goods sold	6,485	5,395
	-----	-----
Gross profit	929	2,491
Expenses	2,139	3,016
	-----	-----
Loss from discontinued operations before income taxes	(1,210)	(525)
Income tax benefit	(416)	(202)
	-----	-----
Loss from discontinued operations	\$ (794)	\$ (323)
	=====	=====

The Company recorded a loss on disposal of discontinued operations (net of income tax) of \$2,893,000 for the fiscal year ended September 30, 2001. The loss included the expected loss on the disposal of the Turkey Creek Farms wholesale inventory, partially offset by expected gains on the sale of property and equipment and other assets, and estimated income tax benefits of \$1,515,000.

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Fiscal Year Ended September 30, 2001

## INDEX TO EXHIBITS

EXHIBIT NUMBER -----	DESCRIPTION -----
(3)	(a) Restated Articles of Incorporation of the Registrant. (Exhibit (3)(a))(1)
	(b) Form of Bylaws of the Registrant. (Exhibit (3)(b))(1)
	(c) Amendment to Bylaws Adopted on May 19, 1993. (Exhibit (3)(c))(1)
(4)	(a) Specimen Stock Certificate. (Exhibit (4)(a))(1)
	(b) Form of Shareholder Rights Plan. (Exhibit (4)(b))(1)
(10)	(a) Form of Employment Agreement dated July 3, 1991 between the Registrant and James C. Estill. (Exhibit (10)(a))(1)
	(b) Form of Employment Agreement dated July 3, 1991 between the Registrant and John T. Cosby. (Exhibit (10)(b))(1)
	(c) Form of Employment Agreement dated July 3, 1991 between the Registrant and John S. Peters. (Exhibit (10)(c))(1)
	(d) Left blank intentionally.
	(e) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and each of James C. Estill and John T. Cosby. (Exhibit (10)(g))(1)
	(f) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and John S. Peters. (Exhibit (10)(h))(1)
	(g) Form of Indemnity Agreement dated July 3, 1991 between the Registrant and each of Robert E. Glaze and Dr. Stanley Block. (Exhibit (10)(i))(1)
	(h) Extension of Employment Agreement between the Registrant and James C. Estill dated July 2, 1996. (Exhibit (10)(m))(2)
	(i) Extension of Employment Agreement between the Registrant and John T. Cosby dated July 2, 1996. (Exhibit (10)(n))(2)
	(j) Extension of Employment Agreement between the Registrant and John S. Peters dated July 2, 1996. (Exhibit (10)(o))(2)
	(k) Employment Agreement between the Registrant and C. Sterling Cornelius dated September 21, 1999.(9)
	(l) Extension of Employment Agreement between the Registrant and James C. Estill dated May 9, 2001. (Exhibit (10)(p))(3)
	(m) Extension of Employment Agreement between the Registrant and John T. Cosby dated May 9, 2001. (Exhibit (10)(q))(3)
	(n) Extension of Employment Agreement between the Registrant and John S. Peters dated May 9, 2001. (Exhibit (10)(r))(3)
	(o) Calloway's Nursery, Inc. Vice President of Merchandising Profit Improvement Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(s))(3)
	(p) Calloway's Nursery, Inc. Profit Improvement Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(t))(3)
	(q) Calloway's Nursery, Inc. Monthly Sales Gain Bonus Plan for the Fiscal Year Ending September 30, 2002. (Exhibit (10)(u))(3)
(21)	(a) Subsidiaries of the Registrant.(3)
(23)	(d) Consent of KPMG LLP.(3)
(99)	(a) Calloway's Nursery, Inc. Stock Purchase Plan. (Exhibit (28))(4)
(99)	(b) Calloway's Nursery, Inc. 1991 Stock Option Plan. (Exhibit

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(10) (d)) (1)

- (99) (c) Calloway's Nursery, Inc. 1995 Stock Option Plan for Independent Directors. (Exhibit (99) (c)) (5)
- (99) (d) Calloway's Nursery, Inc. 1997 Stock Option Plan. (Exhibit A) (6)
- (99) (e) Calloway's Nursery, Inc. 1998 Stock Option Plan. (Exhibit A) (7)
- (99) (f) Calloway's Nursery, Inc. 1999 Stock Option Plan. Exhibit A) (8)
- (99) (g) Cornelius Nurseries, Inc. and Turkey Creek Farms, Inc. Combined Financial Statements as of and for the years ended September 30, 1998 and 1997. (Exhibit 99.1) (9)
- (99) (h) Calloway's Nursery, Inc. and Subsidiaries Unaudited Pro Forma Condensed Financial Information as of June 30, 1999 and for the nine month period ended June 30, 1999 and for the year ended September 30, 1998. (Exhibit 99.2) (8)
- (99) (i) Calloway's Nursery, Inc. 2000 Stock Option Plan. (10)
- (99) (j) Form of Calloway's Nursery, Inc. 2001 Stock Option Plan. (3)
- (99) (k) Calloway's Nursery, Inc. 1996 Stock Option Plan. (Exhibit A) (11)

-----  
(1) Incorporated by reference to the Exhibit shown in parenthesis to Registration Statement No. 33-40473 on Form S-1, and amendments thereto, filed by the Company with the Securities and Exchange Commission and effective June 26, 1991.

(2) Incorporated by reference to the Exhibit shown in parenthesis to the Company's form 10-Q Report for the quarter ended June 30, 1996.

(3) Filed herewith.

(4) Incorporated by reference to the Exhibit shown in parenthesis to Registration Statement No. 33-46170 on Form S-8, and amendments thereto, filed by the Company with the Securities and Exchange Commission and effective March 3, 1992.

(5) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Form 10-K Report for the fiscal year ended September 30, 1995.

(6) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1998 Annual Meeting of Shareholders.

(7) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1999 Annual Meeting of Shareholders.

(8) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 2000 Annual Meeting of Shareholders.

(9) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Form 8-K Report filed October 1, 1999.

(10) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders.

(11) Incorporated by reference to the Exhibit shown in parenthesis to the Company's Proxy Statement for its 1997 Annual Meeting of Shareholders.