

LANDSTAR SYSTEM INC

Form 10-Q

May 05, 2006

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

(Mark One)

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

For the quarterly period ended April 1, 2006

OR

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

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

Commission File Number: 0-21238

**LANDSTAR SYSTEM, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction  
of incorporation or organization)

**06-1313069**

(I.R.S. Employer  
Identification No.)

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

(Address of principal executive offices)

**32224**

(Zip Code)

**(904) 398-9400**

(Registrant's telephone number, including area code)

**N/A**

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

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

Yes  No

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

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

Yes  No

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

FINANCIAL INFORMATION  
Index

**PART I**

**Item 1. Financial Statements**

Consolidated Balance Sheets as of April 1, 2006 and December 31, 2005 Page 3

Consolidated Statements of Income for the Thirteen Weeks Ended April 1, 2006 and March 26, 2005 Page 4

Consolidated Statements of Cash Flows for the Thirteen Weeks Ended April 1, 2006 and March 26, 2005 Page 5

Consolidated Statement of Changes in Shareholders' Equity for the Thirteen Weeks Ended April 1, 2006 Page 6

Notes to Consolidated Financial Statements Page 7

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations** Page 11

**Item 3. Quantitative and Qualitative Disclosures About Market Risk** Page 19

**Item 4. Controls and Procedures** Page 19

**PART I**

Item 1. Financial Statements

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

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

---

LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

(Unaudited)

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

Edgar Filing: LANDSTAR SYSTEM INC - Form 10-Q

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

See accompanying notes to consolidated financial statements.

3

---

LANDSTAR SYSTEM, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share amounts)

(Unaudited)

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

See accompanying notes to consolidated financial statements.



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

(Dollars in thousands)

(Unaudited)

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



Edgar Filing: LANDSTAR SYSTEM INC - Form 10-Q

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

See accompanying notes to consolidated financial statements.

5

---

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

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

See accompanying notes to consolidated financial statements.

6

---

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

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

(1) Share-Based Payments

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

Retrospective Application

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

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

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

Share-based payment arrangements

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

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

#### Employee and director stock option plans

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

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

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

#### Summary details for plan stock options

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

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

Edgar Filing: LANDSTAR SYSTEM INC - Form 10-Q

Forfeited/expired

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

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

8

---

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

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

(2) Dividends on Common Stock

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

(3) Income Taxes

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

(4) Earnings Per Share

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

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

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

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

(5) Additional Cash Flow Information

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

## (6) Segment Information

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

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

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

## (7) Comprehensive Income

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

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

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

## (8) Commitments and Contingencies

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

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



Independent Contractors violate certain federal leasing regulations and seeks injunctive relief, an unspecified amount of damages and attorney's fees. On March 8 and June 4, 2004, the Court dismissed all claims of one of the six individual Plaintiffs on the grounds that the ICC Termination Act (the Act) is not applicable to leases signed before the Act's January 1, 1996 effective date, and dismissed all claims of all remaining Plaintiffs against four of the seven Company entities previously named as defendants. Claims currently survive against the following Company entities: Landstar Inway, Inc., Landstar Ligon, Inc. and Landstar Ranger, Inc. (the Defendants). With respect to the remaining claims, the June 4, 2004 order held that the Act created a private right of action to which a four-year statute of limitation applies. On April 7, 2005, Plaintiffs amended the Complaint (the Amended Complaint) to include additional allegations with respect to violations of certain federal leasing regulations. On August 30, 2005, the Court granted a motion by Plaintiffs to certify the case as a class action. On October 19, 2005, the U.S. Court of Appeals for the Eleventh Circuit denied the Defendants' petition for permission to file an interlocutory appeal of the class-certification order.

Discovery is ongoing in the case, which is set for a jury trial in October 2006, whether all issues will be decided at that October trial is unknown. On January 13, 2006, the Plaintiffs filed a motion for partial summary judgment on liability. On February 15, 2006, the Defendants filed their opposition to that motion and their own motion for partial summary judgment to address the claims of the Amended Complaint. The Defendants' motion for partial summary judgment filed February 15, 2006 supersedes and replaces prior motions for partial summary judgment filed with the Court on April 18 and June 10, 2005. On March 6, 2006, the Plaintiffs filed their opposition to the Defendants' motion for partial summary judgment. The District Court is expected to rule prior to trial on the pending motions for partial summary judgment.

Due to a number of factors, including the unresolved motions for summary judgment, the incomplete state of discovery in this matter, particularly classwide and expert discovery, the fact that it is not certain which issues will be decided during the October 2006 trial and the lack of litigated final judgments in a number of similar cases or otherwise applicable precedents, the Company does not believe it is in a position to conclude whether or not there is a reasonable possibility of an adverse outcome in this case or what damages, if any, Plaintiffs would be awarded should they prevail on all or any part of their claims. However, the Company believes it has meritorious defenses, including to the expanded allegations in the Amended Complaint, and it intends to continue asserting these defenses vigorously. In addition, as a result of recent developments in an insurance coverage dispute relating to the litigation described immediately above, the Company believes it is reasonably probable that it will recover a significant portion of the costs, including legal fees, incurred in defending such litigation.

The Company is involved in certain other claims and pending litigation arising from the normal conduct of business. Based on knowledge of the facts and, in certain cases, opinions of outside counsel, management believes that adequate provisions have been made for probable losses with respect to the resolution of all such other claims and pending litigation and that the ultimate outcome, after provisions thereof, will not have a material adverse effect on the financial condition of the Company, but could have a material effect on the results of operations in a given quarter or year.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the attached interim consolidated financial statements and notes thereto, and with the Company's audited financial statements and notes thereto for the fiscal year ended December 31, 2005 and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2005 Annual Report on Form 10-K.

### **Introduction**

Landstar System, Inc. and its subsidiary, Landstar System Holdings, Inc. (together, referred to herein as "Landstar" or the "Company"), provide transportation services to a variety of market niches throughout the United States and to a lesser extent in Canada, and between the United States and Canada, Mexico and other countries through its operating subsidiaries. Landstar's business strategy is to be a non-asset based provider of transportation capacity and logistics services delivering safe, specialized transportation services globally, utilizing a network of independent commission sales agents and third party capacity providers. Landstar focuses on providing transportation services which emphasize safety, customer service and information coordination among its independent commission sales agents, customers and capacity providers. The Company markets its services primarily through independent commission sales agents and exclusively utilizes third party capacity providers to transport customers' freight. The nature of the Company's business is such that a significant portion of its operating costs varies directly with revenue. The Company has three reportable business segments. These are the carrier, global logistics and insurance segments.

The carrier segment consists of Landstar Ranger, Inc., Landstar Inway, Inc., Landstar Ligon, Inc., Landstar Gemini, Inc. and Landstar Carrier Services, Inc. The carrier segment primarily provides transportation services to the truckload market for a wide range of general commodities over irregular or non-repetitive routes utilizing dry and specialty vans and unsided trailers, including flatbed, drop deck and specialty. It also provides short-to-long haul movement of containers by truck, dedicated power-only truck capacity and truck brokerage. The carrier segment markets its services primarily through independent commission sales agents and utilizes independent contractors who provide truck capacity to the Company under exclusive lease arrangements (the "Business Capacity Owner Independent Contractors" or "BCO Independent Contractors") and other third party truck capacity providers under

non-exclusive contractual arrangements ( Truck Brokerage Carriers ).

The global logistics segment is comprised of Landstar Global Logistics, Inc. and its subsidiaries, Landstar Logistics, Inc. and Landstar Express America, Inc. Transportation and logistics services provided by the global logistics segment include the arrangement of multimodal (ground, air, ocean and rail) moves, contract logistics, truck brokerage, emergency and expedited ground, air and ocean freight and buses. The global logistics segment markets its services primarily through independent commission sales agents and utilizes capacity provided by BCO Independent Contractors and other third party capacity providers, including Truck Brokerage Carriers, railroads, air and ocean cargo carriers and bus providers.

The insurance segment is comprised of Signature Insurance Company ( Signature ), a wholly-owned offshore insurance subsidiary, and Risk Management Claim Services, Inc. The insurance segment provides risk and claims management services to Landstar's operating subsidiaries. In addition, it reinsures certain risks of the Company's BCO Independent Contractors and provides certain property and casualty insurance directly to Landstar's operating subsidiaries.

### Changes in Financial Condition and Results of Operations

Management believes the Company's success principally depends on its ability to generate freight through its network of independent commission sales agents and to efficiently deliver that freight utilizing third party capacity providers. Management believes the most significant factors to the Company's success include increasing revenue, sourcing capacity and controlling costs.

While customer demand, which is subject to overall economic conditions, ultimately drives increases or decreases in revenue, the Company primarily relies on its independent commission sales agents to establish customer relationships and generate revenue opportunities. Management's primary focus with respect to revenue growth is revenue generated by independent commission sales agents who on an annual basis generate \$1 million or more of Landstar revenue ( Million Dollar Agents ). Management believes future revenue growth is primarily dependent on its ability to increase both the revenue generated by Million Dollar Agents and the number of Million Dollar Agents through a combination of recruiting new agents and increasing the revenue opportunities generated by existing independent commission sales agents.

During the 2005 fiscal year, 466 independent commission sales agents generated \$1 million or more of Landstar's revenue and thus qualified as Million Dollar Agents. During the 2005 fiscal year, the average revenue generated by a Million Dollar Agent was \$5,063,000 and revenue generated by Million Dollar Agents in the aggregate represented 94% of consolidated Landstar revenue.

Management monitors business activity by tracking the number of loads (volume) and revenue per load generated by the carrier and global logistics segments. In addition, management tracks revenue per revenue mile, average length of haul and total revenue miles at the carrier segment. Revenue per revenue mile and revenue per load (collectively, price) as well as the number of loads, can be influenced by many factors which do not necessarily indicate a change in price or volume. Those factors include the average length of haul, freight type, special handling and equipment requirements and delivery time requirements. The following table summarizes this data by reportable segment:

	Thirteen Weeks Ended	
	April 1, 2006	March 26, 2005
<u>Carrier Segment:</u>		
External revenue generated through (in thousands):		
BCO Independent Contractors	\$ 303,793	\$ 282,675
Truck Brokerage Carriers	124,520	88,368
	\$ 428,313	\$ 371,043
Revenue per revenue mile	\$ 1.99	\$ 1.80
Revenue per load	\$ 1,580	\$ 1,444
Average length of haul (miles)	793	802

Edgar Filing: LANDSTAR SYSTEM INC - Form 10-Q

Number of loads	271,000	257,000
<u>Global Logistics Segment:</u>		
External revenue generated through (in thousands):		
BCO Independent Contractors(1)	\$ 24,832	\$ 17,838
Truck Brokerage Carriers	100,627	79,081
Rail, air, ocean and bus carriers(2)	47,966	26,777
	\$ 173,425	\$ 123,696
Revenue per load(3)	\$ 1,500	\$ 1,541
Number of loads(3)	92,000	76,000

(1) Includes revenue from freight hauled by carrier segment BCO Independent Contractors for global logistics customers.

(2) Included in the 2006 thirteen week period was \$10,856,000 of revenue attributable to buses provided under contract between Landstar Express America, Inc. and the United States Department of Transportation/Federal Aviation Administration (the FAA ).

(3) Number of loads and revenue per load exclude the effect of \$35,449,000 in 2006 and \$7,300,000 in 2005 of revenue derived from emergency transportation services provided under the FAA contract.

Also critical to the Company's success is its ability to secure capacity, particularly truck capacity, at rates that allow the Company to profitably transport customers' freight. The following table summarizes available truck capacity:

	April 1, 2006	March 26, 2005
BCO Independent Contractors	8,219	7,828
Truck Brokerage Carriers:		
Approved and active(1)	13,698	11,737
Other approved	8,381	7,255
	22,079	18,992
 Total available truck capacity providers	 30,298	 26,820
 Number of trucks provided by BCO Independent Contractors	 8,932	 8,659

(1) Active refers to Truck Brokerage Carriers who moved at least one load in the 180 days immediately preceding the fiscal quarter end.

Historically, the Company's carrier segment has primarily relied on capacity provided by BCO Independent Contractors. Pursuant to a continuing plan to augment its available capacity and increase its revenue, the Company has been increasing the carrier segment's use of capacity provided by Truck Brokerage Carriers. The percent of consolidated revenue generated through all Truck Brokerage Carriers was 38.7% during the first quarter of 2006 and 33.3% during the first quarter of 2005.

The Company incurs costs that are directly related to the transportation of freight that include purchased transportation and commissions to agents. The Company incurs indirect costs associated with the transportation of freight that include other operating costs and insurance and claims. In addition, the Company incurs selling, general and administrative costs essential to administering its business operations. Management continually monitors all components of the costs incurred by the Company and establishes annual cost budgets which, in general, are used to benchmark costs incurred on a monthly basis.

Purchased transportation represents the amount a BCO Independent Contractor or other third party capacity provider is paid to haul freight. The amount of purchased transportation paid to a BCO Independent Contractor is primarily based on a contractually agreed-upon percentage of revenue generated by the haul. Purchased transportation for the brokerage services operations of the carrier segment is based on a negotiated rate for each load hauled. Purchased transportation for the brokerage services operations of the global logistics segment is based on either a negotiated rate for each load hauled or a contractually agreed-upon rate. Purchased transportation for the rail intermodal, air and ocean freight operations of the global logistics segment is based on a contractually agreed-upon fixed rate. Purchased transportation for bus services is based upon a negotiated rate per mile or per day. Purchased

transportation as a percentage of revenue for truck brokerage services, rail intermodal and bus operations is normally higher than that of Landstar's other transportation operations. Purchased transportation is the largest component of costs and expenses and, on a consolidated basis, increases or decreases in proportion to the revenue generated through BCO Independent Contractors, other third party capacity providers and revenue from the insurance segment.

Commissions to agents are based on contractually agreed-upon percentages of revenue or gross profit, defined as revenue less the cost of purchased transportation, at the carrier segment and of gross profit at the global logistics segment. Commissions to agents as a percentage of consolidated revenue will vary directly with fluctuations in the percentage of consolidated revenue generated by the carrier segment, the global logistics segment and the insurance segment and with changes in gross profit at the global logistics segment and the truck brokerage operations of the carrier segment.

Trailing equipment rent, maintenance costs for trailing equipment, BCO Independent Contractor recruiting costs and bad debts from BCO Independent Contractors and independent commission sales agents are the largest components of other operating costs.

Potential liability associated with accidents in the trucking industry is severe and occurrences are unpredictable. Landstar's retained liability for individual commercial trucking claims depends on when such claims are incurred. For commercial trucking claims incurred prior to June 19, 2003 and subsequent to March 30, 2004, Landstar retains liability up to \$5,000,000 per occurrence. For commercial trucking claims incurred from June 19, 2003 through March 30, 2004, Landstar retains liability up to \$10,000,000 per occurrence. The Company also retains liability for each general liability claim up to \$1,000,000, \$250,000 for each workers' compensation claim and \$250,000 for each cargo claim. The Company's exposure to liability associated with accidents incurred by other third party capacity providers who haul freight on behalf of the Company is reduced by various factors including the extent to which they maintain their own insurance coverage. A material increase in the frequency or severity of accidents, cargo or workers compensation claims or the unfavorable development of existing claims could be expected to materially adversely affect Landstar's results of operations.

Employee compensation and benefits account for over half of the Company's selling, general and administrative costs.

Depreciation and amortization primarily relate to depreciation of trailing equipment and management information services equipment.

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

The following table sets forth the percentage relationships of income and expense items to revenue for the periods indicated:

	Thirteen Weeks Ended	
	April	March
	1,	26,
	2006	2005
Revenue	100.0%	100.0%
Investment income	0.0	0.1
Costs and expenses:		
Purchased transportation	75.1	75.2
Commissions to agents	7.7	7.8
Other operating costs	2.0	1.7
Insurance and claims	1.9	2.6
Selling, general and administrative	5.9	6.3
Depreciation and amortization	0.6	0.8
Total costs and expenses	93.2	94.4



Edgar Filing: LANDSTAR SYSTEM INC - Form 10-Q

Operating income	6.8	5.7
Interest and debt expense	0.3	0.2
Income before income taxes	6.5	5.5
Income taxes	2.5	2.2
Net income	4.0%	3.3%

## THIRTEEN WEEKS ENDED APRIL 1, 2006 COMPARED TO THIRTEEN WEEKS ENDED MARCH 26, 2005

Revenue for the 2006 thirteen week period was \$610,042,000, an increase of \$107,830,000, or 21.5%, compared to the 2005 thirteen week period. The increase was attributable to increased revenue of \$57,270,000, \$49,729,000 and \$831,000 at the carrier, global logistics and insurance segments, respectively. With respect to the carrier segment, revenue per load increased approximately 9% in the 2006 thirteen week period while the number of loads delivered in the 2006 thirteen week period increased approximately 5%. The average length of haul per load at the carrier segment decreased approximately 1%, however, revenue per revenue mile increased approximately 11%. Included in revenue at the global logistics segment for the 2006 and 2005 thirteen week periods were \$35,449,000 and \$7,300,000, respectively, of revenue related to disaster relief efforts for the storms that impacted the United States. These emergency transportation services were provided primarily under a contract between Landstar Express America, Inc. and the United States Federal Aviation Administration ( FAA ). Excluding the number of loads and revenue related to disaster relief efforts provided by the global logistics segment in the 2006 and 2005 thirteen week periods, the number of loads delivered by the global logistics segment in the 2006 thirteen week period increased approximately 21%, while revenue per load decreased approximately 3% over the 2005 thirteen week period.

Investment income at the insurance segment was \$379,000 and \$539,000 in the 2006 and 2005 thirteen week periods, respectively. The decrease in investment income was primarily due to a reduction in assets available for investment as these assets were used to finance a portion of the \$215,250,000 year end receivable from the FAA.

Purchased transportation was 75.1% and 75.2% of revenue in 2006 and 2005, respectively. The decrease in purchased transportation as a percentage of revenue was primarily attributable to increased revenue provided for disaster relief services under the FAA contract which tends to have a lower cost of purchased transportation, partially offset by increased truck brokerage revenue, which tends to have a higher cost of purchased transportation. Commissions to agents were 7.7% and 7.8% of revenue in 2006 and 2005, respectively. The decrease in commissions to agents as a percentage of revenue was primarily attributable to a change in revenue mix. Other operating costs were 2.0% of revenue in 2006 and 1.7% of revenue in 2005. The increase in other operating costs as a percentage of revenue was primarily attributable to trailer rental costs incurred in support of disaster relief services under the FAA contract, partially offset by reduced trailer rent and maintenance costs, as a result of the Company's on going effort to reduce the cost of Company provided trailing equipment. Insurance and claims were 1.9% of revenue in 2006 compared with 2.6% of revenue in 2005. The decrease in insurance and claims as a percentage of revenue was primarily attributable to an increase in truck brokerage revenue and rail intermodal, which tend to have a lower claims risk profile compared to revenue generated through BCO Independent Contractors, a lower frequency of trucking accidents in the 2006 period compared to the 2005 period and the unfavorable development of prior years claims during the 2005 period. Selling, general and administrative costs were 5.9% of revenue in 2006 compared with 6.3% of revenue in 2005. The decrease in selling, general and administrative costs as a percentage of revenue was primarily attributable to increased revenue, partially offset by an increased provision for bonuses under the Company's incentive compensation plans and an increased provision for customer bad debt. Depreciation and amortization was 0.6% and 0.8% of revenue in 2006 and 2005, respectively. The decrease in depreciation and amortization as a percentage of revenue compared to 2005 was attributable to the effect of increased revenue.

Interest and debt expense was 0.3% and 0.2% of revenue in 2006 and 2005, respectively. The increase in interest and debt expense as a percentage of revenue was primarily attributable to increased interest rates and increased borrowings under the Company's revolving credit facility which were used to finance a portion of the receivable from the FAA.

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

Net income was \$24,350,000, or \$0.41 per common share (\$0.41 per diluted share), in the 2006 thirteen week period compared with \$16,818,000, or \$0.28 per common share (\$0.27 per diluted share), in the 2005 thirteen week period. The 2006 and 2005 thirteen week periods included stock compensation expense of \$1,411,000 and \$1,512,000, respectively, \$944,000 and \$1,060,000, respectively, net of related income tax benefits. Stock compensation expense

reduced earnings per common share \$0.02 (\$0.02 per diluted share) in both the 2006 and 2005 thirteen week periods.

## USE OF NON-GAAP FINANCIAL MEASURES

In this quarterly report on Form 10-Q, Landstar provided the following information that may be deemed non-GAAP financial measures: (1) revenue per load for the global logistics segment excluding revenue and loads related to emergency transportation services provided primarily under a contract with the FAA and (2) the percentage change in revenue per load for the global logistics segment excluding revenue and loads related to emergency transportation services provided primarily under a contract with the FAA as compared to revenue per load for the global logistics segment for the corresponding prior year period. This financial information should be considered in addition to, and not as a substitute for, the corresponding GAAP financial information also presented in this Form 10-Q.

Management believes that it is appropriate to present this financial information for the following reasons: (1) a significant portion of the emergency relief transportation services were provided under the FAA contract on the basis of a daily rate for the use of transportation equipment in question, and therefore load and per load information is not necessarily available or appropriate for a significant portion of the related revenue, (2) disclosure of the effect of the emergency transportation services provided by Landstar relating to disaster relief efforts for the storms that impacted the United States will allow investors to better understand the underlying trends in Landstar's financial condition and results of operations, (3) this information will facilitate comparisons by investors of Landstar's results as compared to the results of peer companies and (4) management considers this financial information in its decision making.

## CAPITAL RESOURCES AND LIQUIDITY

Shareholders' equity was \$273,690,000 at April 1, 2006, compared to \$255,689,000 at December 31, 2005. The increase in shareholders' equity was primarily a result of net income for the period and exercises of stock options, partially offset by the purchase of 249,300 shares of the Company's common stock at a total cost of \$11,131,000. At April 1, 2006, the Company may purchase up to an additional 2,275,927 shares of its common stock under its authorized stock purchase programs. Shareholders' equity was 72% of total capitalization (defined as total debt plus equity) at April 1, 2006 compared to 60% at December 31, 2005.

Long-term debt including current maturities was \$103,985,000 at April 1, 2006, \$62,988,000 lower than at December 31, 2005, primarily as a result of collecting \$107,000,000 during the thirteen week period ended April 1, 2006 of the \$215,250,000 December 31, 2005 receivable from the FAA.

Working capital and the ratio of current assets to current liabilities were \$269,736,000 and 1.97 to 1, respectively, at April 1, 2006, compared with \$317,359,000 and 2.1 to 1, respectively, at December 31, 2005. Landstar has historically operated with current ratios within the range of 1.5 to 1 to 2.0 to 1. Cash provided by operating activities was \$97,538,000 in the 2006 thirteen week period compared with \$42,305,000 in the 2005 thirteen week period. The increase in cash flow provided by operating activities was primarily attributable to the timing of collections of trade accounts receivable, including a portion of the receivable from the FAA for emergency transportation services provided during the later half of fiscal 2005, and increased earnings.

On July 8, 2004, Landstar renegotiated its existing credit agreement with a syndicate of banks and JPMorgan Chase Bank, as administrative agent (the Fourth Amended and Restated Credit Agreement). The Fourth Amended and Restated Credit Agreement provides \$225,000,000 of borrowing capacity in the form of a revolving credit facility, \$75,000,000 of which may be utilized in the form of letter of credit guarantees.

At April 1, 2006, the Company had \$60,000,000 in borrowings outstanding and \$27,219,000 of letters of credit outstanding under the Fourth Amended and Restated Credit Agreement. At April 1, 2006, there was \$137,781,000 available for future borrowings under the Company's Fourth Amended and Restated Credit Agreement. In addition, the Company has \$39,054,000 in letters of credit outstanding, as collateral for insurance claims, that are secured by investments and cash equivalents totaling \$41,241,000.

On February 2, 2006, the Company announced that its Board of Directors declared a cash dividend of \$0.025 per share with respect to its outstanding shares of common stock. The distribution date for this cash dividend was on February 28, 2006, to stockholders of record on February 14, 2006. It is the intention of the Board of Directors to pay a quarterly dividend going forward.

Historically, the Company has generated sufficient operating cash flow to meet its debt service requirements, fund continued growth, both internal and through acquisitions, and to meet working capital needs. As a non-asset based

provider of transportation capacity and logistics services, the Company's annual capital requirements for operating property are generally for trailers and

management information services equipment. In addition, a significant portion of the trailing equipment used by the Company is provided by third party capacity providers and through leases at rental rates that vary with the revenue generated through the use of the leased equipment, thereby reducing the Company's capital requirements. During the 2006 thirteen week period, the Company purchased \$668,000 of operating property. Landstar anticipates acquiring approximately \$44,000,000 of operating property during the remainder of the 2006 fiscal year either by purchase or by lease financing. It is expected that capital leases will fund any significant acquisitions of Company provided trailing equipment made during 2006.

Management believes that cash flow from operations combined with the Company's borrowing capacity under the Fourth Amended and Restated Credit Agreement will be adequate to meet Landstar's debt service requirements, fund continued growth, both internal and through acquisitions, pay dividends, complete the authorized share purchase programs and meet working capital needs.

#### LEGAL MATTERS

On November 1, 2002, the Owner Operator Independent Drivers Association, Inc. (OOIDA) and six individual independent contractors who provide truck capacity to the Company under exclusive lease arrangements (BCO Independent Contractors) and collectively with OOIDA, the Plaintiffs) filed a putative class action complaint (the Complaint) in the United States District Court for the Middle District of Florida (the Court) in Jacksonville, Florida, against the Company. The Complaint alleges that certain aspects of the Company's motor carrier leases with its BCO Independent Contractors violate certain federal leasing regulations and seeks injunctive relief, an unspecified amount of damages and attorney's fees. On March 8 and June 4, 2004, the Court dismissed all claims of one of the six individual Plaintiffs on the grounds that the ICC Termination Act (the Act) is not applicable to leases signed before the Act's January 1, 1996 effective date, and dismissed all claims of all remaining Plaintiffs against four of the seven Company entities previously named as defendants. Claims currently survive against the following Company entities: Landstar Inway, Inc., Landstar Ligon, Inc. and Landstar Ranger, Inc. (the Defendants). With respect to the remaining claims, the June 4, 2004 order held that the Act created a private right of action to which a four-year statute of limitation applies. On April 7, 2005, Plaintiffs amended the Complaint (the Amended Complaint) to include additional allegations with respect to violations of certain federal leasing regulations. On August 30, 2005, the Court granted a motion by Plaintiffs to certify the case as a class action. On October 19, 2005, the U.S. Court of Appeals for the Eleventh Circuit denied the Defendants' petition for permission to file an interlocutory appeal of the class-certification order.

Discovery is ongoing in the case, which is set for a jury trial in October 2006, whether all issues will be decided at that October trial is unknown. On January 13, 2006, the Plaintiffs filed a motion for partial summary judgment on liability. On February 15, 2006, the Defendants filed their opposition to that motion and their own motion for partial summary judgment to address the claims of the Amended Complaint. The Defendants' motion for partial summary judgment filed February 15, 2006 supersedes and replaces prior motions for partial summary judgment filed with the Court on April 18 and June 10, 2005. On March 6, 2006, the Plaintiffs filed their opposition to the Defendants' motion for partial summary judgment. The District Court is expected to rule prior to trial on the pending motions for partial summary judgment.

Due to a number of factors, including the unresolved motions for summary judgment, the incomplete state of discovery in this matter, particularly classwide and expert discovery, the fact that it is not certain which issues will be decided during the October 2006 trial and the lack of litigated final judgments in a number of similar cases or otherwise applicable precedents, the Company does not believe it is in a position to conclude whether or not there is a reasonable possibility of an adverse outcome in this case or what damages, if any, Plaintiffs would be awarded should they prevail on all or any part of their claims. However, the Company believes it has meritorious defenses, including to the expanded allegations in the Amended Complaint, and it intends to continue asserting these defenses vigorously. In addition, as a result of recent developments in an insurance coverage dispute relating to the litigation described immediately above, the Company believes it is reasonably probable that it will recover a significant portion of the costs, including legal fees, incurred in defending such litigation.

The Company is involved in certain other claims and pending litigation arising from the normal conduct of business. Based on knowledge of the facts and, in certain cases, opinions of outside counsel, management believes

that adequate provisions have been made for probable losses with respect to the resolution of all such other claims and pending litigation and that the ultimate outcome, after provisions thereof, will not have a material adverse effect on the financial condition of the Company, but could have a material effect on the results of operations in a given quarter or year.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The allowance for doubtful accounts for both trade and other receivables represents management's estimate of the amount of outstanding receivables that will not be collected. Historically, management's estimates for uncollectible receivables have been materially correct. Although management believes the amount of the allowance for both trade and other receivables at April 1, 2006 is appropriate, a prolonged period of low or no economic growth may adversely affect the collection of these receivables. Conversely, a more robust economic environment may result in the realization of some portion of the estimated uncollectible receivables.

Landstar provides for the estimated costs of self-insured claims primarily on an actuarial basis. The amount recorded for the estimated liability for claims incurred is based upon the facts and circumstances known on the balance sheet date. The ultimate resolution of these claims may be for an amount greater or less than the amount estimated by management. Historically, the Company has experienced both favorable and unfavorable development of prior year claims estimates. The Company continually revises its existing claim estimates as new or revised information becomes available on the status of each claim. During the 2006 thirteen week period, insurance and claims costs included \$859,000 of favorable adjustments to prior years claims estimates. During the 2005 thirteen week period, insurance and claims costs included \$1,404,000 of unfavorable adjustments to prior years claims estimates. It is reasonably likely that the ultimate outcome of settling all outstanding claims will be more or less than the estimated claims reserve at April 1, 2006.

The Company utilizes certain income tax planning strategies to reduce its overall cost of income taxes. Upon audit, it is possible that certain strategies might be disallowed resulting in an increased liability for income taxes. The Company has provided for its estimated exposure attributable to income tax planning strategies. Management believes that the provision for liabilities resulting from the implementation of income tax planning strategies is appropriate. To date, the Company has not experienced an examination by governmental revenue authorities that would lead management to believe that the Company's past provisions for exposures related to income tax planning strategies are not appropriate.

Significant variances from management's estimates for the amount of uncollectible receivables, the ultimate resolution of claims or the provision for liabilities for income tax planning strategies can be expected to positively or negatively affect Landstar's earnings in a given quarter or year. However, management believes that the ultimate resolution of these items, given a range of reasonably likely outcomes, will not significantly affect the long-term financial condition of Landstar or its ability to fund its continuing operations.

## EFFECTS OF INFLATION

Management does not believe inflation has had a material impact on the results of operations or financial condition of Landstar in the past five years. However, inflation higher than that experienced in the past five years might have an adverse effect on the Company's results of operations.

## SEASONALITY

Landstar's operations are subject to seasonal trends common to the trucking industry. Results of operations for the quarter ending in March are typically lower than the quarters ending June, September and December.

## FORWARD-LOOKING STATEMENTS

The following is a safe harbor statement under the Private Securities Litigation Reform Act of 1995. Statements contained in this document that are not based on historical facts are forward-looking statements. This Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Form 10-Q statement contain forward-looking statements, such as statements which relate to Landstar's business objectives, plans, strategies and expectations. Terms such as anticipates, believes, estimates, expects, plans, predicts, may, could, will, the negative thereof and similar expressions are intended to identify forward-looking statements. Such statements are by nature subject to uncertainties and risks, including but not limited to: an increase in the frequency or severity of accidents or workers' compensation claims; unfavorable development of existing accident claims; dependence on independent commission sales agents; dependence on third party capacity providers; disruptions or failures in our computer systems; a downturn in domestic economic growth or growth in the transportation sector; substantial industry competition; and other operational, financial or legal risks or uncertainties detailed in Landstar's Form 10-K for the 2005 fiscal year, described in Item 1A Risk Factors, this report or in Landstar's other Securities and



Exchange Commission filings from time to time. These risks and uncertainties could cause actual results or events to differ materially from historical results or those anticipated.

Investors should not place undue reliance on such forward-looking statements and the Company undertakes no obligation to publicly update or revise any forward-looking statements.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to changes in interest rates as a result of its financing activities, primarily its borrowings on the revolving credit facility, and investing activities with respect to investments held by the insurance segment.

On July 8, 2004, Landstar entered into a new senior credit facility with a syndicate of banks and JPMorgan Chase Bank, as administrative agent (the Fourth Amended and Restated Credit Agreement). The Fourth Amended and Restated Credit Agreement, which expires on July 8, 2009, provides \$225,000,000 of borrowing capacity in the form of a revolving credit facility, \$75,000,000 of which may be utilized in the form of letter of credit guarantees.

The Fourth Amended and Restated Credit Agreement contains a number of covenants that limit, among other things, the incurrence of additional indebtedness, the incurrence of operating or capital lease obligations and the purchase of operating property. Landstar is required to, among other things, maintain minimum levels of Consolidated Net Worth and Fixed Charge Coverage, as each is defined in the Fourth Amended and Restated Credit Agreement.

Borrowings under the Fourth Amended and Restated Credit Agreement bear interest at rates equal to, at the option of Landstar, either (i) the greatest of (a) the prime rate as publicly announced from time to time by JPMorgan Chase Bank, (b) the three month CD rate adjusted for statutory reserves and FDIC assessment costs plus 1% and (c) the federal funds effective rate plus 1/2%, or, (ii) the rate at the time offered to JPMorgan Chase Bank in the Eurodollar market for amounts and periods comparable to the relevant loan plus a margin that is determined based on the level of the Company's Leverage Ratio, as defined in the Fourth Amended and Restated Credit Agreement. The margin is subject to an increase of 0.125% if the aggregate amount outstanding under the Fourth Amended and Restated Credit Agreement exceeds 50% of the borrowing capacity. As of April 1, 2006, the weighted average interest rate on borrowings outstanding was 5.45%. During the first quarter of fiscal 2006, the average outstanding balance under the Fourth Amended and Restated Credit Agreement was approximately \$109,665,000. Based on the borrowing rates in the Fourth Amended and Restated Credit Agreement and the repayment terms, the fair value of the outstanding borrowings as of April 1, 2006 was estimated to approximate carrying value. Assuming that debt levels on the Fourth Amended and Restated Credit Agreement remain at \$60,000,000, the balance at April 1, 2006, a hypothetical increase of 100 basis points in current rates provided for under the Fourth Amended and Restated Credit Agreement is estimated to result in an increase in interest expense of \$600,000 on an annualized basis.

All amounts outstanding on the Fourth Amended and Restated Credit Agreement are payable on July 8, 2009, the expiration of the Fourth Amended and Restated Credit Agreement.

The Company's obligations under the Fourth Amended and Restated Credit Agreement are guaranteed by all but one of Landstar System Holdings, Inc.'s subsidiaries.

Long-term investments, all of which are available-for-sale, consist of investment grade bonds having maturities of up to five years. Assuming that the long-term portion of investments in bonds remains at \$20,745,000, the balance at April 1, 2006, a hypothetical increase or decrease in interest rates of 100 basis points would not have a material impact on future earnings on an annualized basis. Short-term investments consist of short-term investment grade instruments and the current maturities of investment grade bonds. Accordingly, any future interest rate risk on these short-term investments would not be material.

### Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was carried out, under the supervision and with the participation of the Company's management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended). Based on that evaluation, the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of April 1, 2006, to provide reasonable assurance that information required to be disclosed by the Company in reports that it filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There were no significant changes in the Company's internal controls over financial reporting during the Company's fiscal quarter ended April 1, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

On November 1, 2002, the Owner Operator Independent Drivers Association, Inc. ( OOIDA ) and six individual independent contractors who provide truck capacity to the Company under exclusive lease arrangements ( BCO Independent Contractors ) and collectively with OOIDA, the Plaintiffs ) filed a putative class action complaint (the Complaint ) in the United States District Court for the Middle District of Florida (the Court ) in Jacksonville, Florida, against the Company. The Complaint alleges that certain aspects of the Company's motor carrier leases with its BCO Independent Contractors violate certain federal leasing regulations and seeks injunctive relief, an unspecified amount of damages and attorney's fees. On March 8 and June 4, 2004, the Court dismissed all claims of one of the six individual Plaintiffs on the grounds that the ICC Termination Act (the Act ) is not applicable to leases signed before the Act's January 1, 1996 effective date, and dismissed all claims of all remaining Plaintiffs against four of the seven Company entities previously named as defendants. Claims currently survive against the following Company entities: Landstar Inway, Inc., Landstar Ligon, Inc. and Landstar Ranger, Inc. (the Defendants ). With respect to the remaining claims, the June 4, 2004 order held that the Act created a private right of action to which a four-year statute of limitation applies. On April 7, 2005, Plaintiffs amended the Complaint (the Amended Complaint ) to include additional allegations with respect to violations of certain federal leasing regulations. On August 30, 2005, the Court granted a motion by Plaintiffs to certify the case as a class action. On October 19, 2005, the U.S. Court of Appeals for the Eleventh Circuit denied the Defendants' petition for permission to file an interlocutory appeal of the class-certification order.

Discovery is ongoing in the case, which is set for a jury trial in October 2006, whether all issues will be decided at that October trial is unknown. On January 13, 2006, the Plaintiffs filed a motion for partial summary judgment on liability. On February 15, 2006, the Defendants filed their opposition to that motion and their own motion for partial summary judgment to address the claims of the Amended Complaint. The Defendants' motion for partial summary judgment filed February 15, 2006 supersedes and replaces prior motions for partial summary judgment filed with the Court on April 18 and June 10, 2005. On March 6, 2006, the Plaintiffs filed their opposition to the Defendants' motion for partial summary judgment. The District Court is expected to rule prior to trial on the pending motions for partial summary judgment.

Due to a number of factors, including the unresolved motions for summary judgment, the incomplete state of discovery in this matter, particularly classwide and expert discovery, the fact that it is not certain which issues will be decided during the October 2006 trial and the lack of litigated final judgments in a number of similar cases or otherwise applicable precedents, the Company does not believe it is in a position to conclude whether or not there is a reasonable possibility of an adverse outcome in this case or what damages, if any, Plaintiffs would be awarded should they prevail on all or any part of their claims. However, the Company believes it has meritorious defenses, including to the expanded allegations in the Amended Complaint, and it intends to continue asserting these defenses vigorously. In addition, as a result of recent developments in an insurance coverage dispute relating to the litigation described immediately above, the Company believes it is reasonably probable that it will recover a significant portion of the costs, including legal fees, incurred in defending such litigation.

The Company is involved in certain other claims and pending litigation arising from the normal conduct of business. Based on knowledge of the facts and, in certain cases, opinions of outside counsel, management believes that adequate provisions have been made for probable losses with respect to the resolution of all such other claims and pending litigation and that the ultimate outcome, after provisions thereof, will not have a material adverse effect on the financial condition of the Company, but could have a material effect on the results of operations in a given quarter or year.

### Item 1A. Risk Factors

For a discussion identifying risk factors and other important factors that could cause actual results to differ materially from those anticipated, see the discussion under Part I, Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the fiscal year

ended December 31, 2005 and in Management's Discussion and Analysis of Financial Condition and Results of Operations and Notes to Consolidated Financial Statements in this Quarterly Report on Form 10-Q. There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005 in response to Part I, Item 1A of that form.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

##### Purchases of Equity Securities by the Company

The following table provides information regarding the Company's purchases of its common stock during the period from December 31, 2005 to April 1, 2006, the Company's first fiscal quarter:

Fiscal period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced programs	Maximum number of shares that may yet be purchased under the programs
Dec. 31, 2005				
Jan. 28, 2006				2,525,227
Jan. 29, 2006				
Feb. 25, 2006				
Feb. 26, 2006				
Apr. 1, 2006	249,300	\$ 44.65	249,300	2,275,927
Total	249,300	\$ 44.65	249,300	

On February 2, 2006, Landstar System, Inc. announced that its Board of Directors declared a cash dividend of \$0.025 per share with respect to its outstanding shares of common stock. The distribution date for this cash dividend was on February 28, 2006, to stockholders of record on February 14, 2006. It is the intention of the Board of Directors to pay a quarterly dividend going forward.

On April 28, 2005, Landstar System, Inc. announced that it had been authorized by its Board of Directors to purchase up to an additional 2,000,000 shares of its common stock from time to time in the open market and in privately-negotiated transactions.

On July 28, 2005, Landstar System, Inc. announced that it had been authorized by its Board of Directors to purchase up to an additional 2,000,000 shares of its common stock from time to time in the open market and in privately negotiated transactions.

No specific expiration dates have been assigned to the authorizations.

#### Item 3. Defaults Upon Senior Securities

None.

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

None.

#### Item 5. Other Information

None.

#### Item 6. Exhibits

The exhibits listed on the Exhibit Index are furnished as part of this quarterly report on Form 10-Q.



EXHIBIT INDEX

Registrant's Commission File No.: 0-21238

Exhibit No.	Description
(31)	Certifications Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002:
31.1*	Chief Executive Officer certification, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Chief Financial Officer certification, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
(32)	Certifications Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002:
32.1**	Chief Executive Officer certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Chief Financial Officer certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith

\*\* Furnished  
herewith

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LANDSTAR SYSTEM, INC.

Date: May 5, 2006

/s/ Henry H. Gerkens  
Henry H. Gerkens  
President and Chief Executive Officer

Date: May 5, 2006

/s/ Robert C. LaRose  
Robert C. LaRose  
Executive Vice President and Chief  
Financial Officer

23