# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended September 30, 2005**

**OR**

**o 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** | **76-0526487** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**777 Post Oak Boulevard**
**Suite 500**
**Houston, Texas 77056**
(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 required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o.

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

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

The number of shares outstanding of the issuer's common stock, as of November 1, 2005 was 39,870,692.

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**COMFORT SYSTEMS USA, INC.**

**INDEX TO FORM 10-Q**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2005**

**COMFORT SYSTEMS USA, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(In Thousands, Except Share Amounts)**

| | December 31, 2004 | September 30, 2005 (Unaudited) |
|---|---|---|
| **ASSETS** | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 32,698 | $ 33,709 |
| Accounts receivable, less allowance for doubtful accounts of $5,907 and $4,287, respectively | 171,246 | 206,147 |
| Other receivables | 4,051 | 4,493 |
| Inventories | 9,671 | 9,196 |
| Costs and estimated earnings in excess of billings | 24,683 | 26,467 |
| Prepaid expenses and other | 13,190 | 14,038 |
| Assets related to discontinued operations | 5,860 | 872 |
| Total current assets | 261,399 | 294,922 |
| PROPERTY AND EQUIPMENT, net | 12,456 | 13,889 |
| GOODWILL | 100,123 | 100,123 |
| OTHER NONCURRENT ASSETS | 9,138 | 7,258 |
| Total assets | $ 383,116 | $ 416,192 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | $ 2,071 | $ — |
| Accounts payable | 63,620 | 69,153 |
| Accrued compensation and benefits | 22,548 | 27,006 |
| Billings in excess of costs and estimated earnings | 36,927 | 55,981 |
| Income taxes payable | 3,700 | 2,132 |
| Accrued self insurance expense | 17,017 | 18,645 |
| Other current liabilities | 11,950 | 12,781 |
| Liabilities related to discontinued operations | 1,935 | 38 |
| Total current liabilities | 159,768 | 185,736 |
| LONG-TERM DEBT, NET OF CURRENT MATURITIES | 6,751 | — |
| Total liabilities | 166,519 | 185,736 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, $.01 par, 5,000,000 shares authorized, none issued and outstanding | — | — |
| Common stock, $.01 par, 102,969,912 shares authorized, 39,258,913 and 39,711,142 shares issued, respectively | 393 | 397 |
| Treasury stock, at cost, 24,462 and zero shares, respectively | (148) | — |
| Additional paid-in capital | 337,719 | 339,767 |
| Deferred compensation | (1,587) | (1,266) |
| Retained earnings (deficit) | (119,780) | (108,442) |
| Total stockholders' equity | 216,597 | 230,456 |
| Total liabilities and stockholders' equity | $ 383,116 | $ 416,192 |

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, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| REVENUES | $ 206,171 | $ 243,453 | $ 594,198 | $ 681,937 |
| COST OF SERVICES | 173,706 | 202,418 | 499,670 | 571,690 |
| Gross profit | 32,465 | 41,035 | 94,528 | 110,247 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 26,102 | 29,613 | 77,686 | 87,339 |

| | | | | |
|---|---|---|---|---|
| LOSS (GAIN) ON SALE OF ASSETS | 34 | (53) | (33) | (112) |
| Operating income | 6,329 | 11,475 | 16,875 | 23,020 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | 40 | 165 | 83 | 429 |
| Interest expense | (374) | (166) | (1,196) | (924) |
| Write off of debt costs | — | — | — | (870) |
| Other | (101) | (39) | (438) | 36 |
| Other income (expense) | (435) | (40) | (1,551) | (1,329) |
| INCOME BEFORE INCOME TAXES | 5,894 | 11,435 | 15,324 | 21,691 |
| INCOME TAX EXPENSE | 2,553 | 4,971 | 6,596 | 9,452 |
| INCOME FROM CONTINUING OPERATIONS | 3,341 | 6,464 | 8,728 | 12,239 |
| DISCONTINUED OPERATIONS: | | | | |
| Operating income (loss), net of income tax expense (benefit) of $80, $(461), $73, and $(693) | 149 | (295) | 116 | (1,000) |
| Estimated gain (loss) on disposition, including income tax expense (benefit) of $0, $(17), $235 and $65 | — | (38) | (137) | 99 |
| NET INCOME | $ 3,490 | $ 6,131 | $ 8,707 | $ 11,338 |
| INCOME PER SHARE: | | | | |
| Basic— | | | | |
| Income from continuing operations | $ 0.09 | $ 0.16 | $ 0.23 | $ 0.31 |
| Discontinued operations— | | | | |
| Income (loss) from operations | — | (0.01) | — | (0.02) |
| Estimated gain (loss) on disposition | — | — | — | — |
| Net income | $ 0.09 | $ 0.15 | $ 0.23 | $ 0.29 |
| Diluted— | | | | |
| Income from continuing operations | $ 0.09 | $ 0.16 | $ 0.22 | $ 0.30 |
| Discontinued operations— | | | | |
| Income (loss) from operations | — | (0.01) | — | (0.02) |
| Estimated gain (loss) on disposition | — | — | — | — |
| Net income | $ 0.09 | $ 0.15 | $ 0.22 | $ 0.28 |
| SHARES USED IN COMPUTING INCOME (LOSS) PER SHARE: | | | | |
| Basic | 38,418 | 39,372 | 38,298 | 39,180 |
| Diluted | 39,455 | 40,382 | 39,457 | 40,179 |

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)**

| | Common Stock | | Treasury Stock | | Additional Paid-In Capital | Deferred Compen-sation | Retained Earnings (Deficit) | Total Stock-holders' Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | |
| BALANCE AT DECEMBER 31, 2003 | 39,258,913 | $ 393 | (1,041,864) | $ (6,305) | $ 337,605 | $ (540) | $ (130,493) | $ 200,660 |
| Issuance of Stock: | | | | | | | | |
| Issuance of shares for options exercised including tax benefit | — | — | 440,508 | 2,658 | (724) | — | — | 1,934 |
| Issuance of restricted stock | — | — | 225,000 | 1,353 | 361 | (1,714) | — | — |
| Forfeiture of unvested restricted stock | — | — | (56,250) | (308) | — | 259 | — | (49) |
| Amortization of deferred compensation | — | — | — | — | 115 | 408 | — | 523 |
| Shares issued for exercise of warrant | — | — | 408,144 | 2,454 | 337 | — | — | 2,791 |
| Other | — | — | — | — | 25 | — | — | 25 |
| Net income | — | — | — | — | — | — | 10,713 | 10,713 |
| BALANCE AT DECEMBER 31, 2004 | 39,258,913 | 393 | (24,462) | (148) | 337,719 | (1,587) | (119,780) | 216,597 |
| Issuance of Stock: | | | | | | | | |
| Issuance of shares for options exercised including tax benefit (unaudited) | 382,229 | 3 | 114,959 | 835 | 1,519 | — | — | 2,357 |
| Issuance of restricted stock (unaudited) | 82,500 | 1 | — | — | 574 | (575) | — | — |
| Shares received in lieu of tax witholding payment on vested restricted shares (unaudited) | — | — | (40,797) | (318) | — | — | — | (318) |
| Forfeiture of unvested restricted stock (unaudited) | (12,500) | — | (50,000) | (372) | (74) | 360 | — | (86) |
| Amortization of deferred compensation (unaudited) | — | — | — | — | 32 | 536 | — | 568 |
| Other (unaudited) | — | — | 300 | 3 | (3) | — | — | — |
| Net income (unaudited) | — | — | — | — | — | — | 11,338 | 11,338 |
| BALANCE AT SEPTEMBER 30, 2005 (UNAUDITED) | 39,711,142 | $ 397 | — | $ — | $ 339,767 | $ (1,266) | $ (108,442) | $ 230,456 |

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, 2004 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2004 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| CASH FROM OPERATING ACTIVITIES: | | | | |
| Net income | $ 3,490 | $ 6,131 | $ 8,707 | $ 11,338 |
| Adjustments to reconcile net income to net cash provided by operating activities — | | | | |
| Estimated (gain) loss on disposition of discontinued operations | — | 38 | 137 | (99) |
| Depreciation expense | 1,315 | 1,307 | 3,617 | 3,525 |
| Bad debt expense | 428 | 276 | 1,623 | 944 |
| Write off of debt costs | — | — | — | 870 |
| Deferred tax expense | 1,813 | 296 | 1,950 | 1,403 |
| Tax benefit from exercise of options | 17 | 220 | 498 | 727 |
| Amortization of debt financing costs | 104 | 24 | 300 | 270 |
| Loss (gain) on sale of assets or operations | 34 | (53) | (33) | (112) |
| Deferred compensation expense | 138 | 169 | 199 | 361 |
| Mark-to-market warrant obligation | 86 | — | 457 | — |
| Changes in operating assets and liabilities, net of effects of acquisitions and divestitures— | | | | |
| (Increase) decrease in— | | | | |
| Receivables, net | (10,161) | (8,505) | (10,336) | (29,733) |
| Inventories | 269 | 470 | (684) | 869 |
| Prepaid expenses and other current assets | (1,741) | (1,236) | 970 | (269) |
| Costs and estimated earnings in excess of billings | (554) | (462) | (6,665) | (214) |
| Other noncurrent assets | 438 | (274) | 573 | (218) |
| Increase (decrease) in— | | | | |
| Accounts payable and accrued liabilities | 3,415 | (592) | 5,911 | 5,981 |
| Billings in excess of costs and estimated earnings | 6,030 | 10,294 | 5,557 | 18,848 |
| Net cash provided by operating activities | 5,121 | 8,103 | 12,781 | 14,491 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | | |
| Purchases of property and equipment | (963) | (1,826) | (3,180) | (5,053) |
| Proceeds from sales of property and equipment | — | 353 | 283 | 564 |
| Proceeds from businesses sold, net of cash sold and transaction costs | 156 | 543 | 1,266 | 1,666 |
| Cash paid for acquisition, including cash acquired | — | — | — | (2,943) |
| Net cash used in investing activities | (807) | (930) | (1,631) | (5,766) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | | |
| Net borrowings on revolving line of credit | — | — | — | — |
| Payments on other long-term debt | (533) | (284) | (1,086) | (8,822) |
| Borrowings of other long-term debt | — | — | 32 | — |
| Debt financing costs | (30) | (400) | (808) | (400) |
| Proceeds from exercise of options | 37 | 765 | 1,069 | 1,630 |
| Net cash provided by (used in) financing activities | (526) | 81 | (793) | (7,592) |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 3,788 | 7,254 | 10,357 | 1,133 |
| CASH AND CASH EQUIVALENTS, beginning of period—continuing operations and discontinued operations | 16,705 | 26,455 | 10,136 | 32,576 |
| CASH AND CASH EQUIVALENTS, end of period—continuing operations and discontinued operations | $ 20,493 | $ 33,709 | $ 20,493 | $ 33,709 |

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



**COMFORT SYSTEMS USA, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2005**

**(Unaudited)**

## 1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation ("Comfort Systems" and collectively with its subsidiaries, the "Company"), is a national provider of comprehensive heating, ventilation and air conditioning ("HVAC") installation, maintenance, repair and replacement services within the mechanical services industry. The Company operates primarily in the commercial, industrial and institutional HVAC markets, and performs most of its services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, the Company provides 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 55% of the Company's consolidated 2005 revenues to date are attributable to installation of systems in newly constructed facilities, with the remaining 45% attributable to maintenance, repair and replacement services. The following service activities account for the Company's consolidated 2005 revenues to date: HVAC—73%, plumbing—15%, building automation control systems—7%, and other—5%. These service activities are within the mechanical services industry which is the single industry segment served by Comfort Systems.

## 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, 2004 (the "Form 10-K").

There were no significant changes in the accounting policies of the Company during the current period. For a description of the significant accounting policies of the Company, refer to Note 2 of Notes to Consolidated Financial Statements of Comfort Systems included in 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. The Company believes 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***

Cash paid for interest for continuing and discontinued operations for both of the nine months ended September 30, 2004 and 2005 was approximately $0.7 million. Cash paid for income taxes for continuing operations for the nine months ended September 30, 2004 and 2005 was approximately $4.4 million and $8.3 million, respectively. Cash paid for income taxes for discontinued operations for the nine months ended September 30, 2004 and 2005 was $0.3 million and less than $0.1 million, respectively.



***Segment Disclosure***

Comfort Systems' activities are within the mechanical services industry which is the single industry segment served by the Company. Under Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures About Segments of an Enterprise and Related Information," each operating subsidiary represents an operating segment and these segments have been aggregated, as no individual operating unit is material and the operating units meet a majority of SFAS No. 131's 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 the Company's 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 the Company's goodwill impairment testing.

***Income Taxes***

The Company files a consolidated return for federal income tax purposes. Income taxes are provided for under the liability method in accordance with SFAS No. 109, "Accounting for Income Taxes," 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.

The Company regularly evaluates valuation allowances established for deferred tax assets for which future realization is uncertain. The Company performs this evaluation each quarter. 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. The Company considers projected future taxable income and tax planning strategies in making this assessment. If actual future taxable income differs from our estimates, the Company may not realize deferred tax assets to the extent it has estimated.

The effective tax rate associated with results from continuing operations for the first nine months of 2005 was 43.6%, as compared to 43.0% in 2004. The Company's effective tax rate is generally higher than statutory rates because of the effect of certain expenses that are not deductible for tax purposes. In addition, 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.

***New Accounting Pronouncements***

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 123 (revised 2004), "Share-Based Payment," ("Statement 123(R)") which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation ("Statement 123")." Statement 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("Opinion 25") and amends FASB Statement No. 95, "Statement of Cash Flows." Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.



Statement 123(R) must be adopted no later than January 1, 2006. Early adoption will be permitted for periods in which financial statements have not yet been issued. The Company expects to adopt Statement 123(R) on January 1, 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt Statement 123(R) using the modified prospective method.

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options in its statement of operations. Accordingly, the adoption of Statement 123(R)'s fair value method will have a significant impact on the Company's reported results of operations, although it will have no impact on the Company's cash flows. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to the Company's consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized for the first nine months of 2004 and 2005 for such tax benefits was $0.5 million and $0.7 million, respectively.



***Stock-Based Compensation***

The Company accounts for its stock-based compensation using the intrinsic value method under Opinion 25. Under this accounting method, no expense in connection with the Company's stock option plans is recognized in the consolidated statements of operations when the exercise price of the stock options is greater than or equal to the value of the Common Stock on the date of grant. In October 1995, the FASB issued Statement 123, which requires that if a company accounts for stock-based compensation in accordance with Opinion 25, the company must also disclose the effects on its results of operations as if an estimate of the value of stock-based compensation at the date of grant was recorded as an expense in the company's statement of operations. These effects for the Company are as follows (in thousands, except per share data):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| Net Income as reported | $ 3,490 | $ 6,131 | $ 8,707 | $ 11,338 |
| Add: Stock-based compensation included in reported net income, net of tax | 90 | 110 | 129 | 235 |
| Less: Compensation expense per Statement 123, net of tax | (95) | (234) | (1,027) | (821) |
| Pro Forma Net Income | $ 3,485 | $ 6,007 | $ 7,809 | $ 10,752 |
| Net Income Per Share—Basic | | | | |
| Net Income per share as reported | $ 0.09 | $ 0.15 | $ 0.23 | $ 0.29 |
| Pro Forma Net Income per share | $ 0.09 | $ 0.15 | $ 0.20 | $ 0.27 |
| Net Income Per Share—Diluted | | | | |
| Net Income per share as reported | $ 0.09 | $ 0.15 | $ 0.22 | $ 0.28 |
| Pro Forma Net Income per share | $ 0.09 | $ 0.15 | $ 0.20 | $ 0.27 |

*Stock Option Plans*—The effects of applying Statement 123 in the pro forma disclosure may not be indicative of future amounts, as additional option awards in future years are anticipated. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | 2004 | 2005 |
|---|---|---|
| Expected dividend yield | 0.00% | 0.00% |
| Expected stock price volatility | 61.30% | 61.23% - 63.99% |
| Risk-free interest rate | 3.96% - 4.38% | 3.91% - 4.31% |
| Expected life of options | 7 years | 7 years |

*Restricted Stock*—The Company has awarded shares of restricted stock to members of management, as discussed in Note 8, "Stockholders' Equity." The fair value of shares awarded during the first nine months of 2004 and 2005 was $6.10 and $5.58, respectively.

***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. Acquisition**

On January 17, 2005, the Company completed the acquisition of Granite State Plumbing & Heating ("Granite"), an HVAC contractor located near Manchester, New Hampshire. This acquisition will increase the Company's presence in the Northeast, specifically in the Boston region and southern New Hampshire. The total consideration paid in this transaction was approximately $2.9 million, comprised entirely of cash, including cash acquired. The fair value of the tangible net assets acquired exceeded the total consideration paid. As a result, the long-term fixed assets of the acquisition were reduced by this excess amount. The consolidated balance sheet of Comfort Systems includes an allocation of the purchase price to the assets acquired and liabilities assumed based on preliminary estimates of fair value and are subject to final adjustment. The Company is reviewing the values assigned to certain assumed liabilities, and does not expect that these adjustments will be material. The purchase price was preliminarily allocated as follows (amounts in thousands):

| | |
|---|---|
| Accounts receivable, net | $ 5,223 |

| | |
|---|---|
| Costs and estimated earnings in excess of billings | 1,156 |
| Other current assets | 284 |
| Property and equipment | 210 |
| Less: Accounts payable | (2,983) |
| Less: Billings in excess of costs and estimated earnings | (175) |
| Less: Other current liabilities | (747) |
| Less: Other long-term liabilities | (25) |
| Cash paid, including cash acquired | $ 2,943 |

The results of operations of Granite are included in the Company's consolidated financial statements from January 17, 2005 through September 30, 2005.

The unaudited pro forma data presented below reflect the results of operations of Comfort Systems and the acquisition of Granite assuming the transaction was completed on January 1, 2004 (in thousands, except per share data):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| Revenues | $ 212,192 | $ 243,453 | $ 612,372 | $ 683,007 |
| Net income | $ 3,592 | $ 6,131 | $ 9,134 | $ 11,328 |
| Net income per share—basic | $ 0.09 | $ 0.15 | $ 0.24 | $ 0.29 |
| Net income per share—diluted | $ 0.09 | $ 0.15 | $ 0.23 | $ 0.28 |

## 4. Discontinued Operations

*Individual Sales of Operating Companies*—During the third quarter of 2005, the Company sold a small operating company and shutdown the operations of another small operating company. The after-tax loss of these companies of less than $0.1 million for the first nine months of 2004 and after-tax loss of $1.0 million for the first nine months of 2005 has been reported in discontinued operations under "Operating income (loss), net of income tax expense (benefit)." The Company recorded a loss on these divestitures of less than $0.1 million, including taxes, in the third quarter of 2005 in discontinued operations under "Estimated gain (loss) on disposition, including income tax expense (benefit)."

During the second quarter of 2005, the Company sold a small operating company. This unit's after-tax income of $0.1 million for the first nine months of 2004 and after-tax loss of less than $0.1 million for the first six months of 2005 has been reported in discontinued operations under "Operating income (loss), net



of income tax expense (benefit)." The Company recorded a gain on the sale of this unit of $0.1 million, including taxes, in the second quarter of 2005 in discontinued operations under "Estimated gain (loss) on disposition, including income tax expense (benefit)."

In 2004, the Company sold a small operating company. The after-tax income of this company for the first six months of 2004 was less than $0.1 million and has been reported in discontinued operations under "Operating results, net of tax." The loss recognized on the sale of this unit in the second quarter of 2004 was $0.5 million, including tax expense, and was reported in discontinued operations under "Estimated loss on disposition, including income taxes." This loss primarily resulted from the non-cash write off of goodwill associated with this unit. This goodwill write off was not tax deductible.

Assets and liabilities related to the operations discontinued during 2005 were as follows (in thousands):

| | December 31, 2004 | September 30, 2005 |
|---|---|---|
| Accounts receivable, net | $ 3,436 | $ 626 |
| Inventories | 919 | — |
| Costs and estimated earnings in excess of billings | 757 | — |
| Other current assets | 78 | 101 |
| Property and equipment, net | 532 | — |
| Other noncurrent assets | 138 | 145 |
| Total assets | $ 5,860 | $ 872 |
| | | |
| Accounts payable | $ 1,151 | — |
| Other current liabilities | 784 | 38 |
| Total liabilities | $ 1,935 | $ 38 |

Revenues and pre-tax income (loss) related to the operations discontinued in 2004 and 2005 were as follows (in thousands):

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2004 | 2005 |
| Revenues | $ 14,503 | $ 7,709 |
| Pre-tax income (loss) | $ 190 | $ (1,693) |

The Company's consolidated statements of operations and the related earnings per share amounts have been restated to reflect the effects of discontinued operations.

*Sale of Companies to Emcor*—On March 1, 2002, the Company sold 19 operations to Emcor Group, Inc. ("Emcor"). The total purchase price was $186.25 million, including the assumption by Emcor of approximately $22.1 million of subordinated notes to former owners of certain of the divested companies. The Company has realized an aggregate loss of $10.9 million, including related tax expense, in connection with the sale of these operations. As a result of the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets," the Company also recognized a goodwill impairment charge related to these operations of $32.4 million, net of tax benefit, as of January 1, 2002.

The transaction with Emcor provided for a post-closing adjustment based on a final accounting, done after the closing of the transaction, of the net assets of the operations that were sold to Emcor. That accounting indicated that the net assets transferred to Emcor were approximately $7 million greater than a target amount that had been agreed to with Emcor. In the second quarter of 2002, Emcor paid the



Company that amount, and released $2.5 million that had been escrowed in connection with this element of the transaction.

Of Emcor's purchase price, $5 million was deposited into an escrow account to secure potential obligations on the Company's part to indemnify Emcor for future claims and contingencies arising from events and circumstances prior to closing, all as specified in the transaction documents. Of this escrow, $4 million has been applied in determining the Company's liability to Emcor in connection with the settlement of certain claims as described subsequently in this section. The remaining $1 million of escrow is available for book purposes to apply to any future claims and contingencies in connection with this transaction, and has not been recognized as part of the Emcor transaction purchase price.

The net cash proceeds of approximately $150 million received to date from the Emcor transaction were used to reduce the Company's debt. The Company paid $10.4 million of taxes related to this transaction in March 2003.

In the fourth quarter of 2002, the Company recognized a charge of $1.2 million, net of tax benefit of $2.7 million, in discontinued operations under "Estimated loss on disposition, including income taxes" in connection with the Emcor transaction. This charge primarily related to a settlement with Emcor for reimbursement of impaired assets and additional liabilities associated with the operations acquired from the Company. The gross amount of the settlement, before application of any escrow amounts or related tax benefits, was $7.9 million. Under this settlement, the Company was released from liability on all other outstanding receivables and issues relating to the profitability of projects that were in process at the time Emcor acquired these operations. The Company applied $4 million of the $5 million general escrow described above to reduce its liability under this settlement. Accordingly, for book purposes, $1.0 million of escrow remains available to apply against future claims that may arise from Emcor in connection with this transaction. The Company recorded a tax benefit of $1.4 million related to the net of the settlement amount and the application of the escrow. In addition, the Company also recognized a separate tax credit of $1.3 million in the fourth quarter of 2002 as a result of lower final tax liabilities in connection with the overall Emcor transaction than were estimated when the transaction originally closed in the first quarter of 2002. These fourth quarter 2002 charges are recapped below along with all other activity related to the Company's aggregate loss on disposition recognized on the Emcor transaction.

The fourth quarter 2002 settlement with Emcor described above has been funded through $2.7 million of direct payments by the Company in 2003, and by the application of $3.3 million in escrow funds to date.

Under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which took effect for the Company on January 1, 2002, the operating results of the companies sold to Emcor for all periods presented through the sale, as well as the loss on the sale of these operations, have been presented as discontinued operations.

There are ongoing open matters relating to this transaction that the Company continues to address with Emcor. The Company does not believe these open matters, either individually or in the aggregate, will have a material effect on the Company's financial position when ultimately resolved. The Company maintains reserves for these matters, net of amounts receivable from escrow that it believes will ultimately be applied in settling these matters. During the second quarter of 2004, the Company concluded that the related reserves should be reduced by $0.3 million, net of tax benefit. Additionally, during the fourth quarter of 2004, the Company reduced these reserves by $0.2 million, net of tax. During the third quarter of 2005, the Company reduced tax reserves by $0.1 million in connection with the resolution of state tax examinations. These amounts are reflected in discontinued operations in 2004 as a reduction in the estimated loss on disposition of discontinued operations.



**Recap of Income Statement Activity Affecting Loss on Disposition of Companies to Emcor (in thousands):**

| | Activity During Indicated Quarters | Cumulative Loss On Disposition |
|---|---|---|
| First Quarter 2002 | | |
| Purchase Price | $ 186,250 | |
| Less escrow | (5,000) | |
| Less book basis in net assets of companies sold | (163,576) | |
| Less transaction wrap-up costs | (2,106) | |
| Plus estimated tax liability associated with transaction | (26,180) | |
| Loss recognized during First Quarter 2002 | (10,612) | $ (10,612) |
| Fourth Quarter 2002 | | |
| Settlement with Emcor for reimbursement of impaired assets and additional liabilities associated with companies sold to Emcor | (7,884) | |
| Application of escrow in the settlement | 4,000 | |
| Tax benefit of settlement | 1,359 | |
| Reduction in estimated tax liability on sale transaction as a whole | 1,371 | |
| Other | (67) | |
| Loss recognized during Fourth Quarter 2002 | (1,221) | (11,833) |
| Second Quarter 2004 | | |
| Reduction in reserves needed for ongoing matters related to transaction | 512 | |
| Taxes related to reduction in reserves | (179) | |
| Reduction to loss recognized in Second Quarter 2004 | 333 | (11,500) |

| | | |
|---|---|---|
| Fourth Quarter 2004 | | |
| Reduction in reserves needed for ongoing matters related to transaction | 371 | |
| Taxes related to reduction in reserves | (130) | |
| Reduction in estimated tax liability on sale transaction as a whole | 377 | |
| Reduction to loss recognized in Fourth Quarter 2004 | 618 | (10,882) |
| Third Quarter of 2005 | | |
| Reduction in tax reserves | 125 | $ (10,757) |



**Recap of Cash Proceeds on Emcor Transaction (in thousands):**

| | Cumulative Cash Proceeds |
|---|---|
| Purchase Price | $ 186,250 |
| Less escrow for post-closing balance sheet adjustment | (2,500) |
| Less general escrow | (5,000) |
| Less debt and accrued interest transferred to Emcor relating to companies sold to Emcor | (22,479) |
| Initial cash proceeds | 156,271 |
| Additional proceeds received in Second Quarter 2002 relating to post-closing balance sheet adjustment, net of related escrow | 7,050 |
| Recovery in Second Quarter 2002 of escrow for post-closing balance sheet adjustment | 2,500 |
| Direct payments by the Company in 2003 related to Fourth Quarter 2002 settlement for reimbursement of impaired assets and additional liabilities of companies sold to Emcor | (2,744) |
| Payment of income taxes in 2003 in connection with the transaction | (10,371) |
| Payment of transaction and wrap-up costs | (2,427) |
| Recovery of a portion of general escrow in 2004 in connection with reduction of reserves needed for ongoing matters related to transaction | 400 |
| Other | (557) |
| Net cash proceeds received as of September 30, 2005 | $ 150,122 |

**Recap of Use of General Escrow in Emcor Transaction (in thousands):**

| | |
|---|---|
| *Escrow Income Statement Recognition* | |
| Original general escrow—not recognized in income statement determination of loss on disposition of companies to Emcor | $ 5,000 |
| Application of escrow in Fourth Quarter 2002 to reduce additional loss on transaction in connection with settlement involving reimbursement for impaired assets and additional liabilities of companies sold to Emcor | (4,000) |
| Remaining escrow available as of September 30, 2005 to be applied against any income statement charges associated with future claims that may arise in connection with the transaction | $ 1,000 |
| *Escrow Funds Use* | |
| Original general escrow | $ 5,000 |
| Use in 2003 in connection with settlement in Fourth Quarter 2002 involving reimbursement for impaired assets and additional liabilities of companies sold to Emcor | (3,339) |
| Use in 2004 in connection with the settlement of other matters | (196) |
| Recovery of a portion of general escrow in 2004 in connection with reduction of reserves needed for ongoing matters related to transaction | (400) |
| Remaining escrow balance as of September 30, 2005, available to be applied to future claims that may arise in connection with transaction | $ 1,065 |



## 5. Restructuring Charges

During the first three quarters of 2003, the Company recorded restructuring charges of approximately $3.2 million pre-tax. These charges included approximately $1.5 million for severance costs and retention bonuses primarily associated with the curtailment of the Company’s energy efficiency marketing activities, a reorganization of the Company’s national accounts operations as well as a reduction in corporate personnel. The severance costs and retention bonuses related to the termination of 88 employees, all of whom had left the Company by December 31, 2003. The restructuring charges for this period also included approximately $1.6 million for remaining lease obligations and $0.1 million of other costs recorded in connection with the actions described above. The Company increased its accrual for these remaining lease obligations by $0.6 million in 2004 and by $0.3 million in 2005 based on revised estimates of when and to what extent it believes it can sublease the related facilities. These increases to the accrual were included in “Cost of Services” and in “Selling, General and Administrative Expenses” in the Company’s consolidated statement of operations.

Accrued lease termination costs remaining from past restructuring charges are expected to be completed by 2009.

The following table shows the remaining liabilities associated with the cash portion of the restructuring charges as of December 31, 2004 and September 30, 2005 (in thousands):

| | Balance at Beginning of Period | Additions | Payments | Balance at End of Period |
|---|---|---|---|---|
| **Year Ended December 31, 2004:** | | | | |
| Lease termination costs and other | $ 1,745 | $ 610(a) | $ (1,074) | $ 1,281 |
| **Nine Months Ended September 30, 2005:** | | | | |
| Lease termination costs and other | $ 1,281 | $ 273(a) | $ (555) | $ 999 |

(a) These charges were included in "Cost of Services" and in "Selling, General and Administrative Expenses" in the Company's consolidated statement of operations.

## 6. Long-Term Debt Obligations

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

| | December 31, 2004 | September 30, 2005 |
|---|---|---|
| Revolving credit facility | $ — | $ — |
| Term loan | 8,500 | — |
| Other | 322 | — |
| Total debt | 8,822 | — |
| Less—current maturities | (2,071) | — |
| Total long-term portion of debt | $ 6,751 | $ — |

### *Credit Facility*

On June 30, 2005, the Company entered into a senior credit facility (the "Facility") provided by a syndicate of banks. As of September 30, 2005, the total of the Facility was $75.0 million, with no outstanding borrowings, $20.1 million in letters of credit outstanding, and $54.9 million of credit available. As of November 1, 2005, the total of the Facility was $75.0 million, with no outstanding borrowings, $21.1 million in letters of credit outstanding, and $53.9 million of credit available. The Facility consists of a $75.0 million revolving credit facility which is available for borrowings and letters of credit. The facility will expire on June 30, 2009.



Certain of the Company's vendors require letters of credit to ensure reimbursement for amounts they are disbursing on the Company's behalf, such as to beneficiaries under the Company's self-funded insurance programs. The Company has also occasionally used letters of credit to guarantee performance under its contracts and to ensure payment to its subcontractors and vendors under those contracts. The Company's lenders issue such letters of credit through the Facility. A letter of credit commits the lenders to pay specified amounts to the holder of the letter of credit if the holder demonstrates that the Company has failed to perform specified actions. If this were to occur, the Company would be required to reimburse the lenders for amounts they fund to honor the letter of credit holder's claim. Absent a claim, there is no payment or reserving of funds by the Company in connection with a letter of credit. However, because a claim on a letter of credit would require immediate reimbursement by the Company to its lenders, letters of credit are treated as a use of Facility capacity just the same as actual borrowings. The Company has never had a claim made against a letter of credit that resulted in payments by a lender or by the Company and believes such claim is unlikely in the foreseeable future.

The Company's borrowings and letters of credit outstanding under the Facility at each monthend must be less than a borrowing base measured as of the same monthend. The borrowing base is defined under the Facility as 65% of the following: total trade receivables including costs and estimated earnings in excess of billings, less allowances for doubtful accounts, less receivables related to projects that are subject to payment or performance bonds. The borrowing base as of September 30, 2005 was $86.8 million. This borrowing base is substantially greater than the current $75.0 million face-value limit of the Facility. The Company does not expect that this borrowing base provision will limit credit available under the Facility in the foreseeable future.

The Company's borrowing and letter of credit capacity under the Revolving Loan portion of the Facility at any given time is $75.0 million less borrowings and letters of credit outstanding, subject to the borrowing base described above. The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply, as discussed below under Covenants and Restrictions. Covenant compliance is measured as of each quarter-end. While the Facility's financial covenants do not specifically govern capacity under the Facility, if the Company's debt level under the Facility at a quarter-end covenant compliance measurement date were to cause the Company to violate the Facility's debt-to-Credit Facility Adjusted EBITDA covenant (described in more detail below), the Company's borrowing capacity under the Facility could be restricted by the lenders. Accordingly, available capacity amounts shown below are presented both on a financial covenant basis and on a Facility face value basis.

| | As of September 30, 2005 | As of November 1, 2005 |
|---|---|---|
| | (in thousands) | |
| Amounts Outstanding: | | |
| Revolving loan | $ — | $ — |
| Other non-Facility debt | — | — |
| Total debt | $ — | $ — |
| Letters of credit | $ 20,119 | $ 21,139 |
| Available Capacity: | | |
| Unused Revolving Loan and letter of credit capacity based on Revolving Loan face value of $75 million | $ 54,881 | $ 53,861 |
| Unused Revolving Loan and letter of credit capacity based on quarter-end debt-to-Credit Facility Adjusted EBITDA covenant | $ — | n/a |

The Company may terminate the Facility in full at any time, however, a termination of the Facility prior to June 30, 2006 would require payment of a fee of $500,000. From June 30, 2006 and until June 30, 2007, the Company may partially reduce the Facility provided such reduction does not exceed $5 million. From July 1, 2007 through June 30, 2008, the Company may partially reduce the Facility provided such reduction does not exceed $10 million, less any prior reductions.

***Collateral***

The Facility is secured by first liens on substantially all the assets of the Company except for assets related to projects subject to surety bonds. The Facility is secured by a second lien on these assets, which are discussed further below. The Company's assets are primarily held by its subsidiaries. Accordingly, the Facility is also secured by the capital stock of current and future subsidiaries, and these entities guarantee repayment of amounts due under the Facility.

A common practice in the Company's industry is the posting of payment and performance bonds with customers. These bonds are offered by financial institutions known as sureties, and provide assurance to the customer that in the event the Company encounters significant financial or operational difficulties, the surety will arrange for the completion of the Company's contractual obligations and for the payment of the Company's vendors on the projects subject to the bonds. In cooperation with its lenders, the Company has granted its surety a first lien on assets such as receivables, costs and estimated earnings in excess of billings, and equipment specifically identifiable to projects for which bonds are outstanding, as collateral for potential obligations under bonds. As of September 30, 2005, the amount of these assets was approximately $68.1 million.

***Interest Rates and Fees***

The Company has a choice of two interest rate options for borrowings under the Facility. Under one option termed the Base Rate Option, the interest rate is determined based on the higher of the Federal Funds Rate plus 0.5% or the prime lending rate offered by Citibank, N.A. (not one of the banks providing the Facility to the Company). Additional margins are then added to the higher of these two rates. These additional margins are determined based on the ratio of the Company's total debt outstanding as of a given quarterend to its earnings before interest, taxes, depreciation and amortization ("Credit Facility Adjusted EBITDA") for the twelve months ending as of that quarterend, as shown below. Credit Facility Adjusted EBITDA as defined under the Facility is discussed in more detail below under *Covenants and Restrictions.*

Under the other interest rate option termed the Eurodollar Rate Option, borrowings bear interest based on designated one to six-month Eurodollar rates that correspond very closely to rates described in various general business media sources as the London Interbank Offered Rate or "LIBOR." Additional margins are then added to LIBOR for borrowings based on the Company's ratio of debt to Credit Facility Adjusted EBITDA, as shown below.

Letter of credit fees under the Facility are also based on the Company's ratio of debt to Credit Facility Adjusted EBITDA, as shown below.



The interest rates underlying the Base Rate and Eurodollar Rate Options under the Facility are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. For illustrative purposes, the following are the respective market rates as of September 30, 2005 relating to interest options under the Facility:

| | |
|---|---|
| Base Rate Option—The higher of: | |
| Federal Funds Rate plus 0.50% | 4.25% |
| Citibank, N.A. Prime Rate | 6.75% |
| Eurodollar Rate Option: | |
| One-month LIBOR | 3.86% |
| Six-month LIBOR | 4.23% |

| | Debt to Credit Facility Adjusted EBITDA | | |
|---|---|---|---|
| | **Less than 0.75** | **0.75 to 1.25** | **1.25 or greater** |
| Additional Per Annum Interest Margin Added Under: | | | |
| Base Rate Option | 1.00% | 1.50% | 2.00% |
| Eurodollar Rate Option | 2.00% | 2.50% | 3.00% |
| Per Annum Letter of Credit Fees (not added to underlying Base Rate or Eurodollar Rate) | 1.50% | 1.875% | 2.25% |

Commitment fees of 0.25% per annum are payable on the portion of Revolving Loan capacity not in use for borrowings or letters of credit at any given time.

The Company incurred approximately $0.4 million in financing and professional costs in connection with the arrangement of the Facility. These costs will be amortized as a non-cash charge to interest expense over the term of the Facility in an amount of approximately $0.1 million per year. If the size of the Facility is reduced, the Company may have to accelerate amortization of these deferred financing and professional costs. Excluding the amortization of debt financing and arrangement costs, the Company estimates that the interest rate applicable to borrowings under the Facility would be approximately 5.86% as of September 30, 2005.

***Covenants and Restrictions***

The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply. Covenant compliance is assessed as of each quarterend. Credit Facility Adjusted EBITDA is defined under the Facility for financial covenant purposes as net earnings for the four quarters ending as of any given quarterly covenant compliance measurement date, plus the corresponding amounts for (a) interest expense; (b) income taxes; (c) depreciation and amortization; and (d) other non-cash charges. The following is a reconciliation of Credit Facility Adjusted EBITDA to net income (in thousands):

| | |
|---|---|
| Net income | $ 13,344 |
| Discontinued operations—estimated non-cash gain on dispositions, net | (618) |
| Income taxes—continuing operations and discontinued operations | 10,449 |
| Mark-to-market warrant obligation | (8) |
| Interest expense, net | 776 |
| Write off of debt costs | 870 |
| Depreciation expense | 4,592 |
| Goodwill impairment—continuing operations and discontinued operations | 3,347 |
| Credit Facility Adjusted EBITDA | $ 32,752 |



The Facility's principal financial covenants include:

*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. Interest expense is defined under the Facility as interest expense for the four quarters ending as of any given quarterly covenant compliance measurement date, excluding corresponding twelve-month amounts for (a) amortization of deferred debt arrangement costs; and (b) mark-to-market interest expense. Scheduled principal payments for this ratio are also measured for the twelve months ending as of any given quarterly covenant compliance measurement date. The Company's fixed charge coverage ratio as of September 30, 2005 as measured under this covenant was 18.9 as compared to a minimum covenant requirement of 1.50.

*Tangible Net Worth*—The Facility requires that the Company's tangible net worth not be less than the sum of (a) $100.5 million; (b) 50% of net income earned beginning April 1, 2005; and (c) the net proceeds of any equity transactions. For purposes of this ratio, the Facility defines tangible net worth as stockholders' equity less the book value of the following intangible assets: goodwill, patents, copyrights, licenses, franchises, trade names, trade secrets, and operating leases. The Facility also provides that for purposes of this ratio, net income excludes any goodwill impairment charges. The Company's tangible net worth as of September 30, 2005 as measured under this covenant was $130.3 million, as compared to a covenant minimum of $107.3 million.

*Debt to Credit Facility Adjusted EBITDA*—The Facility requires that the Company's ratio of debt to Credit Facility Adjusted EBITDA not exceed 2.5. The Company's debt-to-Credit Facility Adjusted EBITDA ratio as of September 30, 2005 as measured under this covenant was zero because the Company has no debt.

*Capital Expenditures*—The Facility limits capital expenditures to $20.0 million per year. The Company's capital expenditures during the nine months ended September 30, 2005 were $5.1 million.

*Other Restrictions*—The Facility limits payment of dividends and repurchase of shares by the Company to a combined maximum of $20.0 million per year, and otherwise limits non-Facility debt, capital lease obligations, acquisitions, investments, and sales of assets. Debt under the Facility is classified as long-term as the Facility will expire in June 2009.

***Interest Expense and Related Charges***

As of the end of the second quarter, the Company repaid all borrowings and accrued interest under its previous revolving credit facility. During the third quarter of 2005, the Company paid no interest on either its current or prior revolving credit facility. Interest expense for the three months and nine months ended September 30, 2004 and 2005 included the following primary elements (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| Interest expense on borrowings, and unused commitment fees | $ 140 | $ 60 | $ 557 | $ 348 |
| Letter of credit fees | 130 | 82 | 339 | 306 |
| Amortization of deferred debt arrangement costs | 104 | 24 | 300 | 270 |
| Total | $ 374 | $ 166 | $ 1,196 | $ 924 |



When the Company's previous credit facility was replaced, deferred debt costs totaling $0.9 million were written off during the second quarter of 2005. This charge is reported as "Write off of debt costs" in the Company's consolidated statement of operations.

**7. Commitments and Contingencies**

***Claims and Lawsuits***

The Company is party to litigation and claims in the ordinary course of business, including various state and federal income tax audits. The largest single unresolved matter to which the Company is party involves a construction project. If this matter were ultimately resolved on the least favorable terms to the Company, management estimates that it would incur a liability of approximately $2.5 million. However, management believes the likelihood of such a least-favorable outcome is remote, and believes its asset balances and accruals relating to this matter appropriately reflect a probable outcome. The Company's remaining litigation involves matters with significantly smaller individual potential losses.

The Company has estimated and provided accruals for probable losses and related legal fees associated with certain of its litigation in the accompanying consolidated financial statements. In management's opinion, uninsured losses resulting from the ultimate resolution of these matters will not have a material adverse effect on the Company's operating results or financial condition.

***Surety***

Many customers, particularly in connection with new construction, require the Company to post performance and payment bonds issued by a financial institution known as a surety. If the Company fails 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. The Company must reimburse the sureties for any expenses or outlays they incur. To date, the Company is not aware of any losses to its sureties in connection with bonds the sureties have posted on the Company's behalf, and does 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 30% of the Company's business has required bonds. While the Company has enjoyed a longstanding relationship with its primary surety and has recently added another surety to further support its bonding needs, current market conditions as well as changes in the sureties' assessment of the Company's operating and financial risk could cause the sureties to decline to issue bonds for the Company's 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. The Company would likely also encounter concerns from customers, suppliers and other market participants as to its creditworthiness. While the Company believes its general operating and financial characteristics, including a significant amount of cash on its balance sheet, would enable it to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause the Company's revenues and profits to decline in the near term.

***Self-Insurance***

The Company is 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 the Company absorbs under its 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.

The Company's self-insurance arrangements currently are as follows:

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

*General and Employer's Liability*—For general liability and employer's liability, the Company self-insures the first $500,000 of each loss, is fully insured for the next $500,000 of each loss, then has a single, aggregate excess loss insurance policy that covers losses up to $50 million across both these risk areas (as well as auto liability noted below).

*Auto Liability*—For auto liability, the Company self-insures the first $500,000 of each loss, has insurance coverage for the next $500,000, then again self-insures for the loss amounts between $1 million and $2 million, at which point the Company's $50 million aggregate excess loss coverage picks up coverage.

*Employee Medical*—The Company's per-incident deductible for employee group health claims is $300,000. Insurance then covers any Company responsibility for medical claims in excess of the deductible amount.

It is important to note that the Company's $50 million of aggregate excess loss coverage above applicable per-incident deductibles represents one policy limit that applies to all lines of risk. In other words, the Company does not have a separate $50 million of excess loss coverage for each of general liability, employer's liability and auto liability.

**8. Stockholders' Equity**

***Restricted Stock Grants***

The Company awarded 82,500 shares of restricted stock to nine members of management on January 21, 2005 under its 2000 Equity Incentive Plan. The shares are subject to full forfeiture if the Company does not meet certain performance levels for the twelve-month period ending March 31, 2006. The grants are also subject to forfeiture if a grantee leaves voluntarily or is terminated for cause. The latter forfeiture provisions lapse pro rata over four-year periods that started on the date of the respective grants. Due to the departure of an individual, 12,500 shares of restricted stock were forfeited in the second quarter of 2005.

The Company awarded 225,000 shares of restricted stock to five members of senior management on June 8, 2004 under its 2000 Equity Incentive Plan. The shares were subject to forfeiture if the Company had not achieved certain performance levels for the twelve-month period ending June 30, 2005. These performance levels were met by the Company. The shares are subject to forfeiture if a grantee leaves voluntarily or is terminated for cause. Such forfeiture provisions lapse pro rata over three-year or four-year periods that started on the date of the respective grants. Due to the departure of an individual, 50,000 shares of restricted stock were forfeited during the second quarter of 2005.

The Company awarded 200,000 shares of restricted stock to its Chief Executive Officer on March 22, 2002 under its 2000 Equity Incentive Plan. The shares were subject to forfeiture if the Company had not achieved certain performance levels for the twelve-month period ending March 31, 2003. These performance levels were met by the Company. The shares are subject to forfeiture if the executive leaves voluntarily or is terminated for cause. Such forfeiture provisions lapse pro rata over a four-year period that started on the date of grant.



Compensation expense relating to the grants is charged to earnings over the respective three-year or four-year periods during which their forfeiture provisions lapse. The initial value of each award was established based on the market price on the date of grant, and was reflected as a reduction of stockholders' equity for unearned compensation at that time. This value, and the related compensation expense, is adjusted up or down based on the market price of the Company's stock during the first year following each respective grant while the performance conditions are in effect. Once the performance conditions are met, the value of the award is fixed based on the market price of the Company's stock at that time, and is charged to earnings over the remaining two-year or three-year period during which remaining forfeiture provisions lapse.

***Warrant***

In connection with a previous credit facility, the Company granted a lender a warrant to purchase 409,051 shares of Company common stock ("Common Stock") for nominal consideration. The warrant was exercised in October 2004 in a cashless transaction, whereby the Company issued 408,444 shares upon exercise of the warrant.

When the warrant was originally issued, it carried additional rights involving increases in, registration of, and sale of shares related to the warrant. The warrant holder also had the right to "put," or require the Company to repurchase, some or all of the shares related to the warrant in certain circumstances. Some of these rights were waived in December 2003 when the credit facility in connection with which the warrant was originally issued was terminated.

The value of the warrant and put when originally issued of $2.9 million was reflected as a discount of the Company's obligations under the previous credit facility, and as an obligation in long-term liabilities. When this credit facility was terminated in December 2003, the discount reflected against debt under the facility was written off and included in "Write off of debt costs and discount, net" in the Company's consolidated statement of operations. Also upon the termination of the credit facility, the warrant holder waived certain of the additional rights under the warrant and put.

As noted above, the warrant was exercised in a cashless transaction in October 2004. As a result of the exercise, all additional rights under the warrant described above have terminated. Also as a result of the exercise, the remaining value of the warrant was eliminated as an obligation and added to stockholders' equity in October 2004.

While the warrant and put were outstanding, their value changed over time, principally in response to changes in the market price of the Common Stock. The warrant and the put qualified as a derivative for financial reporting purposes. Accordingly, such changes in the value of the warrant and put in any given period were included in the Company's statement of operations for that period and in the Company's long-term liabilities, even though the warrant and put had not been terminated and settled in cash during the period. Such adjustments are known as mark-to-market adjustments. During the nine months ended September 30, 2004, these adjustments were a loss of $0.5 million, and were reflected as other income (expense) in the Company's statement of operations. Now that the warrant and put are no longer outstanding, there will be no further mark-to-market adjustments to income associated with them.

***Restricted Common Stock***

In March 1997, Notre Capital Ventures II, L.L.C. ("Notre") exchanged 2,742,912 shares of Common Stock for an equal number of shares of restricted voting common stock ("Restricted Voting Common Stock"). The holders of Restricted Voting Common Stock are entitled to elect one member of the Company's Board of Directors and to 0.55 of one vote for each share on all other matters on which they are entitled to vote. Holders of Restricted Voting Common Stock are not entitled to vote on the election of any other directors.



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Each share of Restricted Voting Common Stock will automatically convert to Common Stock on a share-for-share basis (i) in the event of a disposition of such share of Restricted Voting Common Stock by the holder thereof (other than a distribution which is a distribution by a holder to its partners or beneficial owners, or a transfer to a related party of such holders (as defined in Sections 267, 707, 318 and/or 4946 of the Internal Revenue Code of 1986, as amended)), (ii) in the event any person acquires beneficial ownership of 15% or more of the total number of outstanding shares of Common Stock, or (iii) in the event any person offers to acquire 15% or more of the total number of outstanding shares of Common Stock. After July 1, 1998, the Board of Directors may elect to convert any remaining shares of Restricted Voting Common Stock into shares of Common Stock in the event 80% or more of the originally outstanding shares of Restricted Voting Common Stock are converted into shares of Common Stock. As of September 30, 2005, there were 1,000,975 shares of Restricted Voting Common Stock remaining.

***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, warrants and contingently issuable restricted stock.

Under EPS calculation methods established by generally accepted accounting principles, including the effect of options whose exercise price exceeds the average market price of the Common Stock for a given period would increase calculated EPS. This impact is called "anti-dilutive." Generally accepted accounting principles for determining EPS require that any options or other common stock equivalents whose inclusion in determining EPS would have an anti-dilutive effect be excluded. Accordingly, options to purchase 0.2 million shares of Common Stock at prices ranging from $7.94 to $21.438 per share which were outstanding for the three months ended September 30, 2005, and options to purchase 0.4 million shares at prices ranging from $7.625 to $21.438 per share which were outstanding for the nine months ended September 30, 2005, were not included in the computation of diluted EPS because they were anti-dilutive.

Options to purchase 0.9 million shares of the Company's common stock at prices ranging from $6.64 to $21.438 per share were outstanding for the three months ended September 30, 2004 and options to purchase $1.6 million from $7.00 to $21.438 per share were outstanding for the nine months ended September 30, 2004, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the Common Stock.



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The following table summarizes information regarding the Company's outstanding stock options as of September 30, 2004 and 2005:

| | Number of Options Outstanding | |
|---|---|---|
| **Exercise Price** | **September 30, 2004** | **September 30, 2005** |
| $1.90 | 710,250 | 590,250 |

| | | |
|---|---|---|
| $2.14 | 10,000 | 10,000 |
| $2.19 | 10,000 | — |
| $2.25 | 232,500 | 160,125 |
| $2.34 | 500 | — |
| $2.36 | 50,000 | 40,000 |
| $2.43 | 10,000 | 10,000 |
| $2.875 | 1,056,735 | 597,338 |
| $3.39 | 10,000 | 10,000 |
| $3.8125 | 500,000 | 500,000 |
| $3.86 | 79,000 | 72,750 |
| $4.18 | 102,500 | 102,500 |
| $4.24 | 15,000 | 10,000 |
| $4.77 | 40,000 | 30,000 |
| $6.00 | 153,000 | 95,500 |
| $6.38 | — | 272,500 |
| $6.49 | — | 50,000 |
| $6.62 | — | 36,000 |
| $6.64 | 55,000 | 55,000 |
| $6.75 | 5,000 | 5,000 |
| $6.97 | — | 120,000 |
| $7.00 | 50,000 | 40,000 |
| $7.625 | 34,700 | 32,200 |
| $7.94 | — | 15,000 |
| All other outstanding options with prior grant dates with exercise prices ranging from $11.75 to $21.438 | 826,059 | 154,850 |
| | 3,950,244 | 3,009,013 |

As noted above under *Warrant*, the Company issued a warrant to purchase 409,051 shares of Common Stock along with related put rights for nominal consideration. The dilutive impact of this warrant was computed assuming the issuance of shares equal to the value of the warrant obligation at the end of any given period while it was outstanding, and excluding the income effect for the period of any mark-to-market adjustments made in connection with valuing the warrant.

As this impact was anti-dilutive for the three and nine months ended September 30, 2004, the effect of the warrant was excluded from earnings per share amounts for this period. As a result of the warrant's exercise in October 2004, its related shares have now become part of the Company's outstanding Common Stock.



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, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| Common shares outstanding, end of period(a) | 38,425 | 39,468 | 38,425 | 39,468 |
| Effect of using weighted average common shares outstanding | (7) | (96) | (127) | (288) |
| Shares used in computing earnings per share—basic | 38,418 | 39,372 | 38,298 | 39,180 |
| Effect of shares issuable under stock option plans based on the treasury stock method | 998 | 933 | 1,108 | 929 |
| Effect of contingently issuable restricted shares | 39 | 77 | 51 | 70 |
| Shares used in computing earnings per share—diluted | 39,455 | 40,382 | 39,457 | 40,179 |

a) Excludes 325,000 and 242,917 shares of unvested contingently issuable restricted stock outstanding as of September 30, 2004 and 2005, respectively (see "Restricted Stock Grants" above).

### 9. Subsequent Event

On November 2, 2005, the Company's Board of Directors declared an initial quarterly dividend of $0.025 per share on Comfort Systems USA, Inc. common stock. The dividend is payable on December 20, 2005 to shareholders of record at the close of business on November 30, 2005.



## 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, 2004 (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 "Factors Which May Affect Future Results," included in our Form 10-K.

## Introduction and Overview

We are a national provider of comprehensive heating, ventilation and air conditioning ("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 85% 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, 2005, we had 4,973 projects in process. Our average project takes three to six months to complete, with an average contract price of approximately $280,000. 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. 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, 2005, we had two projects in process with a contract price of between $15 and $25 million, 8 projects between $10 million and $15 million, 23 projects between $5 million and $10 million, and 173 projects between $1 million and $5 million. Taken together, projects with contract prices of $1 million or more totaled $670.1 million of aggregate contract value as of September 30, 2005, or approximately 48.2%, out of a total contract value for all projects in progress of $1,390.4 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 15% 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***

Our company was originally formed in 1997 through an initial public offering, or IPO, and simultaneous acquisition of 12 companies engaged in our business. From the time we completed our IPO through December 1999, we acquired 107 HVAC and complementary businesses, of which 26 were “tuck-in” operations that were integrated upon acquisition with existing operations. From 2000 through 2004 we did not acquire any additional companies but rather shifted our strategy from an emphasis on acquisition-based growth to a focus on improving the performance of our existing operations. During that time, we sold or ceased operations at 35 companies and consolidated another 13 companies into other operations. In January 2005 we acquired a business in New England. During 2005, we sold or ceased operations at three of our smaller operating companies and consolidated one company into other operations. Today we have 42 operating units.

We manage our operations 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 US, 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 macroeconomic and geopolitical trends. We have experienced periods of time, such as after the terrorist incidents on September 11, 2001 in the US, and prior to and



during the war in Iraq that occurred in early 2003, when uncertainty caused a significant slowdown in decisions to proceed with installation and replacement project work. The Company believes that the current economic environment is favorable relative to the activity levels of recent years.

***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 in response to the broader US recession as well as uncertainty relating to international events. This was a more extended period of contraction than the sector has experienced in other recent recessions, with particularly steep declines in the commercial and industrial portions of the industry. As a result, like most nonresidential HVAC service providers, we experienced decreasing volume, prices, and therefore gross profits during this period. We responded to these market challenges by pursuing work in sectors less affected by this downturn, such as government, educational, and health care facilities, and by establishing marketing initiatives that take advantage of our size and range of expertise. These initiatives include our regional and national multi-location service efforts, our energy efficiency capabilities, and collaboration among our operating units to seek joint project opportunities. As a result of these responses, the decreases we saw in revenues over the last three years have been less than the overall decline in activity experienced by the broader nonresidential sector. We also responded to declining gross profits over recent years by reducing our selling, general, and administrative expenses, and our indirect project and service overhead costs. We believe our efforts in these areas have partially offset the decline in our profitability over this period. We have experienced improvements in both industry activity as well as our own results in late 2003, throughout 2004 and in the first nine months of 2005.

In addition to addressing revenues and costs more broadly, we also evaluate our operations on a by-unit and by-market basis. A number of our units have experienced significantly lower results at various points over the last three years, including ten units that incurred operating losses in 2003, and four units that incurred operating losses in 2004. While the difficult market conditions over this period of time certainly influenced the performance of these units, we also experienced operational execution shortfalls that contributed to lower results. The majority of such underperforming operations have been closed, sold, merged with stronger operations, or reduced in size or operating scope. We also replaced management at most ongoing operations in this group. The aggregate losses at units that lost money in 2004 were significantly less than the aggregate losses at units that lost money in 2003. We currently have 42 operating units. During the first nine months of 2005 we had 5 units that experienced operating losses. While it would be unusual in a group of this size to have no underperforming units even in better market conditions, we expect to again reduce aggregate full-year losses in 2005 as compared to 2004.

With the difficult market conditions in our industry over recent years along with the integration challenges we encountered following our substantial acquisition growth during the period from 1997 to 1999, we also operated in an environment of relatively tight credit restrictions from our lenders. In addition, we have had to more actively manage our relationships with the surety market, through which we procure payment and performance bonds required for approximately 30% of our work. Accordingly, cash flow and debt reduction were particularly high priorities for us over this period of time. As a result of our sale of certain operations to Emcor in early 2002 as well as our continued strong emphasis on cash flow, our debt outstanding is now zero. At the end of June 2005, we put a new credit facility in place with less restrictive terms than those of our previous facilities. In addition, we have added a second surety to further 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 five 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.



As discussed at greater length in "Results of Operations" below, we have seen increased activity levels in our industry in 2004 and through nine months of 2005. 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. However, our primary emphasis is on internal execution and margin improvement, rather than on revenue growth. In addition to the work we have done on our underperforming units as described above, we have increased our focus on project qualification, estimating, pricing and management, and on service performance. This focus includes significant increases in unit level training.

Based on indications of stabilizing industry conditions and on our emphasis on internal execution and margin improvement, we expect that our 2005 results will be better than our 2004 results. Over the longer term, if industry conditions are stable to improving, we believe we will experience more periods of increased revenues. In addition, given the size and fragmentation of our industry, we believe it makes sense for us to consider acquisition possibilities. However, we plan to do so on a very selective, opportunistic basis, and expect our growth in 2005 will largely be generated internally.

***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 85% of our revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method as provided by American Institute of Certified Public Accountants Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," 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 the Company's 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. Subcontractor 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 the Company's projects are substantially all produced to job specifications and are a value added element to our work. The costs are considered to be incurred when title is transferred to the Company, which typically is upon delivery to the work site.



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 work site. The 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 or deferral of costs 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.

*Accounting for Goodwill and Other Intangible Assets*

In most businesses we have acquired, the value we paid to buy the business was greater than the value of specifically identifiable net assets in the business. Under generally accepted accounting principles, this excess is termed goodwill and is recognized as an asset at the time the business is acquired. It is generally expected that future net earnings from an acquired business will exceed the goodwill asset recognized at the time the business is bought.

We are required to 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 and intangible 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 under Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets." Accordingly, such increases may not be netted against impairments at other business units. The new 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.



**Results of Operations (in thousands):**

**Table 1—Historical Results**

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | % | 2005 | % | 2004 | % | 2005 | % |
| Revenues | $ 206,171 | 100.0% | $ 243,453 | 100.0% | $ 594,198 | 100.0% | $ 681,937 | 100.0% |
| Cost of services | 173,706 | 84.3% | 202,418 | 83.1% | 499,670 | 84.1% | 571,690 | 83.8% |
| Gross profit | 32,465 | 15.7% | 41,035 | 16.9% | 94,528 | 15.9% | 110,247 | 16.2% |
| Selling, general and administrative expenses | 26,102 | 12.7% | 29,613 | 12.2% | 77,686 | 13.1% | 87,339 | 12.8% |
| Loss (gain) on sale of assets | 34 | | (53) | | (33) | | (112) | |
| Operating income | 6,329 | 3.1% | 11,475 | 4.7% | 16,875 | 2.8% | 23,020 | 3.4% |
| Interest expense, net | (334) | (0.2)% | (1) | — | (1,113) | (0.2)% | (495) | (0.1)% |
| Write off of debt costs | — | | — | | — | | (870) | (0.1)% |
| Other income (expense) | (101) | — | (39) | — | (438) | (0.1)% | 36 | — |
| Income before income taxes | 5,894 | 2.9% | 11,435 | 4.7% | 15,324 | 2.6% | 21,691 | 3.2% |
| Income tax expense | 2,553 | | 4,971 | | 6,596 | | 9,452 | |
| Income from continuing operations | 3,341 | 1.6% | 6,464 | 2.7% | 8,728 | 1.5% | 12,239 | 1.8% |
| Discontinued operations— | | | | | | | | |
| Operating results, net of tax | 149 | | (295) | | 116 | | (1,000) | |
| Estimated gain (loss) on disposition, net of tax | | | (38) | | (137) | | 99 | |
| Net income | $ 3,490 | | $ 6,131 | | $ 8,707 | | $ 11,338 | |

**Table 2—Supplemental Non-GAAP Disclosure—Operating Results of Continuing Operations Excluding Certain Items**

The following table presents information excluding the write off of debt costs incurred in the second quarter of 2005. We have included this table because we believe it offers an additional view of the core results of our continuing operations in a way that we find useful in managing these operations, and in a way which also responds to frequent questions we receive about the Company from third parties. However, this presentation of operating results is not in accordance with generally accepted accounting principles, and should not be considered an alternative to income as determined under generally accepted accounting principles and presented above in Table 1-Historical Results.

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | % | 2005 | % | 2004 | % | 2005 | % |
| Income from continuing operations (after tax) | $ 3,341 | | $ 6,464 | | $ 8,728 | | $ 12,239 | |
| Write off of debt costs (after tax) | — | | — | | — | | 479 | |
| Income from continuing operations (after tax), excluding the write off of debt costs | $ 3,341 | 1.6% | $ 6,464 | 2.7% | $ 8,728 | 1.5% | $ 12,718 | 1.9% |
| Diluted earnings per share—income from continuing operations (after tax), excluding the write off of debt costs | $ 0.09 | | $ 0.16 | | $ 0.22 | | $ 0.32 | |

*Revenues—Revenues* increased $37.3 million, or 18.1%, to $243.5 million for the third quarter of 2005 compared to the same period in 2004. Approximately 14.2% of the increase in revenues related to internal growth and the remaining 3.9% resulted from the acquisition of Granite State Plumbing & Heating (“Granite”) in January 2005. The internal revenue growth stemmed primarily from generally improving nonresidential facilities markets throughout the United States especially in the institutional markets such as schools and hospitals (approximately $10.2 million), hotels (approximately $5.4 million), and in the multi-family sector (approximately $3.5 million). In addition, we have seen increased activity levels in the third quarter of 2005, primarily in our Arizona, Wisconsin and Michigan operations, resulting from the start-up of several large projects. These gains were offset to a lesser degree by lower revenues relating to our operations in Southern California that were impacted by continued project delays resulting from extended inclement weather in the first quarter of 2005.

Revenues for the first nine months of 2005 increased $87.7 million, or 14.8%, to $681.9 million compared to the same period in 2004. Approximately 11.1% of the increase in revenues related to internal growth and the remaining 3.7% resulted from the Granite acquisition. Again, this internal growth was from generally improving nonresidential markets throughout the United States included the institutional markets such as schools and hospitals (approximately $24.4 million). In addition, the gain in revenues stemmed from our improving performance in the multi-family sector (approximately $12.6 million) and hotels (approximately $13.3 million). These gains were offset to a lesser degree by lower revenues relating to our operations in Southern California (approximately $13.1 million), as discussed above.

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 associated with continuing operations as of September 30, 2005 was $650.8 million (including $9.6 million from the acquisition of Granite), a 1.7% increase from June 30, 2005 backlog of $639.7 million, and a 37% increase from September 30, 2004 backlog of $475.0 million. The increase in backlog from the prior quarterend is primarily from significant new multi-family projects in Alabama, as well as office building projects in the Washington, D.C. area.

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 2004 and 2005. We continue to see signs that activity levels in our industry may continue to increase throughout 2005. These observations are based on nonresidential construction spending trends, shipment data from HVAC equipment manufacturers, forecasts from construction industry analysts, and anecdotal indications of renewed project consideration.

Along with the indications noted above that suggest industry activity is improving, there remain the following cautionary factors in the industry environment, each of which is discussed at greater length in the introduction above. Since HVAC and related installation and replacement decisions are capital decisions usually involving some amount of discretion, they tend to be affected to a greater degree by macroeconomic or geopolitical uncertainty. Negative developments or events in these arenas, should they occur, will likely cause end users to defer HVAC and related spending decisions, thereby reducing our revenues.

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

While we believe we will see increased industry activity levels throughout 2005, in view of all of the foregoing factors, we may continue to experience only modest revenue growth or revenue declines in upcoming periods. In addition, if general economic activity in the US slows significantly from current levels, we may realize decreases in revenue and lower operating margins.

*Gross Profit*—Gross profit increased $8.6 million, or 26.4%, to $41.0 million for the third quarter of 2005 compared to the same period in 2004. As a percentage of revenues, historical gross profit for the third quarter of 2005 was 16.9%, up from 15.7% in the third quarter of 2004. The increase in gross profit percentage resulted primarily from increased profitability in our Tennessee operations (approximately $1.4 million), higher margin storm-related project repair work performed by our operation in Central Florida (approximately $1.2 million) and improved margins at an operation in Wisconsin which was negatively impacted by increases in the prices for certain commodity materials in the second quarter of 2004 (approximately $1.3 million). These gains were partially offset by job underperformance at one of our larger operations (approximately $2.0 million).

Gross profit for the first nine months of 2005 increased $15.7 million, or 16.6%, as compared to the same period in 2004. As a percentage of revenues, historical gross profit for the first nine months of 2005 was 16.2%, up from 15.9% in the first nine months of 2004. The increase resulted primarily from margin improvement related to operations in Tennessee, Central Florida and Wisconsin as discussed above, partially offset by uneven customer schedules and job underperformance at one of our larger operations (approximately $4.6 million).

As noted in the *Introduction* above, we are currently placing a greater emphasis on internal execution and margin improvement than on revenue growth. This includes a strong focus on those of our units that



have underperformed, along with increased training efforts on project qualification, estimating, pricing and management, and on service performance. While we believe these efforts will help us increase gross profits, we cannot assure that this will occur. Further, if we are successful in these efforts, we cannot assure that they will offset adverse industry trends, if such trends occur.

*Selling, General and Administrative Expenses ("SG&A")*—SG&A increased $3.5 million, or 13.5% for the third quarter of 2005 as compared to the third quarter of 2004. As a percentage of revenues, SG&A declined from 12.7% in the third quarter of 2004 to 12.2% in the third quarter of 2005. This decrease is consistent with our effort to control our SG&A expenses as we experience internal revenue growth, partially offset by an increase resulting from higher medical costs (approximately $0.8 million) in the third quarter of 2005 due to favorable claims experience in the prior year.

For the nine months ended September 30, 2005, SG&A increased $9.7 million, or 12.4% for the first nine months of 2005 as compared to the same period in 2004. As a percentage of revenues, SG&A decreased from 13.1% in the first nine months of 2004 to 12.8% in the first nine months of 2005. This decrease is consistent with our effort to control our SG&A expenses as we experience internal revenue growth, partially offset by an increase resulting from higher medical costs (approximately $2.6 million) as discussed above.

*Interest Expense, Net*—The decrease in interest expense, net is a result of payments on the term loan throughout 2004 and 2005 thereby reducing our average debt outstanding, and interest income earned from higher cash balances in the current year. See "Liquidity and Capital Resources" for a detail of the components of interest expense, net for the three and nine months ended September 30, 2004 and 2005.

*Write off of debt costs*—The second quarter of 2005 includes a non-cash write off of $0.9 million of deferred financing costs resulting from the replacement of our previous credit facility.

*Other Income (Expense)*—Other expense was $0.1 million for the third quarter of 2004 and less than $0.1 million for the third quarter of 2005. Other expense was $0.4 million for the first nine months of 2004 and other income was less than $0.1 million for the first nine months of 2005. The third quarter of 2004 and the first nine months of 2004 include losses of $0.1 million and $0.5 million, respectively, resulting from mark-to-market adjustments on a warrant with a third-party to buy shares of our stock. The warrant also carried a put obligation. This warrant was exercised in October 2004. This exercise also terminated the related put obligation. As a result, there are no further mark-to-market adjustments to income associated with them.

*Income Tax Expense*—The effective tax rate associated with results from continuing operations for the first nine months of 2005 was 43.6%, as compared to 43.0% in 2004. Our effective tax rate is generally higher than statutory rates because of the effect of certain expenses that are not deductible for tax purposes. In addition, 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.

During 2004, the American Jobs Creation Act of 2004 was signed into law. The primary effect of this legislation will be to permit us to claim a deduction for 3% of earnings related to certain of our construction-related activities beginning in 2005. This deduction may decrease our effective tax rate. We currently estimate that our effective tax rate for full-year 2005 will be between 40% and 45%.

*Discontinued Operations*—During the third quarter of 2005, the Company sold a small operating company and shutdown the operations of another small operating company. The after-tax loss of these companies of less than $0.1 million for the first nine months of 2004 and after-tax loss of $1.0 million for the first nine months of 2005 has been reported in discontinued operations under "Operating income (loss), net of income tax expense (benefit)." The Company recorded a loss on these divestitures of less than $0.1 million, including taxes, in the third quarter of 2005 in discontinued operations under "Estimated gain (loss) on disposition, including income tax expense (benefit)."



In 2004, we sold a small operating company. The after-tax income of this company for the first six months of 2004 was less than $0.1 million and has been reported in discontinued operations under "Operating results, net of tax." The loss recognized on the sale of this unit in the second quarter of 2004 was $0.5 million, including tax expense, and was reported in discontinued operations under "Estimated loss on disposition, including income taxes." This loss primarily resulted from the non-cash write off of goodwill associated with this unit. This goodwill write off was not tax deductible. This loss is partially offset by an after-tax gain of approximately $0.3 million related to a reduction in reserves associated with discontinued operations from previous years.

*Outlook*—As noted earlier in this review, while we see signs that industry activity levels are continuing to increase in 2005, our primary emphasis for this year is on margin improvement more so than revenue growth. Our ongoing margin efforts include a focus on improving the results of units that incurred losses or subpar income in 2004, and on intensified project and service performance training at the unit level. Based on these margin improvement efforts and developments, on our increased level of backlog as compared to recent periods, and on our belief that industry and economic conditions are improving, we expect that our full-year 2005 results will be better than our 2004 results.

**Liquidity and Capital Resources**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| | (in thousands) | | (in thousands) | |
| Cash provided by (used in): | | | | |

| | | | | |
|---|---|---|---|---|
| Operating activities | $ 5,121 | $ 8,103 | $ 12,781 | $ 14,491 |
| Investing activities | $ (807) | $ (930) | $ (1,631) | $ (5,766) |
| Financing activities | $ (526) | $ 81 | $ (793) | $ (7,592) |
| Free cash flow: | | | | |
| Cash provided by operating activities | $ 5,121 | $ 8,103 | $ 12,781 | $ 14,491 |
| Purchases of property and equipment | (963) | (1,826) | (3,180) | (5,053) |
| Proceeds from sales of property and equipment | — | 353 | 283 | 564 |
| Free cash flow | $ 4,158 | $ 6,630 | $ 9,884 | $ 10,002 |

*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 may be 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 the Company. 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, 2005, we had positive free cash flow of $6.6 million, as compared to $4.2 million during the third quarter of 2004. This increase is primarily from increased profitability, net of a slight increase in capital expenditures. For the nine months ended September 30, 2005, free cash flow of $10.0 million was essentially unchanged from free cash flow of $9.9 million during the first nine months of 2004.

*Credit Facility*—On June 30, 2005, we entered into a senior credit facility (the "Facility") provided by a syndicate of banks. As of September 30, 2005, the total of the Facility was $75.0 million, with no outstanding borrowings, $20.1 million in letters of credit outstanding, and $54.9 million of credit available. In addition to this credit capacity, as of September 30, 2005, we had $33.7 million in cash. As of November 1, 2005, the total of the Facility was $75.0 million, with no outstanding borrowings, $21.1 million in letters of credit outstanding, and $53.9 million of credit available. The Facility consists of a $75.0 million revolving credit facility which is available for borrowings and letters of credit. The Facility will expire on June 30, 2009.

Excluding the amortization of debt financing and arrangement costs, we estimate that the interest rate applicable to borrowings under the Facility would be approximately 5.86% as of September 30, 2005.

As of the end of the second quarter, the Company repaid all borrowings and accrued interest under its previous revolving credit facility. During the third quarter of 2005, the Company paid no interest on either its current or prior revolving credit facility. Interest expense for the three months and nine months ended June 30, 2004 and 2005 was incurred under this previous facility and included the following primary elements (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| Interest expense on borrowings, and unused commitment fees | $ 140 | $ 60 | $ 557 | $ 348 |
| Letter of credit fees | 130 | 82 | 339 | 306 |
| Amortization of deferred debt arrangement costs | 104 | 24 | 300 | 270 |
| Total | $ 374 | $ 166 | $ 1,196 | $ 924 |

When the Company's previous credit facility was terminated, deferred debt costs totaling $0.9 million were written off during the second quarter of 2005. This charge is reported as "Write off of debt costs" in the Company's consolidated statement of operations.

See Note 6 of the "Condensed Notes to Consolidated Financial Statements" for a detailed discussion of the interest rates and fees associated with the Facility.

Our borrowings and letters of credit outstanding under the Facility at each monthend must be less than a borrowing base measured as of the same monthend. The borrowing base is defined under the Facility as 65% of the following: total trade receivables including costs and estimated earnings in excess of billings, less allowances for doubtful accounts, less receivables related to projects that are subject to payment or performance bonds. The borrowing base as of September 30, 2005 was $86.8 million. This borrowing base is substantially greater than the current $75.0 million face-value limit of the Facility. We do not expect that this borrowing base provision will limit credit available under the Facility in the foreseeable future.

Our borrowings and letters of credit capacity under the Revolving Loan portion of the Facility at any given time is $75.0 million less borrowings and letters of credit outstanding, subject to the borrowing base described above. The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply, as discussed below under Covenants and Restrictions. Covenant compliance is measured as of each quarter-end. While the Facility's financial covenants do not specifically govern capacity under the Facility, if the Company's debt level under the Facility at a quarter-end covenant compliance measurement date were to cause the Company to violate the Facility's debt-to-Credit Facility Adjusted EBITDA covenant (described in more detail below), the Company's borrowing capacity under the Facility could be restricted by the lenders. Accordingly, available capacity amounts shown below are presented both on a financial covenant basis and on a Facility face value basis.

| | As of September 30, 2005 | As of November 1, 2005 |
|---|---|---|
| | (in thousands) | |
| Amounts Outstanding: | | |
| Revolving loan | $ — | $ — |
| Other non-Facility debt | — | — |
| Total debt | $ — | $ — |
| Letters of credit | $ 20,119 | $ 21,139 |
| Available Capacity: | | |
| Unused Revolving Loan and letter of credit capacity based on Revolving Loan face value of $75 million | $ 54,881 | $ 53,861 |

The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply. Covenant compliance is assessed as of each quarterend. Credit Facility Adjusted EBITDA is defined under the Facility for financial covenant purposes as net earnings for the four quarters ending as of any given quarterly covenant compliance measurement date, plus the corresponding amounts for (a) interest expense; (b) income taxes; (c) depreciation and amortization; and (d) other non-cash charges. The following is a reconciliation of Credit Facility Adjusted EBITDA to net income (in thousands):

| | |
|---|---|
| Net income | $ 13,344 |
| Discontinued operations—estimated gain on dispositions, net | (618) |
| Income taxes—continuing operations and discontinued operations | 10,449 |
| Mark-to-market warrant obligation | (8) |
| Interest expense, net | 776 |
| Write off of debt cost | 870 |
| Depreciation expense | 4,592 |
| Goodwill impairment—continuing operations and discontinued operations | 3,347 |
| Credit Facility Adjusted EBITDA | $ 32,752 |

The Facility's principal financial covenants include:

*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. Interest expense is defined under the Facility as interest expense for the four quarters ending as of any given quarterly covenant compliance



measurement date, excluding corresponding twelve-month amounts for (a) amortization of deferred debt arrangement costs; and (b) mark-to-market interest expense. Scheduled principal payments for this ratio are also measured for the twelve months ending as of any given quarterly covenant compliance measurement date. The Company's fixed charge coverage ratio as of September 30, 2005 as measured under this covenant was 18.9 as compared to a minimum covenant requirement of 1.50.

*Tangible Net Worth*—The Facility requires that the Company's tangible net worth not be less than the sum of (a) $100.5 million; (b) 50% of net income earned beginning April 1, 2005; and (c) the net proceeds of any equity transactions. For purposes of this ratio, the Facility defines tangible net worth as stockholders' equity less the book value of the following intangible assets: goodwill, patents, copyrights, licenses, franchises, trade names, trade secrets, and operating leases. The Facility also provides that for purposes of this ratio, net income excludes any goodwill impairment charges. The Company's tangible net worth as of September 30, 2005 as measured under this covenant was $130.3 million, as compared to a covenant minimum of $107.3 million.

*Debt to Credit Facility Adjusted EBITDA*—The Facility requires that the Company's ratio of debt to Credit Facility Adjusted EBITDA not exceed 2.5. The Company's debt-to-Credit Facility Adjusted EBITDA ratio as of September 30, 2005 as measured under this covenant was zero because the Company has no debt.

*Capital Expenditures*—The Facility limits capital expenditures to $20.0 million per year. The Company's capital expenditures during the nine months ended September 30, 2005 were $5.1 million.

*Other Restrictions*—The Facility limits payment of dividends and repurchase of shares by the Company to a combined maximum of $20.0 million per year, and otherwise limits non-Facility debt, capital lease obligations, acquisitions, investments, and sales of assets. Debt under the Facility is classified as long-term as the facility will expire in June 2009.

*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 30% of our business has required bonds. While we have enjoyed a longstanding relationship with our primary surety and we have recently added another surety to further 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 debt along with other contractual obligations as of September 30, 2005 (in thousands):

| | Twelve Months Ended June 30, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
| Revolving loan | $ — | $ — | $ — | $ — | $ — | $ — | $ — |
| Operating lease obligations | 8,345 | 7,357 | 5,960 | 4,390 | 2,004 | 5,848 | 33,904 |
| Total | $ 8,345 | $ 7,357 | $ 5,960 | $ 4,390 | $ 2,004 | $ 5,848 | $ 33,904 |

To estimate future interest payments, we used certain financial institution forecasts that project modest increases in the interest rate over the remaining term of the loans. Absent any significant commitments of capital for items such as capital expenditures, acquisitions, extraordinary dividends or share repurchases, it is reasonable to expect the Company to continue to maintain excess cash on its balance sheet. Therefore, we assumed that the Company would continue its current status of not utilizing any borrowings under its revolving loan.



As of September 30, 2005 we also have $20.1 million of letter of credit commitments, of which $0.1 million expire in 2005 and $20.0 million expire in 2006. 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 the majority of these letter of credit commitments expire in 2006, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually. In addition, given the estimated size and duration of funding of claims under our worker's compensation, auto liability and general liability insurance programs, we recently agreed with our insurers that we will increase the amounts of letters of credit posted with them by an additional $0.5 million in the fourth quarter of 2005 and an additional $0.5 million in the second quarter of 2006.

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 in each of the last five calendar years, most of which occurred during challenging economic and industry conditions. We also have no debt, significant borrowing capacity under our credit facility, and significant cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

**Seasonality and Cyclicality**

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.

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.

**New Accounting Pronouncements**

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued FASB Statement No. 123 (revised 2004), "Share-Based Payment," ("Statement 123(R)'') which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("Statement 123"). Statement 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("Opinion 25") and amends FASB Statement No. 95, "Statement of Cash Flows." Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

Statement 123(R) must be adopted no later than January 1, 2006. Early adoption will be permitted for periods in which financial statements have not yet been issued. We expect to adopt Statement 123(R) on January 1, 2006.



Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

We plan to adopt Statement 123(R) using the modified prospective method.

As permitted by Statement 123, we currently account for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognize no compensation cost for employee stock options in our results of operations. Accordingly, the adoption of Statement 123(R)'s fair value method will have a significant impact on our reported results of operations, although it will have no impact on our cash flows. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in Note 2 to our consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While we cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized for both of the first nine months of 2004 and 2005 for such tax benefits was $0.5 million and $0.7 million, respectively.

**ITEM 3.** ***Quantitative and Qualitative Disclosures about Market Risk***

We are exposed to market risk primarily related to potential adverse changes in interest rates. Management is actively involved in monitoring exposure to market risk and continues 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. Management does not use derivative financial instruments.

## ITEM 4. *Controls and Procedures*

**Evaluation of Disclosure Controls and Procedures**

The Company's 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 most recent fiscal year. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective at the reasonable assurance level to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported in accordance with and within the time periods specified in Securities and Exchange Commission rules and forms.



**Changes in Internal Control over Financial Reporting**

There has been no change in our internal control over financial reporting during the three months ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

## PART II—OTHER INFORMATION

### Item 1. *Legal Proceedings*

The Company is party to litigation and claims in the ordinary course of business including state and federal tax audits or disputes. The largest single unresolved matter to which the Company is party involves a construction project. If this matter were ultimately resolved on the least favorable terms to the Company, management estimates that it would incur a liability of approximately $2.5 million. However, management believes the likelihood of such a least-favorable outcome is remote, and believes its asset balances and accruals relating to this matter appropriately reflect a probable outcome. The Company's remaining litigation involves matters with significantly smaller individual potential losses.

The Company has estimated and provided accruals for probable losses and related legal fees associated with certain of its litigation in the accompanying consolidated financial statements. In management's opinion, uninsured losses resulting from the ultimate resolution of these matters will not have a material adverse effect on the Company's operating results or financial condition.

### Item 2. *Recent Sales of Unregistered Securities*

Following is a summary of the Company's repurchases of common stock during the three-month period ended September 30, 2005.

| Period | Total Number of Shares Purchased (a) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs |
|---|---|---|---|
| July 1-31 | — | $ — | — |
| August 1-31 | 20,241 | $ 7.98 | — |
| September 1-30 | — | $ — | — |
| Total | 20,241 | $7.98 | — |

(a) All of the shares repurchased during the three-month period ended September 30, 2005 were acquired from employees in connection with the settlement of income tax and related benefit withholding obligations arising from vesting in restricted stock grants. These share purchases were not part of a publicly announced program to purchase common shares.

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

(a) Exhibits

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.



(b) Reports on Form 8-K

(i) The Company filed a report on Form 8-K with the Securities and Exchange Commission on August 4, 2005 under Items 2.02 and 9.01. The report related to the Company's announcement of a press release reporting the Company's financial results for the second quarter of 2005.

(ii) The Company filed a report on Form 8-K with the Securities and Exchange Commission on August 11, 2005 under Item 1.01. The report related to the Company's amendment to the compensation for the Registrant's non-employee directors and extended the existing employment agreement with William George, Executive Vice President and Chief Financial Officer of the Company.



## SIGNATURES

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

COMFORT SYSTEMS USA, INC.

November 2, 2005

By: /s/ WILLIAM F. MURDY

William F. Murdy

*Chairman of the Board and*
*Chief Executive Officer*

| | | |
|---|---|---|
| November 2, 2005 | By: | /s/ WILLIAM GEORGE<br>William George<br>*Executive Vice President and*<br>*Chief Financial Officer* |

**Exhibit 31.1**

**RULE 13a-14(a) CERTIFICATION IN ACCORDANCE WITH SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, William F. Murdy, Chairman of the Board and Chief Executive Officer of Comfort Systems USA, Inc. (the “Company”), certify that:

1. I have reviewed this quarterly report on Form 10-Q of the Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15-d-15(f) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: November 2, 2005

By: /s/ WILLIAM F. MURDY
William F. Murdy
*Chairman of the Board and*
*Chief Executive Officer*

**RULE 13a-14(a) CERTIFICATION IN ACCORDANCE WITH SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, William George, Executive Vice President and Chief Financial Officer of Comfort Systems USA, Inc. (the "Company"), certify that:

1. I have reviewed this quarterly report on Form 10-Q of the Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2005

By: /s/ WILLIAM GEORGE
William George
*Executive Vice President and*
*Chief Financial Officer*

**Exhibit 32.1**

**CERTIFICATION PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

In connection with the Quarterly Report of Comfort Systems USA, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William F. Murdy, Chairman of the Board and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: November 2, 2005

By: /s/ WILLIAM F. MURDY
William F. Murdy
*Chairman of the Board and*
*Chief Executive Officer*

* A signed original of this written statement required by Section 906 has been provided to Comfort Systems USA, Inc. and will be retained by Comfort Systems USA, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**Exhibit 32.2**

**CERTIFICATION PURSUANT TO**
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

In connection with the Quarterly Report of Comfort Systems USA, Inc. (the “Company”) on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, William George, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: November 2, 2005

By: /s/ WILLIAM GEORGE
William George
*Executive Vice President and*
*Chief Financial Officer*

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* A signed original of this written statement required by Section 906 has been provided to Comfort Systems USA, Inc. and will be retained by Comfort Systems USA, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.