

VERITAS DGC INC  
Form 10-Q  
June 14, 2004

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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### Form 10-Q

(Mark One)

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

For the quarterly period ended April 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 1-7427

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### Veritas DGC Inc.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**76-0343152**

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

**10300 Town Park  
Houston, Texas**

(Address of principal executive offices)

**77072**

(Zip Code)

**(832) 351-8300**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares of the Company's common stock, \$.01 par value, outstanding at May 31, 2004 was 33,417,540 (including 849,447 Veritas Energy Services Inc. exchangeable shares which are identical to the Common Stock in all material respects).

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## VERITAS DGC INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)

|   | Three Months Ended April 30, |            | Nine Months Ended April 30, |            |
|---|------------------------------|------------|-----------------------------|------------|
|   | 2004                         | 2003       | 2004                        | 2003       |
| (In thousands, except per share amounts)                            |                              |            |                             |            |
| <b>Statement of operations:</b>                                     |                              |            |                             |            |
| Revenues  | \$ 176,547                   | \$ 120,636 | \$ 428,667                  | \$ 383,464 |
| Cost of services  | 143,487                      | 97,497     | 375,492                     | 318,446    |
| Research and development  | 4,118                        | 3,274      | 11,258                      | 9,327      |
| General and administrative  | 7,217                        | 6,261      | 19,791                      | 21,744     |
| Operating income  | 21,725                       | 13,604     | 22,126                      | 33,947     |
| Interest expense  | 8,874                        | 5,992      | 17,349                      | 14,359     |
| Other expense (income), net   | (439)                        | (193)      | (956)                       | 1,454      |
| Income before provision for income taxes                            | 13,290                       | 7,805      | 5,733                       | 18,134     |
| Income taxes  | 3,121                        | 3,077      | 7,672                       | 7,353      |
| Net income (loss)   | \$ 10,169                    | \$ 4,728   | \$ (1,939)                  | \$ 10,781  |
| <b>Net income (loss) per share:</b>                                 |                              |            |                             |            |
| Basic:  |                              |            |                             |            |
| Net income (loss) per common share                                  | \$ .30                       | \$ .14     | \$ (.06)                    | \$ .32     |
| Weighted average common shares (including exchangeable shares)      | 33,455                       | 33,348     | 33,598                      | 33,243     |
| Diluted:  |                              |            |                             |            |
| Net income (loss) per common share                                  | \$ .29                       | \$ .14     | \$ (.06)                    | \$ .32     |
| Weighted average common shares (including exchangeable shares)      | 34,601                       | 33,355     | 33,598                      | 33,280     |
| <b>Comprehensive income (loss):</b>                                 |                              |            |                             |            |
| Net income (loss)   | \$ 10,169                    | \$ 4,728   | \$ (1,939)                  | \$ 10,781  |
| Other comprehensive income (loss) (net of tax, \$0 in all periods): |                              |            |                             |            |
| Foreign currency translation adjustments                            | (3,541)                      | 5,651      | 2,394                       | 7,250      |
| Other unrealized gain (loss)  | 19                           | (584)      | (585)                       | (219)      |
| Total other comprehensive income (loss)                             | (3,522)                      | 5,067      | 1,809                       | 7,031      |
| Comprehensive income (loss)   | \$ 6,647                     | \$ 9,795   | \$ (130)                    | \$ 17,812  |

See Notes to Consolidated Financial Statements



## VERITAS DGC INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except par value)

## UNAUDITED

|   | April 30,<br>2004 | July 31,<br>2003  |
|---|-------------------|-------------------|
|   | <u>          </u> | <u>          </u> |
| <b>Assets:</b>  |                   |                   |
| Current assets:   |                   |                   |
| Cash and cash equivalents   | \$ 87,265         | \$ 72,626         |
| Restricted cash investments   | 111               | 205               |
| Accounts and notes receivable (net of allowance: \$1,068 and \$7,953, respectively)   | 172,714           | 131,645           |
| Materials and supplies inventory  | 3,245             | 5,044             |
| Prepayments and other   | 12,279            | 13,365            |
| Income taxes receivable   | 8,151             | 11,335            |
|   | <u>          </u> | <u>          </u> |
| Total current assets  | 283,765           | 234,220           |
| Property and equipment  | 491,013           | 492,639           |
| Less accumulated depreciation   | 364,295           | 341,430           |
|   | <u>          </u> | <u>          </u> |
| Property and equipment, net   | 126,718           | 151,209           |
| Multi-client data library   | 324,825           | 371,949           |
| Investment in and advances to joint ventures  |                   | 4,657             |
| Deferred tax asset  | 1,755             | 2,546             |
| Other assets  | 26,253            | 23,781            |
|   | <u>          </u> | <u>          </u> |
| Total   | \$ 763,316        | \$ 788,362        |
|   | <u>          </u> | <u>          </u> |
| <b>Liabilities and Stockholder's Equity:</b>  |                   |                   |
| Current liabilities:  |                   |                   |
| Current portion of long-term debt   | \$ 444            | \$ 13,908         |
| Trade accounts payable  | 35,945            | 43,423            |
| Other accrued liabilities   | 46,664            | 41,880            |
|   | <u>          </u> | <u>          </u> |
| Total current liabilities   | 83,053            | 99,211            |
| Non-current liabilities:  |                   |                   |
| Long-term debt  | 181,543           | 180,317           |
| Other non-current liabilities   | 19,085            | 18,701            |
|   | <u>          </u> | <u>          </u> |
| Total non-current liabilities   | 200,628           | 199,018           |
| Stockholders' equity:   |                   |                   |
| Common stock, \$.01 par value; issued: 33,824,509 shares and 32,156,781 shares, respectively (excluding common stock equivalent exchangeable shares of subsidiary of 851,931 and 1,443,411, respectively) | 338               | 322               |
| Additional paid-in capital  | 438,426           | 428,402           |
| Accumulated earnings (from August 1, 1991 with respect to Digicon Inc.)   | 58,578            | 60,517            |
| Accumulated other comprehensive income (loss):  |                   |                   |
| Cumulative foreign currency translation adjustment  | 5,912             | 3,518             |
| Other comprehensive loss  | (1,363)           | (778)             |
| Unearned compensation   | (632)             | (340)             |

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|   | <u>April 30,<br/>2004</u> | <u>July 31,<br/>2003</u> |
|---|---------------------------|--------------------------|
| Treasury stock, at cost; 1,317,314 shares and 84,143 shares, respectively | (21,624)                  | (1,508)                  |
| Total stockholders' equity  | 479,635                   | 490,133                  |
| Total   | \$ 763,316                | \$ 788,362               |

See Notes to Consolidated Financial Statements

## VERITAS DGC INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|  | Nine Months Ended April 30, |                  |
|--|-----------------------------|------------------|
|  | 2004                        | 2003             |
| (In thousands)   |                             |                  |
| <b>Cash flows from operating activities:</b>                 |                             |                  |
| Net income (loss)  | \$ (1,939)                  | \$ 10,781        |
| Non-cash items included in net income (loss):                |                             |                  |
| Depreciation and amortization, net (other than multi-client) | 31,655                      | 36,202           |
| Amortization of multi-client library                         | 163,390                     | 106,809          |
| Impairment of land acquisition equipment                     |                             | 1,780            |
| Loss (gain) on disposition of property and equipment         | 137                         | (225)            |
| Equity in loss of joint venture                              | 958                         | 1,158            |
| Deferred taxes   | 782                         |                  |
| Amortization of unearned compensation                        | 311                         | 520              |
| Change in operating assets/liabilities:                      |                             |                  |
| Accounts and notes receivable                                | (39,730)                    | 5,359            |
| Materials and supplies inventory                             | 1,802                       | 12,903           |
| Prepayments and other  | 603                         | 1,161            |
| Income tax receivable  | 4,328                       | 5,693            |
| Accounts payable and other accrued liabilities               | (3,815)                     | (19,365)         |
| Other  | (6,126)                     | (634)            |
|  | <u>152,356</u>              | <u>162,142</u>   |
| Net cash provided by operating activities                    | 152,356                     | 162,142          |
| <b>Cash flows from investing activities:</b>                 |                             |                  |
| Increase (decrease) in restricted cash                       | 94                          | (39)             |
| Investment in multi-client data library, net cash            | (97,333)                    | (122,652)        |
| Purchase of property and equipment                           | (20,652)                    | (19,530)         |
| Sale of property and equipment                               | 1,225                       | 2,475            |
| Sale of (RC) <sup>2</sup> software operation                 | 2,000                       |                  |
| Acquisition of business                                      |                             | (9,547)          |
|  | <u>(114,666)</u>            | <u>(149,293)</u> |
| Net cash used by investing activities                        | (114,666)                   | (149,293)        |
| <b>Cash flows from financing activities:</b>                 |                             |                  |
| Borrowing of long-term debt                                  | 155,000                     | 308,236          |
| Payments on long-term debt                                   | (167,238)                   | (260,887)        |
| Net proceeds from sale of common stock                       | 9,119                       | 2,065            |
| Purchase of Treasury Stock                                   | (20,000)                    |                  |
|  | <u>(23,119)</u>             | <u>49,414</u>    |
| Net cash (used) provided by financing activities             | (23,119)                    | 49,414           |
| Currency loss on foreign cash                                | 68                          | 466              |
|  | <u>14,639</u>               | <u>62,729</u>    |
| Change in cash and cash equivalents                          | 14,639                      | 62,729           |
| Beginning cash and cash equivalents balance                  | 72,626                      | 10,586           |
|  | <u>\$ 87,265</u>            | <u>\$ 73,315</u> |
| Ending cash and cash equivalents balance                     | \$ 87,265                   | \$ 73,315        |

Nine Months Ended April 30,

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**Schedule of non-cash transactions:**

|   |    |        |    |        |
|---|----|--------|----|--------|
| Capitalization of depreciation and amortization resulting in an increase in multi-client data library | \$ | 14,380 | \$ | 19,606 |
|---|----|--------|----|--------|

See Notes to Consolidated Financial Statements



VERITAS DGC INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

**1. Summary of significant accounting policies**

*Consolidation*

The accompanying consolidated financial statements include our accounts of majority-owned subsidiaries and variable interest entities of which we are the primary beneficiary. On April 30, 2004, we adopted FIN 46R which required us to consolidate our previously unconsolidated 80% owned joint venture in Indonesia. See "Recent accounting pronouncements" below for more detail. All material intercompany balances and transactions have been eliminated. All material adjustments consisting only of normal recurring adjustments that, in the opinion of management are necessary for a fair statement of the results for the interim periods presented, have been reflected. These interim financial statements should be read in conjunction with our annual audited consolidated financial statements.

*Use of estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Reclassification of prior year balances*

Certain prior year balances have been reclassified for consistent presentation.

*Recent accounting pronouncements*

In December 2003, the Financial Accounting Standards Board issued FIN 46R, a revision to FIN 46 (Consolidation of Variable Interest Entities). FIN 46R replaces FIN 46 and provides additional clarification on the application of ARB No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. We adopted FIN 46R on April 30, 2004. Adoption did not have a material effect on our financial position or results of operations, however, it required consolidation of our 80% owned joint venture accounted for under the equity method prior to adoption of FIN 46R. This entailed consolidating the 80% owned joint venture as of April 30, 2004 on a prospective basis. The 80% owned joint venture provides processing and acquisition services and licenses to our multi-client data. This change is reflected in an increase of multi-client data of \$2.3 million, an increase in other assets and liabilities of \$0.8 million and a decrease in investment in and advances to joint ventures of \$3.1 million.

In December 2003, the Financial Accounting Standards Board issued SFAS No. 132 (Revised 2003), Employer's Disclosures about Pension and Other Postretirement Benefits. This statement retains the disclosures required by SFAS No. 132 and adds additional disclosures. Those disclosures include information describing the types of plan assets, investment strategy, measurement date(s), plan obligations, cash flows, and components of net periodic benefit cost recognized during interim periods. We adopted SFAS No. 132 (Revised 2003) in the quarter ended April 30, 2004.

## 2. Multi-client library accounting change

As of August 1, 2003, we changed our multi-client amortization policy to include a minimum amortization from the date of survey completion, instead of only during the last 24 months of survey book life. This change resulted in a catch-up adjustment of \$22.1 million recognized as additional amortization expense during the first quarter of the current fiscal year and is included in cost of services on the "Consolidated Statements of Operations and Comprehensive Income (Loss)."

## 3. Other expense (income), net

Other expense (income), net consists of the following:

|   | Three Months Ended<br>April 30, |                 | Nine Months Ended<br>April 30, |                 |
|---|---------------------------------|-----------------|--------------------------------|-----------------|
|   | 2004                            | 2003            | 2004                           | 2003            |
| (In thousands)                            |                                 |                 |                                |                 |
| Interest income                           | \$ (250)                        | \$ (453)        | \$ (734)                       | \$ (681)        |
| Net foreign currency exchange loss (gain) | (369)                           | 8               | (634)                          | 705             |
| Loss from unconsolidated joint venture    | 345                             | 210             | 958                            | 1,158           |
| Other loss (gain)                         | (165)                           | 42              | (546)                          | 272             |
| <b>Total</b>                              | <b>\$ (439)</b>                 | <b>\$ (193)</b> | <b>\$ (956)</b>                | <b>\$ 1,454</b> |

## 4. Earnings per common share

Basic and diluted earnings per common share are computed as follows:

|   | Three Months Ended April 30, |               | Nine Months Ended April 30, |               |
|---|------------------------------|---------------|-----------------------------|---------------|
|   | 2004                         | 2003          | 2004                        | 2003          |
| (In thousands, except per share amounts)                          |                              |               |                             |               |
| Net income (loss)   | \$ 10,169                    | \$ 4,728      | \$ (1,939)                  | \$ 10,781     |
| Basic:  |                              |               |                             |               |
| Weighted average common shares<br>(including exchangeable shares) | 33,455                       | 33,348        | 33,598                      | 33,243        |
| Net income (loss) per share                                       | \$ .30                       | \$ .14        | \$ (.06)                    | \$ .32        |
| Diluted:  |                              |               |                             |               |
| Weighted average common shares<br>(including exchangeable shares) | 33,455                       | 33,348        | 33,598                      | 33,243        |
| Shares issuable from assumed exercise of<br>options               | 1,146                        | 7             | 37                          |               |
| <b>Total</b>  | <b>34,601</b>                | <b>33,355</b> | <b>33,598</b>               | <b>33,280</b> |
| Net income (loss) per share                                       | \$ .29                       | \$ .14        | \$ (.06)                    | \$ .32        |

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The following options to purchase common shares have been excluded from the computation assuming dilution because the options' exercise prices exceed the average market price of the underlying common shares or the options are anti-dilutive due to a net loss.

|                      | Three Months Ended April 30, |                 | Nine Months Ended April 30, |                  |
|----------------------|------------------------------|-----------------|-----------------------------|------------------|
|                      | 2004                         | 2003            | 2004                        | 2003             |
| Number of options    | 1,012,682                    | 3,854,346       | 3,503,724                   | 3,221,589        |
| Exercise price range | \$19.375-\$55.125            | \$7.30-\$55.125 | \$5.25-\$55.125             | \$10.71-\$55.125 |
| Expiring through     | March 2012                   | March 2012      | March 2012                  | March 2012       |

The Convertible Senior Notes, with potential dilution of 6.4 million shares, are also excluded from the diluted earnings per share computation, as the notes were not convertible under their terms during the quarter ended April 30, 2004.

### 5. Long-term debt

Long-term debt is as follows:

|   | April 30, 2004    | July 31, 2003     |
|---|-------------------|-------------------|
| (In thousands)                          |                   |                   |
| Term A loan due February 2006           | \$ 5,189          | \$ 29,850         |
| Term B loan due February 2007           | 21,798            | 124,375           |
| Term C loan due February 2008           |                   | 40,000            |
| Convertible Senior Notes due March 2024 | 155,000           |                   |
| <b>Total debt</b>                       | <b>181,987</b>    | <b>194,225</b>    |
| Less: Current portion of long-term debt | 444               | 13,908            |
| <b>Total long-term debt</b>             | <b>\$ 181,543</b> | <b>\$ 180,317</b> |

On February 14, 2003, we entered into a Credit Agreement (the "Credit Agreement") with Deutsche Bank AG, New York Branch, as Administrative Agent, Deutsche Bank AG, Canada Branch, as Canadian Administrative Agent, and certain other lending institutions. The Credit Agreement provides term financing of \$195.0 million under term A, term B and term C tranches (the "Term Loans"), a revolving loan facility aggregating \$55.0 million, including a facility for swing line loans of up to \$10.0 million and the issuance of letters of credit in an aggregate amount of up to \$40.0 million. As of April 30, 2004, there were \$2.2 million in letters of credit outstanding, leaving \$52.8 million available for borrowings. Among other restrictions, the Credit Agreement prohibits us from paying cash dividends. Proceeds from the Term Loans were used to satisfy the obligations under our previous credit agreement and our Senior Notes due October 2003.

The term A loan was in the original principal amount of \$30.0 million, matures in February 2006, and requires quarterly interest payments at a rate, at our election, of LIBOR plus a margin ranging from 3.5% to 4.0% or a base rate plus a margin ranging from 2.25% to 2.75%. These margins are based on certain of our financial ratios. The term B loan was in the original principal amount of \$125.0 million, matures in February 2007, and requires quarterly interest payments at a rate, at our election, of LIBOR plus 5.0%, subject to a 2% LIBOR floor or a base rate plus 3.75%. The term C loan was in the original principal amount of \$40.0 million, would have matured in February 2008, and required quarterly interest payments at a rate, at our election, of LIBOR plus 7.5%, subject to a 3% LIBOR floor or a base rate plus 6.25%.

The term A and term B loans required quarterly combined principal payments of \$387,500 representing 0.25% of the initial principal balances. Should there be an event of default or if an unmatured event of default exists, or the credit rating of any of the debt is below Moody's Ba2 or S&P's BB, or our leverage ratio as of the last day of the most recent excess cash flow calculation period rises above certain levels, the term A and B loans also require principal payments of 50% of the prior fiscal year's cash flow, calculated as per the loan agreement. This payment is due 100 days after the end of the fiscal year and results in a ratable reduction of the future required quarterly principal payments. As our lowest debt rating by Moody's was below the minimum level, we paid \$12.4 million of principal in November 2003 related to the company's cash flow from January 1, 2003 through July 31, 2003. Future excess cash flow payments of this type, if any, will be based on cash flow for full fiscal years. We used \$129.0 million of net proceeds from the Floating Rate Convertible Senior Notes described below to repay in full the term C loan and to prepay portions of the term A and B loans. In addition, we prepaid an additional \$25.0 million of term debt using cash on hand. We recorded \$6.4 million in charges relating to the retirement of the \$154.0 million term debt which included expensing of debt issuance costs, cancellation of interest rate swaps and prepayment penalties. These charges are included in interest expense on the "Consolidated Statement of Operations and Comprehensive Income (Loss)." Based upon the payments in November 2003 and March 2004 for the terms A and B loans, our required quarterly combined principal payment was reduced to \$110,916.

Loans made under the revolving loan facility, including swing-line loans, bear interest at a variable rate determined on the date of borrowing that is related to various base rates and margins depending upon our leverage ratio and the location of the borrowing. The revolving loan facility expires in February 2006.

Borrowings under the Credit Agreement are secured by assets, including equipment, vehicles, multi-client data library, intellectual property, and stock of certain material subsidiaries, owned by us and certain of our subsidiaries. At April 30, 2004, the carrying value of the secured assets, including intercompany receivables, was \$1.1 billion. The Credit Agreement and related documents contain a number of covenants, including financial covenants relating to interest coverage, leverage and net worth. At April 30, 2004, we were in compliance with these covenants.

On March 3, 2004, we sold \$125.0 million aggregate principal amount of Floating Rate Convertible Senior Notes Due 2024 in a private placement. On March 11, 2004, we sold an additional \$30.0 million of Convertible Senior Notes to the initial purchaser. The notes are our senior unsecured obligations and are convertible under certain circumstances into a combination of cash and our common stock at a fixed conversion price of \$24.03 (subject to adjustment in certain circumstances), which is equivalent to an initial conversion ratio of approximately 41.6 shares of our common stock per \$1,000 principal amount of Convertible Senior Notes, or a maximum of approximately 6.4 million shares for the \$155.0 million aggregate principal amount. In general, upon conversion of a note, the holder of such note will receive cash equal to the principal amount of the note and shares of our common stock for the note's conversion value in excess of such principal amount. We used \$129.0 million of net proceeds from the sale of Convertible Senior Notes to repay in full the term C loan and to prepay portions of the term A and B loans. The remaining \$20.0 million of net proceeds from the Convertible Senior Notes was used to repurchase, in negotiated transactions, 1,222,494 shares of our common stock sold by certain purchasers of the Convertible Senior Notes in connection with the offering.

The Convertible Senior Notes bear interest at a per annum rate which will equal the three-month LIBOR rate, adjusted quarterly, minus a spread of 0.75%. The initial interest rate of the notes (through June 14, 2004) will be 0.37%. The notes will mature on March 15, 2024 and may not be redeemed by us prior to March 20, 2009. Holders of the notes may require us to repurchase some, or all, of the notes on March 15, 2009, 2014 and 2019. They could also require repurchase upon a change of control (as defined in the indenture under which the Convertible Senior Notes were issued).

Under certain circumstances and at the option of the holder, the Convertible Senior Notes are convertible prior to the maturity date into cash and shares of our common stock. These circumstances include:

- (1) the closing sale price of our common stock is over 120% of the conversion price for a specified number of trading days
- (2) if we called the notes for redemption and the redemption has not occurred
- (3) the occurrence of a five consecutive trading day period in which the trading price of the notes was less than 95% of the closing sale price of our common stock on such day multiplied by the number of shares our common stock issuable upon conversion of the notes
- (4) the occurrence of specified corporate transactions

The Convertible Senior Notes were sold to Deutsche Bank Securities Inc., the initial purchaser, under an exemption provided by section 4 (2) of the Securities Act. The initial purchaser concurrently sold the notes only to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933, as amended. The notes and the underlying common stock issuable upon conversion have not been registered under the Securities Act or any applicable state securities laws and may not be offered or sold in the United States absent registration or an applicable exemption from such registration requirements. We entered into a registration rights agreement in which we agreed to file within 90 days of March 3, 2004 a registration statement with the Securities and Exchange Commission to register resales of the notes and associated shares of common stock. We filed a registration statement on May 28, 2004 in compliance with the registration rights agreement. We are required to pay liquidated damages in the form of additional interest in the event the registration statement is not effective on or before the 180th day after March 3, 2004 or under certain other circumstances.

## 6. Hedge transactions

In March 2001, we entered into a contract requiring payments in Norwegian kroner to charter the seismic vessel M/V Seisquest. The contract required 36 monthly payments commencing on June 1, 2001. To protect against exposure to exchange rate risk, we entered into multiple forward contracts as cash flow hedges effectively fixing our exchange rate for Norwegian kroner to the U.S. dollar. This contract expired on April 30, 2004.

On February 25, 2003, we entered into interest rate swaps in order to reduce our exposure to the variable interest rates under our Credit Agreement described above. These swaps, with notional amounts totaling \$80.0 million, effectively hedged 41% of our exposure to interest rate changes for the two-year term of the swaps and had no value at inception. On March 29, 2004, upon prepayment of amounts outstanding under our current bank credit facility, the swap agreement was amended to an amount totaling \$10.9 million. This amendment resulted in an expense of \$416,000 and is included in interest expense for the current quarter on the "Consolidated Statements on Operations and Comprehensive Income (Loss)."

Details of the interest rate swaps as of April 30, 2004 are summarized in the following table:

| Tranche Hedged | Amount   | Term      | Pay % | Receive | LIBOR<br>Floor |
|----------------|----------|-----------|-------|---------|----------------|
| (in thousands) |          |           |       |         |                |
| Term A         | \$ 2,900 | 24 months | 1.86  | LIBOR   | None           |
| Term B         | \$ 8,000 | 24 months | 2.49  | LIBOR   | 2%             |

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The values of the interest rate swaps are as follows:

|                     | April 30, 2004         |            | July 31, 2003          |            |
|---------------------|------------------------|------------|------------------------|------------|
|                     | Unrealized Gain/(Loss) | Fair Value | Unrealized Gain/(Loss) | Fair Value |
| Interest rate swaps | (37)                   | (37)       | (777)                  | (777)      |

(In thousands)

In March 2004, we entered into a contract in which we receive payments in pounds sterling. In order to minimize our exposure to currency risk, we purchased a put option in the notional amount of 658,000 pounds sterling and a call option in the amount of 366,000 pounds sterling. As of April 30, 2004, we realized a gain of \$31,000 from this hedge.

## 7. Segment information

We have two segments, land and marine operations, both of which provide geophysical products and services to the petroleum industry. The two segments have been aggregated, as they are similar in their economic characteristics and the nature of their products, production processes and customers. A reconciliation of the reportable segments' results to those of the total enterprise is given below:

|   | Three Months Ended<br>April 30, |             |            |            |             |            |
|---|---------------------------------|-------------|------------|------------|-------------|------------|
|   | 2004                            |             |            | 2003       |             |            |
|   | Segments                        | Corporate   | Total      | Segments   | Corporate   | Total      |
|   | (In thousands)                  |             |            |            |             |            |
| Revenues  | \$ 176,547                      |             | \$ 176,547 | \$ 120,636 |             | \$ 120,636 |
| Operating income (loss)                         | 32,628                          | \$ (10,903) | 21,725     | 21,884     | \$ (8,280)  | 13,604     |
| Income (loss) before provision for income taxes | 28,539                          | (18,370)    | 10,169     | 21,558     | (13,753)    | 7,805      |
|   | Nine Months Ended<br>April 30,  |             |            |            |             |            |
|   | 2004                            |             |            | 2003       |             |            |
|   | Segments                        | Corporate   | Total      | Segments   | Corporate   | Total      |
|   | (In thousands)                  |             |            |            |             |            |
| Revenues  | \$ 428,667                      |             | \$ 428,667 | \$ 383,464 |             | \$ 383,464 |
| Operating income (loss)                         | 49,830                          | \$ (27,704) | 22,126     | 59,665     | \$ (25,718) | 33,947     |
| Income (loss) before provision for income taxes | 40,880                          | (42,819)    | (1,939)    | 57,746     | (39,612)    | 18,134     |

## 8. Pension Plan

We maintain a contributory defined benefit pension plan (the "Pension Plan") for eligible participating employees in the United Kingdom. Monthly contributions by employees are equal to 4% of their salaries. We provide an additional contribution in an actuarially determined amount necessary to fund future benefits to be provided under the Pension Plan. Benefits provided are based upon 1/60 of the employee's final pensionable salary (as defined) for each complete year of service up to 2/3 of the employee's final pensionable salary and increase annually in line with inflation subject to a maximum increase of 5% per annum. The Pension Plan also provides for 50% of such actual or expected benefits to be paid to a surviving spouse upon the death of a participant. Pension Plan assets consist mainly of investments in marketable securities that are held and managed by an independent trustee.

The components of net periodic pension costs are as follows:

|   | Three Months Ended<br>April 30, |               | Nine Months Ended<br>April 30, |               |
|---|---------------------------------|---------------|--------------------------------|---------------|
|   | 2004                            | 2003          | 2004                           | 2003          |
|   | (In thousands)                  |               |                                |               |
| Service cost                                  | \$ 133                          | \$ 147        | \$ 396                         | \$ 434        |
| Interest cost on projected benefit obligation | 237                             | 205           | 713                            | 601           |
| Expected return on plan assets                | (177)                           | (149)         | (527)                          | (439)         |
| Net amortization and deferral                 | 44                              | 37            | 129                            | 110           |
| <b>Net periodic pension costs</b>             | <b>\$ 237</b>                   | <b>\$ 240</b> | <b>\$ 711</b>                  | <b>\$ 706</b> |

Contributions for fiscal 2004 are expected to be approximately \$528,000.

## 9. Stock based compensation

We account for stock based employee compensation using the intrinsic method prescribed in Accounting Principles Board Opinion No. 25 and have adopted the disclosure only provisions of Statement of Financial Accounting Standards No. 148. The effect on net income and earnings per share that would have been recorded using the fair value based method for stock options is as follows:

|   | Three Months Ended<br>April 31, |                 | Nine Months Ended April 30, |                 |
|---|---------------------------------|-----------------|-----------------------------|-----------------|
|   | 2004                            | 2003            | 2004                        | 2003            |
|   | (In thousands)                  |                 |                             |                 |
| Net income (loss), as reported  | \$ 10,169                       | \$ 4,728        | \$ (1,939)                  | \$ 10,781       |
| Add: Stock-based employee compensation expense included in net income (loss), net of related tax effects                                    | 47                              | 108             | 203                         | 338             |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (835)                           | (1,891)         | (4,187)                     | (6,435)         |
| <b>Pro forma net income (loss)</b>  | <b>\$ 9,381</b>                 | <b>\$ 2,945</b> | <b>\$ (5,923)</b>           | <b>\$ 4,684</b> |
| <b>Earnings (loss) per share:</b>   |                                 |                 |                             |                 |
| Basic as reported   | \$ .30                          | \$ .14          | \$ (.06)                    | \$ .32          |
| Basic pro forma   | .28                             | .09             | (.18)                       | .14             |
| Diluted as reported   | ..29                            | ..14            | (.06)                       | ..32            |
| Diluted pro forma   | .27                             | .09             | (.18)                       | .14             |

## 10. Subsequent event

On June 10, 2004, we repaid the remaining \$27.0 million of our bank debt and settled our interest rate swaps. We incurred prepayment penalties of \$218,000 and losses on the swaps of \$25,000.

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

*This report on Form 10-Q and the documents incorporated by reference contain 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. These statements include statements incorporated by reference from other documents we file with the SEC. Forward-looking statements include, among other things, business strategy and expectations concerning industry conditions, market position, future operations, margins, profitability, liquidity and capital resources. Forward-looking statements generally can be identified by the use of terminology such as "may," "will," "expect," "intend," "estimate," "anticipate" or "believe" or similar expressions or the negatives thereof. These expectations are based on management's assumptions and current beliefs based on currently available information. Although we believe that the expectations reflected in such statements are reasonable, we can give no assurance that such expectations will be correct. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report on Form 10-Q. Our operations are subject to a number of uncertainties, risks and other influences, many of which are outside our control, and any one of which, or a combination of which, could cause our actual results of operations to differ materially from the forward-looking statements. Important factors that could cause actual results to differ materially from our expectations are disclosed in "Risk Factors" and elsewhere in our Annual Report on Form 10-K.*

**Overview**

We have seen positive trends in the petroleum industry continue during the third quarter of our current fiscal year. Oil prices have climbed to over \$40 per barrel, we believe driven primarily by speculation related to Middle East supply disruptions. While this supply condition is perhaps temporary, the industry is experiencing increased demand fostered in part by development in emerging economies, such as China and India. We are encouraged that many of our customers seem to be reflecting these higher oil prices into their budgets. While we think they are still using conservative figures, these should be sufficient to drive exploration budgets upward. Although the majority of these budgets will be spent on drilling activity, we believe that seismic spending will increase to fill the need for drillable prospects.

As a more direct indicator that higher seismic spending is at hand, we have seen a definite increase in bid invitations over the last two quarters of the current fiscal year. Unfortunately, there is plenty of capacity in the market to absorb a substantial rise in activity. We have seen extreme price competition when large projects are proposed and have seen new entrants into some markets based upon single projects.

Our response to this difficult marketplace has been consistent for a number of quarters, and is designed to deliver positive margins and significant free cash flow while allowing for continued investment in our technology and data library. In the contract market, we do not compete aggressively to win the larger awards where discounting is extreme, but have positioned ourselves to win a series of smaller jobs that allow us to work profitably. In the multi-client market, we have continued to invest in our library and have been rewarded with substantial margins and positive cash flow. Finally, we continue to invest in technology to give ourselves a differentiated, higher margin, service offering.

We have generated two quarters in a row of solid financial performance, but it is the nature of our business to have uneven quarterly results. About 75% of our annual operating margin comes from our multi-client business and much of this comes from sales of completed surveys. These sales are volatile and difficult to predict. Additionally, we are subject to seasonal trends in our contract business, exemplified by the winter acquisition work. Notwithstanding, we have a conservative balance sheet, a large cash balance and relatively low debt, and feel secure in our ability to compete for the long term in this industry.



**Results of operations****Three months ended April 30, 2004 compared with three months ended April 30, 2003**

*Revenues.* Revenues increased by 46% overall. Multi-client revenue increased by 56% compared to the prior year's third quarter. Much of this was due to an increase in revenue from completed surveys, which were up by 78% to \$51.7 million. Revenue from pre-funding of ongoing surveys increased by 27%. The strong multi-client results were generated by increasing sales from surveys around the world, with our North America land, Gulf of Mexico, Brazil, and North Sea portfolios all showing increased revenue over the prior year's third quarter. Contract revenue increased by 32% compared to the prior year's third quarter. Marine contract revenue increased by 53% due to work in India and Australia. Land contract revenue increased by 31% due to additional work in Canada, the United States and Argentina.

Revenues consist of the following:

|                       | Three Months Ended April 30, |                   |               |
|-----------------------|------------------------------|-------------------|---------------|
|                       | 2004                         | 2003              | %<br>Increase |
| (In thousands)        |                              |                   |               |
| <b>Multi-client:</b>  |                              |                   |               |
| Land                  | \$ 22,436                    | \$ 18,964         | 18%           |
| Marine                | 58,022                       | 32,687            | 78%           |
| Subtotal              | 80,458                       | 51,651            | 56%           |
| <b>Contract:</b>      |                              |                   |               |
| Land                  | 58,487                       | 44,460            | 32%           |
| Marine                | 37,602                       | 24,525            | 53%           |
| Subtotal              | 96,089                       | 68,985            | 39%           |
| <b>Total Revenues</b> | <b>\$ 176,547</b>            | <b>\$ 120,636</b> | <b>46%</b>    |

*Operating income.* Operating income as a percentage of revenue increased from 11% to 12%. Contract margins increased primarily due to excellent crew and equipment utilization during the quarter; we operated as many as 15 land crews during the quarter and had four of our six boats working on contract jobs. Contract pricing has not improved noticeably during the recent quarter, but the terms of most projects are more favorable, with customers bearing more risk of downtime for weather and other factors. Multi-client margins decreased due to increased amortization of surveys.

Research and development increased by \$0.8 million as a result of an increase in the number of employees engaged in advanced processing.

General and administrative increased by \$1.0 million with the largest portion due to compliance with requirements of the Sarbanes-Oxley Act and related rules.

*Interest expense.* Interest expense increased by \$2.9 million. The current quarter includes \$6.4 million of charges relating to retirement of \$154.0 million of bank debt, including the expensing of debt issuance costs, cancellation of interest rate swaps and prepayment penalties.

*Income taxes.* The effective tax rate decreased from 39% to 23% as compared to the prior year's second quarter. The 23% effective rate is based upon the expected annual rate (excluding the effect of the multi-client amortization change) using the expected annual mix of income by jurisdictions. The lower rate compared to the prior fiscal year is due to the current use of previously unbenefited loss carryforwards and other tax credits.

*Nine months ended April 30, 2004 compared with nine months ended April 30, 2003*

*Revenues.* Revenues increased by 12% overall. Multi-client revenue increased by 17% due to an increase in sales of completed surveys over the prior year's comparable period. Contract revenue increased by 7%. Land contract revenue remained relatively flat while marine contract revenue increased by 15%. A greater proportion of our vessel time in the current period was spent on contract work, versus multi-client work, than during the prior year.

Revenues consist of the following:

|                       | Nine Months Ended April 30, |                   |               |
|-----------------------|-----------------------------|-------------------|---------------|
|                       | 2004                        | 2003              | %<br>Increase |
| (In thousands)        |                             |                   |               |
| <b>Multi-client:</b>  |                             |                   |               |
| Land                  | \$ 52,263                   | \$ 48,904         | 7%            |
| Marine                | 151,551                     | 124,589           | 22%           |
| Subtotal              | 203,814                     | 173,493           | 17%           |
| <b>Contract:</b>      |                             |                   |               |
| Land                  | 126,929                     | 124,843           | 2%            |
| Marine                | 97,924                      | 85,128            | 15%           |
| Subtotal              | 224,853                     | 209,971           | 7%            |
| <b>Total Revenues</b> | <b>\$ 428,667</b>           | <b>\$ 383,464</b> | <b>12%</b>    |

*Operating income.* Operating income as a percentage of revenue decreased from 8.9% to 5.2%. The decreased results for the current fiscal year were due mostly to a change in accounting for our multi-client library, which resulted in a charge of \$22.1 million, included in cost of services on the "Consolidated Statements of Operations and Comprehensive Income (Loss)." This charge represents the adjustment necessary to reduce each of our surveys as of August 1, 2003 to a balance no greater than that which would have been recorded had we been using the new method. While the sales forecast method remains our primary means of expensing multi-client surveys, we have now established a minimum cumulative amortization for each survey based upon straight-line amortization over five years. The monthly expense recognized for each survey is the greater of the amount derived by the sales forecast method or the amount of minimum amortization. This is a change from the prior method that provided for a minimum amortization only during the last two years of the survey's book lives.

Before the charge for the change in accounting method, operating income as a percentage of revenue increased from 8.9% to 10.3%. The favorable mix of multi-client revenue to contract revenue in the current period was largely offset by increased required multi-client amortization expense of \$26.6 million, compared with \$2.8 million in the prior year. Contract margins were higher for the nine months of fiscal 2004 than in the prior year's comparable period, although the prior fiscal period's margins reflect several operational disruptions and low margins on a large land acquisition job in Peru. Contract pricing has not improved noticeably during the recent quarters, but the terms of most projects are more favorable, with customers bearing more risk of downtime for weather and other factors.

Research and development increased by \$1.9 million as a result of an increase in the number of employees engaged in advanced processing.

General and administrative expense decreased by \$2.0 million. The decrease was due to primarily to higher severance expense in the prior year's first nine months partially offset in the current nine months by expenses associated with compliance with requirements of the Sarbanes-Oxley Act and related rules.

*Other expense (income), net.* Other expense (income), net changed from expense of \$1.5 million to income of \$1.0 million. A combination of items accounted for this, with proceeds from the sale of Miller Exploration stock in the prior year and declining foreign currency exchange losses in the current year accounting for the largest portion of the change.

*Income taxes.* Our effective tax rate for the first nine months of fiscal 2004 (excluding the \$22.1 million charge for the catch-up entry for the change in multi-client amortization policy) was 28% compared to 41% for the first nine months of fiscal 2003. The 28% effective rate is the expected annual rate (excluding the effect of the multi-client amortization change) using the expected mix of income by jurisdiction. The lower rate compared to the prior fiscal year is due to the current use of previously unbenefited loss carryforwards and other tax credits.

## **Liquidity and capital resources**

### ***Cash flow and liquidity***

Our internal sources of liquidity are cash, cash equivalents and cash flow from operations. External sources include public financing, equity sales, equipment financing, our revolving loan facility, and trade credit. We believe that our current cash balance will be adequate to meet our liquidity needs for fiscal 2004. While we believe that we have adequate sources of funds to meet our longer term liquidity needs, our ability to meet our obligations depends on our future performance, which, in turn, is subject to many factors beyond our control. Key internal factors affecting future results include utilization levels of acquisition and processing assets and the level of multi-client data library licensing, all of which are driven by the external factors of exploration spending and, ultimately, underlying commodity prices.

Net cash provided by operating activities decreased by \$9.8 million for the nine months ended April 30, 2004 compared to the nine months ended April 30, 2003. The strong sales of the current quarter led to a large increase in accounts receivable, collection of which should result in higher cash from operating activities during the next quarter. Cash used by investing activities decreased by \$34.6 million for the nine months ended April 30, 2004 compared to the nine months ended April 30, 2003 primarily due to the purchase of Hampson-Russell in fiscal 2003 for \$9.3 million and a \$25.3 million decrease in our multi-client investment in the current year. Cash flow for the nine months ended April 30, 2004 was enhanced by \$2.0 million from the sale of (RC)<sup>2</sup>. Our capital expenditure estimate for fiscal 2004 is approximately \$42 million and will be spent on replacement and upgrading of existing equipment, with very little spent on capacity expansion. For fiscal 2004, we are forecasting approximately \$120 million to \$130 million cash investment in our data library. We expect to fund these investments from our current cash balance and from internally generated cash flows. Net cash provided by financing activities decreased from \$49.4 million in the nine months of 2003 to a use of cash of \$23.1 million in the nine months ended April 30, 2004. In the prior fiscal year, we entered into the Credit Agreement to satisfy the obligations under the previous credit agreement and the Senior Notes. As of April 30, we sold \$155.0 million of Convertible Senior Notes and paid down \$167.2 million of bank debt.

Free cash flow is an important measure of liquidity for us. We define free cash flow as cash from operating activities less cash multi-client spending and capital expenditures. This non-GAAP liquidity measure is useful as an addition to the most directly comparable GAAP measure of "net cash provided by operating activities" because free cash flow includes investments in operational assets and therefore presents a more complete picture of net cash flow from ongoing operations. This measure excludes items such as proceeds from the disposal of assets, cash paid for acquisitions and all financing activities. Some portion of free cash flow may ultimately be committed to items such as debt repayment obligations and so it is not necessarily a measure of residual cash flow available for discretionary expenditures.

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Our free cash flow for the nine months ended April 30, 2004 was \$14.4 million higher than for the same period last year and indicates that we are progressing toward our goal of generating more free cash flow for the year than we did in fiscal 2003. We are managing our business to achieve positive free cash flow by maintaining flexibility in our capital and multi-client investments and spending within the constraints established by our operational cash flow.

A reconciliation of free cash flow to net cash provided by operating activities is presented in the following table:

|   | <b>Nine Months Ended April 30,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2004</b>                        | <b>2003</b> |
| (In thousands)                            |                                    |             |
| Net cash provided by operating activities | \$ 152,356                         | \$ 162,142  |
| Multi-client expenditures, net cash       | (97,333)                           | (122,652)   |
| Capital expenditures                      | (20,652)                           | (19,530)    |
|   | \$ 34,371                          | \$ 19,960   |

The following represents our financial contractual obligations and commitments as of April 30, 2004 for the specified periods:

| Contractual Cash Obligations                        | Payments Due |                     |             |             |                         |
|---|--------------|---------------------|-------------|-------------|-------------------------|
|   | Total        | Less than<br>1 year | 1 - 3 years | 3 - 5 years | Greater than<br>5 years |
| (In thousands)                                      |              |                     |             |             |                         |
| Payments due for operating lease obligations        | \$ 144,137   | \$ 37,540           | \$ 54,123   | \$ 21,179   | \$ 31,295               |
| Scheduled principal payments under debt obligations | 181,987      | 444(1)              | 26,543(1)   |             | 155,000                 |
| Potential payments under letters of credit          | 2,173        | 1,135               | 1,038       |             |                         |

- (1) We repaid the \$27.0 million remainder of our bank debt during the fourth quarter of fiscal 2004. See Note 10, "Subsequent events" of Notes to Consolidated Financial Statements for more detail.

### ***Debt structure***

On February 14, 2003, we entered into a Credit Agreement (the "Credit Agreement") with Deutsche Bank AG, New York Branch, as Administrative Agent, Deutsche Bank AG, Canada Branch, as Canadian Administrative Agent, and certain other lending institutions. The Credit Agreement provides term financing of \$195.0 million under term A, term B and term C tranches (the "Term Loans"), a revolving loan facility aggregating \$55.0 million, including a facility for swing line loans of up to \$10.0 million and the issuance of letters of credit in an aggregate amount of up to \$40.0 million. As of January 31, 2004, there were \$3.1 million in letters of credit outstanding, leaving \$51.9 million available for borrowings. Among other restrictions, the Credit Agreement prohibits us from paying cash dividends. Proceeds from the Term Loans were used to satisfy the obligations under our previous credit agreement and our Senior Notes due October 2003.

The term A loan was in the original principal amount of \$30.0 million, matures in February 2006, and requires quarterly interest payments at a rate, at our election, of LIBOR plus a margin ranging from 3.5% to 4.0% or a base rate plus a margin ranging from 2.25% to 2.75%. These margins are based on certain of our financial ratios. The term B loan was in the original principal amount of \$125.0 million, matures in February 2007, and requires quarterly interest payments at a rate, at our election, of LIBOR plus 5.0%, subject to a 2% LIBOR floor or a base rate plus 3.75%. The term C loan was in the original principal amount of \$40.0 million, would have matured in February 2008, and



required quarterly interest payments at a rate, at our election, of LIBOR plus 7.5%, subject to a 3% LIBOR floor or a base rate plus 6.25%.

The term A and term B loans required quarterly combined principal payments of \$387,500 representing 0.25% of the initial principal balances. Should there be an event of default or if an unmatured event of default exists, or the credit rating of any of the debt is below Moody's Ba2 or S&P's BB, or our leverage ratio as of the last day of the most recent excess cash flow calculation period rises above certain levels, the term A and B loans also require principal payments of 50% of the prior fiscal year's cash flow, calculated as per the loan agreement. This payment is due 100 days after the end of the fiscal year and results in a ratable reduction of the future required quarterly principal payments. As our lowest debt rating by Moody's is below the minimum level, we paid \$12.4 million of principal in November 2003 related to the company's cash flow from January 1, 2003 through July 31, 2003. Future excess cash flow payments of this type, if any, will be based on cash flow for full fiscal years. We used \$129.0 million of net proceeds from the Floating Rate Convertible Senior Notes described below to repay in full the term C loan and to prepay portions of the term A and B loans. In addition, in March 2004, we repaid an additional \$25.0 million of the term A and B loans using cash on hand. We recorded \$6.4 million in charges relating to the retirement of the \$154.0 million term debt which included expensing of debt issuance costs, cancellation of interest rate swaps and prepayment penalties. These charges are included in interest expense on the "Consolidated Statement of Operations and Comprehensive Income (Loss)." Based upon the payments in November 2003 and March 2004 for the term A and B loans, our required quarterly combined principal payment was reduced to \$110,916.

Loans made under the revolving loan facility, including swing-line loans, bear interest at a variable rate determined on the date of borrowing that is related to various base rates and margins depending upon our leverage ratio and the location of the borrowing. The revolving loan facility expires in February 2006.

Borrowings under the Credit Agreement are secured by assets, including equipment, vehicles, multi-client data library, intellectual property, and stock of certain material subsidiaries, owned by us and certain of our subsidiaries. At April 30, 2004, the carrying value of the secured assets, including intercompany receivables, was \$1.1 billion. The Credit Agreement and related documents contain a number of covenants, including financial covenants relating to interest coverage, leverage and net worth. At April 30, 2004, we were in compliance with these covenants.

On March 3, 2004, we sold \$125 million aggregate principal amount of Floating Rate Convertible Senior Notes Due 2024 in a private placement. On March 11, 2004, we sold an additional \$30 million of Convertible Senior Notes to the initial purchaser. The notes are our senior unsecured obligations and are convertible under certain circumstances into a combination of cash and our common stock at a fixed conversion price of \$24.03 (subject to adjustment in certain circumstances), which is equivalent to an initial conversion ratio of approximately 41.6 shares of our common stock per \$1,000 principal amount of Convertible Senior Notes, or a maximum of approximately 6.4 million shares for the \$155 million aggregate principal amount. In general, upon conversion of a note, the holder of such note will receive cash equal to the principal amount of the note and shares of our common stock for the note's conversion value in excess of such principal amount. We used \$129 million of net proceeds from the sale of Convertible Senior Notes to repay in full the term C loan and to prepay portions of the term A and B loans. The remaining \$20 million of net proceeds from the Convertible Senior Notes was used to repurchase, in negotiated transactions, 1,222,494 shares of our common stock sold by certain purchasers of the Convertible Senior Notes in connection with the offering.

The Convertible Senior Notes bear interest at a per annum rate which will equal the three-month LIBOR rate, adjusted quarterly, minus a spread of 0.75%. The initial interest rate of the notes (through June 14, 2004) will be 0.37%. The notes will mature on March 15, 2024 and may not be

redeemed by us prior to March 20, 2009. Holders of the notes may require us to repurchase some, or all, of the notes on March 15, 2009, 2014 and 2019. They could also require repurchase upon a change of control (as defined in the indenture under which the Convertible Senior Notes were issued).

Under certain circumstances and at the option of the holder, the Convertible Senior Notes are convertible prior to the maturity date into cash and shares of our common stock. These circumstances include:

- (1) the closing sale price of our common stock is over 120% of the conversion price for a specified number of trading days
- (2) if we called the notes for redemption and the redemption has not occurred
- (3) the occurrence of a five consecutive trading day period in which the trading price of the notes was less than 95% of the closing sale price of our common stock on such day multiplied by the number of shares of our common stock issuable upon conversion of the notes
- (4) the occurrence of specified corporate transactions

The Convertible Senior Notes were sold to Deutsche Bank Securities Inc., the initial purchaser under an exemption provided by section 4 (3) of the Securities Act. The initial purchaser concurrently sold the notes only to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933, as amended. The notes and the underlying common stock issuable upon conversion have not been registered under the Securities Act or any applicable state securities laws and may not be offered or sold in the United States absent registration or an applicable exemption from such registration requirements. We have entered into a registration rights agreement in which we have agreed to file within 90 days of March 3, 2004 a registration statement with the Securities and Exchange Commission to register resales of the notes and associated shares of common stock. We filed a registration statement on May 28, 2004 in compliance with the registration rights agreement. We will be required to pay liquidated damages in the form of additional interest in the event the registration statement is not effective on or before the 180th day after March 3, 2004 or under certain other circumstances.

#### **Off-balance sheet instruments**

Our limited hedging program consists of off-balance sheet instruments to minimize the currency risk of pounds sterling receivables and to fix the interest rate on \$10.9 million of our variable rate long-term debt through interest rate swap contracts. None of these hedges are critical to our operations but they reduce our exposure to currency and interest rate fluctuations and allow us to better plan our future cash flows. These instruments are described in detail in Item 3, Quantitative and Qualitative Disclosures Regarding Market Risk, as well as in Note 6 of Notes to Consolidated Financial Statements.

#### **Critical accounting policies**

While all of our accounting policies are important in assuring that we adhere to current accounting standards, certain policies are particularly important due to their impact on our financial statements. These are described in detail in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Significant Accounting Policies included in our Annual Report on Form 10-K for the fiscal year ended July 31, 2003 which description is incorporated herein by reference. Since our last annual filing, we have changed our accounting policy regarding the amortization of our multi-client data library. This new policy is described below.

***Multi-client data library***

In our multi-client data library business, we collect and process geophysical data for our own account and retain all ownership rights. We license the data to multiple clients on a non-transferable basis. We capitalize the costs associated with acquiring and processing the multi-client data on a survey-by-survey basis (versus a pooled basis). We amortize these costs using the sales forecast method, but require a minimum amortization expense equal to that which would have been recorded had the survey been amortized over a five-year period on a straight line basis. The sales forecast method amortizes the capitalized cost of multi-client data in the period revenue is recognized in an amount equal to the period revenue multiplied by the percentage of total estimated costs to total estimated revenue. Therefore, multi-client margins recognized in any given period are the product of estimated costs and estimated sales and may not reflect the ultimate cash margins recognized from a survey. We periodically review the carrying value of the multi-client data library to assess whether there has been a permanent impairment of value and then record losses when it is determined that estimated sales will not be sufficient to cover the carrying value of the asset.

Until August 1, 2003, we required a minimum amortization of surveys only during the last twenty-four months of book life, versus from the date of survey completion as we currently require. This change in policy resulted in a charge of \$22.1 million in the current year as a catch-up adjustment to multi-client amortization and is included in cost of services on the "Consolidated Statements of Operations and Comprehensive Income (Loss)."

**Accounting policies recently adopted**

In December 2003, the Financial Accounting Standards Board issued FIN 46R, a revision to FIN 46 (Consolidation of Variable Interest Entities). FIN 46R replaces FIN 46 and provides additional clarification on the application of ARB No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. We adopted FIN 46R on April 30, 2004. Adoption did not have a material effect on our financial position or results of operations, however, it required consolidation of our 80% owned joint venture accounted for under the equity method prior to our adoption of FIN 46R. This entailed consolidating the 80% owned joint venture as of April 30, 2004 on a prospective basis. The 80% owned joint venture provides processing and acquisition services and licenses to our multi-client data. This change is reflected in an increase of multi-client data of \$2.3 million, an increase in other assets and liabilities of \$0.8 million and a decrease in investment in and advances to joint ventures of \$3.1 million.

In December 2003, the Financial Accounting Standards Board issued SFAS No. 132 (Revised 2003), Employer's Disclosures about Pension and Other Postretirement Benefits. This statement retains the disclosures required by SFAS No. 132 and adds additional disclosures. Those disclosures include information describing the types of plan assets, investment strategy, measurement date(s), plan obligations, cash flows, and components of net periodic benefit cost recognized during interim periods. We adopted SFAS No. 132 (Revised 2003) in the quarter ended April 30, 2004.

**Item 3. *Quantitative and Qualitative Disclosures Regarding Market Risk***

At April 30, 2004, we had limited market risk related to foreign currencies. In March 2001, we entered into a contract requiring payments in Norwegian kroner to charter the seismic vessel M/V Seisquest. The contract requires 36 monthly payments commencing on June 1, 2001. To protect against exposure to exchange rate risk, we entered into multiple forward contracts as cash flow hedges fixing our exchange rates for Norwegian kroner to the U.S. dollar. This contract expired on April 30, 2004. We renewed our charter for the M/V Seisquest, with payments in Norwegian kroner, but have not entered into a new hedge agreement.



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We are exposed to interest rate risk based upon fluctuations in the LIBOR rate. To partially mitigate this risk, on February 25, 2003, we entered into interest rate swaps in the notional amounts totaling \$80.0 million, effectively hedging 41% of our then current exposure to interest rate changes for the two-year term of the swaps. These swaps had no value at inception. On March 29, 2004, upon prepayment of certain amounts outstanding under our current bank credit facility, the swap agreement was amended to an amount totaling \$10.9 million.

Details of the interest rate swaps as of April 30, 2004 are summarized in the following table:

| Tranche Hedged | Amount   | Term      | Pay<br>% | Receive | LIBOR<br>Floor |
|----------------|----------|-----------|----------|---------|----------------|
| (in thousands) |          |           |          |         |                |
| Term A         | \$ 2,900 | 24 months | 1.86     | LIBOR   | None           |
| Term B         | \$ 8,000 | 24 months | 2.49     | LIBOR   | 2%             |

The fair value of the swaps on April 30, 2004 was a negative \$37,000 and is included in other accrued liabilities on the "Consolidated Balance Sheets."

As of April 30, 2004, we had \$155.0 million Convertible Senior Notes bearing interest at LIBOR less 0.75% with a fair value of \$181.2 million. These notes are not hedged in any manner.

In March 2004, we entered into a contract in which we receive payments in pounds sterling. In order to minimize our exposure to currency risk, we purchased a put option in the notional amount of 658,000 pounds sterling and a call option in the amount of 366,000 pounds sterling. As of April 30, 2004, we realized a gain of \$31,000 from this hedge.

#### **Item 4. Controls and Procedures**

Our management, including the Chief Executive Officer and the principal financial officer, has conducted an evaluation of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Exchange Act Rule 13a-15. Based on that evaluation, our Chief Executive Officer and the principal financial officer concluded that the disclosure controls and procedures are effective in ensuring that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms. There have been no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described above that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On occasion, we are named as a defendant in litigation relating to our normal business operations. Although we are insured against various business risks to the extent we believe prudent, there is no assurance that the nature and amount of such insurance will be adequate in every case.

**Item 2. Changes in Securities, Use of Proceeds and Purchases of Securities**

In March 2004, we sold \$155.0 million of our Convertible Senior Notes. For a description of the notes and terms of the sale, see Note 5 "Long-term debt" of Notes to Consolidated Financial Statements, which is incorporated herein by reference.

Set forth in the table below are all of our repurchases of our common stock during the quarter ended April 30, 2004, all of which were purchased in privately negotiated transactions in connection with the sale of our Convertible Senior Notes.

| <b>Period</b> | <b>Total number of shares purchased</b> | <b>Average price paid per share</b> | <b>Total number of shares purchased as part of publicly announced plans or programs</b> | <b>Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs</b> |
|---------------|---|-------------------------------------|---|---|
| March 2004    | 1,224,494                               | \$ 16.36                            | 0   | 0   |

**Item 5. Other Information**

b) On June 2, 2004, the Nominating and Corporate Governance Committee of our Board of Directors adopted certain criteria and procedures regarding director nominations by stockholders. A copy of these criteria and procedures are attached hereto as Exhibit 99.1 and are incorporated herein by reference.

**Item 6. Exhibits and Reports on Form 8-K**

a)

**Exhibits filed with this report:**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 10.1               | Indenture dated March 3, 2004 between Veritas DGC Inc. and U.S. Bank National Association, as trustee (Exhibit 4.2 to Veritas DGC Inc.'s Current Report on Form 8-K dated March 3, 2004 is incorporated herein by reference.)   |
| 10.2               | Third Amendment to Credit Agreement dated February 20, 2004 by and among Veritas DGC Inc., Veritas DGC Limited, Veritas Energy Services Inc., Veritas Energy Services Partnership, Deutsche Bank AG, New York Branch, as Administrative Agent, Deutsche Bank AG, Canada Branch, as Canadian Administrative Agent, and the various lending institutions named therein (Exhibit 10.2 to Veritas DGC Inc.'s Form 10-Q for the quarter ended January 31, 2004 is incorporated herein by reference.) |
| 10.3               | Employee Agreement between Veritas DGC Inc. and Thierry Pilenko dated January 26, 2004 (Exhibit 10.3 to Veritas DGC Inc.'s Form 10-Q for the quarter ended January 31, 2004 is incorporated herein by reference.)   |

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| Exhibit<br>No. | Description  |
|----------------|--|
| 10.4           | Retirement Agreement between Veritas DGC Inc. and David B. Robson dated January 1, 2004<br>(Exhibit 10.4 to Veritas DGC Inc.'s Form 10-Q for the quarter ended January 31, 2004 is<br>incorporated herein by reference.) |
| *31.1          | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer   |

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- \*31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by principal financial officer
  - \*32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer.
  - \*32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by principal financial officer.
  - \*99.1 Criteria and Procedures Regarding Director Nominations
- 

\*  
filed herewith

**b)**  
***Reports on Form 8-K***

On February 26, 2004, we filed a Current Report on Form 8-K reporting information under Item 12, 7 and 5 regarding our Results of Operations and Financial Condition and our intention to offer a new issue of Floating Rate Convertible Senior Notes Due 2024.

On February 27, 2004, we filed a Current Report on Form 8-K reporting information under Item 5 regarding our private offering of \$125 million aggregate principal amount of Floating Rate Convertible Senior Notes Due 2024 with an option to purchase up to an additional \$30 million of convertible notes in connection with the offering.

On March 3, 2004, we filed a Current Report on Form 8-K reporting information under Item 5 regarding our close on the previously announced private offering of \$125 million aggregate principal amount of Floating Rate Convertible Senior Notes Due 2024 with an option to purchase up to an additional \$30 million of convertible notes in connection with the offering.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 14<sup>th</sup> day of June 2004.

**VERITAS DGC INC.**

By: /s/ VINCENT M. THIELEN

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VINCENT M. THIELEN  
*Vice President, Corporate Controller*  
*(Chief Accounting Officer)*  
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