

STERLING CONSTRUCTION CO INC

Form 10-Q/A

March 15, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 10-Q/A

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

For the quarterly period ended: June 30, 2004

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: **0-19450**

STERLING CONSTRUCTION COMPANY, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State of Incorporation)

25-1655321

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

2751 CENTERVILLE ROAD SUITE 3131 WILMINGTON, DELAWARE

19803

(Address of principal executive offices)

(Zip Code)

(281) 821-9091

(Registrant's telephone number, including area code)

(Former name, former address, and former fiscal year, if changed from 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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such report(s), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the Registrant is an accelerated filer (as described in Rule 12b-2 of the Exchange Act). Yes No

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As of August 1 2004, 5,343,758 shares of the Registrant's Common Stock, \$0.01 par value per share were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

EXPLANATORY NOTE

This Amendment No. 1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 is being filed for the sole purpose of correcting the balance sheet classification of the revolving line of credit for Steel City Products (the SCPI Revolver) pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22 Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that Include Both a Subjective Acceleration Clause and a Lock-Box Arrangement. The Company has restated borrowings under the SCPI Revolver previously reported as long-term liabilities to current liabilities as of June 30, 2004 and corrected related disclosures accordingly in Note 10 Subsequent Event, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations under the sub-heading Financing SHH Revolver and SCPI Revolver and Item 4. Controls and Procedures. All other information in the original filing remains unchanged and has not been updated.

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STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES**CONDENSED CONSOLIDATED BALANCE SHEETS****(Dollar amounts in thousands, except per share data)**

| | June 30, 2004 | December 31, 2003 |
|---|---------------------------|-------------------------|
| | (Unaudited) (Restated) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,672 | \$ 2,765 |
| Contracts receivable | 25,301 | 26,504 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 3,007 | 1,281 |
| Trade accounts receivable, less allowance of \$1,043 and \$1,013 respectively | 2,741 | 1,919 |
| Inventories | 4,835 | 4,842 |
| Deferred tax asset | 1,452 | 1,452 |
| Other | 2,004 | 1,436 |
| Total current assets | 43,012 | 40,199 |
| Property and equipment, at cost | 32,496 | 31,991 |
| Less accumulated depreciation | (11,270) | (9,611) |
| | 21,226 | 22,380 |
| Goodwill | 7,809 | 7,809 |
| Deferred tax asset | 3,564 | 4,527 |
| Other assets | 613 | 663 |
| | 11,986 | 12,999 |
| | \$ 76,224 | \$ 75,578 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 16,510 | \$ 14,439 |
| Accrued interest | 659 | 530 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 4,654 | 9,742 |
| Revolving line of credit, SCPI | 3,685 | 2,660 |
| Current maturities of long-term obligations | 339 | 708 |
| Current maturities of long-term debt, related parties | 1,310 | 2,310 |
| Other accrued expenses | 2,042 | 3,322 |
| Total current liabilities | 29,199 | 33,711 |
| Long-term obligations: | | |

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| | | |
|---|-----------|-----------|
| Long-term debt | 8,390 | 6,568 |
| Long-term debt, related parties | 7,059 | 6,758 |
| Put liability | 5,578 | 5,578 |
| Other long-term obligations | 1,001 | 1,054 |
| | 22,028 | 19,958 |
| Minority interest | 5,882 | 5,273 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, par value \$0.01 per share; authorized 1,000,000 shares, none issued | | |
| Common stock, par value \$0.01 per share; authorized 14,000,000 shares, 5,333,258 and 5,139,900 shares issued and outstanding | 53 | 51 |
| Additional paid-in capital | 66,971 | 66,400 |
| Deferred compensation expense | (124) | (139) |
| Deficit | (47,784) | (49,675) |
| Treasury stock, at cost, 207 common shares | (1) | (1) |
| Total stockholders' equity | 19,115 | 16,636 |
| | \$ 76,224 | \$ 75,578 |

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

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Dollar amounts in thousands, except per share data)****(Unaudited)**

| | Three months Ended June 30, 2004 | Three months Ended June 30, 2003 |
|--|--|--|
| Contract revenues | \$ 29,354 | \$ 43,858 |
| Sales | 5,389 | 5,453 |
| | 34,743 | 49,311 |
| Cost of contract revenues earned | 24,739 | 39,407 |
| Cost of goods sold, including occupancy, buying and warehouse expenses | 4,527 | 4,605 |
| Selling and administrative expenses | 2,389 | 1,773 |
| Interest expense, net of interest income | 219 | 692 |
| | 31,874 | 46,477 |
| Income before minority interest and income taxes | 2,869 | 2,834 |
| Minority interest in net earnings of subsidiary | 442 | 445 |
| Income before taxes | 2,427 | 2,389 |
| State income tax expense | 9 | 5 |
| Federal income tax expense | 794 | 812 |
| Net income tax expense | 803 | 817 |
| Net income | \$ 1,624 | \$ 1,572 |
| Basic and diluted net income per share: | | |
| Basic | \$ 0.31 | \$ 0.31 |
| Diluted | \$ 0.23 | \$ 0.25 |
| Weighted average number of shares outstanding: | | |
| Basic | 5,316,440 | 5,069,016 |
| Diluted | 7,081,760 | 6,219,826 |

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

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollar amounts in thousands, except per share data)
(Unaudited)

| | Six months Ended June 30, 2004 | Six months Ended June 30, 2003 |
|--|--------------------------------------|--------------------------------------|
| Contract revenues | \$ 54,940 | \$ 79,537 |
| Sales | 12,112 | 11,472 |
| | 67,052 | 91,009 |
| Cost of contract revenues earned | 47,647 | 71,229 |
| Cost of goods sold, including occupancy, buying and warehouse expenses | 10,303 | 9,764 |
| Selling and administrative expenses | 4,865 | 3,769 |
| Interest expense, net of interest income | 738 | 1,292 |
| | 63,553 | 86,054 |
| Income before minority interest and income taxes | 3,499 | 4,955 |
| Minority interest in net earnings of subsidiary | 609 | 769 |
| Income before taxes | 2,890 | 4,186 |
| State income tax expense (benefit) | 16 | (5) |
| Federal income tax expense | 983 | 1,423 |
| Net income tax expense | 999 | 1,418 |
| Net income | \$ 1,891 | \$ 2,768 |
| Basic and diluted net income per share: | | |
| Basic | \$ 0.36 | \$ 0.55 |
| Diluted | \$ 0.27 | \$ 0.45 |
| Weighted average number of shares outstanding: | | |
| Basic | 5,241,973 | 5,069,016 |
| Diluted | 7,174,166 | 6,106,458 |

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

STERLING CONSTRUCTION COMPANY, INC. & SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollar amounts in thousands)
(Unaudited)

| | Six months Ended June 30, 2004 | Six months Ended June 30, 2003 |
|--|---|---|
| Cash flows from operating activities: | | |
| Net income | \$ 1,891 | \$ 2,768 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,362 | 2,286 |
| Loss on sale of property and equipment | 5 | |
| Deferred tax expense | 983 | 1,423 |
| Deferred compensation expense | 258 | |
| Minority interest in net earnings of subsidiary | 609 | 769 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in trade accounts receivable | (822) | 105 |
| Decrease (increase) in contracts receivable | 1,203 | (6,399) |
| Decrease (increase) in inventories | 7 | (657) |
| (Increase) in costs and estimated earnings in excess of billings on uncompleted contracts | (1,726) | (276) |
| (Increase) in prepaid expenses and other assets | (568) | (721) |
| Increase in accounts payable | 2,071 | 7,930 |
| (Decrease) increase in billings in excess of costs and estimated earnings on uncompleted contracts | (5,088) | 6,041 |
| (Decrease) increase in accrued compensation and other liabilities | (870) | 723 |
| Net cash provided by operating activities | 315 | 13,992 |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (1,255) | (3,022) |
| Proceeds from sale of property and equipment | 92 | |
| Net cash used in investing activities | (1,163) | (3,022) |
| Cash flows from financing activities: | | |
| Borrowings under short-term obligations | | 250 |
| Net borrowings (payments) on long-term obligations | 1,425 | (10,819) |
| Cancellation of long term debt | | (22) |
| Cash received from option exercises | 379 | 5 |
| Purchase of minority interest in subsidiary | (49) | |
| Net cash provided by (used in) financing activities | 1,755 | (10,586) |

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| | | |
|--|----------|----------|
| Net increase in cash and cash equivalents | 907 | 384 |
| Cash and cash equivalents, beginning of period | 2,765 | 2,406 |
| Cash and cash equivalents, end of period | \$ 3,672 | \$ 2,790 |

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

STERLING CONSTRUCTION COMPANY, INC. AND SUBSIDIARIES**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SIX MONTHS ENDED JUNE 30, 2004 (UNAUDITED)****1. Basis of Presentation**

The condensed consolidated financial statements included herein have been prepared by Sterling Construction Company, Inc. (Sterling or the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2003. The condensed consolidated financial statements reflect, in the opinion of management, all normal recurring adjustments necessary to present fairly the Company's financial position at June 30, 2004 and the results of operations and cash flows for the periods presented.

The accompanying condensed consolidated financial statements include the accounts of subsidiaries in which the Company has a greater than 50% ownership interest, and all intercompany accounts and transactions have been eliminated in consolidation.

Interim results may be subject to significant seasonal variations and the results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the full year.

The Company reports two operating segments, the Construction segment, which consists of the operations of Sterling Houston Holdings (SHH), a heavy civil construction company based in Houston, Texas, and the Distribution segment, which consists of the operations of Steel City Products, Inc. (SCPI), a wholesale distributor of automotive accessories, non-food pet supplies and lawn and garden products, based in Pittsburgh, Pennsylvania.

The Company has restated its June 30, 2004 balance sheet to correct the balance sheet classification of the SCPI revolving line of credit from a long-term obligation to a current liability, pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22 Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement, as reflected below:

| | Original 10-Q filing | Adjustment | Adjusted 10-Q filing |
|--------------------------------|-------------------------|------------|-------------------------|
| Current liabilities: | | | |
| Revolving line of credit, SCPI | | \$ 3,685 | \$ 3,685 |
| Long-term obligations | | | |
| Long-term debt | \$ 12,075 | (\$ 3,685) | \$ 8,390 |

2. Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management's estimates, judgments and assumptions are continually evaluated based on available information and experience; however actual amounts could differ from those estimates. The Company's significant accounting policies are described in Note 1 of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

3. New Accounting Pronouncements

There are no new accounting pronouncements pending adoption as of June 30, 2004 that the Company believes would have a significant impact on its consolidated financial position or results of operations.

4. Property and Equipment

| | June 30, 2004 (Unaudited) | December 31, 2003 |
|--|---------------------------------|----------------------|
| Construction equipment | \$ 24,920 | \$ 24,367 |
| Transportation equipment | 4,191 | 4,174 |
| Buildings | 1,488 | 1,488 |
| Leasehold improvements | 402 | 402 |
| Office furniture, warehouse equipment and vehicles | 1,311 | 1,378 |
| Land | 182 | 182 |
| | 32,496 | 31,991 |
| Less accumulated depreciation | (11,270) | (9,611) |
| | \$ 21,226 | \$ 22,380 |

5. Goodwill

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

| | Construction Segment | Distribution Segment | Total |
|--------------------------|-------------------------|-------------------------|----------|
| Balance, January 1, 2004 | \$ 7,681 | \$ 128 | \$ 7,809 |
| Goodwill additions | | | |
| Impairment losses | | | |
| Balance, June 30, 2004 | \$ 7,681 | \$ 128 | \$ 7,809 |

The Company performed impairment testing on both segments in the fourth quarter of fiscal 2003. The analysis did not indicate impairment of the Company's recorded goodwill for either segment.

6. Earnings per Share

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is the same as basic net income per share but assumes the exercise of convertible subordinated debt securities and includes dilutive stock options and warrants using the treasury stock method. The following table reconciles the numerators and denominators of the basic and diluted per common share computations for net income for the three and six months ended June 30, 2004

and June 30, 2003 (in thousands, except per share data):

| | Three months ended June 30, 2004 | Three months ended June 30, 2003 |
|--|----------------------------------|----------------------------------|
| Numerator: | | |
| Net income | \$ 1,624 | \$ 1,572 |
| Interest on convertible debt, net of tax | 11 | 11 |
| Net income before interest on convertible debt | \$ 1,635 | \$ 1,583 |
| Denominator: | | |
| Weighted average common shares outstanding basic | 5,316 | 5,069 |
| Shares for convertible debt | 224 | 224 |
| Shares for dilutive stock options and warrants | 1,542 | 927 |
| Weighted average common shares outstanding and assumed conversions diluted | 7,082 | 6,220 |
| Basic income per common share: | \$ 0.31 | \$ 0.31 |
| Diluted income per common share: | \$ 0.23 | \$ 0.25 |
| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
| Numerator: | | |
| Net income | \$ 1,891 | \$ 2,768 |
| Interest on convertible debt, net of tax | 22 | 22 |
| Net income before interest on convertible debt | \$ 1,913 | \$ 2,790 |
| Denominator: | | |
| Weighted average common shares outstanding basic | 5,242 | 5,069 |
| Shares for convertible debt | 224 | 224 |
| Shares for dilutive stock options and warrants | 1,708 | 813 |
| Weighted average common shares outstanding and assumed conversions diluted | 7,174 | 6,106 |
| Basic income per common share: | \$ 0.36 | \$ 0.55 |
| Diluted income per common share: | \$ 0.27 | \$ 0.45 |

7. Stock-Based Compensation

Effective January 1, 2003, the Company adopted FASB No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure* which amends FASB Statement No. 123 to provide alternative methods of transition for a

voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company transitioned utilizing the prospective method for options granted after January 1, 2003. Adoption of SFAS No. 148 did not have a material effect on its financial position or results of operations.

Prior to January 1, 2003, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation prior to January 1, 2003 (dollars in thousands, except per share data).

| | Three months ended June 30, 2004 | Three months ended June 30, 2003 |
|---|--|--|
| Net income, as reported | \$ 1,624 | \$ 1,572 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 44 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (21) | (13) |
| Pro forma net income | \$ 1,647 | \$ 1,559 |
| Basic and diluted net income per share: | | |
| Basic, as reported | \$ 0.31 | \$ 0.31 |
| Diluted, as reported | \$ 0.23 | \$ 0.25 |
| Pro forma, basic | \$ 0.31 | \$ 0.31 |
| Pro forma, diluted | \$ 0.23 | \$ 0.25 |
| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
| Net income, as reported | \$ 1,891 | \$ 2,768 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 258 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (42) | (26) |
| Pro forma net income | \$ 2,107 | \$ 2,742 |
| Basic and diluted net income per share: | | |
| Basic, as reported | \$ 0.36 | \$ 0.55 |
| Diluted, as reported | \$ 0.27 | \$ 0.45 |
| Pro forma, basic | \$ 0.40 | \$ 0.54 |
| Pro forma, diluted | \$ 0.29 | \$ 0.45 |

8. Segment Information

Each of the Construction Segment and the Distribution Segment is managed by its own decision makers and comprises different customers, suppliers and employees. The operating profitability of the Construction Segment is reviewed by its Chief Financial Officer, Joseph P. Harper, to determine its financial needs. Terry Allan, Chief

Executive Officer of SCPI and Maarten Hemsley, the Company's Chief Financial Officer, review the operating profitability of the Distribution Segment and its working capital needs to allocate financial resources. Allocation of resources among the Company's operating segments is determined by Messrs. Harper and Hemsley.

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| | | | | |
|------------------------------|--------------|--------------|-----------|--------------|
| Three months ended 6/30/2003 | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 29,354 | \$ 5,389 | | \$ 34,743 |
| Operating profit (loss) | 3,132 | 209 | (253) | \$ 3,088 |
| Interest expense, net | 167 | (24) | (362) | \$ (219) |
| Minority interest | | | (442) | \$ (442) |
| Pre-tax income | | | | \$ 2,427 |
| Segment assets | \$ 55,366 | \$ 8,365 | \$ 12,493 | \$ 76,224 |
| Three months ended 6/30/2003 | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 43,858 | \$ 5,453 | | \$ 49,311 |
| Operating profit (loss) | 3,452 | 186 | (112) | \$ 3,526 |
| Interest expense, net | (222) | (24) | (446) | \$ (692) |
| Minority interest | | | (445) | \$ (445) |
| Pre-tax income | | | | \$ 2,389 |
| Segment assets | \$ 63,162 | \$ 8,439 | \$ 8,801 | \$ 80,402 |
| Six months ended 6/30/2004 | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 54,940 | \$ 12,112 | | \$ 67,052 |
| Operating profit (loss) | 4,381 | 549 | (693) | \$ 4,237 |
| Interest expense, net | 124 | (47) | (815) | \$ (738) |
| Minority interest | | | (609) | \$ (609) |
| Pre-tax income | | | | \$ 2,890 |
| Segment assets | \$ 55,366 | \$ 8,365 | \$ 12,493 | \$ 76,224 |
| Six months ended 6/30/2003 | | | | Consolidated |
| Segments | Construction | Distribution | Corporate | Total |
| Revenues | \$ 79,537 | \$ 11,472 | | \$ 91,009 |
| Operating profit (loss) | 5,973 | 456 | (182) | \$ 6,247 |
| Interest expense, net | (339) | (47) | (906) | \$ (1,292) |
| Minority interest | | | (769) | \$ (769) |
| Pre-tax income | | | | \$ 4,186 |

| | | | | | | | | |
|----------------|----|--------|----|-------|----|-------|----|--------|
| Segment assets | \$ | 63,162 | \$ | 8,439 | \$ | 8,801 | \$ | 80,402 |
|----------------|----|--------|----|-------|----|-------|----|--------|

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9. Privatization of SCPI

In October 2003, the Board of Directors of SCPI approved a 1 for 300,000 reverse split of SCPI's common stock and deregistration of such stock as a listed equity security. The transaction was approved by the Company, SCPI's majority stockholder. Holders of less than one share as a result of the reverse split became entitled to receive cash in lieu of fractional shares at the rate of \$0.0168 (one point six eight cents) per pre-split share. The transaction was effective March 29, 2004, with the result that SCPI became a wholly-owned subsidiary of the Company from that date and ceased to have any publicly-listed securities.

10. Subsequent Event

On July 16, 2004, the individual shareholders owning the 19.9% of SHH not held by the Company exercised their right to sell (Put) those shares to the Company on July 19, 2004, the earliest date they were permitted to exercise that right under the July 2001 agreement pursuant to which the Company purchased 80.1% of SHH (the Sterling Transaction). The purchase by the Company will be completed before the end of fiscal 2004, following which the Company will own 100% of SHH.

Pursuant to the Sterling Transaction, the purchase price of the SHH shares is computed as a multiple of SHH's trailing twelve months EBITDA, with a minimum price of \$12 million. At the date of the Put exercise, it was estimated that the purchase price would be in the range of \$14 million to \$15 million, to be satisfied through borrowings on available long-term bank facilities (approximately \$2.4 million), five-year notes of \$6.4 million and the balance in shares of the Company's common stock, valued at \$4.00 per share.

The Put also triggers the payment of approximately \$7.9 million of the Company's debt owed to management and others who funded the Sterling Transaction in 2001. The Company will pay this amount as well through a combination of borrowings on available long-term bank facilities (approximately \$2.3 million), issuance of five-year notes (approximately \$4.7 million) and the balance in the Company's common stock, valued at \$4.00 per share.

The completion of the Put transaction is currently estimated to result in an increase of approximately \$3.6 million in the Company's reported amount of goodwill related to SHH.

The following unaudited proforma condensed balance sheet reflects the Put transaction as if it had been completed on June 30, 2004, using an assumed purchase price of \$14.5 million. The condensed statements of operations for the three and six month periods ended June 30, 2004 reflect the Put transaction as if it had been completed at the beginning of its respective period. The condensed statements of operations for fiscal 2003 reflect the transaction as if it had been completed on January 1, 2003, even though, by its terms, the Put was not exercisable before July 19, 2004 (dollar amounts in thousands, except per share data).

STERLING CONSTRUCTION COMPANY, INC.
CONDENSED PROFORMA CONSOLIDATED BALANCE SHEET
(Unaudited, in thousands)

| | June 30, 2004 (unaudited) | Proforma Adjustment (unaudited) | Proforma at June 30, 2004 (unaudited) |
|--|---------------------------------|---------------------------------------|--|
| Assets: | | | |
| Current assets | \$ 43,012 | | \$ 43,012 |
| Fixed assets, net | 21,226 | | 21,226 |
| Goodwill | 7,809 | 3,040(a) | 10,849 |
| Other long-term assets | 4,177 | | 4,177 |
| Total assets | \$ 76,224 | \$ 3,040 | \$ 79,264 |
| | | | |
| Liabilities and stockholders' equity: | | | |
| Accounts payable and other obligations | \$ 28,231 | | \$ 28,231 |
| Current portion of long term debt, related party | 1,310 | 1,271(a) | 2,581 |
| Long-term debt | 8,390 | 4,650(b) | 13,040 |
| Long-term debt, related party (including related accrued interest) | 7,718 | 2,847(c) | 10,565 |
| Put liability | 5,578 | (5,578)(d) | |
| Minority interest | 5,882 | (5,882)(e) | |
| | | | |
| Stockholders' equity: | | | |
| Common stock | 53 | 14(f) | 67 |
| Additional paid in capital | 66,847 | 5,718(f) | 72,565 |
| Accumulated deficit | (47,784) | | (47,784) |
| Treasury stock | (1) | | (1) |
| Total stockholders' equity | 19,115 | | 24,847 |
| Total liabilities and stockholders' equity | \$ 76,224 | \$ 3,040 | \$ 79,264 |

Notes:

- (a) Reflects increase in goodwill of \$3.0 million due to purchase of remaining 19.9% of SHH at a price estimated at \$14.5 million
- (b) Put transaction expected to be funded through availability on long-term bank facilities
- (c) Reflects issuance of \$6.4 million in five-year notes related to Put; repayment of \$2.2 million of existing \$7.7 million notes (the payment of which is triggered by the Put), with the balance of \$5.3 million replaced by new five-year, amortizing notes.

- (d) Liability related to the Put of \$5.9 million is extinguished
- (e) Minority interest of \$5.4 million relating to the Put shares is extinguished
- (f) Approximately 1.4 million shares of common stock, valued at \$4.00 are issued in part satisfaction of the Put consideration.

STERLING CONSTRUCTION COMPANY, INC.
CONDENSED PROFORMA CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited, in thousands)

| | Three months ended June 30, 2004 (unaudited) | Proforma adjustment (unaudited) | Three months Proforma at June 30, 2004 (unaudited) |
|--|---|---------------------------------------|---|
| Total revenues | \$ 34,743 | | \$ 34,743 |
| Operating profit | 3,088 | | 3,088 |
| Interest expense, net of interest income | 219 | 168(a) | 387 |
| Minority interest | 442 | (442)(b) | |
| Income before tax | 2,427 | 274 | 2,701 |
| Net income | \$ 1,624 | \$ 150(d) | \$ 1,774 |
| Weighted average shares, basic | 5,316 | 1,432(c) | 6,748 |
| Earnings per share, basic | \$ 0.31 | | \$ 0.26 |
| Weighted average shares, diluted | 7,082 | 1,432(c) | 8,290 |
| Earnings per share, diluted | \$ 0.23 | | \$ 0.21 |

Notes:

- (a) Interest expense of \$382 related to issuance of new notes pursuant to the Put transaction, offset by decrease in interest expense of \$214 on existing notes that are repaid or replaced as part of the Put transaction.
- (b) Minority interest expense of \$442 related to the Put shares is eliminated.
- (c) Reflects issuance of 1.4 million shares of common stock in part satisfaction of the Put consideration.
- (d) Increase in income, net of tax

| | Six months ended June 30, 2004 (unaudited) | Proforma adjustment (unaudited) | Six months Proforma at June 30, 2004 (unaudited) |
|----------------|--|---------------------------------------|--|
| Total revenues | \$ 67,052 | | \$ 67,052 |

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| | | | |
|--|----------|-----------|----------|
| Operating profit | 4,237 | | 4,237 |
| Interest expense, net of interest income | 738 | 336(a) | 1,074 |
| Minority interest | 609 | (609)(b) | |
| Income before tax | 2,890 | 273 | 3,163 |
| Net income | \$ 1,891 | \$ 180(d) | \$ 2,071 |

| | Six months ended June 30, 2004 (unaudited) | Proforma adjustment (unaudited) | Six months Proforma at June 30, 2004 (unaudited) |
|----------------------------------|--|---------------------------------------|--|
| Weighted average shares, basic | 5,242 | 1,432(c) | 6,674 |
| Earnings per share, basic | \$ 0.36 | | \$ 0.31 |
| Weighted average shares, diluted | 7,174 | 1,432(c) | 8,606 |
| Earnings per share, diluted | \$ 0.27 | | \$ 0.24 |

Notes:

- (a) Interest expense of \$763 related to issuance of new notes pursuant to the Put transaction, offset by decrease in interest expense of \$427 on existing notes that are repaid or replaced as part of the Put transaction.
- (b) Minority interest expense of \$609 related to the Put shares is eliminated.
- (c) Reflects issuance of 1.4 million shares of common stock in part satisfaction of the Put consideration.
- (d) Increase in income, net of tax

STERLING CONSTRUCTION COMPANY, INC.
CONDENSED PROFORMA CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands)

| | Fiscal year ended December 31, 2003 | Proforma adjustment (unaudited) | Proforma Fiscal year ended December 31, 2003 (unaudited) |
|--|--|---------------------------------------|--|
| Total revenues | \$ 170,093 | | \$ 170,093 |
| Operating profit | 10,998 | (1,001)(a) | 11,999 |
| Interest expense, net of interest income | 2,074 | 359(b) | 2,433 |
| Minority interest | 1,627 | (1,627)(c) | |
| Income before tax | 7,297 | 2,269 | 9,566 |
| Net income | \$ 5,419 | \$ 1,498 | \$ 6,916 |

| | | | | |
|----------------------------------|----|-------|----------|---------|
| Weighted average shares, basic | | 5,090 | 1,425(d) | 6,515 |
| Earnings per share, basic | \$ | 1.06 | | \$ 1.06 |
| Weighted average shares, diluted | | 6,488 | 1,425(d) | 7,913 |
| Earnings per share, diluted | \$ | 0.84 | | \$ 0.87 |

Notes:

- (a) Reverses the increase of \$1,001 in the Put liability during fiscal 2003.
- (b) Additional interest expense of \$1,200 related to the issuance of new notes pursuant to the Put transaction is offset by decrease in interest expense of \$897 related to existing notes repaid or replaced as part of the Put transaction.
- (c) Minority interest expense of \$1,600 related to the Put shares is eliminated.
- (d) Reflects the issuance of 1.4 million of additional common stock in part satisfaction of the Put consideration.

The proforma information is presented for informational purposes only and is not necessarily indicative of the results of operations that actually would have been achieved had the Put transaction been consummated as at the times indicated, nor is it intended to be a projection of future results.

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

Forward Looking Statements

From time to time the information provided by the Company or statements made by its employees may contain so-called forward-looking information that involves risks and uncertainties. In particular, statements contained in this Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations, which are not historical facts (including, but not limited to, statements concerning anticipated sales, contracts, profit levels, customers, backlog and cash flows) are forward-looking statements. The Company's actual future results may differ significantly from those stated in any forward-looking statements. Factors that may cause such differences include, but are not limited to, the factors discussed above as well as the accuracy of the Company's internal estimates of revenue and operating expense levels. Each of these factors, and others, are discussed from time to time in the Company's Securities and Exchange Commission filings.

Overview

The Company was formed in 1991 as a result of a merger designed to facilitate capital formation by the Company while permitting the Company and its subsidiary, Steel City Products, Inc. (SCPI or the Distribution Segment) to file consolidated tax returns to utilize existing tax benefits, which at December 31, 2003 included approximately \$88 million of net operating tax loss carryforwards. The Distribution Segment is conducted by SCPI under the trade name Steel City Products and involves the distribution of automotive parts and accessories, together with non-food pet supplies and lawn and garden products, from facilities in McKeesport and Glassport, Pennsylvania. SCPI is believed to be one of the largest independent wholesale distributors of automotive accessories in the Northeastern United States.

In January 1999 the Company made a minority investment in Sterling Houston Holdings, Inc. (SHH or the Construction Segment), a heavy civil construction company based in Houston, Texas that specializes in municipal and state highway contracts for paving, bridge, water and sewer, and light rail projects. In July 2001, the Company increased its equity ownership of SHH from 12% to 80.1% (the Sterling Transaction).

On July 16, 2004, the individual shareholders owning the 19.9% of SHH not held by the Company exercised their right to sell (Put) those shares to the Company on July 19, 2004, the earliest date they were permitted to exercise that right under the Sterling Transaction. The purchase by the Company will be completed by the end of fiscal 2004, following which the Company will own 100% of SHH (the Put Transaction).

Liquidity and Capital Resources

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

At SCPI, the level of working capital needs varies primarily with the amounts of inventory carried, the size and timeliness of payment of receivables from customers and the amount of

credit extended by suppliers, all of which can fluctuate seasonally. SCPI's working capital needs not financed by supplier credit have been financed from cash flow, borrowings under its line of credit and other loans.

Put Liability

As part of the Sterling Transaction, the Company granted a Put option for the 19.9% of SHH not then acquired by the Company, pursuant to which the selling shareholders were granted the right to sell the remaining SHH shares to the Company at a date of their choosing between July 2004 and July 2005. The price of the Put is based on a multiple of EBITDA for the 12 months immediately preceding the Put exercise date.

Pursuant to a Put Restructuring Agreement entered into in September 2003, terms of settlement of the Put were agreed.

The Put was exercised on July 19, 2004 and the Put transaction will be completed by the end of fiscal 2004.

Financing

At June 30, 2004, the Company's debt consisted of (in thousands):

| | |
|----------------------------------|-----------|
| Related party notes: | |
| Subordinated debt | \$ 500 |
| Zero coupon notes | 5,514 |
| Convertible subordinated notes | 560 |
| Management/director notes | 1,796 |
| | 8,370 |
| SHH revolver | 8,390 |
| SCPI revolver | 3,685 |
| Insituform notes | 188 |
| Mortgage payable | 1,080 |
| Equipment notes & capital leases | 71 |
| | \$ 21,784 |

Related Party Notes

Subordinated Debt

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

Subordinated Zero Coupon Notes

The Sterling Transaction was funded in part through the sale of zero coupon notes and the issuance of zero coupon notes to certain selling shareholders of SHH. Warrants for Sterling common stock were issued in connection with the zero coupon notes. The zero coupon notes are shown at their present value, discounted at a rate of 12% and mature

four years from the date of closing of the Sterling Transaction, but become due upon completion of the Put transaction, if sooner. Warrants issued in connection with the notes are exercisable for ten years from closing and become exercisable four years after issuance at \$1.50 per common share. In the Sterling Transaction, Patrick Manning, Chairman and Chief Executive Officer of the Company, and

Joseph P. Harper received zero coupon notes in the face amount of \$799,000 and \$1.0 million, respectively and warrants for 63,486 shares and 80,282 shares, respectively. In December 2003, a prepayment of \$1.3 million was made on the zero coupon note issued to North Atlantic Smaller Companies Investment Trust (NASCIT) in consideration for the forgiveness of six months' interest on such notes.

Pursuant to the Sterling Transaction, as modified by the Put Restructuring Agreement, the exercise of the Put on July 19, 2004 triggered payment of the zero coupon notes. Upon completion of the Put transaction approximately \$1.5 million of the notes is to be paid in cash utilizing funding from long term borrowings under SHH's line of credit, \$765,000 is to be satisfied by the issuance of the Company's shares at a value of \$4.00 per share, and balance will be converted into new five-year obligations.

Convertible Subordinated Notes

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

Management/Director Notes

Notes with an aggregate face amount of \$1.3 million issued in connection with the October 1999 purchase of the second equity tranche of shares of SHH were restructured as part of the Sterling Transaction. Of the total, notes for \$800,000 were due to members of SHH's management, including Joseph P. Harper, since appointed President of the Company. Notes totaling approximately \$550,000 were due to Robert Davies, the Company's former Chairman and Chief Executive Officer, and, through a participation agreement, Maarten Hemsley, formerly the Company's President and now its Chief Financial Officer. In consideration for the extension of the maturity dates of these notes, the face amounts were increased by an aggregate of approximately \$342,000. Furthermore, certain accrued amounts due to Messrs. Davies and Hemsley aggregating approximately \$355,000 were converted into notes. All such notes mature after four years and carry interest at 12%. Principal and interest may be paid only from defined cash flow of Sterling and SCPI, or from proceeds of any sale of SCPI's business. In December 2003, prepayments of accrued interest and principal were made to certain of these noteholders. Mr. Harper received a prepayment \$86,000 and Mr. Davies received a prepayment \$411,000. Mr. Hemsley declined any prepayment of his notes.

Pursuant to the Sterling Transaction, the exercise of the Put on July 19, 2004 triggered payment of the Management/Director notes. Under the terms of the Put Restructuring Agreement, one half of the notes is to be paid in cash utilizing funding from long term borrowings under the SHH line of credit, with the balance to be converted into new five year obligations.

Short Term Promissory Notes

In January 2003, members of management of the Company and of SHH (including Messrs. Harper and Hemsley) further funded SCPI with a \$250,000 short-term loan to reduce SCPI's vendor payables. Interest on the notes was payable monthly at the annual rate of 10%.

The notes, which are subordinated to the SCPI Revolver, matured in July 2003, but have been extended beyond that date, with the granting of a guarantee by SHH and an increase in the interest rate to 12% per annum, effective January 2004. These notes may be prepaid without penalty.

SHH Revolver and SCPI Revolver

In conjunction with the Sterling Transaction, SHH entered into a three-year bank agreement providing for a revolving line of credit originally with a maximum line of \$17.0 million, subject to a borrowing base (the SHH Revolver). The line of credit carries interest at prime, subject to achievement of certain financial targets, is secured by the equipment of SHH and is subject to the maintenance of certain financial covenants. In March 2003, SHH agreed with its bank on a two-year extension of the line of credit, until March 31, 2006, and at the Company's request, reflecting strong cash flow and expected lower borrowing requirements, the maximum amount available was reduced to \$14.0 million. At June 30, 2004, the balance on the SHH Revolver was \$8.4 million, with interest at 4.0%, and SHH was in compliance with its covenants.

Management believes that the SHH Revolver will provide adequate funding for SHH's working capital, debt service and capital expenditure requirements, including seasonal fluctuations, for at least the next twelve months and for the upstreaming to the Company sufficient to satisfy cash payments for the Put and other debt.

In July 2001, in connection with the Sterling Transaction, SCPI replaced its bank line of credit (the SCPI Revolver). The total amount available under the line is \$5.0 million, subject to a borrowing base. The SCPI Revolver carries an interest rate of prime plus 1%, is secured by the assets of SCPI and is subject to the maintenance of financial covenants. At June 30, 2004, the balance on the SCPI Revolver was \$3.7 million and the effective rate of interest was 5.0%. SCPI was in compliance with its covenant requirements. In May 2004 the bank agreed to extend the SCPI Revolver to May 2006.

Although the SCPI Revolver expires in May 2006 and the Company has the intent and believes it will have the ability to maintain this debt outstanding for more than one year, the Company has classified borrowings under the SCPI Revolver as a current liability in accordance with the provisions set forth in Emerging Issues Task Force (EITF) 95-22 Balance Sheet Classifications, Borrowings Outstanding Under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement. As the credit agreement contains these provisions, the accompanying balance sheets have been restated and borrowings under the SCPI Revolver previously reported as a long-term liability have been reclassified as a current liability.

Management believes that the SCPI Revolver and the proceeds from the Convertible Subordinated Notes and short-term notes will provide adequate funding for SCPI's working capital, debt service and capital expenditure requirements, including seasonal fluctuations for at least the next twelve months, assuming no material deterioration in current sales levels or profit margins.

Insituform Notes

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

SHH Mortgage

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

Cash Flows

| (in thousands) | June 30, 2004 | June 30, 2003 |
|---------------------------------|------------------|------------------|
| Cash and cash equivalents | \$ 1,891 | \$ 2,768 |
| Net cash provided by (used in): | | |
| Operating activities | 315 | 13,992 |
| Investing activities | (1,163) | (3,022) |
| Financing activities | 1,755 | (10,586) |
| Capital expenditures | (1,255) | (3,022) |
| Working capital | 17,498 | 4,990 |

For the six months ended June 30, 2004, the Company's consolidated operations provided \$315,000 in cash, as compared with cash provided by operations in the prior year period of \$14.0 million. The change was due to decreases in contracts receivable, inventories, and billings and estimated earnings in excess of costs on uncompleted contracts offset by a smaller increase in trade payables.

In the six months ended June 30, 2004, cash used in investing activities decreased by \$1.8 million compared with the prior year period, due to fewer capital expenditures for construction equipment.

Cash provided by financing activities increased by \$12.3 million in the first six months, compared with the same period last year, due to higher borrowings on the SHH and SCPI revolvers and by cash received from the exercise of options. In the prior year, SHH reduced its line of credit significantly.

The increase of \$12.5 million in the level of working capital at the end of the second quarter, compared with such level at the end of the prior year period reflects changes in several components of working capital as detailed in the Condensed Consolidated Statements of Cash Flows.

Inflation

Management does not believe that inflation has had a material negative impact on the Company's operations or financial results during recent years. However, increases in oil prices may have an adverse effect on the Construction Segment and recent fluctuations in the price of steel have affected the prices at which the Construction Segment has bid certain contracts, and potential gross profits on contracts.

Risk Factors

SHH measures its performance within the construction industry through the bidding process and the number, size and expected profitability of contracts obtained throughout the year. The Company is subject to various risks and uncertainties. Many factors affect the bidding

climate, including, but not limited to, fluctuations in the local economy, the amount of local, state and federal government funds available for infrastructure upgrade and new construction, as well as the number of bidders in the market and the prices at which they are prepared to bid, which are in turn affected by such bidders' profitability, financial strength and contract backlogs. Factors outside the bidding climate include: (a) weather conditions, such as precipitation and temperature, which can result in significant variability in quarterly revenues and earnings, particularly in the first and fourth quarters; (b) the availability of bonding, the absence of which would adversely affect the Company's ability to obtain new contracts; (c) the price of oil products, which can fluctuate significantly impacting operating expenses, and (d) the availability and price of steel and of cement and other raw materials for the production of concrete. While in fiscal 2003, the Company reported significant growth in Construction Segment revenues and profitability, there can be no assurance that it will be able to continue to do so. In the first half of fiscal 2004 the Construction Segment's revenues and profitability were lower than in the prior year first quarter, as described under "Results of Operations" below.

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

Certification

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

Material Changes in Financial Condition

At June 30, 2004, there had been no material changes in the Company's financial condition since December 31, 2003, as discussed in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Results of Operations

Operations include the Company's investment in SHH, net of minority interest, (the "Construction Segment") and the consolidated results for SCPI (the "Distribution Segment").

Three months ended June 30, 2004 compared with three months ended June 30, 2003

Construction

The second quarter of the current year was adversely affected by significant rainfall that resulted in severely curtailed levels of construction work on most of the Company's contracts. In the prior year second quarter there were few delays caused by rain. As a result, construction revenues fell \$14.5 million or 30% compared with the prior year period.

Construction Segment gross profit for the quarter was \$4.6 million, or 15.7% of contract revenues, compared with gross profit in the second quarter last year of \$4.5 million, or 10.1% of contract revenues. Gross profit was adversely affected by the reduction in revenues and higher fixed cost absorption rates. Offsetting this effect were favorable results on a number of contracts during the current year period.

Operating profit at the Construction Segment for the second quarter totaled \$3.1 million, a decrease of \$320,000, principally due to increases in administrative expenses, including the hiring of additional project managers.

Distribution

Sales at the Distribution Segment were essentially unchanged compared with the prior year. Although sales of pet supplies increased by \$154,000 and sales of lawn and garden products increased by \$53,000, sales of automotive accessories decreased by \$271,000 due to unseasonably wet and cold weather, which hindered the sale of appearance products, such as waxes and car wash products. The increase in pet supply sales was due to increased promotional activity and the sales increase in lawn and garden products was due to sales to a new customer added in fiscal 2004.

Gross profit for Distribution was \$862,000, or 16.0% of sales, compared with gross profit in the prior year of \$848,000, or 15.6% of sales. Margins increased on lawn and garden and pet products, but declined on automotive accessories.

The Distribution Segment reported an operating profit of \$209,000 in the second quarter, compared with an operating profit of \$186,000 in the second quarter of the prior year. The increase of \$23,000 was primarily the result of the improvement in gross margin combined with a reduction in expenses.

Corporate

Operating expenses at the corporate level increased by approximately \$141,000 due to a non-cash charge of about \$45,000 related to variable option plan accounting (in March 2004, the Company discontinued variable option plans); additional legal, audit and accounting fees related to the implementation of Sarbanes-Oxley control procedures, and higher expenses related to increased filings of regulatory documents.

Six months ended June 30, 2004 compared with six months ended June 30, 2003

Construction

Contract revenues in the six months of fiscal 2004 reflected a decrease compared with the prior year of \$24.6 million, due to particularly poor weather, which significantly reduced the days available for construction on many of the Segment's contracts. Favorable weather in the prior year first six months had allowed the Construction Segment to complete contracts more quickly and efficiently.

Construction Segment gross profit for the first six months was \$7.3 million, or 13.3% of contract revenues, compared with gross profit in the prior year period of \$8.3 million, or 10.4% of contract revenues. Although gross profit decreased by approximately \$1.0 million due to the reduction in revenues and higher fixed cost absorption rates, margins increased by 2.8% due to favorable results on a number of contracts in the second quarter of the current year.

Operating profit at the Construction Segment decreased by \$1.5 million, principally due to the lower gross profits compared with the prior year and to increases in administrative expenses, including the addition of personnel and increases in employee benefit expenses.

Distribution

The sales increase of approximately \$640,000 at the Distribution Segment was due primarily to increased sales to existing customers of automotive and pet products. Sales of automotive accessories increased by \$402,000 due to more severe winter weather in SCPI's

market area, resulting in higher sales of winter related products in the first quarter. Sales of pet supplies increased by \$241,000 due to the addition of new product lines and increased promotional activity to certain customers, which replaced slower moving items. For the first six months of fiscal 2004, sales of lawn and garden products were unchanged compared with the prior year, due to the longer winter season which delayed shipments of spring and summer products; the bankruptcy filing in the prior year of two lawn and garden customers was offset by sales to a new customer added in the current year.

Gross profit for Distribution was \$1.8 million, or 14.9% of sales, compared with gross profit in the prior year of \$1.7 million, or 14.9% of sales.

The Distribution Segment reported an operating profit of \$549,000 in the first six months, compared with an operating profit of \$456,000 in the first six months of the prior year. The increase of \$94,000 was primarily related to the higher gross profits.

Corporate

Operating expenses at the corporate level increased by approximately \$511,000 due primarily to a non-cash charge of \$258,000 related to variable option expense for option grants after June 2000 and before adoption of SFAS 123 in January 2003. In March 2004, the Company discontinued variable option plans. In addition, the Company experienced higher administrative expenses in connection with the listing of its common shares on the American Stock Exchange in February 2004, for corporate insurance, for additional legal, audit and accounting fees related to the implementation of Sarbanes-Oxley control procedures, and for legal fees related to the Put Transaction.

Company Website

The Company maintains a website at www.sterlingconstructionco.com. The Company makes available free of charge on or through its website, access to its latest Annual Report on Form 10-K, recent Quarterly Reports on Form 10-Q, any amendments to those filings, recent press releases, its Code of Ethics, Audit Committee Charter and Compensation Committee Charter, together with other filings related to shareholdings.

Item 3. Qualitative and Quantitative Disclosure about Market Risk

The Company is exposed to certain market risks from transactions that are entered into during the normal course of business. Sterling's primary market risk exposure is related to interest rate risk. The Company manages its interest rate risk by balancing in part its exposure between fixed and variable rates while attempting to minimize its interest costs.

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

An increase of 1% in the market rate of interest would have increased the Company's net interest expense for the six months ended June 30, 2004 by approximately \$25,000.

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

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

The Company's Chief Executive Officer and Chief Financial Officer (its principal executive officer and principal financial officer, respectively) have evaluated the effectiveness of the Company's disclosure controls and procedures as of June 30, 2004. Based on their evaluation, excepted as noted below, the principal executive officer and principal financial officer concluded that the Company's controls and procedures are effective.

Changes in Internal Controls

Subsequent to the issuance of the Company's financial statement for the quarter ended June 30, 2004, the Company's management determined that borrowings under the SCPI Revolver should have been classified as short-term on the consolidated balance sheets. As a result, the accompanying condensed balance sheets as of June 30, 2004 have been restated and related disclosures have been added in Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations under the sub-heading Financing SHH Revolver and SCPI Revolver. The Company will perform a thorough review of all new loan agreements to specifically identify proper classification of debt.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

There are no material legal proceedings outstanding against the Company.

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

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

No matters were submitted to a vote of security holders during the quarter for which this report is filed.

Item 5. Other Information None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 10.1 Put Exercise Notice dated July 19, 2004
- *31.1 Certification of Patrick T. Manning, Chief Executive Officer pursuant to Rule 13a-14(a)
- *31.2 Certification of Maarten D. Hemsley, Chief Financial Officer, pursuant to Rule 13a-14(a)
- *32.0 Certification of Patrick T. Manning, Chief Executive Officer and Maarten D. Hemsley, Chief Financial Officer 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

Report on Form 8-K announcing results of operations for the quarter ended March 31, 2004, dated May 13, 2004

Report on Form 8-K announcing new contract wins dated May 18, 2004

Report on Form 8-K announcing a new contract award dated June 7, 2004

*filed herewith

SIGNATURES

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

**STERLING
CONSTRUCTION
COMPANY, INC.**

Date:
March 14,
2005

By: /s/ Patrick T. Manning.

Patrick T. Manning.
Chief Executive Officer

Date:
March 14,
2005

/s/ Maarten D. Hemsley

By:

Maarten D. Hemsley
Chief Financial Officer