DEERE & CO
Form 11-K
February 21, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 11-K

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

For the fiscal year ended October 31, 2016

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

For the transition period from _______ to _______

COMMISSION FILE NUMBER 1-4121

A. Full title of the plan and the address of the plan, if different from that of the issuer named below:

JOHN DEERE SAVINGS AND INVESTMENT PLAN

B. Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:

DEERE & COMPANY
ONE JOHN DEERE PLACE
MOLINE, ILLINOIS 61265

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REQUIRED INFORMATION

1. The Financial Statements and Schedule of the John Deere Savings and Investment Plan prepared in accordance with the financial reporting requirements of the Employee Retirement Income Security Act of 1974, as amended.

Exhibit 23. Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm

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JOHN DEERE SAVINGS AND INVESTMENT PLAN

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All other schedules required by Section 2520.103-10 of the Department of Labor s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 have been omitted because they are not applicable.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Participants in the John Deere Savings and Investment Plan:

We have audited the accompanying statements of net assets available for benefits of the John Deere Savings and Investment Plan (the Plan) as of October 31, 2016 and 2015, and the related statement of changes in net assets available for benefits for the year ended October 31, 2016. These financial statements are the responsibility of the Plan s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the net assets available for benefits of the Plan as of October 31, 2016 and 2015, and the changes in net assets available for benefits for the year ended October 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

The supplemental schedule of assets (held at end of year) as of October 31, 2016, has been subjected to audit procedures performed in conjunction with the audit of the Plan s financial statements. The supplemental schedule is the responsibility of the Plan s management. Our audit procedures included determining whether the supplemental schedule reconciles to the financial statements or the underlying accounting and other records, as applicable, and performing procedures to test the completeness and accuracy of the information presented in the supplemental schedule. In forming our opinion on the supplemental schedule, we evaluated whether the supplemental schedule, including its form and content, is presented in compliance with the Department of Labor s Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. In our opinion, such schedule is fairly stated, in all material respects, in relation to the financial statements as a whole.

/s/ DELOITTE & TOUCHE LLP

Chicago, Illinois

February 21, 2017

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JOHN DEERE SAVINGS AND INVESTMENT PLAN

STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS
AS OF OCTOBER 31, 2016 AND 2015 (IN THOUSANDS)

ASSETS:	2016	2015
PARTICIPANT-DIRECTED INVESTMENTS		
Investment in John Deere Savings Plans Master Trust	$ 4,956,907	$ 4,713,356
RECEIVABLES - Loans to participants	42,103	42,763
NET ASSETS AVAILABLE FOR BENEFITS	$ 4,999,010	$ 4,756,119

See notes to financial statements.

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JOHN DEERE SAVINGS AND INVESTMENT PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS
FOR THE YEAR ENDED OCTOBER 31, 2016 (IN THOUSANDS)

ADDITIONS:		
CONTRIBUTIONS:		
Participant	$	171,701
Company		159,362
Total contributions		331,063
INVESTMENT INCOME - Net participation in activity of John Deere Savings Plans Master Trust		173,447
Net transfers from affiliate plan		1,659
Interest on participant loans		2,152
TOTAL ADDITIONS		508,321
DEDUCTIONS:		
Benefits paid to participants		265,133
Administrative expenses		297
Total deductions		265,430
INCREASE IN NET ASSETS		242,891
NET ASSETS AVAILABLE FOR BENEFITS:		
Beginning of year		4,756,119
End of year	$	4,999,010

See notes to financial statements.

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JOHN DEERE SAVINGS AND INVESTMENT PLAN

NOTES TO FINANCIAL STATEMENTS AS OF

OCTOBER 31, 2016 AND 2015 AND FOR THE YEAR ENDED OCTOBER 31, 2016

1. DESCRIPTION OF PLAN

The following is a general description of the John Deere Savings and Investment Plan (the Plan). This description applies to each of the years for which financial statements are presented and provides only general information. For a more complete description of the Plan s provisions, participants should refer to the Plan agreement.

Deere & Company (the Company) maintains two defined contribution plans in the U.S. for the benefit of its employees. The investment assets of these plans are commingled and held in the John Deere Savings Plans Master Trust (the Master Trust). These plans are the John Deere Savings and Investment Plan and the John Deere Tax Deferred Savings Plan for Wage Employees. Each of the participating plans has an interest in the net assets of the Master Trust and changes therein.

General The Plan was established July 1, 1984 by the Company for eligible employees of the Company and its subsidiaries. The purpose of the Plan is to encourage those employees to provide for their financial security through regular tax advantaged savings and to assist them through matching contributions from the Company s profits. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The Deere & Company 401(k) Benefits Committee is the administrator of the Plan. Fidelity Management Trust Company, Boston, Massachusetts (Fidelity), is the Plan trustee (Trustee), and Fidelity Investment Institutional Operations Company, Inc., an affiliate of the Trustee, is the recordkeeper (collectively, Fidelity).

Eligibility Employees are eligible to participate in the Plan immediately upon hire if they are salaried or certain non-bargained hourly employees on the United States payroll of the Company or its participating subsidiaries.

Contributions An eligible employee may elect to become a participant in the Plan by contacting Fidelity to authorize the Company to withhold contributions from his or her compensation during the period of participation. The Plan provides for automatic enrollment of all eligible newly-hired employees at a three percent deferral rate. The Plan has an Annual Increase Program whereby newly hired eligible employees will have their deferral rates automatically increased by one percent every March 1st until changed by the employee. Participant contributions and investment elections are processed through Fidelity using a voice-response system, on-line through NetBenefits, or through a Fidelity representative. Participant contributions can range from one percent to 75 percent of compensation, as elected by the participant, as limited by the Internal Revenue Code (IRC). Participants may amend or revoke their elections as of the next occurring payroll period. The Plan accepts Roth elective contributions, as well as Roth catch-up contributions, made on behalf of eligible participants which are allocated to a separate account source.

The Company provides matching contributions to employees participating in the Plan up to a maximum of six percent of the employee s earnings, as limited by the IRC. The percentage is determined in accordance with the Plan agreement, and is based on the profitability of the Company during the preceding fiscal year ended October 31.

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Contributions are sent to Fidelity as soon as practicable following each payroll period, and are invested by Fidelity in the funds as specified by participants. Monies will be held and invested by Fidelity in a BlackRock Lifepath Index Fund closest to the employee s 65th birthday (the default investment option) until designated investments have been elected by the participant.

All contributions are considered tax deferred under section 401(a) of the IRC, with the exception of Roth elective deferrals, which are made on an after-tax basis.

Effective January 1, 1997, the Plan was modified to incorporate changes which occurred with the introduction of a new defined benefit pension plan for salaried employees. The modification created a Traditional Option and a Contemporary Option. Participants were required to make a one-time, irrevocable election of one of these options. Generally, employees hired on or after November 1, 1996, are permitted to participate in only the Contemporary Option.

Traditional Option Under this option, participant and Company contributions are calculated as previously described and participants are fully vested in their account balance at all times.

Contemporary Option Participants who elected the Contemporary Option receive a higher matching contribution from the Company than participants in the Traditional Option. In the Contemporary Option, the Company match is three times greater for the first two percent of participant contributions than the next four percent. For participants with less than three years of service, the matching contributions to the Contemporary Option do not vest until the participant has completed their third year of service.

Participant Accounts Individual accounts are maintained for each Plan participant. Each participant s account is credited with contributions made by the participant and the Company together with earnings and losses allocated daily among participants based on the ratio of their respective account balances as of the preceding day. Participants are immediately vested in their contributions and allocated earnings or losses. Except for participants in the Contemporary Option with less than three years of service, the participant also is immediately vested in the matching contributions from the Company. The benefit to which a participant is entitled is one that can be provided from the participant s vested account balance.

Forfeited Accounts At October 31, 2016 and 2015, forfeited nonvested accounts totaled $343,747 and $212,053, respectively. These accounts will be used to reduce future Company contributions. During the year ended October 31, 2016, Company contributions were reduced by $1,035,432 from forfeited nonvested accounts.

Fund Elections Participants in the Plan direct the investment of their account balances into one or more investment funds which include the following as of October 31, 2016:

- Blended Interest Fund

- Wells Fargo Core Plus Bond Fund
- Deere & Company Common Stock Fund*
- Any of 22 Common Collective Trust Funds
- Mutual Fund

*Beginning January 27, 2014, participants may not invest more than 20% of their future contributions in the Deere & Company Common Stock Fund. As of this same date, exchanges into the Deere & Company Common Stock Fund may not result in more than a 20% investment in the Deere & Company Stock Fund.

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In addition, participants have access to Fidelity BrokerageLink, which is a self-directed brokerage account. Through this account, a participant has access to over 3,000 open-ended mutual funds from a variety of fund families.

The Plan includes an Employee Stock Ownership Plan and dividend payout feature whereby participants may elect to receive dividends on their vested shares of Company common stock in the Deere & Company Common Stock Fund in either cash or as a reinvestment in Company common stock. If no election is made, the default option is reinvestment in Company common stock.

Loans Employees who participate in the Plan are eligible to borrow against their account balances. Loans must be at least $1,000 and are limited to the lesser of $50,000 (reduced by the participant s highest outstanding loan balance during the immediately preceding one year period) or 50 percent of their vested account balances on the effective dates of the loans, and the term of the loan may not exceed five years (ten years if the loan proceeds are used to purchase a primary residence). The loans are secured by the balance in the participant s account and interest is assessed at a rate which is determined based on the published prime interest rate. Repayment for actively employed participants is intended to be made via payroll deductions. A participant with an outstanding loan at the time of unpaid leave of absence, retirement, or separation from service may opt to continue making loan payments through the financial institution of their choice, which sends payments to Fidelity via Automated Clearing House transfers. A minimum of one payment must be made each quarter (equal to all payments due for the quarter) to keep the loan current. The entire loan must be repaid within five years of the effective date of the loan or the original loan term, whichever is less. Failure by the participant to make a quarterly payment or pay the loan off within five years of inception or the original loan term, whichever is less, will result in the outstanding loan balance becoming a taxable distribution to the participant. If an eligible participant elects to take full distribution of his account balance and a loan balance remains, the entire loan balance remaining will be taxable.

Payment of Benefits Distributions are not permitted while the participants are employed by the Company unless a distribution is required to meet legal requirements or the participant has reached age 59-1/2. Participants who have terminated employment with the Company or retired may elect an immediate distribution or may defer the start of distributions up to age 70-1/2. Retired and separated participants with vested balances of $1,000 or less are required to take full distribution of their account. The beneficiary of a participant who died may elect a deferred distribution payable no later than five years after the participant s death. Distributions from the Deere & Company Common Stock Fund may be in cash or whole shares and residual cash. Distributions from all of the other funds are in cash.

Participants may take a lump-sum distribution or elect one of the following distribution options:

(a) Level Sum Distribution A specified dollar amount is distributed monthly.

(b) Decremental Distribution A decremental withdrawal is made over a specified period of time.

(c) Unscheduled, Partial Distribution Unscheduled amounts are distributed at the discretion of the participant with a minimum distribution of $1,000.

(d) Mandated Distribution after 70-1/2 By April 1 of the year following the year in which the participant turns 70-1/2, if no longer employed by the Company, the participant must either take a lump sum distribution or begin systematic withdrawals which are actuarially determined.

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Hardship Withdrawals Participants in the Plan, under Internal Revenue Service (IRS) guidelines, may request hardship withdrawals for heavy and immediate financial needs which cannot be reasonably met from other resources of the participant. A hardship withdrawal results in a six-month suspension of participant contributions and Company matching contributions. Only one hardship withdrawal is allowed in a 12-month period.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting The Plan s financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).

Use of Estimates The preparation of financial statements in conformity with GAAP requires Plan management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and changes therein and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Risks and Uncertainties The Plan utilizes various investment instruments, including mutual funds, common collective trusts, common stock, fixed income securities, and investment contracts. Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the value of the participants account balances and the amounts reported in the financial statements.

Valuation of Investments Investments are stated at fair value except for the Blended Interest Fund which is recorded at contract value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Deere & Company Common Stock Fund Fair value is based on the closing sales price reported on recognized securities exchanges on the last business day of the fiscal year. The Deere & Company Common Stock Fund is maintained on a unit value basis and includes a money market fund for liquidity purposes. The number of units and related net asset value per unit as of October 31, 2016 and 2015 for the fund are as follows:

	Master Trust	**Plan**	**Net Asset**

The interest rate on borrowings under the revolving credit facility is based on either the Bank s prime rate or LIBOR and varies depending on the Company s leverage ratio, as defined, determined quarterly. As of February 29, 2004, the applicable interest rate was the prime rate or LIBOR plus 2.75%, and the Company had elected the LIBOR option for substantially all amounts outstanding under the facility. The Company has fixed the interest rate on $8 million of outstanding borrowings under the facility, and the balance of outstanding borrowings bears interest at a floating rate. At February 29, 2004, the average interest rate on all borrowings under the facility was 5.80%. Borrowings under the revolving credit facility are limited to 85% of eligible accounts receivable and 50% of eligible inventory amounts (which increases to 65% of eligible inventory amounts during certain specified months of the year). At February 29, 2004, the Company s available credit under the facility was approximately $2.3 million.

The Agreement provides a capital expenditure term loan facility of $1 million for capital assets. As of February 29, 2004, the Company had borrowed $856,000 under the capital expenditure facility. Of such borrowings, $419,000 was outstanding at February 29, 2004, and is repaid in equal monthly principal installments of $14,266, plus interest. The Agreement also provides for financing the purchase of certain real estate and improvements. At February 29, 2004, the Company had indebtedness to the Bank for real estate loans of $529,000, secured by a deed of trust on real estate either leased or used as a branch facility in the Houston area, which is repaid in equal monthly principal installments of $6,463, plus interest. Both the real estate and the capital expenditures loan facilities bear interest at a variable rate, which were the prime rate or LIBOR plus 2.75% at February 29, 2004.

The Company has significant commitments for non-cancelable operating leases as of February 29, 2004. The majority of such commitments is for office and warehouse space occupied by the Company s branch operations. The Company also has operating leases for vehicles and office equipment. Management believes that its capital resources are better utilized for working capital needed to support the growth of operations than for investment in real property and other capital assets that may be leased.

The Company s future contractual obligations and potential commercial commitments as of February 29, 2004 are summarized as follows:

	Payments Due by Period				
	(in thousands)				
		Less than	1-3	4-5	After 5
Contractual Obligations	Total	1 year	years	years	years
Revolving credit facility	$ 21,086	$	$ 21,086	$	$
Long-term debt	1,752	283	489	216	764
	299	123	167	9	

Capital lease obligations					
Operating leases	18,521	5,195	7,420	3,800	2,107
	$ 41,658	$ 5,601	$ 29,162	$ 4,025	$ 2,871

Other Commercial Commitments	**Amounts Committed**	**Expiration Per Period Less Than 1 Year**
Consigned inventory	$ 5,466	$ 5,466

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The Company expects that cash flows from operations and the borrowing availability under its revolving credit facility will provide sufficient liquidity to meet its normal operating requirements, debt service and expected capital expenditures. The Company has engaged in negotiations to expand the capacity of its loan facilities and to extend the maturity dates, but has not yet decided whether to conclude such negotiations. Management believes that the Company will generate cash flow from operations in fiscal 2005, and has no plans that would require a significant investment of additional working capital. Subject to limitations set forth in its loan agreement with the Bank, funds available under the Company s revolving credit facility may also be utilized to finance acquisitions. However, management is not presently evaluating any acquisition opportunities.

Seasonality

The Company s sales volume and, accordingly, its operating income vary significantly during its fiscal year. The highest levels of sales occur during the times of the year when climatic conditions require the greatest use of air conditioning, since the Company s operations are concentrated in the warmer regions of the United States. Accordingly, sales will be highest in the Company s second quarter ending August 31, and will be lowest in its fourth fiscal quarter.

Inflation

The Company does not believe that inflation has had a material effect on its results of operations in recent years. Generally, manufacturer price increases attributable to inflation uniformly affect both the Company and its competitors, and such increases are passed through to customers as an increase in sales prices.

Recently Issued Accounting Standards

In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others . The Interpretation requires certain guarantees to be recorded at fair value and also requires a guarantor to make certain disclosures regarding guarantees. The Interpretation s initial recognition and initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements became effective for the Company s first quarter of fiscal 2004. The adoption of the Statement had no material impact on the Company s financial position or results of operations.

In January 2003, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor . EITF 02-16 clarifies certain aspects for accounting and recording of consideration received from vendors. Certain provisions of the EITF are effective for fiscal years beginning after December 15, 2002, and other provisions of the EITF are effective for arrangements entered into after November 21, 2003. The Company s historical accounting for consideration received from vendors is consistent with the provisions of EITF 02-16. Therefore, the adoption of this standard has not had a material impact on the Company s financial statements.

In January 2003, the FASB issued Interpretation 46, Consolidation of Variable Interest Entities. In general, a variable interest entity is a corporation, partnership, trust, or other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns or both. The Interpretation is effective for all interest entities created after January 31, 2003 and is effective in the third quarter for any variable interest entities created before February 1, 2003. The adoption of the Interpretation did not have nor is expected to have a material impact on its financial statements.

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Safe Harbor Statement

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements, which are other than statements of historical facts. Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially. The Company s expectations and beliefs are expressed in good faith and are believed by the Company to have a reasonable basis but there can be no assurance that management s expectations, beliefs or projections will be achieved or accomplished. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided under the securities laws. In addition to other factors and matters discussed elsewhere herein, the following are important factors that, in the view of the Company, could cause actual results to differ materially from those discussed in the forward-looking statements: the ability of the Company to continue to expand through acquisitions, the availability of debt or equity capital to fund the Company s expansion program, unusual weather conditions, the effects of competitive pricing and general economic conditions.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The Company is subject to market risk exposure related to changes in interest rates on its senior credit facility, which includes revolving credit and term notes. These instruments carry interest at a pre-agreed upon percentage point spread from either the prime interest rate or LIBOR. Under its senior credit facility the Company may, at its option, fix the interest rate for certain borrowings based on a spread over LIBOR for 30 days to 6 months. At February 29, 2004 the Company had $22.0 million outstanding under its senior credit facility, of which $14.0 million is subject to variable interest rates. Based on this balance, an immediate change of one percent in the interest rate would cause a change in interest expense of approximately $140,000, or $.01 per basic share, on an annual basis.

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Item 8. Financial Statements and Supplementary Data.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

OF ACR GROUP, INC. AND SUBSIDIARIES

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders

ACR Group, Inc.

We have audited the accompanying consolidated balance sheets of ACR Group, Inc. and subsidiaries as of February 29, 2004 and February 28, 2003, and the related consolidated statements of operations, shareholders equity and cash flows for each of the three years in the period ended February 29, 2004. Our audits also included the financial statement schedule listed in the index at Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of ACR Group, Inc. and subsidiaries at February 29, 2004 and February 28, 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended February 29, 2004, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective March 1, 2002, the Company changed its method of accounting for goodwill.

ERNST & YOUNG LLP

Houston, Texas

May 13, 2004

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ACR GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands)

ASSETS

	February 29, 2004	February 28, 2003
Current assets:		
Cash	$ 52	$ 104
Accounts receivable, net of allowance for doubtful accounts of $793 in 2004 and $685 in 2003	18,120	15,202
Inventory	27,833	24,997
Prepaid expenses and other	1,120	311
Deferred income taxes	1,167	1,458
Total current assets	48,292	42,072
Property and equipment, net of accumulated depreciation	4,461	4,955
Goodwill, net of accumulated amortization of $1,038 in 2004 and 2003	5,258	5,258
Other assets	716	443
Total assets	$ 58,727	$ 52,728

The accompanying notes are an integral part of these financial statements

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ACR GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

LIABILITIES AND SHAREHOLDERS EQUITY

	February 29, 2004	February 28, 2003
Current liabilities:		
Current maturities of long-term debt	$ 283	$ 316
Current maturities of capital lease obligations	123	87
Accounts payable	18,756	16,967
Accrued liabilities and other liabilities	3,249	2,097
Total current liabilities	22,411	19,467
Revolving line of credit	21,086	20,172
Long-term debt	1,469	1,808
Long-term capital lease obligations	176	95
Deferred taxes	219	
Total long-term obligations	22,950	22,075
Shareholders equity:		
Preferred stock. $.01 par, authorized 2,000,000 shares, none outstanding		
Common stock, $.01 par, authorized 25,000,000 shares, 10,681,294 issued and outstanding in 2004 and 2003	107	107
Additional paid-in capital	41,691	41,691
Accumulated deficit	(28,432)	(30,612)
Total shareholders equity	13,366	11,186
Total liabilities and shareholders equity	$ 58,727	$ 52,728

The accompanying notes are an integral part of these financial statements

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ACR GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	February 29,	February 28,	
	2004	**2003**	**2002**
Sales	$ 174,353	$ 161,822	$ 155,490
Cost of sales	135,795	126,149	121,920
Gross profit	38,558	35,673	33,570
Selling, general and administrative expenses	34,106	32,983	31,473
Operating income	4,452	2,690	2,097
Interest expense	1,510	1,731	2,086
Other non-operating (income)	(491)	(474)	(531)
Income before income taxes and cumulative effect of accounting change	3,433	1,433	542
Provision for income taxes:			
Current	743	79	123
Deferred	510	251	
Income before cumulative effect of accounting change	2,180	1,103	419
Cumulative effect of accounting change, net of taxes		(483)	
Net income	$ 2,180	$ 620	$ 419
Basic and dilutive earnings per share:			
Before cumulative effect of accounting change	$ .20	$ .10	$ .04
Cumulative effect of accounting change		(.04)	
	$ .20	$ .06	$ .04

The accompanying notes are an integral part of these financial statements

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ACR GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(in thousands, except share data)

	No. of shares outstanding	Par Value	Additional Paid-in Capital	Accumulated Deficit	Total
Balance, February 28, 2001	10,681,294	$ 107	$ 41,691	$ (31,651)	$ 10,147
Net income				419	419
Balance, February 28, 2002	10,681,294	107	41,691	(31,232)	10,566
Net income				620	620
Balance, February 28, 2003	10,681,294	107	41,691	(30,612)	11,186
Net income				2,180	2,180
Balance, February 29, 2004	10,681,294	$ 107	$ 41,691	$ (28,432)	$ 13,366

The accompanying notes are an integral part of these financial statements

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ACR GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	February 29,	February 28,	
	2004	**2003**	**2002**
Operating activities:			
Net income	$ 2,180	$ 620	$ 419
Adjustments to reconcile net income to net cash provided by (used in)			
Operating activities:			
Depreciation	969	1,168	1,133
Amortization	13	94	300
Provision for doubtful accounts	696	418	704
Gain on sale of assets	(27)	(7)	(21)
Deferred income taxes	510		
Cumulative effect of accounting change		483	
Changes in operating assets and liabilities:			
Accounts receivable	(3,614)	1,238	(1,586)
Inventory	(3,623)	990	(2,155)
Prepaid expenses and other assets	(315)	114	238
Accounts payable	1,811	(2,445)	2,265
Accrued expenses and other liabilities	1,154	70	189
Net cash provided by (used in) operating activities	(246)	2,743	1,486
Investing activities:			
Purchase of property and equipment	(528)	(636)	(766)
Proceeds from disposition of assets	281	88	61
Net cash used in investing activities	(247)	(548)	(705)
Financing activities:			
Proceeds from long-term debt	914	191	888
	(473)	(2,411)	(1,711)

Payments on long-term debt			
Net cash provided by (used in) financing activities	441	(2,220)	(823)
Net decrease in cash	(52)	(25)	(42)
Cash at beginning of year	104	129	171
Cash at end of year	$ 52	$ 104	$ 129
Schedule of non-cash investing and financing activities:			
Sale of subsidiaries:			
Book value of assets sold	$ 22	$	$
Book value of liabilities sold	22		
Purchases of property and equipment			
For notes payable		52	
Under capital leases	218	20	19
Supplemental cash flow information:			
Interest paid	$ 1,510	$ 1,728	$ 2,047
Income taxes paid	500	4	10

The accompanying notes are an integral part of these financial statements

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except per share data)

1 - Description of Business and Summary of Significant Accounting Policies

Description of Business

ACR Group, Inc. s (the Company) principal business is the wholesale distribution of heating, ventilating, air conditioning and refrigeration (HVACR) equipment, parts and supplies in the southeastern United States, Texas, Nevada, New Mexico, Colorado and California. Substantially all of the Company s sales are to contractor dealers and institutional end-users.

Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information, allows the aggregation of an enterprise s segments if they are similar. The Company operates in different geographic areas; however, the Company has reviewed the aggregation criteria and determined that the Company operates as one segment based on the high degree of similarity of the following aspects of the Company s operations:

- nature of products and services
- customer markets served
- methods used to acquire and distribute products
- economic characteristics that influence the results of operations in different geographical areas

Principles of Consolidation

The consolidated financial statements include the accounts of ACR Group, Inc. and its subsidiaries, all of which are wholly owned. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue Recognition

The Company s revenues consist of sales of HVACR products. The Company recognizes revenue when the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the amounts recognized are fixed and determinable, and (4) collectibility is reasonably assured.

Inventories

Inventories are valued at the lower of cost or market using the average cost method. Substantially all inventories represent finished goods held for sale. The Company has an arrangement with an HVACR equipment manufacturer and a bonded warehouse agent whereby HVACR equipment is held for sale in bonded warehouses located at the premises of certain of the Company s operations, with payment due only when products are sold. The supplier retains legal title and substantial management control with respect to the consigned inventory. The Company is responsible for damage to and loss of inventory that may occur at its premises. The Company has the ability to return consigned inventory, at its sole discretion, to the supplier for a specified period of time after receipt of the inventory. Such inventory is accounted for as consigned merchandise and is not recorded on the Company s balance sheet. The cost of consigned inventory held in the bonded warehouses was $5,466 at February 29, 2004 and $7,693 at February 28, 2003.

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

The terms of the consignment agreement further provide that the Company may be required to purchase inventory not sold within a specified period of time. Historically, most consigned inventory is sold before the specified purchase date, and the supplier has never enforced its right to demand payment, instead permitted such inventory to remain on consignment. As of February 29, 2004 and February 28, 2003, inventory of approximately $207 and $565, respectively, remained on consignment although it had been held in excess of the allowable period of time.

Vendor Rebates

The Company receives rebates from certain vendors based on the volume of product purchased from the vendor. The Company records rebates when they are earned, i.e. when specified purchase volume levels are reached. Vendor rebates attributable to unsold inventory are carried as a reduction of the carrying value of inventory until such inventory is sold, at which time the related rebates are used to reduce cost of sales.

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization are provided on the straight-line method over the following estimated useful lives.

Buildings	20-40 years
Leasehold improvements	Primary term of the lease
Furniture and fixtures	5-7 years
Vehicles	3-6 years
Other equipment	3-10 years

Goodwill

Goodwill represents the excess cost of companies acquired over the fair value of their tangible net assets. Prior to the adoption of Financial Accounting Standards (SFAS) No. 142, Accounting for Goodwill and Other Intangible Assets , goodwill was amortized on a straight-line basis over 40 years. Effective March 1, 2002, the Company adopted SFAS 142 which established new accounting and reporting requirements for goodwill and other intangible assets. Under SFAS 142, all goodwill amortization ceased effective March 1, 2002. Goodwill attributable to each of the Company s reporting units was tested for impairment by comparing the fair value of each reporting unit with its carrying value. These impairment tests are required to be performed at adoption of SFAS 142 and at least annually thereafter. On an ongoing basis (absent any impairment indicators), the Company performs the annual impairment test as of the end of its fiscal year.

Based on the Company s impairment tests performed upon the adoption of SFAS 142, the Company recognized a charge of $733, or $483 net of taxes, to reduce the carrying value of goodwill to its implied fair value. This charge has been recorded as a cumulative effect of change in accounting principle in the Company s first quarter of fiscal year 2003. The Company completed its annual impairment test as of February 29, 2004 in the fourth quarter of fiscal year 2004. This impairment test resulted in no additional impairment charges for the year ended February 29, 2004.

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

Effect of implementation of SFAS 142:

	2004	2003	2002
Net income	$ 2,180	$ 620	$ 419
Pro forma amortization expense, net of taxes			183
Pro forma net income	$ 2,180	$ 620	$ 602
Earnings per share	$ .20	$ .06	$ .04
Effect of implementation of SFAS 142 on earnings per share			.02
Pro forma earnings per share	$ .20	$ .06	$ .06

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The Company uses the liability method in accounting for income taxes. Under the liability method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Stock-Based Compensation

In accordance with the provisions of SFAS 123, Accounting for Stock-based Compensation , the Company has elected to follow the Accounting Principles Board Opinion (APB) 25, Accounting for Stock Issued to Employees , and related interpretations in accounting for its employees stock-based compensation plans. Under APB 25, if the exercise price of employee stock options equals or exceeds the fair value of the underlying stock on the date of grant, no compensation expense is recognized.

Had compensation expense been determined consistent with SFAS 123, the Company s net income and earnings per share would have been changed to the following pro forma amounts:

	Year Ended February 29 or 28,		
	2004	**2003**	**2002**
Net income applicable to common shareholders as reported	$ 2,180	$ 620	$ 419
Total stock-based employee compensation expense under fair value method for all awards, net of tax	(19)	(41)	(157)
Pro forma income applicable to common shareholders	$ 2,161	$ 579	$ 262
Basic and diluted earnings per share:			
As reported	$ .20	$ .06	$ .04
Pro forma	.20	.05	.02

The fair value of each option grant under the Company plans for the three years ended February 29, 2004 was estimated using the Black-Scholes options pricing model using the following assumptions:

Expected life of 5 to 8 years

No expected dividend yield

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

Expected volatility of .669 for all years in which options were granted, representing 48 periods ending March 31, 2002.

Risk-free interest rate of 5.0% in each fiscal period in which options were granted, representing an approximate average yield over the option periods presented

No options were granted during fiscal 2004, 2003 or 2002.

Supplier/Sources of Supply

The Company currently purchases a majority of its HVACR equipment and repair parts from two primary suppliers. Purchases from such suppliers comprised 38% of all purchases made in fiscal 2004, 34% in fiscal 2003 and 36% in fiscal 2002. The Company has not encountered any significant difficulty to date in obtaining equipment and repair parts to support its operations at current or expected near-term future levels. Any significant interruption by such a manufacturer, or a termination of a distributor agreement, could temporarily disrupt the operations of certain subsidiaries. The Company believes that its relationships with suppliers of complementary equipment products are a mitigating factor against this risk.

Reclassifications

Certain reclassifications were made to the prior years financial statements to conform with current year presentation.

Recent Accounting Issues

In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others . The Interpretation requires certain guarantees to be recorded at fair value and also requires a guarantor to make certain disclosures regarding guarantees. The Interpretation s initial recognition and initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements became effective for the Company s first quarter of 2004. The adoption of the statement had no material impact on the Company s financial position or results of operations.

In January 2003, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor . EITF 02-16 clarifies certain aspects for accounting and recording of consideration received from vendors. Certain provisions of the EITF are effective for fiscal years beginning after December 15, 2002, and other provisions of the EITF are effective for arrangements entered into after November 21, 2003. The Company s accounting for consideration received from vendors is consistent with the provisions of EITF 02-16 as of February 29, 2004.

In January 2003, the FASB issued Interpretation 46, Consolidation of Variable Interest Entities. In general, a variable interest entity is a corporation, partnership, trust, or other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns or both. The Interpretation is effective for all Variable Interest Entities created after January 31, 2003, and is effective for special purpose entities created before February 1, 2003 for the first reporting period after December 15, 2003 and for non-special purpose entities for the first reporting period beginning after March 15, 2004. The adoption of the Interpretation did not have nor is expected to have a material impact on its financial statements.

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

2 - Property and Equipment

Property and equipment consisted of the following at the end of February:

	2004	2003
Land	$ 311	$ 311
Building and leasehold improvements	3,759	3,684
Furniture and fixtures	276	262
Vehicles	1,089	1,150
Other equipment	5,322	5,379
	10,757	10,786
Less: accumulated depreciation	(6,296)	(5,831)
Net property and equipment	$ 4,461	$ 4,955

Capitalized lease assets of $562 and $586 together with accumulated amortization of $169 and $281 are included in property and equipment as of February 29, 2004 and February 28, 2003. Amortization expense is included with depreciation expense.

3 - Debt

Debt is summarized as follows at the end of February:

	2004	2003

Revolving line of credit	$ 21,086	$ 20,172
Real estate loan	529	607
Equipment term loan	419	627
Note payable to sellers of real property	757	778
Notes payable to sellers of companies acquired		25
Other	47	87
	22,838	22,296
Less current maturities	(283)	(316)
Long-term debt, less current maturities	$ 22,555	$ 21,980

The Company has a loan agreement (Agreement) with a commercial bank (Bank) that provides a $25 million revolving credit facility and additional credit facilities for the purchase of both real estate and capital assets. The Agreement terminates in May 2005, but is automatically extended for one-year periods unless either party gives notice of termination to the other. Restrictive covenants of the Agreement prohibit the Company from paying dividends, prepaying any subordinated indebtedness or incurring certain other debt without the Bank s consent, and also requires the Company to maintain certain financial ratios. As of February 29, 2004, the Company was in compliance with all of the required financial ratios.

The interest rate on borrowings under the revolving credit facility is based on either the Bank s prime rate or LIBOR and varies depending on the Company s leverage ratio, as defined, determined quarterly. As of February 29, 2004, the applicable interest rate was the prime rate or LIBOR plus 2.75%, and the Company had elected the LIBOR option for substantially all amounts outstanding under the facility. The Company has elected to fix the interest rate on $8 million of outstanding borrowings under the facility, and the balance of outstanding borrowings bears interest at a floating rate. At February 29, 2004, the average interest rate on all borrowings under the facility was 5.80%. Borrowings under the revolving credit facility are limited to 85% of eligible

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

accounts receivable and 50% of eligible inventory amounts (which increases to 65% of eligible inventory amounts during certain specified months of the year). At February 29, 2004, the Company s available credit under the facility was approximately $2.3million.

The Agreement provides a capital expenditure term loan facility of $1 million for capital assets. As of February 29 2004, the Company had borrowed $856 under the capital expenditure facility. Of such borrowings, $419 was outstanding at February 29, 2004, and is repaid in equal monthly principal installments of $14, plus interest. The Agreement also provides for financing the purchase of certain real estate and improvements. At February 29, 2004, the Company had indebtedness to the Bank for real estate loans of $529, secured by a deed of trust on both the land and building occupied by two branch facilities in the Houston area, which is repaid in equal monthly principal installments of $6, plus interest. Both the real estate and the capital expenditures facilities bear interest at a variable rate, which were the prime rate or LIBOR plus 2.75% at February 29, 2004.

In fiscal 2003, the Company repaid its outstanding indebtedness to The Catalyst Fund, Ltd. and an affiliate (Catalyst) in the amount of $469, all of which was subordinated to the Bank. Subsequent to the repayment of such indebtedness, the Company and Catalyst entered into a settlement with respect to warrants held by Catalyst for 925,000 shares of the Company s common stock.

In August 2000, the Company purchased real estate in Gainesville, Florida to be occupied as a branch operation for approximately $957. Of the purchase price, the sellers financed $825 for a term of 25 years at an interest rate of 8.25% per annum. The note is secured by a deed of trust on the real estate and all improvements.

A note payable to a seller incurred in connection with an acquisition, which was payable in installments over three years, was repaid in full during fiscal 2004.

Based upon the borrowing rates currently available to the Company for debt instruments with similar terms and average maturities, the carrying value of long-term debt approximates fair value.

Future maturities of debt are $283 in 2005 $21,395 in 2006, $180 in 2007, $107 in 2008, $109 in 2009, and $764 after 2010.

4 - Lease Commitments

The Company leases warehouse and office equipment and vehicles under capital leases. Future minimum lease payments under capital leases are as follows:

Year ended February 28 or 29,	**Capital lease payments**
2005	$ 140
2006	106
2007	72
2008	6
2009	3
Total minimum lease payments	327
Less amounts representing interest	(28)
Present value of future minimum lease payments	299
Less current maturities of capital lease obligations	(123)
Long-term obligations under capital leases	$ 176

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

Additionally, the Company leases its corporate offices, office and warehouse space occupied by its HVACR operations and office equipment and various vehicles under non-cancelable operating lease agreements that expire at various dates through 2012. The leases for its branch facilities often require that the Company pay the taxes, insurance and maintenance expenses related to the leased properties. Certain of the Company s lease agreements include renewal and/or purchase options. Future minimum lease payments under such leases are $5,195 in 2005, $4,177 in 2006, $3,243 in 2007, $2,402 in 2008 and $3,526 thereafter.

Rental expenses were $5,405, $4,444 and $4,668 in 2004, 2003 and 2002, respectively.

5 - Income Taxes

Federal and state income tax provisions are as follows:

	Year Ended February 29 or 28,		
	2004	**2003**	**2002**
Federal			
Current	$ 573	$ 20	$ 16
Deferred	510	227	
State			
Current	170	59	107
Deferred		24	
	$ 1,253	$ 330	$ 123

The difference between the income tax provision computed at the statutory federal income tax rate and the financial statement provision for taxes is summarized below:

	Year Ended February 29 or 28,		
	2004	**2003**	**2002**
Tax at statutory rate	$ 1,167	$ 487	$ 184
Increase (reduction) in tax expense Resulting from:			
Change in valuation allowance	(102)	(961)	(804)
Nondeductible expenses	60	90	96
State income taxes	128	79	107
Expired tax credits and expired NOL carryforwards		635	540
Actual income tax provision	$ 1,253	$ 330	$ 123

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

The Company recognizes a tax benefit from a net operating loss carryforward if it is more likely than not that such benefit will ultimately be realized. Such a tax benefit is recorded on the balance sheet as a deferred tax asset. The deferred tax assets and liabilities consist of the following as of February 29, 2004 and February 28, 2003:

	2004	2003
Deferred tax assets:		
NOL carryforwards	$ 205	$ 674
Section 263A capitalization	454	492
Allowance for doubtful accounts	365	274
Alternative minimum tax credit		71
Accrued vacation	185	179
Fixed asset depreciation	164	114
Accrued medical claims	93	
Other	69	33
Total deferred tax assets	1,535	1,837
Deferred tax liabilities:		
Goodwill and other amortization	(472)	(162)
Net total temporary difference	1,063	1,675
Valuation allowance	(115)	(217)
Net deferred tax assets	$ 948	$ 1,458

The Company applied net operating loss carryforwards of $1,300 to offset taxable income during the fiscal 2004. The Company has a valuation allowance of $115 to offset California state tax net operating loss carryforwards that have been suspended by the state.

6 - Stock Option Agreements and Equity Transactions

Pursuant to employment contracts that were effective in 1998, both the President and the Chief Financial Officer of the Company received options to purchase 300,000 and 100,000 shares of the Company s common stock (Stock), respectively, at $2.24 per share. Such options would have vested in 2006. Both officers forfeited their respective options, unexercised, in fiscal 2004.

Effective March 1, 2004, both the Chief Financial Officer and the General Counsel of the Company entered into employment contracts that each provide for the contingent issuance of 500,000 shares of Stock upon both continuation of employment and attainment of specified financial performance objectives by the Company. Up to 125,000 shares will vest for each officer on each of the four succeeding anniversary dates of the grant if the performance objectives are also satisfied. Any such shares not fully vested as of March 1, 2009, will be forfeited and returned to the Company. As of March 1, 2004, the Company had not attained any of the performance objectives required to vest Stock under the employment agreements. Effective March 1, 2004, the two outside directors of the Company each received restricted stock grants of 42,000 shares, subject to continuation of service as a director for four years. Such shares will vest annually pro-rata over such period.

The Company has a stock option plan for key employees and directors of the Company and its subsidiaries. The plan provides for the granting of up to 500,000 non-qualified and/or incentive stock options. At February 29, 2004, 227,500 shares of common stock were available for future grants. Options granted under the plan are vested ratably over three years.

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

A summary of the Company s stock option activity and related information follows:

	Year Ended February 29 or 28,					
	2004		2003		2002	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding - Beginning of year	715,500	$ 1.81	905,000	$ 1.94	941.000	$ 1.92
Granted						
Exercised						
Forfeited	(443,000)	2.16	(189,500)	2.40	(36,000)	1.53
Outstanding - End of year	272,500	1.25	715,500	1.81	905,000	1.94
Exercisable- End of year	272,500	1.25	646,833	1.89	322,667	1.98

Outstanding options at February 29, 2004 that are exercisable have a weighted average contractual life remaining of 1.75 years.

7 - Profit Sharing Plan

The Company has a qualified profit sharing plan (Plan) under Section 401(k) of the Internal Revenue Code. The Plan is open to all eligible employees. The Company matches 50% of the participant s contributions, not to exceed 3% of each participant s compensation. Company contributions to the Plan were $251, $261 and $258 for fiscal 2004, 2003 and 2002, respectively.

8 - Earnings per Share

The numerator used in the calculations of both basic and diluted earnings per share for all periods presented was net income. The denominator for each period presented was determined as follows:

	Year ended February 29 or 28,		
	2004	**2003**	**2002**
Denominator:			
Denominator for basic earnings per share-weighted average shares	10,681,294	10,681,294	10,681,294
Effect of dilutive securities:			
Employee stock options			
Warrants			5,377
Dilutive potential common shares			5,377
Denominator for diluted earnings per share adjusted weighted average shares and assumed conversions	10,681,294	10,681,294	10,686,671

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(in thousands, except per share data)

9 - Quarterly Results (Unaudited)

	Quarter			
	First	**Second**	**Third**	**Fourth**
Fiscal year ended February 29, 2004				
Sales	$ 42,316	$ 51,543	$ 42,187	$ 38,307
Gross profit	9,305	11,348	9,130	8,776
Net income	$ 488	$ 1,479	$ 286	$ (73)
Earnings per common share basic and diluted	$ .05	$ .13	$ .03	$ (.01)
Fiscal year ended February 28, 2003				
Sales	$ 42,869	$ 47,810	$ 37,902	$ 33,241
Gross profit	9,210	10,614	8,480	7,834
Income before cumulative effect of accounting change	459			
Cumulative effect of accounting change, net of taxes	(483)			
Net income	$ (24)	$ 1,152	$ (107)	$ (399)
Earnings per common share basic and diluted:				
Before cumulative effect of accounting change	$ (.04)	$ .11	$ (.01)	$ (.03)
Cumulative effect of accounting change	$ (.04)	$	$	$
	$	$ .11	$ (.01)	$ (.03)

Fiscal year ended February 28, 2002				
Sales	$ 39,709	$ 46,509	$ 37,007	$ 32,265
Gross profit	8,602	9,920	7,981	7,426
Net income	$ 396	$ 1,044	$ (336)	$ (685)
Earnings per common share basic and diluted	$ .04	$ .10	$ (.03)	$ (.06)

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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.

Incorporated by reference.

Item 11. Executive Compensation.

Incorporated by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

Incorporated by reference.

Item 13. Certain Relationships and Related Transactions.

Incorporated by reference.

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PART IV

Item 14. Controls and Procedures.

As of February 29, 2004, an evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s management, including the Chief Executive Officer and the Chief Financial Officer, concluded that the Company s disclosure controls and procedures were effective as of February 29, 2004. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect internal controls subsequent to February 29, 2004.

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K.

(a)(1) Financial Statements included in Item 8.

See Index to Financial Statements of ACR Group, Inc. set forth in Item 8, Financial Statements and Supplementary Data.

(a)(2) Index to Financial Statement Schedules included in Item 15.

The following financial statement schedule for the years ended February 29, 2004, February 28, 2003 and 2002 is included in this report:

Schedule II - Valuation and Qualifying Accounts

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

(a)(3) Exhibits

The following exhibits are filed with or incorporated by reference into this report. The exhibits which are denoted by an asterisk (*) were previously filed as a part of, and are hereby incorporated by reference from, either (a) Annual Report on Form 10-K for fiscal year ended June 30, 1991 (referred to as 1991 10-K), or (b) Annual Report on Form 10-K for fiscal year ended February 28, 1993 (referred to as 1993 10-K), or (c) Annual Report on Form 10-K for fiscal year ended February 28, 1998 (referred to as 1998 10-K), or (d) Annual Report on Form 10-K for fiscal year ended February 29, 2000 (referred to as 2000 Form 10-K), (e) Annual Report on Form 10-K for fiscal year ended February 28, 2001 (referred to as 2001 Form 10-K) or (f) Annual Report on Form 10-K for fiscal year ended February 28, 2002 (referred to as 2002 Form 10-K)

Exhibit Number	Description
* 3.1	Restated Articles of Incorporation (Exhibit 3.1 to 1991 10-K)
* 3.2	Articles of Amendment to Articles of Incorporation (Exhibit 3.2 to 1993 10-K)
* 3.3	Amended and Restated Bylaws (Exhibit 3.2 to 1991 10-K)
* 3.4	Amendment to Bylaws dated December 8, 1992 (Exhibit 3.4 to 1993 10-K)
* 4.1	Specimen of Common Stock Certificate of ACR Group, Inc. (Exhibit 4.1 to 1993 10-K)
*10.1	Employment Agreement between the Company and Alex Trevino, Jr. dated as of March 1, 1998 (Exhibit 10.1 to 1998 10-K)
*10.2	Stock Option Agreement between the Company and Alex Trevino, Jr. dated as of March 1, 1998 (Exhibit 10.2 to 1998 10-K)

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Exhibit Number	Description
*10.3	Employment Agreement between the Company and Anthony R. Maresca dated as of March 1, 1998 (Exhibit 10.3 to 1998 10-K)
10.3A	Employment Agreement between the Company and Anthony R. Maresca dated as of March 1, 2004
*10.4	Stock Option Agreement between the Company and Anthony R. Maresca dated as of March 1, 1998 (Exhibit 10.4 to 1998 10-K)
*10.5	Registration Rights Agreement by and between the Company, Alex Trevino, Jr. and Anthony R. Maresca (Exhibit 10.5 to 1998 10-K)
*10.6	Note Agreement between The Catalyst Fund, Ltd., as Lender, and the Company, ACR Supply, Inc., Fabricated Systems, Inc. and Heating and Cooling Supply, Inc., as Borrowers, dated as of May 27, 1993 (Exhibit 10.18 to 1993 10-K)
*10.7	First Amendment to Note Agreement by and among The Catalyst Fund, Ltd., the Company, ACR Supply, Inc., Total Supply, Inc. f/k/a Fabricated Systems, Inc., Heating and Cooling Supply, Inc. and West Coast HVAC Supply, Inc., dated as of April 14, 1997 (Exhibit 10.7 to 1998 10-K)
*10.8	Second Amendment and Restated Note Agreement by and between the Company, all subsidiaries of the Company, The Catalyst Fund, Ltd., and Southwest/Catalyst Capital, Ltd., dated as of January 28, 1998 (Exhibit 10.8 to 1998 10-K)
*10.9	Warrant for the Purchase of 750,000 Shares of Common Stock of the Company issued to The Catalyst Fund, Ltd. dated January 28, 1998 (Exhibit 10.9 to 1998 10-K)
*10.10	Warrant for the Purchase of 50,000 Shares of Common Stock of the Company issued to The Catalyst Fund, Ltd. dated January 28, 1998 (Exhibit 10.10 to 1998 10-K)
*10.11	Warrant for the Purchase of 125,000 Shares of Common Stock of the Company issued to Southwest/Catalyst Capital, Ltd. dated January 28, 1998 (Exhibit 10.11 to 1998 10-K)

*10.12	Registration Rights Agreement between The Catalyst Fund, Ltd. and the Company dated as of January 28, 1998 (Exhibit 10.12 to 1998 10-K)
*10.13	Registration Rights Agreement between Southwest/Catalyst Capital, Ltd. and the Company dated as of January 28, 1998 (Exhibit 10.13 to 1998 10-K)
*10.14	Amended and Restated Loan and Security Agreement between the Company and Bank of America, N.A. dated as of May 25, 2000. (Exhibit 10.15A to 2000 10-K)
*10.15	First Amendment to Amended and Restated Loan and Security Agreement between the Company and Bank of America, N.A. dated as of March 30, 2001. (Exhibit 10.15 to 2001 10-K)
*10.15A	Second Amendment to Amended and Restated Loan and Security Agreement between the Company and Bank of America, N.A. dated as of November 30, 2001. (Exhibit 10.15A to 2002 10-K)
*10.16	1996 Stock Option Plan of ACR Group, Inc. (Exhibit 4 to RS 333-16325)
10.17	Director Restricted Stock Agreement between the Company and Roland H. St. Cyr dated as of March 1, 2004.
10.18	Director Restricted Stock Agreement between the Company and Alan D. Feinsilver dated as of March 1, 2004

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Exhibit Number	Description
10.19	Employment Agreement between the Company and A. Stephen Trevino dated as of March 1, 2004
21.1	Subsidiaries of the Company
23.1	Consent of Independent Auditors
31.1	Certificate of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated January 14, 2004,
31.2	Certificate of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated January 14, 200414, 2003,
32.1	Certification from the Chief Executive Officer of ACR Group, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification from the Chief Financial Officer of ACR Group, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K.

No report on form 8-K was filed during the period from December 1, 2003 to February 29, 2004.

(c) Exhibits

See Item 14(a)(3), above.

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SCHEDULE II

ACR GROUP, INC. AND SUBSIDIARIES

VALUATION AND QUALIFYING ACCOUNTS

(in thousands)

Description	Balance at beginning of period	Charged to costs and expenses	Allowance written off	Balance at end of period
Year ended February 29, 2004:				
Allowance for doubtful accounts:				
Accounts receivable	$ 685	$ 696	$ 588	$ 793
Year ended February 28, 2003:				
Allowance for doubtful accounts:				
Accounts receivable	$ 844	$ 418	$ 577	$ 685
Year ended February 28, 2002:				
Allowance for doubtful accounts:				
Accounts receivable	$ 670	$ 704	$ 530	$ 844

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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.

ACR GROUP, INC.

Date: June 1, 2004 By: /s/ Anthony R. Maresca

Anthony R. Maresca

Senior Vice President and

Chief Financial Officer

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

Signature		
/s/ Alex Trevino, Jr. **Alex Trevino, Jr.**	Chairman of the Board, President and Chief Executive Officer (Principal executive officer)	June 1, 2004
/s/ Anthony R. Maresca **Anthony R. Maresca**	Senior Vice President, Chief Financial Officer and Director (Principal financial and accounting officer)	June 1, 2004
/s/ A. Stephen Trevino **A. Stephen Trevino**	Senior Vice President, General Counsel and Director	June 1, 2004
/s/ Alan D. Feinsilver	Director	June 1, 2004

Alan D. Feinsilver		
/s/ ROLAND H. ST. CYR	Director	June 1, 2004
Roland H. St. Cyr		