LUFKIN INDUSTRIES, INC.

1992 ANNUAL REPORT

LUFKIN

CORPORATE PROFILE

Lufkin Industries, Inc. is the country's leading manufacturer of oil field pumping units. The Company sells oil field products, industrial and marine gearing products, commercial products including castings and fabrications and industrial supplies throughout the world. The Company has vertically integrated all vital technologies required to design, manufacture and market its products. Lufkin's common stock is traded on The Nasdaq Stock Market (National Market) under the symbol LUFK.

NOTICE OF ANNUAL MEETING

The Annual Meeting of Shareholders of Lufkin Industries, Inc. will be held at the Lufkin Civic Center, 601 North Second Street, Lufkin, Texas, on May 19, 1993, at 9:00 a.m. local time.

FINANCIAL HIGHLIGHTS

(Thousands of dollars, except per share amounts)

	December 31, 1992	1991
Sales	$ 126,635	$ 193,585
Operating expenses	142,229	184,698
Restructuring costs	24,339	–
Earnings (loss) from continuing operations	(27,253)	8,969
Net earnings (loss)	(34,759)	6,867
Earnings (loss) per share:		
Continuing operations	(4.01)	1.32
Discontinued operations	–	(.31)
Accounting change	(1.11)	–
Total	(5.12)	1.01
Total assets	170,326	215,969
Working capital	59,778	81,274

LETTER TO SHAREHOLDERS

The year 1992 was a very challenging one for Lufkin Industries. Our financial objectives were not met. Responding to a downturn in the oilfield markets and a global recession, Lufkin Industries took steps in 1992 and early 1993 to reposition itself with the technologies and strategies needed to assure the Company's success in a marketplace and economy characterized by continuing restructuring and change.

Since the Company's financial performance was severely impaired by a significant downturn in its oilfield pumping unit markets, the Board of Directors asked that a thorough study be made to evaluate all of the Company's existing facilities, to make recommendations to achieve manufacturing efficiencies, and to identify strategic alternatives to enhance shareholder value. Recommendations have been made calling for restructuring charges totaling approximately $24 million covering the write-down of certain facilities and related inventories and other costs. Action has been initiated to reduce spending and employment levels in response to current operating and economic conditions. Other recommendations to position Lufkin for the future are being analyzed by management and the Board and will be announced in the coming months.

Many of these recommendations are being directed by Douglas V. Smith, who was chosen by the Board of Directors to serve as President and Chief Executive Officer and as a member of the Company's Board of Directors, effective January 15, 1993. Mr. Smith was most recently Vice President of Worldwide Manufacturing for Cooper Oil Tool Division of Cooper Industries, Houston, where he was responsible for that Division's 13 manufacturing plants located throughout the world.

The Company's restructuring charges along with the adoption of the Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Post-Retirement Benefits other than Pensions" in the fourth quarter and the previously described decrease in sales resulted in the Company reporting a net loss of $34.8 million, or $5.12 per share for the year ended December 31, 1992. This compares with net earnings of $6.9 million, or $1.01 per share, a year ago.

Sales for 1992 were $126.6 million compared with $193.6 million a year ago. Export sales for the year were $44.8 million, or 35% of total sales, compared with $85.1 million, or 44% of total sales a year ago. Sales of oilfield equipment were $55.1 million compared with $124.1 million last year. Power transmission products sales for the year were $43.6 million compared with $46.6 million a year ago, and commercial product sales were $20.0 million compared with $15.3 million last year.

The greatest impact on the Company's performance came from conditions in the world oilfield market. The number of oil wells drilled in the United States was the lowest since 1943, and the international markets also declined in response to the uncertain price of oil and the over capacity of oilfield equipment which had accumulated during the 1990-1991 period.

In 1992, as part of the overall plan to expand Lufkin's global presence in the oilfield markets, Lufkin entered into a joint venture agreement with Hughes Christensen Company, a subsidiary of Baker Hughes, Inc., to manufacture and sell Lufkin oilfield pumping equipment in Argentina. In October we also completed the purchase of all the oilfield inventory from American International Manufacturing Corporation of Fort Worth, a wholly-owned subsidiary of Guardian Industries Corporation of Detroit, Michigan.

Company sales to the countries of the former Soviet Union were significantly less than anticipated. The current business climate in Russia reflects numerous changes in the organization of the country's oil and gas industry. Delays have been experienced in the installation of pumping units previously shipped and in the scheduling of additional deliveries. As a result of these delays, we have deleted from our reported backlog the previously announced $96.0 million Russian order. While our position remains strong in this market, we expect pumping unit sales for 1993 to be below those of the last two years.

Power transmission and industrial gear sales were relatively flat for 1992. However, there were several important product developments for these product groups. New technology using case hardened and ground gear units enables us to deliver higher horsepower in a smaller package with improved accuracies and at higher speeds. These new product developments are being well received by the market.

Approximately 30% of the Company's power transmission business was international in 1992, and we believe this percentage will increase over the next several years. To better serve the international power transmission market, we opened a sales office in Europe, added gear grinding capacity during 1992, and will add more capacity in 1993. We remain encouraged about the long-term growth and profitability of this product group.

The operating results of our trailer segment improved in 1992 by achieving a break-even level overall with significant positive cash flows. We do not anticipate future losses from this business segment, but we continue to believe that our previous decision to exit the trailer business remains the proper business strategy.

We are continuing to search for and develop new business opportunities outside of our traditional businesses. However, the generally weak economic conditions of 1992 adversely affected sales of castings and fabricated products which make up the commercial products group. As sales improve with new customers and new products, the commercial products group should become an important growing segment of our overall business.

At December 31, 1992, the Company's total backlog was $32.9 million, compared with $51.8 million a year ago. Of this amount, $9.0 million was for oilfield equipment compared with $27.1 million a year ago.

In addition to Douglas V. Smith, Bob H. O'Neal was added to our Board. Mr. O'Neal is President, Chief Executive Officer, and Director of Stewart & Stevenson, a company engaged in the design, fabrication, and assembly of diesel and gas turbine power systems located in Houston, Texas. Mr. O'Neal's experience and background have already added significantly to our Board, and we look forward to his continuing counsel as a Director.

From a balance sheet perspective, Lufkin remains in sound financial condition. At December 31, 1992, the Company had working capital of $59.7 million, stockholders' equity of $145.0 million, and no long-term debt. The book value of the Company was $21.36 per share at year's end.

We continue to believe that Lufkin's strong balance sheet, the favorable long-term prospects for new products and business development, Lufkin's repuration for quality products, and our continuing restructuring efforts will enhance shareholder values as conditions improve.

We appreciate the continuing support that our shareholders and employees have given the Company despite adverse conditions in 1992. We look forward to reporting future results which will better show the underlying strength of your Company.

Sincerely,

Frank B. Stevenson
Chairman of the Board

Douglas V. Smith
President and Chief Executive Officer

PRODUCT LINE INFORMATION

Oil Field Products

The Lufkin oil well pumping unit is recognized the world over as the industry standard in beam-type pumping. These units are extremely adaptable, well engineered to meet a wide range of applications, and are easy to install. Lufkin's mechanical pumping system is used in oil wells that do not naturally flow to drive a subsurface pump through a sucker rod string to lift the oil to the surface.

Lufkin offers a complete line of pumping units including the Churchill line, which addresses the market for smaller capacity units. The Company's units can be found in all areas of the world. Wholly owned or joint venture manufacturing plants are located in five countries outside the United states. All manufacturing plants conform to the high standards Lufkin is known for in quality and in innovation of product design.

Due to the weak domestic markets in 1992, 71% of Lufkin's pumping units went to customers overseas. Lufkin has recognized the growing foreign market and has taken steps to strengthen its global position. These include re-organizing the international sales force to better service the market and insuring that local market manufacturing capabilities meet local content requirements.

Industrial and Marine Gear Products

Gearing for heavy industrial applications and marine propulsion drives continues to be an area of growing opportunity for Lufkin. These engineering-intensive parallel shaft speed reducers and increasers vary in size power requirements in the range of 20 to 85,000 horsepower. Lufkin's CAD/CAM equipped gear engineers develop drives to customers' requirements for such industries as power generation, plastics, steel, rubber, pulp and paper, marine, petrochemical, and sugar mills. These units would typically interface with generators, compressors, extruders, crushers, material handing drives, and ship propulsion drives.

In 1992, Lufkin opened an office in Europe and additional representative agreements were signed in several new areas to better serve our growing international presence. Exports currently account for 35% of our gear shipments. We expect this growing trend to continue.

Over the past several years, Lufkin has made significant capital investments in state-of-the-art technology to increase production capability and improve the quality of its gearing products. Also, Lufkin opened a new gear facility capable of completely rebuilding and testing any manufacturer's gear drive. This commitment to continuous improvement has allowed Lufkin to meet the highest precision and quality standards.

Lufkin's reputation, capacity, and technical expertise continue to improve each year coupled with aggressive sales, engineering, and manufacturing. The future for Lufkin in the industrial and marine gear products offers many opportunities.

Commercial Products

Lufkin's commercial products include grey iron and ductile iron castings, heavy steel fabrications and a line of winches primarily used in the timber harvesting industry. State of the art foundry and metal fabrication technology is utilized to produce components for a wide variety of customers through out the United States. The winches are sold to the major manufacturers of timber skidder tractors.

Industrial Supplies

Industrial supplies is Lufkin's oldest product line. It consists of the distribution of industrial supplies, plumbing fixtures and electrical pole line hardware. The East Texas region is served through distribution centers in Lufkin and Jasper, Texas. Customers include wood products and paper manufacturing, building contractors, electric utilities and in the Company's own manufacturing plants.

Strengths for the Future

The Company's outstanding reputation for dependable, on-time delivery of the highest quality; complete assistance through installation and start-up; and trained field representatives to provide on-going support is virtually unmatched. Lufkin's products have consistently demonstrated superior dependability and reliability.

To help bring about these unsurpassed levels, Lufkin has vertically integrated all vital technologies in one location. This has provided Lufkin with a competitive advantage in the market place. Lufkin has one of the finest CAD/CAM systems in engineering and design which enables it to more efficiently design and produce its products.

Of all the strengths Lufkin possesses, none is greater than the people that work for Lufkin. Their product knowledge, skill, experience and dedication enable Lufkin to provide customers with the greatest amount of service at a competitive price. The commitment to full service and quality is part of the effort that Lufkin brings to providing the finest products to customers worldwide.

FINANCIAL REVIEW

Common Stock Information

	1992			1991		
	Stock Price			Stock Price		
Quarter	High	Low	Dividend	High	Low	Dividend
First	$27.75	$24.25	$ .40	$31.00	$26.00	$ .40
Second	32.50	23.50	.40	33.00	28.00	.40
Third	27.50	18.50	.40	36.00	29.75	.40
Fourth	20.50	14.00	.15	35.00	24.50	.40

The Company's common stock is traded on the Nasdaq Stock Market (National Market) under the symbol LUFK and as of February 1993, there were approximately 1,000 record holders of its common stock.

The Company has paid cash dividends for 53 consecutive years. Total dividend payments were $9,170,000 in 1992 and $10,868,000 in 1991.

Quarterly Financial Data (Unaudited)

In millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1992				
Net sales	$41.2	$34.0	$26.0	$ 25.4
Gross margin	9.6	5.0	1.1	(5.8)
Net earnings (loss):				
Continuing operations	2.2	(0.4)	(2.3)	(26.8) *
Discontinued operations	—	—	—	—
Accounting change	—	—	—	(7.5) **
	$ 2.2	$ (0.4)	$ (2.3)	$ (34.3)
Earnings (loss) per share:				
Continuing operations	$0.33	$ (.06)	$ (.33)	$ (3.95) *
Discontinued operations	—	—	—	—
Accounting change	—	—	—	(1.11) **
	$0.33	$ (.06)	$ (.33)	$ (5.06)
1991				
Net sales	$52.6	$41.6	$50.6	$ 48.8
Gross margin	10.4	8.3	9.0	8.7
Net earnings (loss):				
Continuing operations	3.5	2.4	1.6	1.5
Discontinued operations	(0.7)	(0.2)	(0.4)	(0.8)
	$ 2.8	$ 2.2	$ 1.2	$ 0.7
Earnings (loss) per share:				
Continuing operations	$0.51	$0.35	$ 0.24	$ 0.22
Discontinued operations	(0.10)	(.03)	$ (.06)	(.12)
	$0.41	$0.32	$ 0.18	$ 0.10

* Fourth quarter 1992 net loss from continuing operations includes a $24.3 million (pre-tax) charge for restructuring costs (see Footnote No. 2)
** Fourth quarter 1992 net income includes a $7.5 million charge (net of tax) for a change in accounting for post retirement benefits (See Footnote No. 7)

Additional Financial Information

Stockholders may obtain additional financial information for the year ended December 31, 1992 from the Company's Form 10-K Report filed with the Securities and Exchange Commission. A copy of such report may be obtained without charge by written request to The Secretary, Lufkin Industries, Inc., P. O. Box 849, Lufkin, Texas 75901.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Results of operations

Sales from continuing operations for 1992 were $126.6 million compared to $193.6 and $135.9 million for 1991 and 1990, respectively. A loss from continuing operations of $27.3 million was reported for 1992. In 1991 and 1990, the Company had earnings from continuing operations of $9.0 and $2.6 million, respectively. The net loss for 1992 was $34.8 million. In 1991 and 1990, the Company reported net income of $6.9 and $2.0 million, respectively.

The 1992 loss was the result of three significant items. First, the decline in worldwide demand for oilfield equipment resulted in reduced sales volumes and profits. Second, and linked to the market decline, was the Company's decision to record restructuring costs totaling $24.3 million to reflect the write-down of certain facilities and related inventories and to provide for other related costs in light of the current and anticipated market conditions. Third, the Company recorded a $7.5 million after tax charge for the cost of adopting and implementing Statement of Financial Accounting Standards (SFAS) No. 106 "Accounting for Post Retirement Benefits other than Pensions."

The annual percentage increase (decrease) in sales of the Company's product groups for the three years ended December 31, 1992 were as follows:

	Annual increase (decrease)		
	1992	1991	1990
Oilfield pumping units	(56) %	86 %	33 %
Power transmission	(7) %	4 %	34 %
Commercial products	31 %	(1) %	80 %
Industrial supplies	5 %	(12) %	8 %
Total company	(35) %	43 %	35 %

The sales mix of the Company's products for the three years ended December 31, 1992 were as follows:

	Percent of total sales		
	1992	1991	1990
Oilfield pumping units	44 %	64 %	50 %
Power transmission	34 %	24 %	33 %
Commercial products	16 %	8 %	11 %
Industrial supplies	6 %	4 %	6 %
Total company	100 %	100 %	100 %

The decline in the international demand for oilfield products, specifically in the former Soviet Union and Venezuela, represented the single largest factor for the significant decline in the 1992 oilfield pumping unit sales. Political uncertainties within both countries delayed anticipated orders. The decline in U.S. drilling activity to historically low levels also contributed to the reduced oilfield sales in 1992. These declines were offset somewhat by continued expansion of the Company's market presence in Indonesia and Argentina where government sponsored incentives and the privatization of the oil industry provided growth opportunities.

In the fourth quarter of 1992, the Company determined that certain 1992 orders from the former Soviet Union should be excluded from the backlog because of various uncertainties that had developed. Accordingly, the backlog at December 31, 1992 for oilfield pumping units was adjusted to $9.0 million. Because the sale of the Company's oilfield products is dependent on world oil markets and the demand for and price of oil, the Company has recently consolidated certain of its facilities and reduced its work force to better match the uncertainties of today's markets.

Power transmission sales in 1992 declined 6.5% to $43.5 million, as compared to $46.6 and $45.0 million in 1991 and 1990, respectively. The 1992 decline reflects reduced capital spending by the Company's customers associated with the weak domestic economy. In 1992, the Company booked approximately $42.8 million in power transmission orders and ended the year with a backlog of $21.6 million compared to $22.3 at December 31, 1991. To further expand market presence and offer a more complete package to customers worldwide, the Company opened a dedicated gear service center in Lufkin, conducted an internal quality audit and established an international sales office in Holland.

Commercial product sales were up 31% to $20.0 million in 1992 as compared to $15.3 and $15.5 million in 1991 and 1990, respectively. As a percentage of total sales, 1992 commercial product sales rose to 16% of all products sold. This percentage compares to 8% and 11% for 1991 and 1990, respectively. The 1992 sales increase reflected increased revenue from government R&D projects. During 1992, the Company added additional sales representatives for commercial product sales and government R&D activities. The backlog for this product group at December 31, 1992 was $2.3 million, compared to $2.4 million at year end 1991.

The Company's gross profit for 1992 decreased by 73%, while the decline in revenues was 35%. The decrease in gross profit was due primarily to the 56% reduction in oilfield pumping units sales. Gross margins decreased to 8% of revenues as compared to 19% and 12% for 1991 and 1990, respectively. The reduced margins reflect the fact that the Company has been unable to generate adequate margins to cover its fixed costs in the fourth quarter of 1992. In an effort to improve profitability, the Company has reduced or eliminated certain fixed costs through its restructuring program which was recently announced. The Company continues to closely monitor its sales outlook and cost structure in an effort to maximize its opportunities.

Selling, general and administrative expenses (S.G.&A.) decreased by 7% to $25.5 million, compared to $27.5 million in 1991. S.G.&A. expenses for 1990 were $19.0 million. The major components of the 1992 S.G.&A. reductions were reduced sales commissions to overseas representatives and expenses eliminated through various cost cutting programs.

Investment income decreased by $2.6 million or 45% as compared to the $5.9 million reported in 1991. The reduction of installment notes receivables and the revaluation of certain investments to market value represent the majority of this reduction.

In 1992, aggregate tax benefits of $14.8 million have been recorded as an offset to losses from continuing operations and the accounting changes for post retirement benefits by reversing the net amount of previously recorded deferred income taxes payable. In 1991, the Company recorded an income tax provision of $4.3 million on pretax profits from continuing operations of $13.2 million.

See footnote 3 for an explanation of the status of the Company's discontinued operations.

With the relatively low level of annual inflation in the last several years, the Company believes that the impact of inflation on sales and expenses has been modest.

Liquidity and capital resources

At December 31, 1992, the Company had working capital of $59.8 million compared to $81.3 million in 1991 and $83.1 million in 1990. The Company provided $26.0 million net cash from operating activities during 1992 including cash generated from discontinued operations of $4.1 million. This compares to net cash provided from operations of $11.2 million and $11.0 million in 1991 and 1990, respectively. Collection of receivables represented the largest source of increased operating cash flows in 1992. The Company spent $9.4 million on capital additions in 1992 compared to $18.4 million and $9.5 million in 1991 and 1990, respectively. The Company believes that existing working capital will be sufficient to satisfy its 1993 requirements. In recent years, the expansion of the Company's facilities has been financed with internally generated funds and the Company plans to finance future improvements of its facilities in this manner. No significant commitments were outstanding at December 31, 1992.

CONSOLIDATED BALANCE SHEET

December 31, 1992 and 1991
(Thousands of dollars)

Assets	**1992**	1991
Current assets:		
Cash	**$ 49**	$ 170
Temporary investments	**11,518**	5,367
Accounts receivable, less allowances of $225	**15,101**	36,975
Installment notes, less allowances of $650	**16,410**	26,462
Taxes receivable	**1,612**	—
Inventories	**28,961**	23,680
Total current assets	**73,651**	92,654
Property, plant and equipment:		
Land and improvements	**7,034**	7,315
Buildings	**46,253**	45,401
Machinery and equipment	**153,756**	146,885
Total property, plant and equipment	**207,043**	199,601
Less accumulated depreciation	**144,482**	113,952
Total property, plant and equipment - net	**62,561**	85,649
Other investments	**—**	5,074
Prepaid pension costs	**10,881**	7,709
Other assets	**4,059**	1,257
Net assets of discontinued operations	**19,174**	23,626
Total	**$170,326**	$215,969

Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	**$ 3,863**	$ 6,547
Accrued liabilities:		
Payrolls and benefits	**4,182**	2,593
Property taxes	**1,872**	1,583
Commissions and other	**3,956**	657
Total current liabilities	**13,873**	11,380
Deferred income taxes	**—**	14,843
Post retirement benefits liability	**11,372**	—
Stockholders' equity:		
Common stock, par $1 per share; 20,000,000 shares authorized; 6,792,381 shares issued	**6,792**	6,792
Capital in excess of par	**15,372**	15,372
Retained earnings	**123,653**	167,582
Cumulative translation adjustment	**(736)**	—
Total stockholders' equity	**145,081**	189,746
Total	**$170,326**	$215,969

See notes to consolidated financial statements

CONSOLIDATED STATEMENT OF EARNINGS

Years ended December 31, 1992, 1991 and 1990
(Thousands of dollars, except per share data)

	1992	1991	1990
Sales	**$126,635**	$193,585	$135,895
Costs and expenses:			
Cost of sales	**116,713**	157,190	119,118
Selling, general and administrative expenses	**25,516**	27,508	18,996
Restructuring costs	**24,339**	—	—
Other expense (net)	**1,552**	1,510	58
Total costs and expenses	**168,120**	186,208	138,172
Operating income (loss)	**(41,485)**	7,377	(2,277)
Investment income	**3,255**	5,866	6,015
Earnings (loss) from continuing operations before income taxes	**(38,230)**	13,243	3,738
Income taxes (benefits)	**(10,977)**	4,274	1,163
Earnings (loss) from continuing operations	**(27,253)**	8,969	2,575
Loss from discontinued operations including applicable income tax benefit of $1,083 and $283	—	(2,102)	(550)
Cumulative effect of a change in accounting for post-retirement benefits including applicable income tax benefit of $3,866	**(7,506)**	—	—
Net earnings (loss)	**$ (34,759)**	$ 6,867	$ 2,025
Earnings (loss) per share:			
Continuing operations	**$ (4.01)**	$ 1.32	$ .38
Discontinued operations	—	(.31)	(.08)
Cumulative effect of change in accounting	**(1.11)**	—	—
Net earnings (loss) per share	**$ (5.12)**	$ 1.01	$ .30

See notes to consolidated financial statements

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Years ended December 31, 1992, 1991, and 1990
(Thousands of dollars, except per share data)

	Common Stock		Capital In Excess Of Par	Retained Earnings	Cumulative Translation Adjustment
	Shares	Amount			
Balance December 31, 1989	1,698,024	$1,698	$15,364	$185,009	$ —
Net earnings				2,025	
Cash dividends, $1.53 per share				(10,357)	
Stock split in the form of a 3 for 1 stock dividend	5,094,072	5,094	—	(5,094)	—
Balance December 31, 1990	6,792,096	6,792	15,364	171,583	
Net earnings				6,867	
Cash dividends, $1.60 per share				(10,868)	
Stock issued pursuant to employee stock option plan	285	—	8	—	—
Balance December 31, 1991	6,792,381	6,792	15,372	167,582	
Net loss				(34,759)	
Cash dividends, $1.35 per share				(9,170)	
Foreign currency translation adjustment	—	—	—	—	(736)
Balance December 31, 1992	6,792,381	$6,792	$15,372	$123,653	$(736)

See notes to consolidated financial statements

CONSOLIDATED STATEMENT OF CASH FLOWS

Years ended December 31, 1992, 1991 and 1990
(Thousands of dollars)

	1992	1991	1990
Cash flow from operating activities:			
Net earnings (loss)	**$(34,759)**	$ 6,867	$ 2,025
Adjustments to reconcile earnings (loss) to net cash provided by operating activities:			
Depreciation	**11,613**	11,552	11,221
Restructuring charges	**21,002**	—	—
Deferred income tax provision (benefit)	**(14,843)**	1,088	880
Post retirement benefits	**11,372**	—	—
Changes in assets and liabilities:			
Accounts receivable	**23,448**	(14,315)	(9,220)
Taxes receivable	**(1,612)**	—	—
Installment notes	**10,051**	10,113	630
Inventories	**(3,495)**	(3,501)	2,810
Accounts payable	**(2,762)**	(2,065)	2,306
Accrued liabilities	**5,955**	1,464	367
Net cash provided by operating activities	**25,970**	11,203	11,019
Cash flows from investing activities:			
Additions to property, plant and equipment	**(9,373)**	(18,428)	(9,477)
Retirement of property, plant and equipment	**472**	1,582	332
(Increase) decrease in other investments and other assets	**(1,869)**	4,404	(1,448)
Net cash used by investing activities	**(10,770)**	(12,442)	(10,593)
Cash flows from financing activities:			
Dividends paid	**(9,170)**	(10,868)	(10,357)
Proceeds from exercise of stock options	**—**	8	—
Net cash used by financing activities	**(9,170)**	(10,860)	(10,357)
Net increase (decrease) in cash and temporary investments	**6,030**	(12,099)	(9,931)
Cash and temporary investments, at beginning of year	**5,537**	17,636	27,567
Cash and temporary investments, at end of year	**$ 11,567**	$ 5,537	$ 17,636

See notes to consolidated financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of major accounting policies

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of all significant intercompany accounts and transactions.

Temporary investments and other investments: Temporary investments are carried at the lower of cost or market. The fair value of temporary investments at December 31, 1992 was $11,518,000 and was based on quotes and market prices of similar investments. Other investments of 1991 consisted of preferred stock. Market value of other investments at December 31, 1991 was $4,010,000.

Installment notes: Installment notes due after one year which equalled $9,038,000 at December 31, 1992 and $16,404,000 at December 31, 1991 are included in current assets.

Inventories: The Company uses the last-in, first-out (LIFO) and the first-in, first-out (FIFO) methods of determining inventory cost, which does not exceed market. Inventory costs include material, labor and factory overhead.

Property, plant and equipment: The Company records investments in these assets at cost. Improvements are capitalized, while repair and maintenance costs are charged to operations as incurred. Gains or losses realized on the sale or retirement of these assets are reflected in income. Depreciation for financial reporting purposes is provided on a straight-line method based upon the estimated useful lives of the assets. In 1992, restructuring charges of $21,002,000 were reported as additional accumulated depreciation to reflect the write down of certain assets. Expenditures for maintenance and repairs were $4,439,000 in 1992, $7,300,000 in 1991, and $5,177,000 in 1990.

Earnings per share: Earnings per share amounts are based on the weighted average number of shares of common stock outstanding during the period.

Other: Certain items have been reclassified in the 1991 and 1990 consolidated financial statements to conform with 1992 classifications.

(2) Restructuring costs

During the fourth quarter of 1992, the Company recorded a pre-tax charge to operations of $24,300,000 to reduce the carrying value of certain facilities and to reflect the write off of excess facilities, consolidate certain operating facilities and make related work force reductions. Management believes these decisions will improve operating efficiencies.

(3) Discontinued operations

In November 1991, the Company announced its decision to exit the trailer business. Accordingly, these operations including the direct administrative expenses related thereto and the applicable provision or benefit for income taxes have been reported as the results of discontinued operations for all periods in the consolidated statement of earnings. Revenues generated from discontinued operations were $51,929,000, $53,492,000, $58,853,000 for 1992, 1991 and 1990, respectively. The Company is currently seeking a buyer of these operations and the related net assets are included in the balance sheet as net assets of discontinued operations.

(4) Sales by product groups and geographic information

The Company manufactures, sells and services various types of oilfield pumping units, power transmission products and commercial castings and fabrications. The Company also sells industrial supplies. The following is a summary of net sales for each of these product groups (thousands of dollars):

Product groups	1992	1991	1990
Oilfield pumping units	**$ 55,115**	$124,123	$ 66,868
Power transmission	**43,580**	46,595	45,003
Commercial products	**20,028**	15,301	15,452
Industrial supplies	**7,912**	7,566	8,572
Total	**$126,635**	$193,585	$135,895

Geographic areas	1992	1991	1990
United States	**$ 81,774**	$108,513	$109,971
Europe	**21,838**	39,703	1,786
Canada	**5,544**	7,744	7,131
Latin America	**9,292**	29,375	5,969
Other	**8,187**	8,250	11,038
Total	**$126,635**	$193,585	$135,895

(5) Income taxes

During the fourth quarter of 1992, the Company changed its methods of accounting for income taxes to adopt Statement of Financial Accounting Standards (SFAS) No. 109 "Accounting for Income Taxes," effective January 1, 1992. Previously the Company was using SFAS No. 96 for income tax accounting. This change had no effect on the Company's consolidated financial statements. Under SFAS No. 109, deferred tax assets or liabilities are computed based on the difference between the financial statements and income tax bases of assets and liabilities using the enacted tax rates. The net deferred tax liability is comprised of the following (thousands of dollars):

	1992	1991
Current deferred taxes		
Gross assets	**$ 2,607**	$ 1,840
Gross liabilities	**(143)**	(180)
Less: Valuation allowance	**(100)**	—
Total, net	**$ 2,364**	$ 1,660
Noncurrent deferred taxes		
Gross assets	**$ 8,653**	$ 1,169
Gross liabilities	**(11,017)**	(17,672)
Total, net	**$ (2,364)**	$ (16,503)
Net deferred income taxes	**$ —**	$ (14,843)

The tax effect of significant temporary differences representing deferred tax assets and liabilities are as follows (in thousands of dollars):

	1992	1991
Accounting change for post retirement benefits	**$ 3,866**	$ —
Prepaid pension costs	**(3,691)**	(2,613)
Net operating loss and tax credit carry forwards	**3,787**	2,343
Depreciation	**(6,165)**	(13,614)
Other, net	**2,203**	(959)
Net deferred tax liabilities	**$ —**	$ (14,843)

The income tax provision (benefit) for 1992, 1991 and 1990 consisted of the following (thousands of dollars):

	1992	1991	1990
Current	**$ —**	$ 1,346	$ 283
Deferred	**(10,977)**	2,928	880
Discontinued operations	**—**	(1,083)	(283)
Accounting change for post retirement benefits	**(3,866)**	—	—
Total	**$ (14,843)**	$ 3,191	$ 880

A reconciliation of the provision (benefit) for income taxes to the statutory United States tax rate is as follows (thousands of dollars):

	1992	1991	1990
Tax computed at statutory rate	**$ (16,865)**	$ 3,420	$ 988
Expenses for which no benefit was realized	**2,100**	—	—
Tax-exempt interest	**(32)**	(16)	(21)
Dividend income exclusion	**(84)**	(118)	(122)
Other, net	**38**	(95)	35
Actual provision (benefit)	**$ (14,843)**	$ 3,191	$ 880

Cash payments for taxes were $1,036,000, $2,383,000 and $167,000 for 1992, 1991, and 1990, respectively.

For income tax reporting purposes, the Company has a net operating loss carry forward at December 31, 1992 of approximately $10,300,000 which is available to reduce future taxable income. The Company also has unused foreign tax credits of approximately $1,000,000 which begin expiring in 1995.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(6) Inventories

Inventories used in determining cost of sales were as follows (thousands of dollars):

	1992	1991
Finished goods	**$13,575**	$ 4,294
Work in process	**7,493**	8,752
Raw materials	**7,893**	10,634
Total	**$28,961**	$23,680

Inventories accounted for on a LIFO basis were $16,164,000 and $19,288,000 and on a FIFO basis were $12,797,000 and $4,392,000 at December 31, 1992 and 1991, respectively. Had the FIFO method been used in determining all inventory values, inventories would have been $20,741,000 and $23,958,000 higher at December 31, 1992 and 1991, respectively.

During 1992 and 1990, LIFO inventories declined. These reductions resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years. The effect of these liquidations had no material effect on either 1992 or 1990 net earnings (loss) or earnings (loss) per share.

(7) Retirement benefits

The Company has noncontributory pension plans covering substantially all employees. The benefits provided by these plans are measured by length of service, compensation and other factors, and are currently funded by trusts established under the plans. Funding of retirement costs for these plans complies with the minimum funding requirements specified by the Employee Retirement Income Security Act. Plan investment assets are invested primarily in equity securities, corporate and United States government securities and cash equivalents.

The following tables detail the components of pension income and expense, the funded status of the plans and amounts of prepaid pension cost recognized in the Company's consolidated balance sheet, and major assumptions used to determine these amounts.

(Thousands of dollars)	1992	1991	1990
Components of pension credit:			
Service cost	**$ 2,207**	$ 1,946	$ 2,338
Interest cost	**5,184**	4,872	4,977
Actual return on plan assets	**(6,353)**	(17,981)	(5,305)
Net amortization and deferral	**(4,208)**	8,709	(3,588)
Net pension credit	**$ (3,170)**	$(2,454)	$(1,578)
Plan assets at fair value	**$108,035**	$105,971	$92,165
Actuarial present value of projected benefit obligations:			
Accumulated benefit obligations			
Vested	**(50,074)**	(47,455)	(46,789)
Nonvested	**(6,014)**	(5,627)	(5,274)
Provision for future salary increases	**(14,039)**	(12,604)	(15,662)
Plan assets over projected benefit obligations	**37,908**	40,285	24,440
Unrecognized transition gain	**(14,536)**	(15,462)	(16,389)
Unrecognized gain	**(8,630)**	(12,728)	(3,183)
Unrecognized prior service cost	**(3,861)**	(4,386)	387
Net prepaid pension cost	**$ 10,881**	$ 7,709	$ 5,255
Major assumptions at year end:			
Discount rate	**8%**	8 %	8 %
Rate of increase in compensation levels	**6%**	6 %	6 %
Expected long-term rate of return on plan assets	**9%**	9 %	9 %

The Company also has defined contribution retirement plans covering substantially all of its employees. The Company makes contributions of 75% of employee contributions during the year. All obligations of the Company are funded through December 31, 1992. Pension expense for these plans totaled $1,295,000, $1,394,000 and $541,000 in 1992, 1991, and 1990, respectively.

The Company sponsors two defined benefit post retirement plans that cover both salaried and hourly employees. One plan provides medical benefits, and the other plan provides life insurance benefits. Both plans are contributory, with retiree contributions adjusted periodically. Prior to 1992, the costs of these plans were charged to expense when paid. Effective January 1, 1992, the Company adopted SFAS No. 106 "Employers' Accounting for Postretirement Benefits Other Than Pensions." This standard requires that the Company accrue the estimated costs of these plans over the employee service period. The accumulated obligation at January 1, 1992 was approximately $11,000,000 and this amount, net of tax benefit, was regarded as a cummulation effect of an accounting change in the Consolidated Statement of Earnings.

The following table sets forth the plans' combined funded status reconciled with the amount shown in the Company's balance sheet at December 31, 1992 (thousands of dollars):

	Medical and Life Total
Accumulated post retirement benefit obligation:	
Retirees	$ 8,500
Fully eligible active plan participants	1,038
Other active plan participants not yet eligible	1,823
Total accumulated post retirement benefit obligation	11,361
Unrecognized net actuarial gain	11
Accrued post retirement benefit cost	$11,372
Net periodic cost of post retirement benefit for 1992:	
Service cost	$ 113
Interest cost	912
Net periodic post retirement benefit cost	$ 1,025

The Company's post retirement health care plan is unfunded and there are no plan assets; the accumulated post retirement benefit obligation is $11,361,000. For measurement purposes, the submitted claims medical trend was assumed to be 13% in 1992, grading down to 5.5% in years 2006 and thereafter. The medicare paid claims trend was assumed to be 10% in 1992, grading down to 5.5% in years 2006 and thereafter. A one percentage point increase in each year's healthcare costs trend rate would increase the accumulated post retirement benefit obligation as of December 31, 1992 by $272,500 and the aggregate of the service and interest costs components of net periodic post retirement cost for the year ended December 31, 1992 by $29,900. In determining the accumulated post retirement obligation, a weighted-average discount rate of 8.5% was used.

(8) Employee stock option plan

The Company's 1990 Stock Option Plan provides for the granting of options to key employees to purchase an aggregate of 400,000 shares of the Company's stock at fair market value on the date of grant. One fourth of granted options become exercisable after one year and each year thereafter. The options may not be exercised after ten years from the date of grant. Outstanding options may be cancelled and reissued under terms specified in the plan.

The following table summarizes activity under the Company's stock option plans:

	1992	1991	1990
Outstanding, beginning of year	**82,715**	73,200	—
Granted (per share):			
1990 ($30.00)			73,200
1991 ($28.50)	—	9,800	
1992 ($17.50)	**90,000**		
Exercised (per share):			
1991 ($30.00)	—	(285)	—
Outstanding, end of year	**172,715**	82,715	73,200

At December 31, 1992, there were 38,765 options exercisable at a price of $28.50 to $30.00 per share.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(9) Capital stock

In May 1987, the Board of Directors adopted a "Shareholder Rights Plan" designed to protect against unsolicited attempts to acquire control of the Company that the Board believes are not in the best interest of the shareholders. The Plan provides for the possible issuance of a dividend of one common stock purchase right for each outstanding share of common stock. Under certain conditions, each right may be exercised to purchase one share of common stock at an exercise price of $100, subject to adjustment. Under certain circumstances, the rights entitle holders to purchase the common stock of the Company or an acquiring company having a value of twice the exercise price of the rights. The rights would become exercisable, or transferable apart from the common stock, ten days after a person or group acquired 20% or more, or announced or made a tender offer for 30% or more, of the outstanding common stock. Under certain circumstances, all rights owned by an acquiring person would be null and void. The rights expire on May 31, 1996, and may be redeemed by the Company at any time prior to the occurrence of certain events at $.05 per right.

The Company is authorized to issue 2.0 million shares of Preferred Stock, the terms and conditions to be determined by the Board of Directors in creating any particular series.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Stockholders of Lufkin Industries, Inc.:

We have audited the accompanying consolidated balance sheets of Lufkin Industries, Inc. (a Texas corporation) and subsidiaries as of December 31, 1992 and 1991, and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1992. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Lufkin Industries, Inc., and subsidiaries as of December 31, 1992 and 1991, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1992, in conformity with generally accepted accounting principles.

As discussed in notes 5 and 7 to the consolidated financial statements, effective January 1, 1992, the Company changed its methods of accounting for income taxes and post retirement benefits other than pensions.

ARTHUR ANDERSEN & CO.

Houston, Texas
February 17, 1993

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W. T. Little, Management consultant

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D. V. Smith, President and Chief Executive Officer

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LUFKIN
INDUSTRIES, INC.
P.O. Box 849
Lufkin, Texas 75902