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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended September 30, 2004**

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

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

The number of shares outstanding of the issuer's common stock, as of October 29, 2004 was 39,158,292.

**COMFORT SYSTEMS USA, INC.**
**INDEX TO FORM 10-Q**
**FOR THE QUARTER ENDED SEPTEMBER 30, 2004**

**COMFORT SYSTEMS USA, INC.**

**CONSOLIDATED BALANCE SHEETS**

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

| | December 31, 2003 | September 30, 2004 |
|---|---|---|
| | | (Unaudited) |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 10,129 | $ 20,493 |
| Accounts receivable, less allowance for doubtful accounts of $5,010 and $4,723 | 167,567 | 176,227 |
| Other receivables | 5,171 | 4,888 |
| Inventories | 9,825 | 10,510 |
| Costs and estimated earnings in excess of billings | 16,162 | 22,825 |
| Prepaid expenses and other | 13,675 | 10,547 |
| Assets related to discontinued operations | 973 | — |
| Total current assets | 223,502 | 245,490 |
| PROPERTY AND EQUIPMENT, net | 13,223 | 12,529 |
| GOODWILL, net | 103,470 | 103,470 |
| OTHER NONCURRENT ASSETS | 10,915 | 9,262 |
| Total assets | $ 351,110 | $ 370,751 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | $ 1,594 | $ 2,076 |
| Accounts payable | 58,516 | 58,894 |
| Accrued compensation and benefits | 22,664 | 21,670 |
| Billings in excess of costs and estimated earnings | 29,657 | 35,213 |
| Income taxes payable | — | 1,701 |
| Other current liabilities | 26,746 | 29,864 |
| Liabilities related to discontinued operations | 122 | — |
| Total current liabilities | 139,299 | 149,418 |
| LONG-TERM DEBT, NET OF CURRENT MATURITIES | 8,809 | 7,273 |
| OTHER LONG-TERM LIABILITIES | 2,342 | 2,800 |
| Total liabilities | 150,450 | 159,491 |
| 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 shares issued | 393 | 393 |
| Treasury stock, at cost, 1,041,864 and 508,765 shares, respectively | (6,305) | (3,060) |
| Additional paid-in capital | 337,605 | 337,230 |
| Deferred compensation | (540) | (1,517) |
| Retained earnings (deficit) | (130,493) | (121,786) |
| Total stockholders' equity | 200,660 | 211,260 |
| Total liabilities and stockholders' equity | $ 351,110 | $ 370,751 |

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, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| REVENUES | $ 207,740 | $ 211,530 | $ 585,808 | $ 608,279 |
| COST OF SERVICES | 172,900 | 178,250 | 490,079 | 511,854 |
| Gross profit | 34,840 | 33,280 | 95,729 | 96,425 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 27,825 | 26,687 | 86,999 | 79,459 |
| RESTRUCTURING CHARGES | 949 | — | 3,223 | — |
| Operating income | 6,066 | 6,593 | 5,507 | 16,966 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | 29 | 40 | 80 | 83 |
| Interest expense | (1,107) | (374) | (2,752) | (1,196) |
| Write-off of debt costs | — | — | (823) | — |
| Other | 42 | (135) | (105) | (405) |
| Other income (expense) | (1,036) | (469) | (3,600) | (1,518) |
| INCOME BEFORE INCOME TAXES | 5,030 | 6,124 | 1,907 | 15,448 |
| INCOME TAX EXPENSE | 2,435 | 2,634 | 1,005 | 6,643 |
| INCOME FROM CONTINUING OPERATIONS | 2,595 | 3,490 | 902 | 8,805 |
| DISCONTINUED OPERATIONS: | | | | |
| Operating income, net of income tax expense of $229, $0, $454 and $27 | 353 | — | 715 | 39 |
| Estimated loss on disposition, including income tax expense of $43, $0, $274 and $235 | (2,773) | — | (3,685) | (137) |
| NET INCOME (LOSS) | $ 175 | $ 3,490 | $ (2,068) | $ 8,707 |
| INCOME (LOSS) PER SHARE: | | | | |
| Basic— | | | | |
| Income from continuing operations | $ 0.07 | $ 0.09 | $ 0.02 | $ 0.23 |
| Discontinued operations— | | | | |
| Income from operations | 0.01 | — | 0.02 | — |
| Estimated loss on disposition | (0.08) | — | (0.09) | — |
| Net income (loss) | $ — | $ 0.09 | $ (0.05) | $ 0.23 |
| Diluted— | | | | |
| Income from continuing operations | $ 0.07 | $ 0.09 | $ 0.02 | $ 0.22 |
| Discontinued operations— | | | | |
| Income from operations | 0.01 | — | 0.02 | — |
| Estimated loss on disposition | (0.08) | — | (0.09) | — |
| Net income (loss) | $ — | $ 0.09 | $ (0.05) | $ 0.22 |
| SHARES USED IN COMPUTING INCOME (LOSS) PER SHARE: | | | | |
| Basic | 37,713 | 38,418 | 37,659 | 38,298 |
| Diluted | 38,454 | 39,455 | 38,081 | 39,457 |

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 Compensation | Retained Earnings (Deficit) | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | |
| BALANCE AT DECEMBER 31, 2002 | 39,258,913 | $ 393 | (1,341,419) | $ (8,214) | $ 338,606 | $ (785) | $ (124,914) | $ 205,086 |
| Issuance of Treasury Stock: | | | | | | | | |
| Issuance of shares for options exercised including tax benefit | — | — | 332,041 | 2,009 | (907) | — | — | 1,102 |
| Shares received from sale of assets | — | — | (32,486) | (100) | — | — | — | (100) |
| Amortization of deferred compensation | — | — | — | — | (69) | 245 | — | 176 |
| Other | — | — | — | — | (25) | — | — | (25) |
| Net loss | — | — | — | — | — | — | (5,579) | (5,579) |
| BALANCE AT DECEMBER 31, 2003 | 39,258,913 | 393 | (1,041,864) | (6,305) | 337,605 | (540) | (130,493) | 200,660 |
| Issuance of Treasury Stock: | | | | | | | | |
| Issuance of shares for options exercised including tax benefit (unaudited) | — | — | 364,349 | 2,200 | (633) | — | — | 1,567 |
| Issuance of restricted stock (unaudited) | — | — | 225,000 | 1,353 | 361 | (1,714) | — | — |
| Forfeiture of unvested restricted stock (unaudited) | — | — | (56,250) | (308) | — | 259 | — | (49) |
| Amortization of deferred compensation (unaudited) | — | — | — | — | (128) | 478 | — | 350 |
| Other (unaudited) | — | — | — | — | 25 | — | — | 25 |
| Net income (unaudited) | — | — | — | — | — | — | 8,707 | 8,707 |
| BALANCE AT SEPTEMBER 30, 2004 (unaudited) | 39,258,913 | $ 393 | (508,765) | $ (3,060) | $ 337,230 | $ (1,517) | $ (121,786) | $ 211,260 |

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

## COMFORT SYSTEMS USA, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## (In Thousands)

## (Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Net income (loss) | $ 175 | $ 3,490 | $ (2,068) | $ 8,707 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities— | | | | |
| Estimated loss on disposition of discontinued operations | 2,773 | — | 3,685 | 137 |
| Restructuring charges | 949 | — | 3,223 | — |
| Write-off of debt costs | — | — | 823 | — |
| Depreciation expense | 1,301 | 1,315 | 4,024 | 3,617 |
| Bad debt expense | 420 | 428 | 1,888 | 1,623 |
| Deferred tax expense | 1,009 | 1,813 | 2,222 | 1,950 |
| Amortization of debt financing costs | 178 | 104 | 634 | 300 |
| Loss (gain) on sale of assets | (31) | 34 | 184 | (33) |
| Deferred compensation expense | 61 | 138 | 96 | 199 |
| Mark-to-market warrant obligation | 280 | 86 | 188 | 457 |
| Amortization of debt discount | 150 | — | 450 | — |
| Changes in operating assets and liabilities, net of effects of divestitures— | | | | |
| (Increase) decrease in— | | | | |
| Receivables, net | (7,401) | (10,161) | (5,938) | (10,336) |
| Inventories | 184 | 269 | 1,617 | (684) |
| Prepaid expenses and other current assets | (954) | (1,741) | (16) | 970 |
| Costs and estimated earnings in excess of billings | (559) | (554) | 1,196 | (6,665) |
| Other noncurrent assets | (30) | 438 | 138 | 573 |
| Increase (decrease) in— | | | | |
| Accounts payable and accrued liabilities | (4,000) | 3,432 | 607 | 6,409 |
| Billings in excess of costs and estimated earnings | (942) | 6,030 | 2,580 | 5,557 |
| Other, net | — | — | (19) | — |
| Taxes paid related to the sale of businesses | — | — | (10,371) | — |
| Net cash provided by (used in) operating activities | (6,437) | 5,121 | 5,143 | 12,781 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | | |
| Purchases of property and equipment | (714) | (963) | (2,661) | (3,180) |
| Proceeds from sales of property and equipment | 208 | — | 319 | 283 |
| Proceeds from businesses sold, net of cash sold and transaction costs | (4) | 156 | (2,754) | 1,266 |
| Net cash used in investing activities | (510) | (807) | (5,096) | (1,631) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | | |
| Net borrowings (payments) on revolving line of credit | 3,779 | — | 3,672 | — |
| Payments on other long-term debt | (399) | (533) | (1,402) | (1,086) |
| Borrowings of other long-term debt | — | — | 18 | 32 |
| Debt financing costs | (158) | (30) | (835) | (808) |
| Proceeds from exercise of options | 130 | 37 | 216 | 1,069 |
| Net cash provided by (used in) financing activities | 3,352 | (526) | 1,669 | (793) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (3,595) | 3,788 | 1,716 | 10,357 |
| CASH AND CASH EQUIVALENTS, beginning of period—continuing operations and discontinued operations | 11,415 | 16,705 | 6,104 | 10,136 |
| CASH AND CASH EQUIVALENTS, end of period—continuing operations and discontinued operations | $ 7,820 | $ 20,493 | $ 7,820 | $ 20,493 |

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

COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

(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 2004 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 2004 revenues to date: HVAC—74%, plumbing—13%, building automation control systems—6%, and other—7%. 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, 2003 (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 the nine months ended September 30, 2003 and 2004 was approximately $1.4 million and $0.7 million, respectively. Cash paid for income taxes for continuing operations for the nine months ended September 30, 2003 and 2004 was approximately $1.8 million and $4.4 million, respectively. Cash paid for income taxes for discontinued operations for the nine months ended September 30, 2003 and 2004 was approximately $9.0 million and $0.4 million, respectively. The cash tax payments for 2003 include approximately $10.4 million associated with the sale in 2002 of 19 operations to Emcor Group, Inc. ("Emcor"). These taxes are included in the caption "Taxes paid related to the sale of businesses" in the accompanying Consolidated Statement of Cash Flows.

***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 include revenue and cost recognition for construction contracts, allowance for doubtful accounts, self-insurance 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.

The Company's effective tax rate associated with results from continuing operations for the third quarter of 2004 was 43.0% as compared to 48.4% in 2003. For the first nine months of 2004 and 2003, the Company's corresponding effective tax rates were 43.0% and 52.7%, respectively. The Company's effective rate is generally higher than statutory rates because of the effect of certain expenses that it incurs that are not deductible for tax purposes, and due to reserves that the Company has established against certain deferred tax assets based on the possibility that it will not be able to ultimately realize the tax benefit for certain losses it has incurred, primarily at the state income tax level. In addition, since the Company's recent pre-tax profit margins have been relatively low on a historical and an absolute basis, the impact of non-deductible expenses and deferred tax reserves on the Company's effective rate is magnified. This latter impact also contributes to the higher level of the Company's 2003 effective rates as compared to 2004, as its pre-tax profit levels were noticeably lower in 2003 than in 2004.

***Stock-Based Compensation***

The Company accounts for its stock-based compensation using the intrinsic value method under Accounting Principles Board Statement No. 25, "Accounting for Stock Issued to Employees" ("APB 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 Financial Accounting Standards Board ("FASB") issued SFAS No. 123, "Accounting for Stock-Based Compensation," which requires that if a company accounts for stock-based compensation in accordance with APB 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, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Net Income (Loss) as reported | $ 175 | $ 3,490 | $ (2,068) | $ 8,707 |
| Add: Stock-based compensation included in reported net income, net of tax | 40 | 90 | 62 | 129 |
| Less: Compensation expense per SFAS No. 123, net of tax | (479) | (95) | (1,953) | (1,027) |
| Pro forma Net Income (Loss) | $ (264) | $ 3,485 | $ (3,959) | $ 7,809 |
| Net Income (Loss) Per Share—Basic | | | | |
| Net Income (Loss) per share as reported | $ — | $ 0.09 | $ (0.05) | $ 0.23 |
| Pro forma Net Income (Loss) per share | $ (0.01) | $ 0.09 | $ (0.11) | $ 0.20 |
| Net Income (Loss) Per Share—Diluted | | | | |
| Net Income (Loss) per share as reported | $ — | $ 0.09 | $ (0.05) | $ 0.22 |
| Pro forma Net Income (Loss) per share | $ (0.01) | $ 0.09 | $ (0.10) | $ 0.20 |

One element of determining the pro forma expense for stock-based compensation per SFAS No. 123 included in the above table is an estimate of the amount of forfeitures of stock-based compensation awards the Company will experience. The Company updated its estimates of forfeitures during the third quarter to more fully reflect the forfeiture activity it has observed over recent periods. This update resulted in an increase in forfeiture estimates, which in turn resulted in a lower pro forma expense amount for the third quarter than the Company generally experiences. Management believes that the effect of these increased forfeiture estimates and corresponding decreases in pro forma expense are not material.

*Stock Option Plans*—The effects of applying SFAS No. 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:

| | 2003 | 2004 |
|---|---|---|
| Expected dividend yield | 0.00% | 0.00% |
| Expected stock price volatility | 62.08% | 61.30% |
| Risk-free interest rate | 2.94%-3.64% | 3.96%-4.38% |
| Expected life of options | 7 years | 7 years |

***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. Discontinued Operations

*Individual Sales of Operating Companies*—During the second quarter of 2004, the Company sold a small operating company. This unit's after-tax income of $0.1 million for the first nine months of 2003 and less than $0.1 million for the first six months of 2004 has been reported in discontinued operations under "Operating income, net of income tax expense". The Company recorded a loss on the sale of this unit of $0.5 million, including taxes, in the second quarter of 2004 in discontinued operations under "Estimated loss on disposition, including income tax expense". The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the fourth quarter of 2003, the Company sold a small operating company. This unit's after-tax income of $0.3 million for the nine months ended September 30, 2003 has been reported in discontinued operations under "Operating income, net of income tax expense." The Company recorded a loss of $1.5 million, net of tax benefit, in the fourth quarter of 2003 in discontinued operations under "Estimated loss on disposition, including income tax expense." The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the third quarter of 2003, the Company committed to a plan to divest of a small operating company. This unit's after-tax income of $0.2 million for the nine months ended September 30, 2003 has been reported in discontinued operations under "Operating income, net of income tax expense." The Company recorded an estimated loss of $2.8 million, including taxes, in the third quarter of 2003 related to this planned disposition in discontinued operations under "Estimated loss on disposition, including income tax expense" based upon an estimated sales price. The final loss as measured at the closing of this sale in the fourth quarter of 2003 was not materially different than the estimate recorded in the preceding quarter. The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the first quarter of 2003, the Company committed to a plan to divest of a small operating company. This unit's after-tax income of $0.1 million for the six months ended June 30, 2003 has been reported in discontinued operations under "Operating income, net of income tax expense." The Company recorded an estimated loss of $0.9 million, including tax expense, in the first quarter of 2003 related to this transaction in discontinued operations under "Estimated loss on disposition, including income tax expense." The final loss as measured at the closing of this sale in the second quarter of 2003 was not materially different than the estimate recorded in the preceding quarter. The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

Assets and liabilities related to the operation sold in the second quarter of 2004 were as follows (in thousands):

| | | December 31, 2003 |
|---|---|---|
| Cash | $ | 7 |
| Accounts receivable, net | | 372 |
| Other current assets | | 22 |
| Property and equipment, net | | 8 |
| Goodwill, net | | 564 |
| Total assets | $ | 973 |
| | | |
| Accounts payable | $ | 50 |
| Other current liabilities | | 72 |
| Total liabilities | $ | 122 |

Revenues and pre-tax income related to the operations discontinued in 2003 and 2004 were as follows (in thousands):

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2003 | 2004 |
| Revenues | $ 12,753 | $ 684 |
| Pre-tax income | $ 1,169 | $ 66 |

*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 realized an aggregate loss of $11.5 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 tax expense" in connection with the Emcor transaction. This charge primarily relates to a settlement with Emcor for reimbursement of impaired assets and additional liabilities associated with the operations acquired from the Company. 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. During May 2003, the Company paid $2.7 million in cash to Emcor associated with this settlement. The settlement agreement also included the use of $2.5 million of the $5 million escrow described above to fund settled claims. The Company further recognized an additional $1.5 million of the remaining escrow applicable to elements of the settlement still to be funded, of which $0.8 million was paid from escrow during September 2003 and an additional $0.2 million was paid from escrow during May 2004. 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 this additional charge. In addition, the $1.2 million charge recognized during the fourth quarter of 2002 is also net of a tax credit of $1.3 million 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.

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. This amount was reflected in discontinued operations in the second quarter of 2004 as a reduction in the estimated loss on disposition of discontinued operations.

**4. 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 $0.5 million in 2004 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.

The Company also recorded restructuring charges in 2000 and 2002. As of December 31, 2003 and September 30, 2004, accrued lease termination costs of $0.6 million and $0.3 million, respectively, remain that were associated with the restructuring charges recorded during 2000 and 2002.

The following table shows the remaining liabilities associated with the cash portion of the restructuring charges as of December 31, 2003 and September 30, 2004 (in thousands):

| | Balance at Beginning of Period | Additions | Payments | Balance at End of Period |
|---|---|---|---|---|
| **Year Ended December 31, 2003:** | | | | |
| Severance | $ — | $ 1,507 | $ (1,507) | $ — |
| Lease termination costs and other | 1,000 | 1,716 | (971) | 1,745 |
| Total | $ 1,000 | $ 3,223 | $ (2,478) | $ 1,745 |
| **Nine Months Ended September 30, 2004:** | | | | |
| Lease termination costs and other | $ 1,745 | $ 478(a) | $ (877) | $ 1,346 |

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

## 5. Long-Term Debt Obligations

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

| | December 31, 2003 | September 30, 2004 |
|---|---|---|
| Revolving credit facility | $ — | $ — |
| Term loan | 10,000 | 9,000 |
| Other | 403 | 349 |
| Total debt | 10,403 | 9,349 |
| Less—current maturities | (1,594) | (2,076) |
| Total long-term portion of debt | $ 8,809 | $ 7,273 |

***Credit Facility***

On December 31, 2003, the Company entered into a senior credit facility (the "Facility") provided by a syndicate of banks. As of September 30, 2004 the total of the Facility was $54.0 million, with $26.3 million in borrowings and letters of credit outstanding, and $27.7 million of credit available. As of October 29, 2004, the total of the Facility was $53.5 million, with $25.8 million in borrowings and letters of credit outstanding, and $27.7 million of credit available. The Facility consists of two parts: a term loan and a revolving credit facility.

The original term loan under the Facility (the "Term Loan") was $10 million, which the Company borrowed upon the closing of the Facility. The Term Loan must be repaid in installments of $0.5 million payable at the beginning of each quarter over five years, the first installment of which was paid in the second quarter of 2004. The Facility requires prepayments of the Term Loan in certain circumstances generally involving the sale of assets. All principal payments under the Term Loan permanently reduce the original $10 million capacity under this portion of the Facility.

The Facility also included a three-year $40 million revolving credit facility (the "Revolving Loan") available for borrowings or letters of credit. This was increased to $45 million in the second quarter of 2004. The Facility requires that borrowings outstanding under the Revolving Loan must be less than $2 million for ten consecutive business days at least once during each year. The Company has already satisfied this condition for 2004.

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 Revolving Loan portion of 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. Depending on the circumstances of such a reimbursement, the Company may also have to record a charge to earnings for the reimbursement. Claims against letters of credit are rare in the Company's industry. The Company has never had a claim made against a letter of credit that resulted in payments by the issuer of the letter of credit or by the Company. The Company believes that it is unlikely that it will have to fund claims under a letter of credit 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 60% 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, 2004 was $92.8 million. This borrowing base is substantially greater than the current $53.5 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 $45 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 quarterend. 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 quarterend covenant compliance measurement date caused the Company to violate the Facility's debt-to-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, 2004 | As of October 29, 2004 |
|---|---|---|
| | (in thousands) | |
| *Amounts Outstanding* | | |
| Revolving loan | $ — | $ — |
| Term loan | 9,000 | 8,500 |
| Other non-Facility debt | 349 | 346 |
| Total debt | $ 9,349 | $ 8,846 |
| Letters of credit | $ 17,280 | $ 17,280 |
| *Available Capacity* | | |
| Unused Revolving Loan and letter of credit capacity based on Revolving Loan face value of $45 million | $ 27,720 | $ 27,720 |
| Unused Revolving Loan and letter of credit capacity based on quarterend debt-to-EBITDA covenant | $ 27,720 | n/a |

If the Company voluntarily terminates the Facility in full before December 31, 2004, it would owe the Facility's lenders a termination fee of $0.5 million. The Company may voluntarily terminate the Facility in full on or after December 31, 2004 without a termination fee. Short of a full termination, the Company may not reduce the Revolving Loan commitment within the Facility prior to December 31, 2004. During the second year of the Facility, the Company may voluntarily reduce the Revolving Loan commitment by as much as $5 million. During the third year of the Facility, the Company may voluntarily reduce the Revolving Loan commitment by as much as $10 million, less any reductions it made prior to the third year of the Facility.

***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, 2004, the amount of these assets was approximately $44.2 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 for Term Loan and Revolving Loan borrowings, respectively. 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 ("EBITDA") for the twelve months ending as of that quarterend, as shown below. 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 Term Loan and Revolving Loan borrowings, respectively, based on the Company's ratio of debt to EBITDA, as shown below.

Letter of credit fees under the Facility are also based on the Company's ratio of debt to 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, 2004 relating to interest options under the Facility:

| | |
|---|---|
| Base Rate Option—The higher of: | |
| Federal Funds Rate plus 0.50% | 2.25% |
| Citibank, N.A. Prime Rate | 4.75% |
| | |
| Eurodollar Rate Option | |
| One-month LIBOR | 1.84% |
| Six-month LIBOR | 2.20% |

| | Debt to EBITDA | | |
|---|---|---|---|
| | **Less than 0.75** | **0.75 to 1.50** | **1.50 or greater** |
| Additional Per Annum Interest Margin Added Under: | | | |
| Term Loan— | | | |
| Base Rate Option | 1.75% | 2.25% | 2.75% |
| Eurodollar Rate Option | 2.75% | 3.25% | 3.75% |
| Revolving Loan— | | | |
| Base Rate Option | 1.50% | 2.00% | 2.50% |
| Eurodollar Rate Option | 2.50% | 3.00% | 3.50% |
| Per Annum Letter of Credit Fees (not added to underlying Base Rate or Eurodollar Rate) | 1.875% | 2.25% | 2.625% |

Commitment fees of 0.375% 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 $1.2 million in financing and professional costs in connection with the arrangement and the closing of the Facility. These costs will be amortized as a noncash charge to interest expense over the term of the Facility in an amount of approximately $0.4 million per year for the first three years of the Facility, and less than $0.1 million per year during the fourth and fifth years of the Facility. To the extent prepayments of the Term Loan are made or the size of the Facility is reduced, the Company may have to accelerate amortization of these deferred financing and professional costs.

The weighted average interest rate that the Company has paid on borrowings under the Facility during 2004 is 5.2% per annum. This reflects a combination of borrowings under both interest rate options described above, as well as a transaction in which the interest rate relating to $10 million in principal value of debt was fixed at 5.12% through early July, 2004. These rates do not include amortization of debt financing and arrangement costs or mark-to-market adjustments for derivatives. Following the expiration in early July, 2004 of the fixed interest commitment referred to above, the Company estimates that its weighted average interest rate, now entirely on a floating basis, is currently approximately 4.6%.

***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. 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 Facility's principal financial covenants include:

*Debt Service Coverage Ratio*—The Facility requires that the ratio of EBITDA to the sum of interest expense and scheduled principal payments be at least 2.50. Interest expense is defined under the Facility for purposes of this covenant 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 Facility provides, however, that during the first three quarters of 2004, interest expense and scheduled principal payments used in this ratio will be the annualized amounts of actual year-to-date interest expense and scheduled principal payments, instead of actual amounts for these items for the twelve months then ended. The Company's debt service coverage ratio as of September 30, 2004 as measured under this covenant was 7.56 as compared to a minimum covenant requirement of 2.50.

*Tangible Net Worth*—The Facility requires that the Company's tangible net worth not be less than the sum of (a) $75.4 million; (b) 75% of net income earned beginning October 1, 2003; 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, 2004 as measured under this covenant was $107.8 million, as compared to a covenant minimum of $84.3 million.

*Debt to EBITDA*—The Facility requires that the Company's ratio of debt to EBITDA not exceed 2.0. The Company's debt-to-EBITDA ratio as of September 30, 2004 as measured under this covenant was 0.37.

*Capital Expenditures*—The Facility limits capital expenditures to $8.0 million per year. The Company's capital expenditures during the nine months ended September 30, 2004 were $3.2 million.

*Other Restrictions*—The Facility prohibits payment of dividends and repurchase of shares by the Company, and limits non-Facility debt, capital lease obligations, acquisitions, investments, and sales of assets. The Facility also includes a customary provision under which the lenders may demand immediate repayment of borrowings and disposition of letters of credit if they conclude that the Company's business or financial position has suffered a material adverse change. However, the Facility does not include any mechanisms allowing the lenders immediate access to the Company's ongoing cash flow in the event of a default or an immediate repayment demand by the lenders. In view of the Company's financial position, and what management believes are its prospects for profitability and positive cash flow in the future, the Company believes that the probability that its lenders will invoke the Facility's material adverse change provision in the foreseeable future is remote. As a result, debt under the Facility is classified as long-term, other than amounts due within one year.

***Interest Expense and Related Charges***

The credit facility that preceded the Company's current one was in place from October, 2002 to December, 2003. Interest expense for the three months and nine months ended September 30, 2003 and 2004 included the following primary elements (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Interest expense on borrowings, and unused commitment fees | $ 349 | $ 140 | $ 1,125 | $ 557 |
| Letter of credit fees | 150 | 130 | 355 | 339 |
| Amortization of deferred debt arrangement costs and discount | 328 | 104 | 1,084 | 300 |
| Mark-to-market adjustments on derivatives | 280 | — | 188 | — |
| Total | $ 1,107 | $ 374 | $ 2,752 | $ 1,196 |

When the Company's previous credit facilities were reduced in size or terminated, corresponding amounts of deferred debt arrangement costs were written off. During the three months ended March 31, 2003, the Company wrote off $0.8 million of deferred financing fees due to a reduction in the size of the Company's credit facility. This charge is reported as "Write-off of debt costs" in the Company's consolidated statement of operations.

## 6. Commitments and Contingencies

***Claims and Lawsuits***

The Company is party to litigation in the ordinary course of business. 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. These bonds provide a guarantee to the customer that the Company will perform under the terms of a contract and that the Company will pay subcontractors and vendors who provided goods and services under a contract. If the Company fails to perform under a contract or to pay subcontractors and vendors, the customer may demand that the surety make payments or provide services under the bond. The Company must reimburse the surety for any expenses or outlays it incurs. To date, the Company is not aware of any losses to its surety in connection with bonds the surety has posted on the Company's behalf, and does not expect such losses to be incurred in the foreseeable future.

Surety market conditions are currently difficult as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% of the Company's business has required bonds. While the Company has enjoyed a longstanding relationship with its surety, current market conditions as well as changes in the surety's assessment of the Company's operating and financial risk could cause the surety 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 performance 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 semi-annually.

## 7. Stockholders' Equity

***Restricted Stock Grants***

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 are subject to full forfeiture if the Company does not meet certain performance levels for the twelve-month period ending June 30, 2005. 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 a three-year or four-year period that started on the date of grant.

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 for nominal consideration. The warrant was exercised in October, 2004.

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. In connection with this waiver, the Company recognized a $1.3 million gain in December 2003 associated with the reduction in the value of the warrant and put obligation. This gain was also included in the "Write-off of debt costs and discount, net" caption.

As noted above, the warrant was exercised 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, $2.8 million reflected under Other Long-Term Liabilities as of September 30, 2004, has been eliminated as an obligation and added to stockholders' equity in October.

While the warrant and put were outstanding, their value changed over time, principally in response to changes in the market price of the Company's 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, 2003, these adjustments were a loss of $0.2 million, and were included in interest expense because the warrant and put related to the Company's then-existing credit facility. Because the warrant and put did not relate to the Company's current credit facility, mark-to-market adjustments during the nine months ended September 30, 2004, which were losses of $0.5 million, are 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.

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 of the Company, or (iii) in the event any person offers to acquire 15% or more of the total number of outstanding shares of Common Stock of the Company. 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 have been previously converted into shares of Common Stock. As of September 30, 2004, there were 1,067,099 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 Company's common stock ("Common Stock") for a given period would increase calculated EPS. This impact is called "anti-dilutive." Generally accepted accounting principles for determining EPS also 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 0.9 million shares of Common Stock at prices ranging from $6.64 to $21.438 per share which were outstanding for the three months ended September 30, 2004, and options to purchase 1.6 million shares at prices ranging from $7.00 to $21.438 per share which were outstanding for the nine months ended September 30, 2004, were not included in the computation of diluted EPS because they were anti-dilutive. Options to purchase 3.0 million shares of Common Stock at prices ranging from $3.8125 to $21.438 per share which were outstanding for the three months ended September 30, 2003, and options to purchase 3.1 million shares at prices ranging from $3.39 to $21.438 per share which were outstanding for the nine months ended September 30, 2003, were not included in the computation of diluted EPS because they were anti-dilutive.

The following table summarizes information regarding the Company's outstanding stock options as of September 30, 2003 and 2004:

| | Number of Options Outstanding | |
|---|---|---|
| **Exercise Price** | **September 30, 2003** | **September 30, 2004** |
| $1.90 | 952,000 | 710,250 |
| $2.14 | 10,000 | 10,000 |
| $2.19 | 10,000 | 10,000 |
| $2.25 | 327,500 | 232,500 |
| $2.34 | 52,000 | 500 |
| $2.36 | 50,000 | 50,000 |
| $2.43 | 10,000 | 10,000 |
| $2.875 | 1,535,058 | 1,056,735 |
| $3.39 | 110,000 | 10,000 |
| $3.8125 | 500,000 | 500,000 |
| $3.86 | 79,000 | 79,000 |
| $4.18 | — | 102,500 |
| $4.24 | 15,000 | 15,000 |
| $4.77 | 40,000 | 40,000 |
| $6.00 | 193,500 | 153,000 |
| $6.64 | — | 55,000 |
| $6.75 | 5,000 | 5,000 |
| $7.00 | — | 50,000 |
| $7.625 | 37,700 | 34,700 |
| All other outstanding options with prior grant dates with exercise prices ranging from $11.75 to $21.438 | 2,142,031 | 826,059 |
| | 6,068,789 | 3,950,244 |

As noted above, the Company issued a warrant to purchase 409,051 shares of Company 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 the reporting period, 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 months and nine months ended September 30, 2003 and 2004, the effect of the warrant was excluded from earnings per share amounts for those periods. As a result of the warrant's exercise in October 2004, its related shares have now become part of the Company's issued and outstanding common shares.

The following tables reconcile the income from continuing operations and the net income (loss) on the statement of operations with the corresponding earnings (losses) that are 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, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Income from continuing operations used in computing earnings per share—basic | $ 2,595 | $ 3,490 | $ 902 | $ 8,805 |
| Mark-to-market adjustment related to warrant and put obligation (after tax) | — | — | — | — |
| Income from continuing operations used in computing earnings per share—diluted | $ 2,595 | $ 3,490 | $ 902 | $ 8,805 |
| Net income (loss) used in computing earnings per share—basic | $ 175 | $ 3,490 | $ (2,068) | $ 8,707 |
| Mark-to-market adjustment related to warrant and put obligation (after tax) | — | — | — | — |
| Net income (loss) used in computing earnings per share—diluted | $ 175 | $ 3,490 | $ (2,068) | $ 8,707 |

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, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Common shares outstanding, end of period(a) | 37,738 | 38,425 | 37,738 | 38,425 |
| Effect of using weighted average common shares outstanding | (25) | (7) | (79) | (127) |
| Shares used in computing earnings per share—basic | 37,713 | 38,418 | 37,659 | 38,298 |
| Effect of shares issuable under stock option plans based on the treasury stock method | 516 | 998 | 197 | 1,108 |
| Effect of shares issuable related to warrants | — | — | — | — |
| Effect of contingently issuable restricted shares | 225 | 39 | 225 | 51 |
| Shares used in computing earnings per share—diluted | 38,454 | 39,455 | 38,081 | 39,457 |

(a) Excludes 225,000 and 325,000 shares of unvested contingently issuable restricted stock outstanding as of September 30, 2003 and 2004, respectively (see "Restricted Stock Grants" above).

**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, 2003 (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 80% 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, 2004, we had 4,690 projects in process. Our average project takes three to six months to complete, with an average contract price of approximately $226,000. 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, 2004, we had one project in process with a contract price of $20.5 million, six projects between $10 million and $15 million, eleven projects between $5 million and $10 million, and 161 projects between $1 million and $5 million. Taken together, projects with contract prices of $1 million or more totaled $503.3 million of aggregate contract value as of September 30, 2004, out of a total contract value for all projects in progress of $1,061.7 million. Generally, projects closer in size to $1 million will be completed in a 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 20% 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 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. Since December 1999, we have not acquired any additional companies. Further, since that time, we have sold or ceased operations at 35 companies. We have consolidated another 14 companies into other operations, such that today we have 44 operating units.

Beginning in the fourth quarter of 1999, we shifted our strategy from an emphasis on acquisition-based growth to a focus on improving the performance of our existing operations. Significantly, on March 1, 2002, we sold 19 operations to Emcor Group, Inc. for $186.25 million, including Emcor's assumption of approximately $22.1 million of subordinated notes to former owners of certain of the divested companies. We used the proceeds from this sale to reduce debt. We recognized a loss, including taxes, of $11.5 million and a goodwill impairment charge prior to the sale of $32.4 million, net of taxes, related to the sold operations. For a further discussion of this sale, see Note 3, "Discontinued Operations," in the notes to the historical consolidated Financial Statements.

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 4.5% over the last two decades.

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.

Most of the HVAC equipment we install is provided by four large manufacturers. We regularly seek the views of these manufacturers about trends in the commercial HVAC sector. We also evaluate HVAC equipment shipment statistics reported monthly by the Air Conditioning and Refrigeration Institute, which is the principal industry organization of HVAC equipment manufacturers. We believe that many owners of installed HVAC equipment have deferred maintenance and replacement activity during the very challenging economic conditions of the last several years. We also believe that this trend will not continue indefinitely due to the fundamental mechanical nature of the equipment. The large HVAC manufacturers have each made public statements supporting this view. However, there can be no assurance of whether or when we might actually experience increased demand for HVAC service and replacement.

***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 began to see improvement in both industry activity as well as our own results in late 2003 and in the first half of 2004, as discussed further under "Results of Operations" below.

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. 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. Our efforts in this area continued in the quarter just ended, as we took further steps to consolidate operations and reduce costs at our Northern California and Salt Lake City units, both of which have been underperforming operations for some time. We believe these operations are now at or near breakeven levels and should produce profits over upcoming quarters, although there can be no assurance that we will achieve this outcome. We currently have 44 operating units. While it would be unusual in a group of this size to have no underperforming units even in better market conditions, we expect to have fewer units with significantly decreased operating results or losses in 2004 than we had in 2003. During the first nine months of 2004 we have experienced operating losses at four units, and those losses in the aggregate have been significantly less than the losses we incurred in 2003.

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 25% of our work. Accordingly, cash flow and debt reduction have been 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, net of cash, is now at zero. At the end of 2003, we put a new credit facility in place with considerably less restrictive and more traditional terms than those of our previous facilities. Further, we believe our relationship with our surety provider, which has been effective over recent years, continues to improve in light of our strong recent results and financial position. We have generated positive free cash flow in fourteen of the last eighteen quarters, and will continue our emphasis in this area. However, we expect that we will have to devote noticeably fewer management and organizational resources to debt and capital structure matters in 2004 than we have in recent years.

As discussed at greater length in "Results of Operations" below, we have seen increased activity levels in our industry in 2004, along with indications that increases may continue in 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 for 2004 will be 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.

There has been substantial cost inflation in 2004 in certain commodities that are used in construction activity, including steel, iron, copper, lumber, and polyvinyl chloride ("PVC") pipe. We estimate that direct purchase of these commodities, principally steel, iron and copper, comprises between 10% and 15% of our average project cost. As noted below in "Results of Operations," for some of the project work we have performed in 2004, the actual cost of certain commodities necessary for these projects was significantly greater than the commodity cost estimates we used when we committed to prices for these projects, which typically was done in 2003 before commodity cost inflation became apparent. We experienced most of the negative effect of this unrecovered commodity cost inflation in the second quarter of this year. On an ongoing basis, we began taking steps early in 2004 to reduce future commodity cost exposure, such as early buying of commodities for particular projects, or for general inventory, as well as including escalation and escape provisions in project bids and contracts. Based on our project experience so far as well as the mitigating steps we have taken, we believe the negative effect of commodity cost inflation specific to our activity will only have a modest impact on our 2004 results. Following our second quarter impact, we experienced virtually no unrecovered cost inflation in the third quarter. However, commodity markets remain unsettled, and while we are taking steps as noted above to minimize unrecoverable commodity cost inflation, these steps cannot guarantee that we will avoid all such exposure. More broadly, it is also possible that further increases in or uncertainty about commodity costs will decrease demand for nonresidential construction activity, which could in turn reduce our future revenues. To date, though, we have not seen an identifiable negative effect of commodity costs on activity in our industry.

Based on indications of stabilizing industry conditions and on our emphasis on internal execution and margin improvement, we expect that our 2004 results will be significantly better than our 2003 results, and that we have reasonable prospects for continued profitability in 2005, although there can be no assurance that we will achieve these outcomes. Over the longer term, if industry conditions are stable to improving, we believe we will experience more periods of increased revenues. In addition, while we would not rule out growth by acquisition, particularly in view of how fragmented our industry is, we have no current acquisition plans, and believe it is likely that any acquisitions we might consider during the near term would be relatively modest.

*Critical Accounting Policies*

In response to the Securities and Exchange 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 80% 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 (net of estimated rebates), labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. 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. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments. Our contracts typically provide for a schedule of billings or invoices to the customer based on reaching agreed upon milestones or as we incur costs, although the billing schedule usually does 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.

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. We do not recognize revenues or margin based on change orders or claims until they have been agreed upon with the customer, with immaterial exceptions. 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. Inherent in the assessment of the allowance for doubtful accounts are certain judgments and estimates including, among others, the creditworthiness of the customer, our prior collection history with the customer, the 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 semi-annually. 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 the 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 at least annually at the end of each fiscal year. The estimation of required valuation allowances includes 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 the scheduled reversal of deferred tax liabilities, 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. 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, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | | 2004 | | 2003 | | 2004 | |
| Revenues | $ 207,740 | 100.0% | $ 211,530 | 100.0% | $ 585,808 | 100.0% | $ 608,279 | 100.0% |
| Cost of services | 172,900 | 83.2% | 178,250 | 84.3% | 490,079 | 83.7% | 511,854 | 84.1% |
| Gross profit | 34,840 | 16.8% | 33,280 | 15.7% | 95,729 | 16.3% | 96,425 | 15.9% |
| Selling, general and administrative expenses | 27,825 | 13.4% | 26,687 | 12.6% | 86,999 | 14.9% | 79,459 | 13.1% |
| Restructuring charges | 949 | 0.5% | — | — | 3,223 | 0.6% | — | |
| Operating income | 6,066 | 2.9% | 6,593 | 3.1% | 5,507 | 0.9% | 16,966 | 2.8% |
| Interest expense, net | (1,078) | (0.5)% | (334) | (0.2)% | (2,672) | (0.5)% | (1,113) | (0.2)% |
| Write-off of debt costs | — | — | — | — | (823) | (0.1)% | — | — |
| Other expense (income) | 42 | — | (135) | (0.1)% | (105) | — | (405) | (0.1)% |
| Income before income taxes | 5,030 | 2.4% | 6,124 | 2.9% | 1,907 | 0.3% | 15,448 | 2.5% |
| Income tax expense | 2,435 | | 2,634 | | 1,005 | | 6,643 | |
| Income from continuing operations | 2,595 | 1.2% | 3,490 | 1.6% | 902 | 0.2% | 8,805 | 1.4% |
| Discontinued operations— | | | | | | | | |
| Operating results, net of tax | 353 | | — | | 715 | | 39 | |
| Estimated loss on disposition, including tax | (2,773) | | — | | (3,685) | | (137) | |
| Net income (loss) | $ 175 | | $ 3,490 | | $ (2,068) | | $ 8,707 | |

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

The following table presents information excluding operations we have sold or shut down that did not qualify for presentation as discontinued operations under generally accepted accounting principles in our historical income statement. This table also excludes from operating income restructuring charges and goodwill impairment charges in 2003.

We have included this table because we believe it offers an additional view of the core results of our ongoing operations in a way 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 income 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. In particular, while this table excludes restructuring charges, we have recorded them in each of the previous three years. In addition, impairment charges under the recently changed goodwill accounting rules are generally expected to occur periodically as goodwill recognized in connection with the acquisition of businesses responds over time to changes in those businesses' markets and operations.

| | 2003 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | % | O2 | % | Q3 | % | Q4 | % | Total | % |
| Revenues | $ 179,269 | | $ 198,799 | | $ 207,740 | | $ 197,363 | | $ 783,171 | |
| Divested units not reflected in discontinued operations | (4,037) | | — | | (4) | | — | | (4,041) | |
| Revenues from ongoing operations | 175,232 | 100.0% | 198,799 | 100.0% | 207,736 | 100.0% | 197,363 | 100.0% | 779,130 | 100.0% |
| Cost of services | 152,277 | | 164,902 | | 172,900 | | 167,246 | | 657,325 | |
| Divested units not reflected in discontinued operations | (4,021) | | (16) | | (9) | | — | | (4,046) | |
| Cost of services from ongoing operations | 148,256 | 84.6% | 164,886 | 82.9% | 172,891 | 83.2% | 167,246 | 84.7% | 653,279 | 83.8% |
| Gross profit from ongoing operations | 26,976 | 15.4% | 33,913 | 17.1% | 34,845 | 16.8% | 30,117 | 15.3% | 125,851 | 16.2% |
| Selling, general and administrative expenses | 30,412 | | 28,762 | | 27,825 | | 27,031 | | 114,030 | |
| Divested units not reflected in discontinued operations | (723) | | (20) | | (11) | | — | | (754) | |
| Selling, general and administrative expenses from ongoing operations | 29,689 | 16.9% | 28,742 | 14.5% | 27,814 | 13.4% | 27,031 | 13.7% | 113,276 | 14.5% |
| Operating income (loss) from ongoing operations excluding goodwill impairment and restructuring charges | (2,713) | (1.5)% | 5,171 | 2.6% | 7,031 | 3.4% | 3,086 | 1.6% | 12,575 | 1.6% |
| Interest expense, net | (542) | (0.3)% | (1,052) | (0.5)% | (1,078) | (0.5)% | (1,155) | (0.6)% | (3,827) | (0.5)% |
| Other income (expense) | (249) | (0.1)% | 102 | 0.1% | 42 | — | (73) | — | (178) | — |
| Income (loss) from ongoing operations before income taxes excluding goodwill impairment, restructuring charges and the writeoff of debt costs and discount, net | (3,504) | | 4,221 | | 5,995 | | 1,858 | | 8,570 | |
| Income tax expense (benefit) | (1,114) | | 1,028 | | 2,775 | | (277) | | 2,412 | |
| Income (loss) from ongoing operations (after tax), excluding goodwill impairment, restructuring charges and the writeoff of debt costs and discount, net | $ (2,390) | (1.4)% | $ 3,193 | 1.6% | $ 3,220 | 1.6% | $ 2,135 | 1.1% | $ 6,158 | 0.8% |
| Income (loss) from continuing operations (after tax) | $ (4,140) | | $ 2,447 | | $ 2,595 | | $ (2,038) | | $ (1,136) | |
| Divested units not reflected in discontinued operations (after tax) | 460 | | 23 | | 8 | | — | | 491 | |
| Restructuring charges (after tax) | 755 | | 723 | | 617 | | — | | 2,095 | |
| Goodwill impairment (after tax) | — | | — | | — | | 2,460 | | 2,460 | |
| Writeoff of debt costs and discount (after tax) | 535 | | — | | — | | 1,713 | | 2,248 | |
| Income (loss) from ongoing operations (after tax), excluding restructuring charges, goodwill impairment and the writeoff of debt costs and discount, net | $ (2,390) | (1.4)% | $ 3,193 | 1.6% | $ 3,220 | 1.6% | $ 2,135 | 1.1% | $ 6,158 | 0.8% |
| Diluted earnings per share—income (loss) from ongoing operations (after tax), excluding restructuring charges, goodwill impairment and the writeoff of debt costs and discount, net | $ (0.07) | | $ 0.08 | | $ 0.08 | | $ 0.05 | | $ 0.16 | |

| | 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Q1 | % | Q2 | % | Q3 | % |
| Revenues | $ 192,801 | | $ 203,948 | | $ 211,530 | |
| Divested units not reflected in discontinued operations | — | | — | | — | |
| Revenues from ongoing operations | 192,801 | 100.0% | 203,948 | 100.0% | 211,530 | 100.0% |
| Cost of services | 162,777 | | 170,827 | | 178,250 | |
| Divested units not reflected in discontinued operations | — | | — | | — | |
| Cost of services from ongoing operations | 162,777 | 84.4% | 170,827 | 83.8% | 178,250 | 84.3% |
| Gross profit from ongoing operations | 30,024 | 15.6% | 33,121 | 16.2% | 33,280 | 15.7% |
| Selling, general and administrative expenses | 27,055 | | 25,717 | | 26,687 | |
| Divested units not reflected in discontinued operations | — | | — | | — | |
| Selling, general and administrative expenses from ongoing operations | 27,055 | 14.0% | 25,717 | 12.6% | 26,687 | 12.6% |
| Operating income (loss) from ongoing operations excluding goodwill impairment and restructuring charges | 2,969 | 1.5% | 7,404 | 3.6% | 6,593 | 3.1% |
| Interest expense, net | (497) | (0.3)% | (282) | (0.1)% | (334) | (0.2)% |
| Other income (expense) | (666) | (0.3)% | 396 | 0.2% | (135) | (0.1)% |
| Income (loss) from ongoing operations before income taxes excluding goodwill impairment, restructuring charges and the writeoff of debt costs and discount, net | 1,806 | | 7,518 | | 6,124 | |
| Income tax expense (benefit) | 796 | | 3,213 | | 2,634 | |
| Income (loss) from ongoing operations (after tax), excluding goodwill impairment, restructuring charges and the writeoff of debt costs and discount, net | $ 1,010 | | $ 4,305 | | $ 3,490 | |
| Income (loss) from continuing operations (after tax) | $ 1,010 | | $ 4,305 | | $ 3,490 | |
| Divested units not reflected in discontinued operations (after tax) | — | | — | | — | |
| Restructuring charges (after tax) | — | | — | | — | |
| Writeoff of debt costs (after tax) | — | | — | | — | |
| Income (loss) from ongoing operations (after tax), excluding restructuring charges, goodwill impairment and the writeoff of debt costs and discount, net | $ 1,010 | 0.5% | $ 4,305 | 2.1% | $ 3,490 | 1.6% |
| Diluted earnings per share—income (loss) from ongoing operations (after tax), excluding restructuring charges, goodwill impairment and the writeoff of debt costs and discount, net | $ 0.03 | | $ 0.10 | | $ 0.09 | |

*Revenues*—Revenues increased $3.8 million, or 1.8%, to $211.5 million for the third quarter of 2004 as compared to the same period in 2003. This increase resulted from growth in our multi-family sector activity, primarily in the Washington D.C. area, Atlanta, New England and Florida, offset to a lesser degree by a decline in our San Diego operations, where we have combined three companies and where we have seen a decrease in bio-tech and pharmaceutical building activity, and by a decline in our Phoenix operations, which had a relatively strong activity level in the third quarter of 2003. Our Southeast operations also experienced a modest impact on revenues this quarter in connection with the four hurricanes that struck this part of the US this quarter.

Revenues increased $22.5 million, or 3.8%, to $608.3 million for the first nine months of 2004 as compared to the same period in 2003. Excluding operations that were sold in 2003 and not reflected in discontinued operations, revenues increased 4.6% at ongoing operations for the first nine months of 2004. This gain in revenues also stemmed from our growth in our multi-family activity, primarily in the Washington D.C. area, Atlanta, New England and Florida, offset to a lesser degree by consolidation of certain underperforming operations in Western Colorado, along with declines off historically high activity levels in 2003 in certain of our Alabama and New York State operations.

Following the three-year period of industry activity declines noted previously, we saw modest year-over-year revenue increases at our ongoing operations beginning in the third and fourth quarters of 2003 and continuing in each of the first three quarters of 2004. We continue to see signs that activity levels in our industry may increase in 2004 and 2005 as compared to the levels of the last three years. These observations are based on nonresidential construction spending trends, shipment data from HVAC equipment manufacturers, and anecdotal indications of renewed project consideration.

We and other industry participants also believe that there has been a general deferral of maintenance and replacement activity in the installed base of commercial, industrial, and institutional HVAC equipment, in response to the more difficult economy of the last several years. We and other industry participants believe this trend will not continue indefinitely due to the fundamental mechanical nature of the equipment, but it is not clear when maintenance and replacement activity might increase. While we believe these trends and expectations are positive, there can be no assurance that industry activity levels will actually increase this year or in the foreseeable future.

Also as noted in the introduction above, there has been significant inflation in the first half of 2004 in the cost of certain commodities used in the construction sector, including steel, iron, copper, lumber, PVC pipe, and motor vehicle fuel. This inflation does not appear to have affected our revenues or backlog, and is expected to have only a modest impact on our profitability, as discussed further below under *Gross Profit*. However, more broadly, it is possible that further increases in or uncertainty about commodity costs will decrease demand for nonresidential construction activity, which could in turn reduce our future revenues. To date, though, we have not seen any negative effect of commodity costs on demand for our services.

In view of all of these 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.

Backlog primarily contains installation and replacement project work, and maintenance agreements. These projects generally last less than a year. Service work and short duration projects are generally billed as performed and therefore 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, 2004 was $516.3 million, a 27.8% increase from December 31, 2003 backlog of $403.9 million, and a 17.4% increase from comparable September 30, 2003 backlog of $439.6 million.

*Gross Profit*—Gross profit decreased $1.6 million, or 4.5%, to $33.3 million for the third quarter of 2004 as compared to the same period in 2003. As a percentage of revenues, gross profit for the third quarter of 2004 was 15.7%, down from 16.8% in the third quarter of 2003, and 16.8% for the same period at ongoing operations. This decline resulted from decreased profitability in our Tennessee operations, costs associated with operational consolidations in our Northern California and Salt Lake City operations, reserves on a project in our Florida operations where we are in discussions with parties to the project which we believe will lead to significant recovery of those reserves, and the impact of the four hurricanes that struck the Southeastern US this quarter. These factors were offset to a lesser extent by an improvement from sharply curtailing operations this year in Western Colorado, which were unprofitable in the third quarter of 2003.

Gross profit increased $0.7 million, or 0.7%, to $96.4 million for the first nine months of 2004 compared to the same period in 2003. As a percentage of revenues, historical gross profit for the first nine months of 2004 was 15.9%, down from 16.3% in the first nine months of 2003, and 16.5% for the same period at ongoing operations. In addition to reduced profitability at our operations in Tennessee, Northern

California and Salt Lake City described above, this decline also resulted from increases in the prices for certain commodity materials that we could not recover in higher prices to our customers, the principal impact of which was in the second quarter of this year. Commodity cost trends are discussed further below.

For some of the projects we performed in the first nine months of 2004, the actual cost of certain commodities necessary for these projects, principally steel, iron and copper, was significantly greater than the commodity cost estimates we used when we committed to prices for these projects, which typically was done in 2003 before commodity price inflation became apparent. We estimate that unrecovered commodity inflation had a negative effect of approximately $1.0 million on year-to-date 2004 gross profit, or 0.2% of year-to-date revenues, most of which occurred during the second quarter. We began taking steps early in 2004 to reduce future commodity cost exposure, such as early buying of commodities for particular projects, or for general inventory, as well as including escalation and escape provisions in project bids and contracts. Following our second quarter impact, we experienced virtually no unrecovered cost inflation in the third quarter. However, commodity markets remain unsettled, and while we are taking steps as noted above to minimize unrecoverable commodity cost inflation, these steps cannot guarantee that we will avoid all such exposure.

Gross profit indications in our backlog as of September 30, 2004 were marginally lower than they were at the end of the preceding quarter. However, these gross profit indications are generally consistent with the levels we have seen over the last year. Nonetheless, we remain cautious about gross profit expectations in coming periods. While we believe industry activity levels are increasing, they appear to be doing so at only a modest rate, and still remain at relatively low levels following the three years of decline the industry experienced from 2001 to 2003. We expect continuing price competition in this environment until noticeably higher activity levels are reached and until the majority of our competition becomes convinced that industry growth is more than temporary. Additionally, with regard to gross profit indications in backlog, as noted above under *Revenues*, a significant portion of our activity is not captured in backlog at any given quarterend due to the amount of service and short-duration project work we do. Further, we can and have experienced lower final gross profit margins when work in backlog is ultimately completed, as compared to the gross profit indications that work had when it was only partially completed or new to backlog. Accordingly, while gross profit information in backlog provides some indication of general direction of gross profit, it does not assure future levels or trends in consolidated gross profit percentage.

As noted in the *Introduction* above, we are placing a particular emphasis in 2004 on internal execution and margin improvement, rather 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. In the quarter just ended, for example, our gross profit decreased over the comparable period last year, due in significant part to continued strong steps to consolidate operations and reduce costs at our Northern California and Salt Lake City units, both of which have been underperforming operations for some time. We believe these operations are now at or near breakeven levels and should produce profits over upcoming quarters. We also believe we will improve the lowered level of profitability in our Tennessee operations within the next several quarters. However, we cannot assure we will be successful in achieving these results, or that they will occur in the reasonably near future. 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 decreased $1.1 million, or 4.1%, to $26.7 million for the third quarter of 2004 as compared to the third quarter of 2003, and as a percentage of revenues, declined from 13.4% in last year's third quarter to 12.6% this year. These decreases resulted primarily from consolidation of certain operating units in San Diego, Colorado, and Northern California, offset to a lesser extent by higher corporate incentive compensation accruals and increased accounting and auditing fees associated with the requirements of the Sarbanes-Oxley Act.

For the nine months ended September 30, 2004, SG&A decreased $7.5 million, or 8.7%, to $79.5 million as compared to the same period in 2003, and as a percentage of revenues, declined from 14.9% in 2003 to 13.1% in 2004. These decreases resulted primarily from consolidation of certain operating units in San Diego, Salt Lake City, and Colorado, as well as from the sale or closure of certain units that did not qualify for discontinued operations presentation.

*Restructuring Charges*—During the first three quarters of 2003, we 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 our energy efficiency marketing activities, a reorganization of our 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. We increased our accrual for these remaining lease obligations by $0.5 million in 2004 based on revised estimates of when and to what extent we believe we can sublease the related facilities. These increases to the accrual were included in "Cost of Services" and in "Selling, General and Administrative Expenses" in our results of operations.

*Interest Expense, Net*—Interest expense, net for the three months and nine months ended September 30, 2003 and 2004 included the following primary elements (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| Interest expense on borrowings, and unused commitment fees | $ 349 | $ 140 | $ 1,125 | $ 557 |
| Letter of credit fees | 150 | 130 | 355 | 339 |
| Amortization of deferred debt arrangement costs and discount | 328 | 104 | 1,084 | 300 |
| Mark-to-market adjustments on derivatives | 280 | — | 188 | — |
| Interest income | (29) | (40) | (80) | (83) |
| Total | $ 1,078 | $ 334 | $ 2,672 | $ 1,113 |

Interest expense is significantly lower in 2004 as compared to 2003 as a result of much lower debt levels in 2004 stemming from increased cash flows during current year periods, and because our current credit facility cost noticeably less in upfront fees when it was established in the fourth quarter of 2003, thereby resulting in lower ongoing amortization of these fees in the current year.

*Other Expense (Income)*—Other expense was $0.1 million for the third quarter of 2004 and other income was less than $0.1 million for the third quarter of 2003. Other expense was $0.4 million for the first nine months of 2004 and $0.1 million for the first nine months of 2003. 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 that was outstanding 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 will be no further mark-to-market adjustments relating to this warrant and put subsequent to the third quarter of 2004.

The first quarter of 2003 includes a loss of $0.3 million on the disposition of a division of one of our operations.

*Write-off of Debt Costs*—The first quarter of 2003 reflects a non-cash charge of $0.8 million for deferred debt costs that were associated with previously higher levels of capacity under our previous credit facility.

*Income Tax Expense (Benefit)*—Our effective tax rate associated with results from continuing operations for the third quarter of 2004 was 43.0% as compared to 48.4% in 2003. For the first nine months of 2004 and 2003, our corresponding effective tax rates were 43.0% and 52.7%, respectively. Our effective rate is generally higher than statutory rates because of the effect of certain expenses that we incur that are not deductible for tax purposes, and due to reserves that we have established against certain deferred tax assets based on the possibility that we will not be able to ultimately realize the tax benefit for certain losses we have incurred, primarily at the state income tax level. In addition, since our recent pre-tax profit margins have been relatively low on a historical and an absolute basis, the impact of non-deductible expenses and deferred tax reserves on our effective rate is magnified. This latter impact also contributes to the higher level of our 2003 effective rates as compared to 2004, as our pre-tax profit levels were noticeably lower in 2003 than in 2004.

*Discontinued Operations—Individual Sales of Operating Companies*—During the second quarter of 2004, we sold a small operating company. This unit's after-tax income of $0.1 million for the first nine months of 2003 and less than $0.1 million for the first six months of 2004 has been reported in discontinued operations under "Operating income, net of income tax expense". We recorded a loss on the sale of this unit of $0.5 million, including taxes, in the second quarter of 2004 in discontinued operations under "Estimated loss on disposition, including income tax expense". The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the fourth quarter of 2003, we sold a small operating company. This unit's after-tax income of $0.3 million for the nine months ended September 30, 2003 has been reported in discontinued operations under "Operating results, net of tax." We recorded a loss of $1.5 million, net of tax benefit, in the fourth quarter of 2003 in discontinued operations under "Estimated loss on disposition, including tax." The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the third quarter of 2003, we committed to a plan to divest of a small operating company. This unit's after-tax income of $0.2 million for the nine months ended September 30, 2003 has been reported in discontinued operations under "Operating results, net of tax." We recorded an estimated loss of $2.8 million, including taxes, in the third quarter of 2003 related to this planned disposition in "Estimated loss on disposition, including tax" based upon an estimated sales price. The final loss as measured at the closing of this sale in the fourth quarter of 2003 was not materially different than the estimate recorded in the preceding quarter. The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

During the first quarter of 2003, we committed to a plan to divest of a small operating company. This unit's after-tax income of $0.1 million for the six months ended June 30, 2003 has been reported in discontinued operations under "Operating results, net of tax." We recorded an estimated loss of $0.9 million, including taxes, in the first quarter of 2003 related to this transaction in "Estimated loss on disposition, including tax." The final loss as measured at the closing of this sale in the second quarter of 2003 was not materially different than the estimate recorded in the preceding quarter. The loss resulted from the non-cash writeoff of goodwill associated with this unit. The goodwill writeoff was not tax deductible.

*Discontinued Operations—Sale of Companies to Emcor*—On March 1, 2002, we sold 19 operations to Emcor Group. 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. We realized an aggregate loss of $11.5 million, including related tax expense, in connection with the sale of these operations. As a result of the adoption of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," we 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 us 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 our 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 our debt. We paid $10.4 million of taxes related to this transaction in March 2003.

In the fourth quarter of 2002, we recognized a charge of $1.2 million, net of tax benefit of $2.7 million, in discontinued operations under "Estimated loss on disposition, including tax" 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 us. Under this settlement, we were 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 from us. During May 2003, we paid $2.7 million in cash to Emcor associated with this settlement. The settlement agreement also includes the use of $2.5 million of the $5 million escrow described above to fund settled claims. We further recognized an additional $1.5 million of the remaining escrow applicable to elements of the settlement still to be funded, of which $0.8 million was paid from escrow in September 2003 and an additional $0.2 million was paid from escrow during May 2004. 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. We recorded a tax benefit of $1.4 million related to this additional charge. In addition, the $1.2 million charge recognized during the fourth quarter of 2002 is also net of a tax credit of $1.3 million as a result of lower final tax liabilities in connection with the overall Emcor transaction than we estimated when the transaction originally closed in the first quarter of 2002.

There are ongoing open matters relating to this transaction that we continue to address with Emcor. We do not believe these open matters, either individually or in the aggregate, will have a material effect on our financial position when ultimately resolved. We maintain reserves for these matters, net of amounts receivable from escrow that we believe will ultimately be applied in settling these matters. During the second quarter of 2004, we concluded that the related reserves should be reduced by $0.3 million, net of tax benefit. This amount was reflected in discontinued operations in the second quarter of 2004 as a reduction in the estimated loss on disposition of discontinued operations.

*Outlook*—As noted earlier in this review, while we see signs that industry activity levels are increasing in 2004 and may continue to do so in 2005, our primary emphasis for this year is on margin improvement rather than revenue growth. Our ongoing margin improvement efforts include a focus on reducing the number of our units with significantly decreased operating results or losses in 2004 as compared to 2003, and on intensified project and service performance training at the unit level. While these efforts have contributed to increased operating profit margins in the three preceding quarters, we did not achieve increased operating profit margins in the quarter just ended, when the effect of 2003 restructuring charges is excluded. This was due in significant part to continued steps to consolidate operations and reduce costs at our Northern California and Salt Lake City units, both of which have been underperforming operations for some time. We believe these operations are now at or near breakeven levels and should produce profits over upcoming quarters. We also believe we will improve the lowered level of profitability in our Tennessee operations within the next several quarters. Our primary near-term emphasis remains margin improvement, and given our expectations for improved results in these particular operations, we are optimistic that we will be successful again at increasing margins in coming periods, although there can be no assurance of this.

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 2004 results will be significantly better than our 2003 results, and that we have reasonable prospects for continued profitability in 2005, although there can be no assurance that we will achieve these outcomes.

**Liquidity and Capital Resources**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2004 | 2003 | 2004 |
| | (in thousands) | | (in thousands) | |
| Cash provided by (used in): | | | | |
| Operating activities | $ (6,437) | $ 5,121 | $ 5,143 | $ 12,781 |
| Investing activities | $ (510) | $ (807) | $ (5,096) | $ (1,631) |
| Financing activities | $ 3,352 | $ (526) | $ 1,669 | $ (793) |
| Free cash flow: | | | | |
| Cash provided by (used in) operating activities | $ (6,437) | $ 5,121 | $ 5,143 | $ 12,781 |
| Taxes paid related to the sale of businesses | — | — | 10,371 | — |
| Purchases of property and equipment | (714) | (963) | (2,661) | (3,180) |
| Proceeds from sales of property and equipment | 208 | — | 319 | 283 |
| Free cash flow | $ (6,943) | $ 4,158 | $ 13,172 | $ 9,884 |

*Cash Flow*—We define free cash flow as cash provided by operating activities excluding items related to sales of businesses, 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 and exceeds on-hand balances, additional debt or equity is generally required to fund the outflow of cash. Free cash flow may be defined differently by other companies.

Our business does not require significant amounts of investment in long-term fixed assets. The substantial majority of the capital used in our business is working capital that funds our costs of labor and installed equipment deployed in project work until our customers pay us. Customary terms in our industry allow customers to withhold a small portion of the contract price until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage. Our average project duration together with typical retention terms generally allow us to complete the realization of revenue and earnings in cash within one year. Accordingly, we believe free cash flow, by encompassing both profit margins and the use of working capital over our approximately one-year working capital cycle, is an effective measure of operating effectiveness and efficiency. We have included free cash flow information here for this reason, and because we are often asked about it by third parties evaluating 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, 2004, we had positive free cash flow of $4.2 million, as compared to negative free cash flow of $6.9 million during the third quarter of 2003. This increase resulted primarily from a somewhat better billing and collection cycle, and from a somewhat reduced pace of non-payroll disbursements, in the quarter just ended as compared to last year's third quarter. For the nine months ended September 30, 2004, we had free cash flow of $9.9 million following very strong fourth quarter 2003 cash flow, as compared to free cash flow of $13.2 million during the first nine months of 2003. This decrease resulted from the requirement of $4.2 million in working capital primarily relating to early buying of metal commodities due to volatile conditions in the markets for these materials, and due to an increase in the proportion of projects that are in early stages when the lag between labor and equipment cash requirements and contractual billing dates is typically the greatest. This compares to a recovery of $0.2 million of working capital from our operations in the first nine months of 2003 following comparatively low cash flow in the fourth quarter of 2002.

During the first quarter of 2003, free cash flow as well as borrowings from our credit facility were used to pay final tax payments of $10.4 million associated with the sale of the operations to Emcor.

*Credit Facility*—On December 31, 2003, we entered into a senior credit facility (the "Facility") provided by a syndicate of banks. As of September 30, 2004 the total of the Facility was $54.0 million, with $26.3 million in borrowings and letters of credit outstanding, and $27.7 million of credit available. As of October 29, 2004, the total of the Facility was $53.5 million, with $25.8 million in borrowings and letters of credit outstanding, and $27.7 million of credit available. The Facility is secured by substantially all of our assets, including the capital stock of all our current and future subsidiaries and substantially all of their assets. Amounts due under the Facility are also guaranteed by our current and future subsidiaries. The Facility consists of two parts: a term loan and a revolving credit facility.

The original term loan under the Facility (the "Term Loan") was $10 million, which the Company borrowed upon the closing of the Facility. The Term Loan must be repaid in installments of $0.5 million payable at the beginning of each quarter over five years, the first installment of which was paid in the second quarter of 2004. The Facility requires prepayments of the Term Loan in certain circumstances generally involving the sale of assets. All principal payments under the Term Loan permanently reduce the original $10 million capacity under this portion of the Facility.

The Facility also included a three-year $40 million revolving credit facility (the "Revolving Loan") available for borrowings or letters of credit. This was increased to $45 million in the second quarter of 2004. Letters of credit are discussed at greater length below under *Off-Balance Sheet Arrangements and Other Commitments.* The Facility requires that borrowings outstanding under the Revolving Loan must be less than $2 million for ten consecutive business days at least once during each year. We have already satisfied this condition for 2004.

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 60% 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, 2004 was $92.8 million. This borrowing base is substantially greater than the current $53.5 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 borrowing and letter of credit capacity under the Revolving Loan portion of the Facility at any given time is $45 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 we must comply, as discussed further below. Covenant compliance is measured as of each quarterend. While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarterend covenant compliance measurement date caused us to violate the Facility's debt-to-EBITDA covenant (described in more detail below) our 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, 2004 | | As of October 29, 2004 |
|---|---|---|---|---|
| | | (in thousands) | | |
| *Amounts Outstanding* | | | | |
| Revolving loan | $ | — | $ | — |
| Term loan | | 9,000 | | 8,500 |
| Other non-Facility debt | | 349 | | 346 |
| Total debt | $ | 9,349 | $ | 8,846 |
| Letters of credit | $ | 17,280 | $ | 17,280 |
| *Available Capacity* | | | | |
| Unused Revolving Loan and letter of credit capacity based on Revolving Loan face value of $45 million | $ | 27,720 | $ | 27,720 |
| Unused Revolving Loan and letter of credit capacity based on quarterend debt-to-EBITDA covenant | $ | 27,720 | | n/a |

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. Covenant compliance is assessed as of each quarterend. Earnings before interest, taxes, depreciation and amortization ("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 Facility's principal financial covenants include:

*Debt Service Coverage Ratio*—The Facility requires that the ratio of EBITDA to the sum of interest expense and scheduled principal payments be at least 2.50. Interest expense is defined under the Facility for purposes of this covenant 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 Facility provides, however, that during the first three quarters of 2004, interest expense and scheduled principal payments used in this ratio will be the annualized amounts of actual year-to-date interest expense and scheduled principal payments, instead of actual amounts for these items for the twelve months then ended. The Company's debt service coverage ratio as of September 30, 2004 as measured under this covenant was 7.56 as compared to a minimum covenant requirement of 2.50.

*Tangible Net Worth*—The Facility requires that our tangible net worth not be less than the sum of (a) $75.4 million; (b) 75% of net income earned beginning October 1, 2003; 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, 2004 as measured under this covenant was $107.8 million, as compared to a covenant minimum of $84.3 million.

*Debt to EBITDA*—The Facility requires that our ratio of debt to EBITDA not exceed 2.0. Our debt-to-EBITDA ratio as of September 30, 2004 as measured under this covenant was 0.37.

*Capital Expenditures*—The Facility limits capital expenditures to $8.0 million per year. Our capital expenditures during the nine months ended September 30, 2004 were $3.2 million.

*Other Restrictions*—The Facility prohibits payment of dividends and repurchase of shares by the Company, and limits non-Facility debt, capital lease obligations, acquisitions, investments, and sales of assets. The Facility also includes a customary provision under which the lenders may demand immediate repayment of borrowings and disposition of letters of credit if they conclude that our business or financial position has suffered a material adverse change. However, the Facility does not include any mechanisms allowing the lenders immediate access to our ongoing cash flow in the event of a default or an immediate repayment demand by the lenders. In view of our financial position, and what we believe are our prospects for profitability and positive cash flow in the future, we believe that the probability that our lenders will invoke the material adverse change provision of the Facility in the foreseeable future is remote. As a result, debt under the Facility is classified as long-term, other than amounts due within one year.

*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 our Credit 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 the Company 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 Credit Facility 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 our lenders 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. These bonds provide a guarantee to the customer that we will perform under the terms of a contract and that we will pay subcontractors and vendors who provided goods and services under a contract. If we fail to perform under a contract or to pay subcontractors and vendors, the customer may demand that the surety make payments or provide services under the bond. We must reimburse the surety for any expenses or outlays it incurs. To date, we are not aware of any losses to our surety in connection with bonds the surety has posted on our behalf, and we do not expect such losses to be incurred in the foreseeable future.

Surety market conditions are currently difficult as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% of our business has required bonds. While we have enjoyed a longstanding relationship with our surety, current market conditions as well as changes in our surety's assessment of our operating and financial risk could cause our surety 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 performance 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, 2004 (in thousands):

| | Twelve Months Ended September 30, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | Total |
| Revolving loan | $ — | $ — | $ — | $ — | $ — | $ — | $ — |
| Term loan | 2,000 | 2,000 | 2,000 | 2,000 | 1,000 | — | 9,000 |
| Other debt | 76 | 77 | 67 | 62 | 36 | 31 | 349 |
| Total debt | $ 2,076 | $ 2,077 | $ 2,067 | $ 2,062 | $ 1,036 | $ 31 | $ 9,349 |
| Operating lease obligations | $ 8,030 | $ 6,515 | $ 5,554 | $ 4,458 | $ 3,193 | $ 12,790 | $ 40,540 |

As of September 30, 2004 we also have $17.3 million of letter of credit commitments, of which $16.9 million expire in 2004 and the remaining $0.4 million expire in 2005. 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 2004, 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 amount of letters of credit posted with them in quarterly installments beginning in November 2004 and aggregating to an additional $3 million in letters of credit outstanding in August of 2005.

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. In addition, Other Long-Term Liabilities on our balance sheet is comprised of $2.8 million associated with a warrant and put obligation. This warrant was exercised in October, 2004, which also resulted in the termination of the related put obligation. Accordingly, the $2.8 million value of the warrant and related put as of September 30, 2004 have been eliminated as an obligation and added to stockholders' equity in October, with no cash outlay required of us. As a result, this obligation was not included in the table of commitments above.

*Outlook*—We have generated positive net free cash flow in fourteen of the last eighteen quarters in challenging economic and industry conditions. We also have a relatively low level of debt, and cash balances that exceed our total debt. We anticipate that free cash flow from operations and credit capacity under the Facility 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.

## 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 (except as discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Results of Operations"), foreign currency exchange risk or interest rate risks from the use of derivative financial instruments. Management does not use derivative financial instruments for trading or to speculate on changes in interest rates or commodity prices.

## ITEM 4. *Controls and Procedures*

The Company's executive management is responsible for insuring the effectiveness 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 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. There has been no change in our internal control over financial reporting during the three months ended September 30, 2004 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 in the ordinary course of business. 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***

None.

**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 J. Gordon Beittenmiller 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 J. Gordon Beittenmiller 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 3, 2004. Under Item 7 of that report the Company announced that on August 2, 2004, the Company issued a press release, reporting Comfort's financial results for the second quarter of 2004 and for the year 2004.

## 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, 2004 | By: | /s/ WILLIAM F. MURDY |
| | | William F. Murdy<br>*Chairman of the Board and*<br>*Chief Executive Officer* |
| November 2, 2004 | By: | /s/ J. GORDON BEITTENMILLER |
| | | J. Gordon Beittenmiller<br>*Executive Vice President,*<br>*Chief Financial Officer and Director* |

**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 quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) 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) 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

   (c) 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, 2004

By: /s/ WILLIAM F. MURDY

William F. Murdy
*Chairman of the Board and Chief Executive Officer*

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Exhibit 31.1

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

**Exhibit 31.2**

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

I, J. Gordon Beittenmiller, 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 quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) 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) 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

   (c) 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, 2004

By: /s/ J. GORDON BEITTENMILLER

J. Gordon Beittenmiller
*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, 2004 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.

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.

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**Exhibit 32.2**

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

In connection with the Annual Report of Comfort Systems USA, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, J. Gordon Beittenmiller, 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.

By: /s/ J. GORDON BEITTENMILLER

J. Gordon Beittenmiller
*Executive Vice President and Chief Financial 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.