

COMFORT SYSTEMS USA INC  
Form 10-Q  
November 03, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2009

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: 1-13011

COMFORT SYSTEMS USA, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction  
of Incorporation or Organization)

76-0526487  
(I.R.S. Employer  
Identification No.)

675 Bering Drive  
Suite 400  
Houston, Texas 77057

(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: (713) 830-9600

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

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No x

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer o      Accelerated filer x      Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x

The number of shares outstanding of the issuer's common stock, as of October 30, 2009 was 38,223,710.

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COMFORT SYSTEMS USA, INC.  
INDEX TO FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2009

	Page
Part I—Financial Information	
Item 1—Financial Statements	
COMFORT SYSTEMS USA, INC.	
<u>Consolidated Balance Sheets</u>	1
<u>Consolidated Statements of Operations</u>	2
<u>Consolidated Statements of Stockholders' Equity</u>	3
<u>Consolidated Statements of Cash Flows</u>	4
<u>Condensed Notes to Consolidated Financial Statements</u>	5
Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3—Quantitative and Qualitative Disclosures about Market Risk	27
Item 4—Controls and Procedures	28
Part II—Other Information	
Item 1—Legal Proceedings	29
Item 2—Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 6—Exhibits	31
Signatures	32

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## COMFORT SYSTEMS USA, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts)

	December 31, 2008	September 30, 2009 (Unaudited)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 117,015	\$ 139,863
Accounts receivable, less allowance for doubtful accounts of \$5,250 and \$6,897, respectively	266,602	228,250
Other receivables	6,156	8,686
Inventories	11,350	9,412
Prepaid expenses and other	23,399	26,694
Costs and estimated earnings in excess of billings	19,123	17,373
Assets related to discontinued operations	1,544	438
Total current assets	445,189	430,716
PROPERTY, PLANT AND EQUIPMENT, net	35,650	34,083
GOODWILL	90,940	95,590
IDENTIFIABLE INTANGIBLE ASSETS, net	16,281	13,841
MARKETABLE SECURITIES	8,423	5,590
OTHER NONCURRENT ASSETS	2,009	1,506
Total assets	\$ 598,492	\$ 581,326
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term debt	\$	\$
Current maturities of notes to former owners	1,336	2,018
Accounts payable	98,190	75,291
Accrued compensation and benefits	46,623	42,366
Billings in excess of costs and estimated earnings	97,505	89,647
Income taxes payable	1,011	
Accrued self-insurance expense	25,360	26,925
Other current liabilities	27,963	29,702
Liabilities related to discontinued operations	397	—
Total current liabilities	298,385	265,949
LONG-TERM DEBT, NET OF CURRENT MATURITIES	—	—
NOTES TO FORMER OWNERS, NET OF CURRENT MATURITIES	9,363	6,607
OTHER LONG-TERM LIABILITIES	4,273	5,677
Total liabilities	312,021	278,233
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding	—	—
Common stock, \$.01 par, 102,969,912 shares authorized, 41,123,365 and 41,123,365 shares issued, respectively	411	411
Treasury stock, at cost, 2,453,245 and 2,827,755 shares, respectively	(27,069 )	(30,324 )

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Additional paid-in capital	328,621	325,458
Accumulated other comprehensive income (loss)	(326 )	(217 )
Retained earnings (deficit)	(15,166 )	7,765
Total stockholders' equity	286,471	303,093
Total liabilities and stockholders' equity	\$ 598,492	\$ 581,326

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

COMFORT SYSTEMS USA, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(In Thousands, Except Per Share Data)  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
REVENUES	\$346,705	\$291,591	\$993,862	\$872,214
COST OF SERVICES	280,011	234,186	806,784	701,335
Gross profit	66,694	57,405	187,078	170,879
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	45,078	41,713	128,397	126,175
GAIN ON SALE OF ASSETS	(183 )	(101 )	(311 )	(98 )
Operating income	21,799	15,793	58,992	44,802
OTHER INCOME (EXPENSE):				
Interest income	565	117	2,049	492
Interest expense	(377 )	(301 )	(1,045 )	(946 )
Other		3	158	5
Other income (expense)	188	(181 )	1,162	(449 )
INCOME BEFORE INCOME TAXES	21,987	15,612	60,154	44,353
INCOME TAX EXPENSE	8,250	6,072	23,070	17,293
INCOME FROM CONTINUING OPERATIONS	13,737	9,540	37,084	27,060
DISCONTINUED OPERATIONS:				
Operating income (loss), net of income tax (expense) benefit of \$(46), \$ , \$(145), and \$133	28		115	(387 )
Estimated loss on disposition, net of tax of \$—, \$—, \$—, and \$—			—	(93 )
NET INCOME	\$13,765	\$9,540	\$37,199	\$26,580
INCOME PER SHARE:				
Basic —				
Income from continuing operations	\$0.35	\$0.25	\$0.94	\$0.71
Discontinued operations —				
Income (loss) from operations	—		—	(0.01 )
Estimated loss on disposition	—	—	—	—
Net income	\$0.35	\$0.25	\$0.94	\$0.70
Diluted —				
Income from continuing operations	\$0.34	\$0.25	\$0.92	\$0.70
Discontinued operations —				
Income (loss) from operations	—		—	(0.01 )
Estimated loss on disposition	—	—	—	—
Net income	\$0.34	\$0.25	\$0.92	\$0.69
SHARES USED IN COMPUTING INCOME PER SHARE:				
Basic	39,403	37,995	39,625	38,135
Diluted	40,048	38,382	40,296	38,533
DIVIDENDS PER SHARE	\$0.045	\$0.050	\$0.135	\$0.140

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

## COMFORT SYSTEMS USA, INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In Thousands, Except Share Amounts)

	STOCKHOLDERS' EQUITY								
	Common Stock			Treasury Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total Stockholders' Equity
	Comprehensive Income	Shares	Amount	Shares	Amount				
BALANCE AT DECEMBER 31, 2007		41,123,365	\$411	(781,415 )	\$(9,973 )	\$336,996	\$	\$(64,856)	\$262,578
Comprehensive Income:									
Net income	\$49,690	—	—	—	—	—	—	49,690	49,690
Unrealized loss on marketable securities, net of tax	(326 )	—	—	—	—	—	(326)	—	(326 )
Comprehensive Income	\$49,364	—	—	—	—	—	—	—	—
Issuance of Stock:									
Issuance of shares for options exercised including tax benefit	—	—	—	514,658	6,566	(2,789 )	—	—	3,777
Issuance of restricted stock	—	—	—	201,309	2,485	(2,485 )	—	—	—
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	—	(39,100 )	(513 )	—	—	—	(513 )
Stock-based compensation expense	—	—	—	—	—	3,851	—	—	3,851
Forfeiture of unvested restricted stock	—	—	—	(8,288 )	(93 )	93	—	—	—
Tax benefit from vesting of	—	—	—	—	—	89	—	—	89



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restricted stock									
Dividends		—	—	—	—	(7,134 )	—	—	(7,134 )
Share									
repurchase		—	—	(2,340,409)	(25,541)	—	—	—	(25,541 )
BALANCE AT									
DECEMBER									
31, 2008		41,123,365	411	(2,453,245)	(27,069)	328,621	(326)	(15,166)	286,471
Comprehensive									
Income:									
Net income									
(unaudited)	\$ 26,580	—	—	—	—	—	—	26,580	26,580
Unrealized									
income on									
marketable									
securities, net									
of tax									
(unaudited)	109	—	—	—	—	—	109	—	109
Comprehensive									
Income									
(unaudited)	\$ 26,689								
Issuance of									
Stock:									
Issuance of									
shares for									
options									
exercised									
including tax									
benefit									
(unaudited)	—		280,150	3,012	(1,271 )	—	—	—	1,741
Issuance of									
restricted stock									
(unaudited)	—		241,857	2,652	(2,652 )	—	—	—	—
Shares received									
in lieu of tax									
withholding									
payment on									
vested									
restricted stock									
(unaudited)	—	—	(45,779 )	(459 )	—	—	—	—	(459 )
Stock-based									
compensation									
expense									
(unaudited)	—	—	—	—	2,543	—	—	—	2,543
Forfeiture of									
unvested									
restricted stock									
(unaudited)	—	—	(7,038 )	(76 )	76	—	—	—	—
Tax benefit									
from vesting of									
restricted stock									
(unaudited)	—	—	—	—	(124 )	—	—	—	(124 )

Dividends (unaudited)	—	—	—	(1,735 )	—	(3,649 )	(5,384 )	
Share repurchase (unaudited)	—	—	(843,700 )	(8,384 )	—	—	(8,384 )	
BALANCE AT SEPTEMBER 30, 2009 (unaudited)	41,123,365	\$411	(2,827,755)	\$(30,324)	\$325,458	\$ (217)	\$ 7,765	\$ 303,093

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

COMFORT SYSTEMS USA, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In Thousands)  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
Net income	\$13,765	\$9,540	\$37,199	\$26,580
Adjustments to reconcile net income to net cash provided by operating activities				
Estimated loss on disposition of discontinued operations	—		—	93
Amortization of identifiable intangible assets	1,458	709	3,301	2,511
Depreciation expense	2,231	2,541	6,269	7,357
Bad debt expense	1,597	467	1,973	2,577
Deferred tax (benefit) expense	2,361	(380 )	2,640	(2,427 )
Amortization of debt financing costs	27	27	81	81
Gain on sale of assets	(183 )	(101 )	(316 )	(97 )
Stock-based compensation expense	891	481	2,971	2,543
Changes in operating assets and liabilities, net of effects of acquisitions —				
(Increase) decrease in —				
Receivables	11,297	28,360	(7,429 )	36,230
Inventories	963	767	200	1,898
Prepaid expenses and other current assets	(347 )	(321 )	2,244	(1,421 )
Costs and estimated earnings in excess of billings	1,197	(1,052 )	(5,085 )	1,747
Other noncurrent assets	(4,313 )	(1,803 )	(3,122 )	(1,837 )
Increase (decrease) in —				
Accounts payable and accrued liabilities	(5,781 )	(5,790 )	2,200	(24,655 )
Billings in excess of costs and estimated earnings	(3,504 )	(10,564 )	4,044	(7,829 )
Other long-term liabilities	(716 )	1,922	(214 )	1,403
Net cash provided by operating activities	20,943	24,803	46,956	44,754
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>				
Purchases of property, plant and equipment	(3,773 )	(1,986 )	(10,778 )	(6,420 )
Proceeds from sales of property and equipment	539	326	656	500
Proceeds from businesses sold	208	278	324	584
Sale of marketable securities	25	1,000	7,600	3,000
Purchases of marketable securities			(18,525 )	
Cash paid for acquisitions and intangible assets, net of cash acquired	(12,513 )	(1,056 )	(40,398 )	(4,905 )
Net cash used in investing activities	(15,514 )	(1,438 )	(61,121 )	(7,241 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>				
Net borrowings on revolving line of credit				
Payments on other long-term debt	(1,432 )	(365 )	(6,665 )	(2,074 )
Payments of dividends to shareholders	(1,786 )	(1,912 )	(5,387 )	(5,365 )

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Share repurchase program and shares received in lieu of tax withholding	(4,747 )	(2,652 )	(15,002 )	(8,843 )
Excess tax benefit of stock-based compensation	1,755	439	1,844	593
Proceeds from exercise of options	1,573	573	2,044	1,024
Net cash used in financing activities	(4,637 )	(3,917 )	(23,166 )	(14,665 )
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>792</b>	<b>19,448</b>	<b>(37,331 )</b>	<b>22,848</b>
CASH AND CASH EQUIVALENTS, beginning of period – continuing and discontinued operations	101,508	120,415	139,631	117,015
<b>CASH AND CASH EQUIVALENTS, end of period– continuing and discontinued operations</b>	<b>\$ 102,300</b>	<b>\$ 139,863</b>	<b>\$ 102,300</b>	<b>\$ 139,863</b>

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

COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2009

(Unaudited)

1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation, provides comprehensive heating, ventilation and air conditioning (“HVAC”) installation, maintenance, repair and replacement services within the mechanical services industry. We operate primarily in the commercial, industrial and institutional HVAC markets, and perform most of our services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, we provide specialized applications such as building automation control systems, fire protection, process cooling, electronic monitoring and process piping. Certain locations also perform related activities such as electrical service and plumbing. Approximately 52% of our consolidated 2009 revenues are attributable to installation of systems in newly constructed facilities, with the remaining 48% attributable to maintenance, repair and replacement services. The following service activities account for our consolidated 2009 revenues: HVAC 77%, plumbing 13%, building automation control systems 3%, and other 7%. These service activities are within the mechanical services industry which is the single industry segment we serve.

2. Summary of Significant Accounting Policies

Basis of Presentation

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) for the year ended December 31, 2008 (the “Form 10-K”).

The accompanying unaudited consolidated financial statements were prepared using generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the SEC. Accordingly, these financial statements do not include all the footnotes required by generally accepted accounting principles for complete financial statements, and should be read in conjunction with the Form 10-K. We believe all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for interim periods are not necessarily indicative of the results for the full fiscal year.

Cash Flow Information

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Cash paid for interest for the three months ended September 30, 2008 and 2009 was approximately \$0.1 million and \$0.3 million, respectively. Cash paid for income taxes for continuing operations for the three months ended September 30, 2008 and 2009 was approximately \$11.7 million and \$9.9 million, respectively. Cash paid for income taxes for discontinued operations for both the three months ended September 30, 2008 and 2009 was less than \$0.1 million. Cash paid for interest for the nine months ended September 30, 2008 and 2009 was approximately \$0.6 million and \$0.8 million, respectively. Cash paid for income taxes for continuing operations for the nine months ended September 30, 2008 and 2009 was approximately \$21.8 million and \$22.6 million, respectively. Cash paid for income taxes for discontinued operations for both the nine months ended September 30, 2008 and 2009 was less than approximately \$0.1 million.

### Subsequent Events

We evaluated subsequent events through the time of filing this Quarterly Report on Form 10-Q on November 3, 2009. No significant events occurred subsequent to the balance sheet or prior to the filing of this report that would have a material impact on our consolidated financial statements.

### Segment Disclosure

Our activities are within the mechanical services industry which is the single industry segment we serve. Each operating subsidiary represents an operating segment and these segments have been aggregated, as the operating units meet all of the aggregation criteria.

### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions by management in determining the reported amounts of assets and liabilities, revenues and expenses and disclosures regarding contingent assets and liabilities. Actual results could differ from those estimates. The most significant estimates used in our financial statements affect revenue and cost recognition for construction contracts, the allowance for doubtful accounts, self-insurance accruals, deferred tax assets, warranty accruals, and the quantification of fair value for reporting units in connection with our goodwill impairment testing.

### Income Taxes

We file a consolidated return for federal income tax purposes. Income taxes are provided for under the liability method, which takes into account differences between financial statement treatment and tax treatment of certain transactions. Deferred tax assets represent the tax effect of activity that has been reflected in the financial statements but which will not be deductible for tax purposes until future periods. Deferred tax liabilities represent the tax effect of activity that has been reflected in the financial statements but which will not be taxable until future periods.

We regularly evaluate valuation allowances established for deferred tax assets for which future realization is uncertain. Estimations of required valuation allowances include estimates of future taxable income. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which the activity underlying these assets becomes deductible. We consider projected future taxable income and tax planning strategies in making this assessment. If actual future taxable income is less than the estimates, we may not realize all or a portion of the recorded deferred tax assets.

### Financial Instruments

Our financial instruments consist of cash and cash equivalents, marketable securities, accounts receivable, other receivables, accounts payable, notes to former owners and a revolving credit facility. We believe that the carrying values of these instruments on the accompanying balance sheets approximate their fair values.

Marketable securities are classified as available-for-sale. These investments are recorded at fair value and are classified as marketable securities in the accompanying consolidated balance sheet as of September 30, 2009. The

changes in fair values, net of applicable taxes, are recorded as unrealized gains (losses) as a component of accumulated other comprehensive income (loss) in stockholders' equity.

#### Recent Accounting Pronouncements

On September 30, 2009, we adopted changes issued by the Financial Accounting Standards Board ("FASB") to the authoritative hierarchy of generally accepted accounting principles ("GAAP"). These changes establish the FASB Accounting Standards Codification™ ("Codification") as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. These changes and the Codification itself do



not change GAAP. Other than the manner in which new accounting guidance is referenced, the adoption of these changes had no impact on the consolidated financial statements.

#### Fair Value Accounting

On January 1, 2009, we adopted changes issued by the FASB to fair value accounting and reporting as it relates to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on at least an annual basis. These changes define fair value, establish a framework for measuring fair value in GAAP, and expand disclosures about fair value measurements. This guidance applies to other GAAP that require or permit fair value measurements and is to be applied prospectively with limited exceptions. The adoption of these changes, as it relates to nonfinancial assets and nonfinancial liabilities, had no impact on the consolidated financial statements, however we have expanded the disclosures regarding marketable securities, goodwill, and intangible assets.

#### Business Combinations and Consolidation Accounting

On January 1, 2009, we adopted changes issued by the FASB to accounting for business combinations. These changes apply to all assets acquired and liabilities assumed in a business combination that arise from certain contingencies and requires (i) an acquirer to recognize at fair value, at the acquisition date, an asset acquired or liability assumed in a business combination that arises from a contingency if the acquisition date fair value of that asset or liability can be determined during the measurement period otherwise the asset or liability should be recognized at the acquisition date if certain defined criteria are met; (ii) contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination be recognized initially at fair value; (iii) subsequent measurements of assets and liabilities arising from contingencies be based on a systematic and rational method depending on their nature and contingent consideration arrangements be measured subsequently; and (iv) disclosures of the amounts and measurement basis of such assets and liabilities and the nature of the contingencies. The adoption did not have a material impact on our consolidated financial statements. The adoption will significantly impact our accounting and reporting for future acquisitions, principally as a result of the expanded requirements to value acquired assets, liabilities and contingencies at their fair values and the requirement that acquisition related transaction costs be expensed as incurred rather than capitalized as a part of the cost of the acquisition.

#### Earnings Per Share

On January 1, 2009, we adopted changes issued by the FASB to the calculation of earnings per share. These changes state that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method for all periods presented. There was no significant impact upon the adoption of these changes.

#### Subsequent Events

On June 30, 2009, we adopted changes issued by the FASB to accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The new guidance also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. This change had no impact on our consolidated financial statements.

#### Reclassifications

Certain reclassifications have been made in prior period financial statements to conform to current period presentation. These reclassifications have not resulted in any changes to previously reported net income for any periods.

### 3. Fair Value Measurements

We use a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy, which gives the highest priority to quoted prices in active markets, is comprised of the following three levels:

- Level 1 - defined as observable inputs such as quoted prices in active markets;
- Level 2 - defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and
- Level 3 - defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The assets measured at fair value on a recurring basis as of September 30, 2009 are as follows (in thousands):

		Fair Value Measurements at Reporting Date Using		
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Total			
Cash and cash equivalents	\$ 139,863	\$ 139,863	\$ —	\$ —
Auction rate securities	\$ 6,590	\$ —	\$ 925	\$ 5,665

Cash and cash equivalents consist primarily of highly rated money market funds at a variety of well-known institutions with original maturities of three months or less. The original cost of these assets approximates fair value due to their short term maturity.

As of September 30, 2009, our marketable securities consisted of \$6.6 million of auction rate securities, which are variable rate debt instruments, having long-term maturities (with final maturities up to October 2034), but whose interest rates are designed to reset through an auction process, at intervals ranging from seven to 35 days. We had investments in marketable securities of \$9.4 million as of December 31, 2008. All of our auction rate securities are high quality municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. During the nine months ended September 30, 2009, we sold \$3.0 million of these auction rate securities at face value. An additional \$1.0 million were sold at face value during October 2009; this is included in "Prepaid Expenses and Other" in our consolidated balance sheet. The remaining \$5.6 million has been classified as a noncurrent asset on the consolidated balance sheet as we have the intent and ability to hold these securities until the market for auction rate securities stabilizes or until the issuer refinances the underlying security.

The auction events for some of these instruments failed during 2008 due to events in the credit markets. As a result of the temporary declines in fair value for our auction rate securities, which we attribute to liquidity issues rather than credit issues, we recorded an unrealized loss of \$0.3 million, net of tax of less than \$0.1 million, to accumulated other comprehensive income (loss). Our analysis of the fair values of these securities considered, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose to sell the securities in the absence of a successful auction. These securities were also compared, when possible, to other observable market data with similar characteristics.

As of September 30, 2009 we continue to collect interest when due on all of our auction rate securities. Any future fluctuation in fair value related to these instruments that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive income (loss). If

we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings as appropriate.

We measure certain assets, including our goodwill and intangible assets, at a fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be impaired. During the nine months ended September 30, 2009, we did not recognize any impairments on those assets required to be measured at fair value on a nonrecurring basis.

#### 4. Acquisitions

We completed various acquisitions in 2008 which were not material individually or in the aggregate. Additional contingent purchase price (“earn-out”) has been and will be paid if certain acquisitions achieve predetermined profitability targets. The total purchase price for these acquisitions was \$68.9 million, including \$4.7 million in earn-outs that were recorded during the nine months of 2009. There were no acquisitions for the nine months ended September 30, 2009. The results of operations of these acquisitions are included in our consolidated financial statements from their respective acquisition dates.

#### 5. Discontinued Operations

We sold a small operating company in June 2009. This company’s after-tax income of \$0.1 million for the nine months ended September 30, 2008 and after-tax loss of \$0.4 million for the nine months ended September 30, 2009 have been reported in discontinued operations under “Operating income (loss), net of income tax (expense) benefit.” We recorded an estimated loss on the sale of this company of \$0.1 million in the second quarter of 2009. This loss has been reported in discontinued operations under “Estimated loss on disposition, net tax.”

Our consolidated statements of operations and the related earnings per share amounts have been restated to reflect the effects of this discontinued operation. No interest expense was allocated to this discontinued operation.

Revenues and pretax income (loss) related to this company in 2008 and 2009 were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Revenues	\$ 1,930	\$	\$ 5,575	\$ 1,795
Pre-tax income (loss)	\$ 74	\$	\$ 260	\$ (520 )

#### 6. Long-Term Debt Obligations

Long-term debt obligations consist of the following (in thousands):

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	December 31, 2008	September 30, 2009
Revolving credit facility	\$	\$
Notes to former owners	10,699	8,625
<b>Total debt</b>	<b>10,699</b>	<b>8,625</b>
Less current maturities of notes to former owners	1,336	2,018
<b>Total long-term portion of debt</b>	<b>\$ 9,363</b>	<b>\$ 6,607</b>

We have a \$100.0 million senior credit facility (the ‘‘Facility’’) provided by a syndicate of banks which is available for borrowings and letters of credit. The Facility expires in February 2012 and is secured by the capital stock of our current and future subsidiaries. As of September 30, 2009, we had no outstanding borrowings, \$43.1 million in letters of credit outstanding, and \$56.9 million of credit available.

We have a choice of two interest rate options for borrowings under the Facility; these rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. We estimate that the interest rate applicable to the borrowings under the Facility would be approximately 1.5% as of September 30, 2009. Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20%-0.30% per annum, based on the ratio of debt to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. The Facility's principal financial covenants include:

**Leverage Ratio** — The Facility requires that the ratio of our total indebtedness less cash and cash equivalents to our Credit Facility Adjusted EBITDA not exceed 2.50. The leverage ratio as of September 30, 2009 was 0.11.

**Fixed Charge Coverage Ratio** — The Facility requires that the ratio of Credit Facility Adjusted EBITDA, less non-financed capital expenditures, tax provision, dividends and amounts used to repurchase stock to the sum of interest expense and scheduled principal payments be at least 1.50. Capital expenditures, tax provision, dividends and stock repurchase payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The calculation of the fixed charge coverage ratio excludes acquisitions, stock repurchases and the payment of cash dividends, at any time that the Leverage Ratio does not exceed 1.0. The fixed charge coverage ratio as of September 30, 2009 was 13.34.

**Other Restrictions** — The Facility permits acquisitions of up to \$25.0 million per transaction, or \$50.0 million in the aggregate. However, these limitations only apply when the Leverage Ratio is greater than 1.0.

While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility's debt-to-Credit Facility Adjusted EBITDA covenant, our borrowing capacity under the Facility and the favorable terms that we currently enjoy could be negatively impacted by the lenders.

We are in compliance with all the financial covenants as of September 30, 2009.

#### Notes to Former Owners

We issued subordinated notes to the former owners of acquired companies, as part of the consideration used to acquire these companies. These notes had an outstanding balance of \$8.6 million as of September 30, 2009, of which \$2.0 million is current as of September 30, 2009 and bear interest, payable annually, at a weighted average interest rate of 5.7%.

## 7. Commitments and Contingencies

### Claims and Lawsuits

We are subject to certain legal and regulatory claims, including lawsuits arising in the normal course of business. We maintain various insurance coverages to minimize financial risk associated with these claims. We have estimated and provided accruals for probable losses and related legal fees associated with certain of its litigation in the accompanying consolidated financial statements. While we cannot predict the outcome of these proceedings, in management's opinion and based on reports of counsel, any liability arising from these matters individually and in the aggregate will not have a material effect on our operating results or financial condition, after giving effect to provisions already recorded.

In addition to the matters described above, we have accrued \$5.7 million as of September 30, 2009 for potential and asserted backcharges from several customers of our large multi-family operation based in Texas. The related expense was included in "Cost of Services" prior to 2009 and the accrual is included in "Other



Current Liabilities.” We believe these accruals reflect a probable outcome with respect to such backcharges and potential backcharges, however, if we are not successful in resolving these disputes, we may in the future experience a material adverse effect on our operating results.

The following table shows the activity during the first nine months of 2009 and the remaining backcharges as of September 30, 2009 (in thousands):

Balance at December 31, 2008	\$5,838
Additions	—
Utilization	(169 )
Balance at September 30, 2009	\$5,669

#### Surety

Many customers, particularly in connection with new construction, require us to post performance and payment bonds issued by a financial institution known as a surety. If we fail to perform under the terms of a contract or to pay subcontractors and vendors who provided goods or services under a contract, the customer may demand that the surety make payments or provide services under the bond. We must reimburse the surety for any expenses or outlays it incurs. To date, we are not aware of any losses to our sureties in connection with bonds the sureties have posted on our behalf, and do not expect such losses to be incurred in the foreseeable future.

Surety market conditions remain challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 30% of our business has required bonds. While we have strong surety relationships to support our bonding needs, current market conditions as well as changes in the sureties’ assessment of our operating and financial risk could cause the sureties to decline to issue bonds for our work. If that were to occur, the alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics, including a significant amount of cash on our balance sheet, would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenues and profits to decline in the near term.

#### Self-Insurance

We are substantially self-insured for worker’s compensation, employer’s liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident deductibles we absorb under our insurance arrangements for these risks. Losses up to deductible amounts are estimated and accrued based upon known facts, historical trends and industry averages. Loss estimates associated with the larger and longer-developing risks, such as worker’s compensation, auto liability and general liability, are reviewed by a third-party actuary quarterly. Our self-insurance arrangements currently are as follows:

Worker's Compensation — The per-incident deductible for worker's compensation is \$500,000. Losses above \$500,000 are determined by statutory rules on a state-by-state basis, and are fully covered by excess worker's compensation insurance.

Employer's Liability — For employer's liability, the per incident deductible is \$500,000. We are fully insured for the next \$500,000 of each loss, and then have a single, aggregate excess loss insurance policy that covers losses up to \$50 million across both of these risk areas (as well as general liability and auto liability noted below).

General Liability — For general liability, the per incident deductible is \$500,000. We are fully insured for the next \$1.5 million of each loss, and then have a single, aggregate excess loss insurance policy that covers losses up to \$50 million across both these risk areas (as well as employer’s liability and auto liability noted below).

Auto Liability — For auto liability, the per incident deductible is \$500,000. We are fully insured for the next \$1.5 million of each loss, and then have a single, aggregate excess loss insurance policy that covers losses up to \$50 million.

Employee Medical — We have two medical plans. The deductible for employee group health claim is \$300,000 per person, per policy (calendar) year for one plan and \$150,000 per person, per policy (calendar) year for the other plan. Insurance then covers any responsibility for medical claims in excess of the deductible amount.

Our \$50 million of aggregate excess loss coverage above applicable per-incident policy limits represents one policy limit that applies to all lines of risk; we do not have a separate \$50 million of excess loss coverage for each of general liability, employer’s liability and auto liability.

## 8. Stockholders’ Equity

### Earnings Per Share

Basic earnings per share (“EPS”) is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year. Diluted EPS is computed considering the dilutive effect of stock options and contingently issuable restricted stock.

There were approximately 2,000 and 0.4 million of anti-dilutive stock options that were excluded from the calculation of diluted EPS for the three months ended September 30, 2008 and 2009, respectively. There were approximately 0.2 million and 0.6 million of anti-dilutive stock options that were excluded from the calculation of diluted EPS for the nine months ended September 30, 2008 and 2009, respectively.

The following table reconciles the number of shares outstanding with the number of shares used in computing basic and diluted earnings per share for each of the periods presented (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Common shares outstanding, end of period(a)	39,532	37,919	39,532	37,919
Effect of using weighted average common shares outstanding	(129 )	76	93	216
Shares used in computing earnings per share—basic	39,403	37,995	39,625	38,135

Effect of shares issuable under stock option plans based on the treasury stock method	571	350	618	380
Effect of contingently issuable restricted stock	74	37	53	18
Shares used in computing earnings per share—diluted	40,048	38,382	40,296	38,533

(a) Excludes 0.3 million and 0.4 million shares of unvested contingently issuable restricted stock outstanding as of September 30, 2008 and 2009, respectively.

#### Share Repurchase Program

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to one million shares of our outstanding common stock. As of December 31, 2008, the Board approved extensions of the program to cover an additional 2.9 million shares. During the first quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. During the third quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. Since the inception of the repurchase program, the Board has approved 4.9 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 843,700 shares during the nine months ended September 30, 2009, at an average price of \$9.94 per share. Since the inception of the program in 2007, we have repurchased a cumulative total of 4.0 million shares as of September 30, 2009, at an average price of \$11.12 per share.

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

The following discussion should be read in conjunction with our historical Consolidated Financial Statements and related notes thereto included elsewhere in this Form 10-Q and the Annual Report on Form 10-K as filed with the Securities and Exchange Commission for the year ended December 31, 2008 (the "Form 10-K"). This discussion contains "forward-looking statements" regarding our business and industry within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on our current plans and expectations and involve risks and uncertainties that could cause our actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in "Item 1A. Company Risk Factors" included in our Form 10-K. The terms "Comfort Systems," "we," "us," or "the Company," refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

#### Introduction and Overview

We are a national provider of comprehensive HVAC installation, maintenance, repair and replacement services within the mechanical services industry. The services we provide address a very broad need, as air is circulated through almost all commercial, industrial and institutional buildings virtually year-round. We operate primarily in the commercial, industrial and institutional HVAC markets and perform most of our services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, we provide specialized applications such as building automation control systems, fire protection, process cooling, electronic monitoring and process piping. Certain locations also perform related activities such as electrical service and plumbing.

#### Nature and Economics of Our Business

Approximately 86% of our revenues are earned on a project basis for installation of HVAC systems in newly constructed facilities or for replacement of HVAC systems in existing facilities. Customers hire us to ensure such systems deliver specified or generally expected heating, cooling, conditioning and circulation of air in a facility. This entails installing core system equipment such as packaged heating and air conditioning units, or in the case of larger facilities, separate core components such as chillers, boilers, air handlers, and cooling towers. We also typically install connecting and distribution elements such as piping and ducting. Our responsibilities usually require conforming the systems to pre-established engineering drawings and equipment and performance specifications, which we frequently participate in establishing. Our project management responsibilities include staging equipment and materials to project sites, deploying labor to perform the work, and coordinating with other service providers on the project, including any subcontractors we might use to deliver our portion of the work.

When competing for project business, we usually estimate the costs we will incur on a project, then propose a bid to the customer that includes a contract price and other performance and payment terms. Our bid price and terms are intended to cover our estimated costs on the project and provide a profit margin to us commensurate with the value of the installed system to the customer, the risk that project costs or duration will vary from estimate, the schedule on

which we will be paid, the opportunities for other work that we might forego by committing capacity to this project, and other costs that we incur more broadly to support our operations but which are not specific to the project. Typically customers will seek bids from competitors for a given project. While the criteria on which customers select the winning bid vary widely and include factors such as quality, technical expertise, on-time performance, post-project support and service, and company history and financial strength, we believe that price is the most influential factor for most customers in choosing an HVAC installation and service provider.

After a customer accepts our bid, we generally enter into a contract with the customer that specifies what we will deliver on the project, what our related responsibilities are, and how much and when we will be paid. Our overall price for the project is typically set at a fixed amount in the contract, although changes in project specifications or work conditions that result in unexpected additional work are usually subject to additional payment from the customer via what are commonly known as change orders. Project contracts typically provide for periodic billings to the customer as we meet progress milestones or incur cost on the project.. Project

contracts in our industry also frequently allow for a small portion of progress billings or contract price to be withheld by the customer until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage.

Labor and overhead costs account for the majority of our cost of service. Accordingly, labor management and utilization have the most impact on our project performance. Given the fixed price nature of much of our project work, if our initial estimate of project costs is wrong or we incur cost overruns that cannot be recovered in change orders, we can experience reduced profits or even significant losses on fixed price project work. We also perform some project work on a cost-plus or a time and materials basis, under which we are paid our costs incurred plus an agreed-upon profit margin. These margins are typically less than fixed-price contract margins because there is less risk of unrecoverable cost overruns in cost-plus or time and materials work.

As of September 30, 2009, we had 4,468 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$425,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. We have what we believe is a well-diversified distribution of revenues across end-use sectors that we believe reduces our exposure to negative developments in any given sector. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

We also perform larger HVAC projects. As of September 30, 2009, we had 6 projects in process with a contract price of between \$15 million and \$30 million, 19 projects between \$10 million and \$15 million, 53 projects between \$5 million and \$10 million, and 241 projects between \$1 million and \$5 million. Taken together, projects with contract prices of \$1 million or more totaled \$1,286.0 million of aggregate contract value as of September 30, 2009, or approximately 68%, out of a total contract value for all projects in progress of \$1,898.5 million. Generally, projects closer in size to \$1 million will be completed in one year or less. It is unusual for us to work on a project that exceeds two years in length.

In addition to project work, approximately 14% of our revenues represent maintenance and repair service on already-installed HVAC and controls systems. This kind of work usually takes from a few hours to a few days to perform. Prices to the customer are usually based on the equipment and materials used in the service as well as technician labor time. We usually bill the customer for service work when it is complete, typically with payment terms of up to thirty days. We also provide maintenance and repair service under ongoing contracts. Under these contracts, we are paid regular monthly or quarterly amounts and provide specified service based on customer requirements. These agreements typically cover periods ranging from one to three years and are cancelable on 30 to 60 days notice.

A relatively small but growing portion of our revenues comes from national and regional account customers. These customers typically have multiple sites, and contract with us to perform maintenance and repair service. These contracts may also provide for us to perform new or replacement systems installation. We operate a national call



center to dispatch technicians to sites requiring service. We perform the majority of this work with our own employees, with the balance being subcontracted to third parties that meet our performance qualifications. We will also typically use proprietary information systems to maintain information on the customer's sites and equipment, including performance and service records, and related cost data. These systems track the status of ongoing service and installation work, and may also monitor system performance data. Under these contractual relationships, we usually provide consolidated billing and credit payment terms to the customer.

#### Profile and Management of Our Operations

We manage our 41 operating units based on a variety of factors. Financial measures we emphasize include profitability, and use of capital as indicated by cash flow and by other measures of working capital principally involving project cost, billings and receivables. We also monitor selling, general, administrative and indirect

project support expense, backlog, workforce size and mix, growth in revenues and profits, variation of actual project cost from original estimate, and overall financial performance in comparison to budget and updated forecasts. Operational factors we emphasize include project selection, estimating, pricing, management and execution practices, labor utilization, safety, training, and the make-up of both existing backlog as well as new business being pursued, in terms of project size, technical application and facility type, end-use customers and industries, and location of the work.

Most of our operations compete on a local or regional basis. Attracting and retaining effective operating unit managers is an important factor in our business, particularly in view of the relative uniqueness of each market and operation, the importance of relationships with customers and other market participants such as architects and consulting engineers, and the high degree of competition and low barriers to entry in most of our markets. Accordingly, we devote considerable attention to operating unit management quality, stability, and contingency planning, including related considerations of compensation, and non-competition protection where applicable.

#### Economic and Industry Factors

As an HVAC and building controls services provider, we operate in the broader nonresidential construction services industry and are affected by trends in this sector. While we do not have operations in all major cities of the United States, we believe our national presence is sufficiently large that we experience trends in demand for and pricing of our services that are consistent with trends in the national nonresidential construction sector. As a result, we monitor the views of major construction sector forecasters along with macroeconomic factors they believe drive the sector, including trends in gross domestic product, interest rates, business investment, employment, demographics, and the general fiscal condition of federal, state and local governments. Although nonresidential construction activity has demonstrated periods of both significant growth and decline, it has grown at a compound annual rate of approximately 4.2% over the last twenty-five years.

Spending decisions for building construction, renovation and system replacement are generally made on a project basis, usually with some degree of discretion as to when and if projects proceed. With larger amounts of capital, time, and discretion involved, spending decisions are affected to a significant degree by uncertainty, particularly concerns about economic and financial conditions and trends. We have experienced periods of time, when economic weakness caused a significant slowdown in decisions to proceed with installation and replacement project work.

#### Operating Environment and Management Emphasis

Nonresidential building construction and renovation activity, as reported by the federal government, declined over the three year period of 2001 to 2003, expanded moderately during 2004 and 2005, and was strong over the three year period from 2006 to 2008. During the decline and through 2003, we responded to market challenges by pursuing work in sectors less affected by this downturn, such as government, educational, and healthcare facilities, and by establishing marketing initiatives that take advantage of our size and range of expertise. We also responded to declining gross profits over those years by reducing our selling, general, and administrative expenses, and our indirect project and service overhead costs. We believe our efforts in these areas partially offset the decline in our profitability

over that period. We experienced notable improvements in both industry activity as well as our own results from 2004 to 2008.

As discussed at greater length in “Results of Operations” below, we have seen declining activity levels in our industry since late 2008 and we expect price competition to continue to be strong, as local and regional competitors respond cautiously to changing conditions. We will continue our efforts to find the more active sectors in our markets, and to increase our regional and national account business. Our primary emphasis for 2009 will be on execution and cost control, and on maintaining activity levels that will permit us to earn reasonable profits while preserving our core workforce. We have increased our focus on project qualification, estimating, pricing and management, and on service performance.

As a result of our continued strong emphasis on cash flow, our debt outstanding under our revolving credit facility is zero, and we have substantial uncommitted cash balances, as discussed further in “Liquidity and Capital Resources” below. We have a credit facility in place with considerably less restrictive terms than those of our previous facilities; this facility does not expire until February 2012. We have strong surety relationships to

support our bonding needs, and we believe our relationships with the surety markets are positive in light of our strong current results and financial position. We have generated positive free cash flow in each of the last ten calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our balance sheet and surety support as compared to most companies in our industry represent competitive advantages for us.

### Critical Accounting Policies

In response to the Commission's Release No. 33-8040, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies," we identified our critical accounting policies based upon the significance of the accounting policy to our overall financial statement presentation, as well as the complexity of the accounting policy and our use of estimates and subjective assessments. We have concluded that our most critical accounting policy is our revenue recognition policy. As discussed elsewhere in this report, our business has two service functions: (i) installation, which we account for under the percentage of completion method, and (ii) maintenance, repair and replacement, which we account for as the services are performed, or in the case of replacement, under the percentage of completion method. In addition, we identified other critical accounting policies related to our allowance for doubtful accounts receivable, the recording of our self-insurance liabilities, valuation of deferred tax assets and the assessment of goodwill impairment. These accounting policies, as well as others, are described in Note 2 to the Consolidated Financial Statements included in our Form 10-K.

### Percentage of Completion Method of Accounting

Approximately 86% of our revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method contract revenue recognizable at any time during the life of a contract is determined by multiplying expected total contract revenue by the percentage of contract costs incurred at any time to total estimated contract costs. More specifically, as part of the negotiation and bidding process in which we engage in connection with obtaining installation contracts, we estimate our contract costs, which include all direct materials (exclusive of rebates), labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. These contract costs are included in our results of operations under the caption "Cost of Services." Then, as we perform under those contracts, we measure such costs incurred, compare them to total estimated costs to complete the contract, and recognize a corresponding proportion of contract revenue. Labor costs are considered to be incurred as the work is performed. Subcontract labor is recognized as the work is performed, but is generally subjected to approval as to milestones or other evidence of completion. Non-labor project cost consists of purchased equipment, prefabricated materials and other materials. Purchased equipment on our projects is substantially produced to job specifications and is a value added element to our work. The costs are considered to be incurred when title is transferred to us, which typically is upon delivery to the worksite. Prefabricated materials, such as ductwork and piping, are generally performed at our shops and recognized as contract costs when fabricated for the unique specifications of the job. Other materials cost are not significant and are generally recorded when delivered to the worksite. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments.

Our contracts typically provide for a schedule of billings or invoices to the customer based on reaching agreed-upon milestones or as we incur costs. The schedules for such billings usually do not precisely match the schedule on which

we incur costs. As a result, contract revenues recognized in the statement of operations can and usually do differ from amounts that can be billed or invoiced to the customer at any point during the contract. Amounts by which cumulative contract revenues recognized on a contract as of a given date exceed cumulative billings to the customer under the contract are reflected as a current asset in our balance sheet under the caption "Costs and estimated earnings in excess of billings." Amounts by which cumulative billings to the customer under a contract as of a given date exceed cumulative contract revenues recognized on the contract are reflected as a current liability in our balance sheet under the caption "Billings in excess of costs and estimated earnings."

The percentage of completion method of accounting is also affected by changes in job performance, job conditions, and final contract settlements. These factors may result in revisions to estimated costs and, therefore,

revenues. Such revisions are frequently based on further estimates and subjective assessments. We recognize these revisions in the period in which they are determined. If such revisions lead us to conclude that we will recognize a loss on a contract, the full amount of the estimated ultimate loss is recognized in the period we reach that conclusion, regardless of the percentage of completion of the contract.

Revisions to project costs and conditions can give rise to change orders under which the customer agrees to pay additional contract price. Revisions can also result in claims we might make against the customer to recover project variances that have not been satisfactorily addressed through change orders with the customer. Except in certain circumstances, we do not recognize revenues or margin based on change orders or claims until they have been agreed upon with the customer. The amount of revenue associated with unapproved change orders and claims is currently immaterial. Variations from estimated project costs could have a significant impact on our operating results, depending on project size, and the recoverability of the variation via additional customer payments.

#### Accounting for Allowance for Doubtful Accounts

We are required to estimate the collectibility of accounts receivable and provide an allowance for doubtful accounts for receivable amounts we believe we will not ultimately collect. This requires us to make certain judgments and estimates involving, among others, the creditworthiness of the customer, our prior collection history with the customer, ongoing relationships with the customer, the aging of past due balances, our lien rights, if any, in the property where we performed the work, and the availability, if any, of payment bonds applicable to our contract. These estimates are re-evaluated and adjusted as additional information is received.

#### Accounting for Self-Insurance Liabilities

We are substantially self-insured for worker's compensation, employer's liability, auto liability, general liability and employee group health claims in view of the relatively high per-incident deductibles we absorb under our insurance arrangements for these risks. Losses up to deductible amounts are estimated and accrued based upon known facts, historical trends and industry averages. Loss estimates associated with the larger and longer-developing risks—worker's compensation, auto liability and general liability—are reviewed by a third party actuary quarterly. We believe these accruals are adequate. However, insurance liabilities are difficult to estimate due to unknown factors, including the severity of an injury, the determination of our liability in proportion to other parties, timely reporting of occurrences, ongoing treatment or loss mitigation, general trends in litigation recovery outcomes and the effectiveness of safety and risk management programs. Therefore, if actual experience differs from the assumptions and estimates used for recording the liabilities, adjustments may be required and would be recorded in the period that such experience becomes known.

#### Accounting for Deferred Tax Assets

We regularly evaluate valuation allowances established for deferred tax assets for which future realization is uncertain. We perform this evaluation quarterly. Estimations of required valuation allowances include estimates of future taxable income. The ultimate realization of deferred tax assets is dependent upon the generation of future

taxable income during the periods in which the activity underlying these assets becomes deductible. We consider projected future taxable income and tax planning strategies in making this assessment. If actual future taxable income differs from our estimates, we may not realize deferred tax assets to the extent we have estimated.

#### Recoverability of Goodwill and Identifiable Intangible Assets

Goodwill is the excess of purchase cost over the fair value of the net assets of acquired businesses. We do not amortize goodwill. We assess our goodwill asset amounts for impairment each year, and more frequently if circumstances suggest an impairment may have occurred. Impairment must be reflected when the value of a given business unit in excess of its tangible net assets falls below the goodwill asset balance carried for that unit on our books. If other business units have had increases in the value of their respective goodwill balances, such increases may not be recorded. Accordingly, such increases may not be netted against impairments at other business units. The requirements for assessing whether goodwill assets have been impaired involve market-based information. This information, and its use in assessing goodwill, entails some degree of subjective assessment.

We currently perform our annual impairment testing as of October 1 and any impairment charges resulting from this process are reported in the fourth quarter. We segregate our operations into reporting units based on the degree of operating and financial independence of each unit and our related management of them. We perform our annual goodwill impairment testing at the reporting unit level. We have 41 reporting units of which 25 reporting units have a goodwill balance. These reporting units are tested for impairment by comparing each unit's fair value to its carrying value. The fair value of each reporting unit was estimated using a discounted cash flow model combined with market valuation approaches. Significant estimates and assumptions are used in assessing the fair value of reporting units. These estimates and assumptions involved future cash flows, growth rates, discount rates, weighted average cost of capital and estimates of market valuations for each of the reporting units.

We amortize identifiable intangible assets with finite lives over their useful lives. Changes in strategy and/or market condition, may result in adjustments to recorded intangible asset balances or their useful lives.

Results of Operations (in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008	%	2009	%	2008	%	2009	%
Revenues	\$346,705	100.0%	\$291,591	100.0%	\$993,862	100.0%	\$872,214	100.0%
Cost of services	280,011	80.8 %	234,186	80.3 %	806,784	81.2 %	701,335	80.4 %
Gross profit	66,694	19.2 %	57,405	19.7 %	187,078	18.8 %	170,879	19.6 %
Selling, general and administrative expenses	45,078	13.0 %	41,713	14.3 %	128,397	12.9 %	126,175	14.5 %
Gain on sale of assets	(183 )	(0.1 )%	(101 )		(311 )		(98 )	
Operating income	21,799	6.3 %	15,793	5.4 %	58,992	5.9 %	44,802	5.1 %
Interest income (expense), net	188	0.1 %	(184 )	(0.1 )%	1,004	0.1 %	(454 )	(0.1 )%
Other income			3		158		5	
Income before income taxes	21,987	6.3 %	15,612	5.4 %	60,154	6.1 %	44,353	5.1 %
Income tax expense	8,250		6,072		23,070		17,293	
Income from continuing operations	13,737	4.0 %	9,540	3.3 %	37,084	3.7 %	27,060	3.1 %
Discontinued operations -								



Operating results, net of tax	28		115	(387 )
Estimated loss on disposition, net of tax	—	—	—	(93 )
Net income	\$13,765	\$9,540	\$37,199	\$26,580

Revenues — Revenues decreased \$55.1 million, or 15.9% to \$291.6 million for the third quarter of 2009 compared to the same period in 2008. Approximately 19.1% of the decrease in revenues related to the same store activity offset by 3.2% increase from 2008 acquisitions. The same store revenue decrease stemmed primarily from reduced activity in the nonresidential markets throughout the United States especially in the lodging and entertainment sector (approximately \$13.5 million) and manufacturing (approximately \$12.2 million) as well as continued decreases in the multi-family sector (approximately \$23.6 million). These decreases were partially offset by increased activity in the governmental sector (approximately \$3.9 million). We have seen decreased activity, primarily in our central Arizona and Virginia operations, resulting from a significant decrease in both markets resulting in limited new projects and from the planned downsizing of our large multi-family operation based in Texas.

Revenues for the first nine months of 2009 decreased \$121.6 million, or 12.2%, to \$872.2 million as compared to the same period in 2008. Approximately 16.7% of the decrease in revenues related to same store activity offset by 4.5% increase from 2008 acquisitions. The same store decrease stemmed primarily from decreased activity in the nonresidential markets throughout the United States especially in office buildings (approximately \$37.3 million) and in the healthcare sector (approximately \$23.3 million). There has been decreased activity in our multi-family sector (approximately \$62.0 million) as a result of our planned downsizing of our large multi-family operation based in Texas. These decreases were partially offset by increased activity in the educational and religious and not-for-profit sectors (approximately \$7.7 million). We have seen decreased activity, primarily in our central Arizona operation resulting from a decline in market activity in the Phoenix

market and from the planned downsizing of our large multi-family operation based in Texas.

Backlog reflects revenues still to be recognized under contracted or committed installation and replacement project work. Project work generally lasts less than one year. Service agreement revenues and service work and short duration projects which are generally billed as performed do not flow through backlog. Accordingly, backlog represents only a portion of our revenues for any given future period, and it represents revenues that are likely to be reflected in our operating results over the next six to twelve months. As a result, we believe the predictive value of backlog information is limited to indications of general revenue direction over the near term, and should not be interpreted as indicative of ongoing revenue performance over several quarters.

Backlog as of September 30, 2009 was \$554.3 million a 13.4% decrease from June 30, 2009 backlog of \$639.8 million. The sequential decrease was primarily related to our Arkansas, Wisconsin, and northern Florida operations. Backlog as of September 30, 2008 was \$803.7 million, a decrease of \$249.4 million or 31.0%. The year-over-year decrease is primarily related to the planned downsizing of our large multi-family operation based in Texas, and decreases at our central Arizona, central Florida, New Hampshire and Arkansas operations due to the close out of several jobs and a decline in market activity.

Following the three-year period of industry activity declines from 2001-2003 noted previously, we saw modest year-over-year revenue increases at our ongoing operations beginning in mid-2003 and continuing throughout 2008. Based on our backlog and forecasts from industry construction analysts, we expect that activity levels in our industry are likely to decrease over the next twelve months, particularly in the area of new construction.

We continue to experience a noticeable amount of price competition in our markets, which restrains our ability to profitably increase revenues.

Gross Profit — Gross profit decreased \$9.3 million, or 13.9%, to \$57.4 million for the third quarter of 2009 as compared to the same period in 2008. As a percentage of revenues, gross profit increased from 19.2% in 2008 to 19.7% in 2009. The increase in gross profit percentage resulted primarily from higher profitability at our southern Maryland operation (approximately \$1.1 million).

Gross profit for the first nine months of 2009 decreased \$16.2 million, or 8.7% to \$170.9 million, as compared to the same period in 2008. As a percentage of revenues, gross profit increased from 18.8% in 2008 to 19.6% in 2009. The increase in gross profit percentage for the first nine months of 2009 resulted primarily from higher profitability at our central Florida operation (approximately \$4.7 million), and southern Maryland operation (approximately \$2.1 million) as well as improved profitability at our northern Maryland operation (approximately \$1.9 million). These increases were partially offset by underperformance at our southeast Texas operation (approximately \$2.0 million).

Selling, General and Administrative Expenses (“SG&A”) — SG&A decreased \$3.4 million, or 7.5% for the third quarter of 2009 as compared to the same period in 2008. This decrease is primarily due to overhead reductions and lower bad debt expense (approximately \$1.1 million) during the third quarter of 2009 as compared to the third quarter of 2008. These decreases were partially offset by higher medical costs (approximately \$1.0 million) primarily from

terminated employees that elected health insurance coverage under COBRA. As a percentage of revenues, SG&A increased from 13.0% in 2008 to 14.3% in 2009 due to a lower 2009 revenue base. SG&A decreased \$2.2 million, or 1.7%, to \$126.2 million for the first nine months ended September 30, 2009 as compared to the same period in 2008. On a same store basis, SG&A decreased \$5.0 million. These decreases were primarily related to overhead reductions and lower compensation accruals due to lower profitability in 2009 partially offset by higher medical costs (approximately \$0.9 million). As a percentage of revenues, SG&A increased from 12.9% for the first nine months of 2008 to 14.5% for the first nine months of 2009 due to a lower 2009 revenue base.

Interest Income (Expense), Net — Interest income decreased \$0.4 million for the third quarter of 2009 as compared to the same period in 2008. Interest income decreased \$1.6 million for the first nine months ended September 30, 2009 as compared to the same period of 2008. The decrease is due to lower interest rates in 2009.

**Income Tax Expense** — Our year to date effective tax rate for 2009 was 39.0%, as compared to 38.4% in 2008. The increase in the effective tax rate for 2009 is primarily due to an increase in tax reserves. Adjustments to tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. We currently estimate our effective tax rate for 2009 will be between 38% and 40%.

**Outlook** — We expect that developing weakness in the underlying environment for non-residential activity has and will continue to affect 2009 activity levels in our industry compared to 2008. Our backlog while still at solid levels by historical standards has been declining. Our primary emphasis for 2009 has been and continues to be on execution including a focus on cost controls and efficient project and service performance at the unit level. Based on our backlog and the weakening economic conditions for our industry, we expect continued profitability over the next twelve months, but we expect lower profitability than we achieved over the past twelve months as industry conditions continue to weaken.

**Liquidity and Capital Resources:**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
	(in thousands)			
<b>Cash provided by (used in):</b>				
Operating activities	\$ 20,943	\$ 24,803	\$ 46,956	\$ 44,754
Investing activities	\$ (15,514 )	\$ (1,438 )	\$ (61,121 )	\$ (7,241 )
Financing activities	\$ (4,637 )	\$ (3,917 )	\$ (23,166 )	\$ (14,665 )
<b>Free cash flow:</b>				
Cash provided by operating activities	\$ 20,943	\$ 24,803	\$ 46,956	\$ 44,754
Purchases of property and equipment	(3,773 )	(1,986 )	(10,778 )	(6,420 )
Proceeds from sales of property and equipment	539	326	656	500
<b>Free cash flow</b>	<b>\$ 17,709</b>	<b>\$ 23,143</b>	<b>\$ 36,834</b>	<b>\$ 38,834</b>

**Cash Flow** — We define free cash flow as cash provided by operating activities less customary capital expenditures, plus the proceeds from asset sales. Positive free cash flow represents funds available to invest in significant operating initiatives, to acquire other companies, or to reduce a company's outstanding debt or equity. If free cash flow is negative, additional debt or equity is generally required to fund the outflow of cash. Free cash flow may be defined differently by other companies.

Our business does not require significant amounts of investment in long-term fixed assets. The substantial majority of the capital used in our business is working capital that funds our costs of labor and installed equipment deployed in project work until our customers pay us. Customary terms in our industry allow customers to withhold a small portion

of the contract price until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage. Our average project duration together with typical retention terms generally allow us to complete the realization of revenue and earnings in cash within one year. Accordingly, we believe free cash flow, by encompassing both profit margins and the use of working capital over our approximately one year working capital cycle, is an effective measure of operating effectiveness and efficiency. We have included free cash flow information here for this reason, and because we are often asked about it by third parties evaluating us. However, free cash flow is not considered under generally accepted accounting principles to be a primary measure of an entity's financial results, and accordingly free cash flow should not be considered an alternative to operating income, net income, or amounts shown in our consolidated statements of cash flows as determined under generally accepted accounting principles.

For the three months ended September 30, 2009, we had free cash flow of \$23.1 million as compared to free cash flow of \$17.7 million in 2008. This increase is primarily due to improved working capital efficiency due to

lower revenue growth. For the nine months ended September 30, 2009, we had free cash flow of \$38.8 million, as compared to free cash flow of \$36.8 million for the nine months ended September 30, 2008. This decrease is primarily due to lower net income in 2009.

As of September 30, 2009, our marketable securities consisted of \$6.6 million of auction rate securities, which are variable rate debt instruments, having long-term maturities, but whose interest rates are designed to reset through an auction process, at intervals ranging from seven to 35 days. We had \$9.4 million investments in marketable securities as of December 31, 2008. All of our auction rate securities are high quality direct municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. In February 2008, liquidity issues in the global credit markets caused auctions representing some of the auction rate securities we hold to fail because the amount of securities offered for sale exceeded the bids. As a result, the liquidity of our remaining auction rate securities has diminished, and we expect that this decreased liquidity for our auction rate securities will continue as long as the present depressed global credit market environment persists, or until issuers refinance and replace these securities with other instruments. As a result of the temporary declines in fair value for our auction rate securities, which we attribute to liquidity issues rather than credit issues, we recorded an unrealized loss of \$0.3 million, net of tax of \$0.1 million, to accumulated other comprehensive income (loss). Our analysis of the fair values of these securities considered, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose to sell the securities in the absence of a successful auction. These securities were also compared, when possible, to other observable market data with similar characteristics.

As a result of the current situation in the auction markets, our ability to liquidate our investment in auction rate securities and fully recover the carrying value of our investment in the near term may be limited or impossible. If in the future the issuers are unable to successfully close future auctions and their credit ratings deteriorate and if we determine that any future valuation adjustment was other than temporary, we may be required to record an impairment charge on these investments. Because the tax exempt interest rates on these bonds are relatively attractive, we believe that we may be able to liquidate our investment without significant loss in the foreseeable future; however, it could take until the final maturity of the underlying notes (up to October 2034) to be repaid. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan. During the nine months ended September 30, 2009, we sold \$3.0 million of these auction rate securities at face value. An additional \$1.0 million was sold at face value during October 2009; this is included in "Prepaid Expenses and Other" in our consolidated balance sheet.

As of December 31, 2008, the Board approved extensions of the program to cover an additional 2.9 million shares. During the first quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. During the third quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. Since the inception of the repurchase program, the Board has approved 4.9 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 843,700 shares during the nine months ended September 30, 2009, at an average price of \$9.94 per share. Since the inception of the repurchase program in 2007, we have repurchased a cumulative total of 4.0 million shares as of September 30,

2009, at an average price of \$11.12 per share.

Credit Facility — On February 20, 2007, we entered into a \$100.0 million senior credit facility (the “Facility”) provided by a syndicate of banks. The Facility expires in February 2012 and is secured by the capital stock of our current and future subsidiaries. As of September 30, 2009, we had no outstanding borrowings, \$43.1 million in letters of credit outstanding, and \$56.9 million of credit available.

We have a choice of two interest rate options for borrowings under the Facility; these rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Excluding the amortization of debt financing and arrangement cost, we estimate that the interest rate applicable to

the borrowings under the Facility would be approximately 1.5% as of September 30, 2009. Commitment fees are payable on the portion of the capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20%-0.30% per annum, based on the ratio of debt to Credit Facility Adjusted EBITDA.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. The Facility's principal financial covenants include:

**Leverage Ratio** — The Facility requires that the ratio of our total indebtedness less cash and cash equivalents to our Credit Facility Adjusted EBITDA not exceed 2.50. The leverage ratio as of September 30, 2009 was 0.11.

**Fixed Charge Coverage Ratio** — The Facility requires that the ratio of Credit Facility Adjusted EBITDA, less non-financed capital expenditures, tax provision, dividends and amounts used to repurchase stock to the sum of interest expense and scheduled principal payments be at least 1.50. Capital expenditures, tax provision, dividends and stock repurchase payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The calculation of the fixed charge coverage ratio excludes acquisitions, stock repurchases and the payment of cash dividends, at any time that the Leverage Ratio does not exceed 1.0. The fixed charge coverage ratio as of September 30, 2009 was 13.34.

**Other Restrictions** — The Facility permits acquisitions of up to \$25.0 million per transaction, or \$50.0 million in the aggregate. However, these limitations only apply when the Leverage Ratio is greater than 1.0.

While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility's debt-to-Credit Facility Adjusted EBITDA covenant, our borrowing capacity under the Facility and the favorable terms that we currently enjoy could be negatively impacted by the lenders.

We are in compliance with all the financial covenants as of September 30, 2009.

**Notes to Former Owners** — We issued subordinated notes to the former owners of acquired companies, as part of the consideration used to acquire these companies. These notes had an outstanding balance of \$8.6 million, of which \$2.0 million is current as of September 30, 2009. These notes bear interest, payable annually, at a weighted average interest rate of 5.7%.

**Off-Balance Sheet Arrangements and Other Commitments** — As is common in our industry, we have entered into certain off-balance sheet arrangements in the ordinary course of business that result in risks not directly reflected in our balance sheets. Our most significant off-balance sheet transactions include liabilities associated with noncancelable operating leases. We also have other off-balance sheet obligations involving letters of credit and surety guarantees.



We enter into noncancelable operating leases for many of our facility, vehicle and equipment needs. These leases allow us to conserve cash by paying a monthly lease rental fee for use of facilities, vehicles and equipment rather than purchasing them. At the end of the lease, we have no further obligation to the lessor. If we decide to cancel or terminate a lease before the end of its term, we would typically owe the lessor the remaining lease payments under the term of the lease.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. The letters of credit we provide are actually issued by our lenders through the Facility as described above. A letter of credit commits the lenders to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, we would be required to reimburse the lenders. Depending on the circumstances of such a reimbursement, we may also have to record a charge to earnings for the reimbursement. Absent a claim, there is no payment or reserving of funds by us in connection with a letter of credit. However, because a claim on a letter of credit would require immediate reimbursement by us to our lenders, letters of credit are treated as a use of the Facility's capacity just the same as actual borrowings. Claims against letters of credit are rare in our industry. To date we

have not had a claim made against a letter of credit that resulted in payments by a lender or by us. We believe that it is unlikely that we will have to fund claims under a letter of credit in the foreseeable future.

Many customers, particularly in connection with new construction, require us to post performance and payment bonds issued by a financial institution known as a surety. If we fail to perform under the terms of a contract or to pay subcontractors and vendors who provided goods or services under a contract, the customer may demand that the surety make payments or provide services under the bond. We must reimburse the sureties for any expenses or outlays they incur. To date, we are not aware of any losses to our sureties in connection with bonds the sureties have posted on our behalf, and we do not expect such losses to be incurred in the foreseeable future.

Surety market conditions are currently challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 30% of our business has required bonds. While we have strong surety relationships to support our bonding needs, current market conditions as well as changes in our sureties' assessment of our operating and financial risk could cause our sureties to decline to issue bonds for our work. If that were to occur, our alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics, including a significant amount of cash on our balance sheet, would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenues and profits to decline in the near term.

The following recaps the future maturities of our contractual obligations as of September 30, 2009 (in thousands):

	Twelve Months Ended September 30,						
	2010	2011	2012	2013	2014	Thereafter	Total
Liabilities – Notes to former owners	\$ 2,018	\$ 6,232	\$ 375	\$	\$	\$	\$ 8,625
Operating lease obligations	9,740	8,519	7,374	6,270	4,166	6,083	42,152
Interest payable	457	196					653
Total	\$ 12,215	\$ 14,947	\$ 7,749	\$ 6,270	\$ 4,166	\$ 6,083	\$ 51,430

Absent any significant commitments of capital for items such as capital expenditures, acquisitions, dividends and share repurchases, it is reasonable to expect us to continue to maintain excess cash on our balance sheet. Therefore, we assumed that we would continue our current status of not utilizing any borrowings under our revolving credit facility.

As of September 30, 2009, we also have \$43.1 million letter of credit commitments, of which \$42.5 million will expire in 2009 and \$0.6 million will expire in 2010. The substantial majority of these letters of credit are posted with insurers who disburse funds on our behalf in connection with our worker's compensation, auto liability and general liability insurance program. These letters of credit provide additional security to the insurers that sufficient financial

resources will be available to fund claims on our behalf, many of which develop over long periods of time, should we ever encounter financial duress. Posting of letters of credit for this purpose is a common practice for entities that manage their self-insurance programs through third-party insurers as we do. While most of these letter of credit commitments expire in 2009, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually.

Other than the operating lease obligations noted above, we have no significant purchase or operating commitments outside of commitments to deliver equipment and provide labor in the ordinary course of performing project work.

Outlook — We have generated positive net free cash flow for the last ten calendar years, much of which occurred during challenging economic and industry conditions. We also expect to have significant borrowing capacity under our credit facility and we continue to have substantial uncommitted cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

### Cyclical and Seasonality

Historically, the construction industry has been highly cyclical. As a result, our volume of business may be adversely affected by declines in new installation and replacement projects in various geographic regions of the United States during periods of economic weakness.

The HVAC industry is subject to seasonal variations. Specifically, the demand for new installation and replacement is generally lower during the winter months (the first quarter of the year) due to reduced construction activity during inclement weather and less use of air conditioning during the colder months. Demand for HVAC services is generally higher in the second and third calendar quarters due to increased construction activity and increased use of air conditioning during the warmer months. Accordingly, we expect our revenues and operating results generally will be lower in the first and fourth calendar quarters.

### Recent Accounting Pronouncements

On September 30, 2009, we adopted changes issued by the Financial Accounting Standards Board (“FASB”) to the authoritative hierarchy of generally accepted accounting principles (“GAAP”). These changes establish the FASB Accounting Standards Codification™ (“Codification”) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. These changes and the Codification itself do not change GAAP. Other than the manner in which new accounting guidance is referenced, the adoption of these changes had no impact on the consolidated financial statements.

### Fair Value Accounting

On January 1, 2009, we adopted changes issued by the FASB to fair value accounting and reporting as it relates to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on at least an annual basis. These changes define fair value, establish a framework for measuring fair value in GAAP, and expand disclosures about fair value measurements. This guidance applies to other GAAP that require or permit fair value measurements and is to be applied prospectively with limited exceptions. The adoption of these changes, as it relates to nonfinancial assets and nonfinancial liabilities, had no impact on the consolidated financial statements, however we have expanded the disclosures regarding marketable securities, goodwill, and intangible assets.

## Business Combinations and Consolidation Accounting

On January 1, 2009, we adopted changes issued by the FASB to accounting for business combinations. These changes apply to all assets acquired and liabilities assumed in a business combination that arise from certain contingencies and requires (i) an acquirer to recognize at fair value, at the acquisition date, an asset acquired or liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period otherwise the asset or liability should be recognized at the acquisition date if certain defined criteria are met; (ii) contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination be recognized initially at fair value; (iii) subsequent measurements of assets and liabilities arising from contingencies be based on a systematic and rational method depending on their nature and contingent consideration arrangements be measured subsequently; and (iv) disclosures of the amounts and measurement basis of such assets and liabilities and the nature of the contingencies. The adoption did not have a material impact on our consolidated financial statements. The adoption will significantly impact our accounting and reporting for future acquisitions, principally as a result of the expanded requirements to value acquired assets, liabilities and contingencies at their

fair values and (ii) the requirement that acquisition related transaction costs be expensed as incurred rather than capitalized as a part of the cost of the acquisition.

#### Earnings Per Share

On January 1, 2009, we adopted changes issued by the FASB to the calculation of earnings per share. These changes state that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method for all periods presented. There was no significant impact upon the adoption of these changes.

#### Subsequent Events

On June 30, 2009, we adopted changes issued by the FASB to accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The new guidance also requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. This change had no impact on our consolidated financial statements.

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

We are exposed to market risk primarily related to potential adverse changes in interest rates as discussed below. We are actively involved in monitoring exposure to market risk and continue to develop and utilize appropriate risk management techniques. We are not exposed to any other significant financial market risks including commodity price risk, foreign currency exchange risk or interest rate risks from the use of derivative financial instruments. We do not use derivative financial instruments.

We have limited exposure to changes in interest rates under our revolving credit facility. We have a debt facility under which we may borrow funds in the future. We do not currently foresee any borrowing needs. Our debt with fixed interest rates consists of notes to former owners of acquired companies.

The following table presents principal amounts (stated in thousands) and related average interest rates by year of maturity for our debt obligations and their indicated fair market value at September 30, 2009:

	Twelve Months Ended September 30,						Fair
	2010	2011	2012	2013	2014	Thereafter	Value
Fixed Rate							
Debt	\$ 2,018	\$ 6,232	\$ 375	\$	\$	\$	\$ 8,625
Average							
Interest Rate	5.5 %	5.8 %	6.0 %				5.7 %

As of September 30, 2009, our marketable securities consisted of \$6.6 million of auction rate securities, which are variable rate debt instruments, having long-term maturities, but whose interest rates are designed to reset through an auction process, at intervals ranging from seven to 35 days. We had \$9.4 million in investments of marketable securities as of December 31, 2008. All of our auction rate securities are high quality direct municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. In February 2008, liquidity issues in the global credit markets caused auctions representing some of the auction rate securities we hold to fail because the amount of securities offered for sale exceeded the bids. As a result, the liquidity of our auction rate securities has diminished, and we expect that this decreased liquidity for our auction rate securities will continue as long as the present depressed global credit market environment persists, or until issuers refinance and replace these securities with other instruments. As a result of the temporary declines in fair value for our auction rate securities, which we attribute to liquidity issues rather than credit issues, we recorded an unrealized loss of \$0.3 million, net of tax, of less than \$0.1 million to accumulated other comprehensive income (loss). Our analysis of the fair values of these securities considered, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose to sell the securities in the absence of a successful auction. These securities were also compared, when possible, to other observable market data with similar characteristics.

As a result of the current situation in the auction markets, our ability to liquidate our investment in auction rate securities and fully recover the carrying value of our investment in the near term may be limited or impossible. If in the future the issuers are unable to successfully close future auctions and their credit ratings deteriorate and if we determine that any future valuation adjustment was other than temporary, we may be required to record an impairment

charge on these investments. Because the tax exempt interest rates on these bonds are relatively attractive, we believe that we may be able to liquidate our investment without significant loss in the foreseeable future; however, it could take until the final maturity of the underlying notes (up to October 2034) to be repaid. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

We measure certain assets, including our goodwill and intangible assets at a fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be impaired. During the nine months ended September 30, 2009, we did not recognize any impairments on those assets required to be measured at fair value on a nonrecurring basis.



Item 4.

## Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

Our executive management is responsible for ensuring the effectiveness of the design and operation of our disclosure controls and procedures. We carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) are effective as of the end of the period covered by this report.

### Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) during the three months ended September 30, 2009 that have materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

COMFORT SYSTEMS USA, INC.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

We are subject to certain claims and lawsuits arising in the normal course of business. We maintain various insurance coverages to minimize financial risk associated with these claims. We have estimated and provided accruals for probable losses and related legal fees associated with certain of our litigation in our consolidated financial statements. While we cannot predict the outcome of these proceedings, in our opinion and based on reports of counsel, any liability arising from these matters individually and in the aggregate will not have a material effect on our operating results or financial condition, after giving effect to provisions already recorded.

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

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to one million shares of our outstanding common stock. As of December 31, 2008, the Board approved extensions of the program to cover an additional 2.9 million shares. During the first quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. During the third quarter of 2009, the Board approved an extension of the program to cover an additional 0.5 million shares. Since the inception of the repurchase program, the Board has approved 4.9 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 843,700 shares during the nine months ended September 30, 2009, at an average price of \$9.94 per share. Since the inception of the program, we have repurchased a cumulative total of 4.0 million shares as of September 30, 2009, at an average price of \$11.12 per share.

During the quarter ended September 30, 2009, we purchased our common shares in the following amounts at the following average prices:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of	Maximum Number of Shares that May Yet Be
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			Publicly Announced Plans or Programs	Purchased Under the Plans or Programs
July 1 – July 31	56,000	\$ 10.06	3,857,409	541,600
August 1 – August 31	18,000	\$ 11.31	3,875,409	1,000,000
September 1 – September 30	168,600	\$ 11.16	4,044,009	831,400
	242,600	\$ 10.92	4,044,009	831,400

Under our restricted share plan, employees may elect to have us withhold common shares to satisfy minimum statutory federal, state and local tax withholding obligations arising on the vesting of restricted stock awards and exercise of options. When we withhold these shares, we are required to remit to the appropriate taxing authorities the market price of the shares withheld, which could be deemed a purchase of the common shares by us on the date of withholding. During the quarter ended September 30, 2009, we withheld common shares to satisfy these tax withholding obligations as follows:

Period	Number of Shares Purchased	Average Price Paid Per Share
July 1 – July 31		\$
August 1 – August 31	220	\$ 12.64
September 1 – September 30		\$
	220	\$ 12.64

Item 6.

Exhibits

(a) Exhibits.

- 10.1 Supplemental Schedules and Exhibits to Amended and Restated Senior Credit Facility dated February 20, 2007.
- 31.1 Rule 13a-14(a) Certification of William F. Murdy pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Rule 13a-14(a) Certification of William George pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Section 1350 Certification of William F. Murdy pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Section 1350 Certification of William George pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

November 3, 2009	Comfort Systems USA, Inc. By:	/s/ William F. Murdy William F. Murdy Chairman of the Board and Chief Executive Officer
November 3, 2009	By:	/s/ William George William George Executive Vice President and Chief Financial Officer
November 3, 2009	By:	/s/ Julie S. Shaeff Julie S. Shaeff Senior Vice President and Chief Accounting Officer

