

COMFORT SYSTEMS USA INC
Form 10-Q
November 03, 2010

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from to

Commission file number: 1-13011

COMFORT SYSTEMS USA, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of
Incorporation or Organization)

76-0526487

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

**675 Bering Drive
Suite 400**

Houston, Texas 77057

(Address of Principal Executive Offices) (Zip Code)

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a
smaller reporting company)

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

The number of shares outstanding of the issuer's common stock, as of October 29, 2010 was 37,865,589.

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COMFORT SYSTEMS USA, INC.
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Amounts)

	December 31, 2009	September 30, 2010 (Unaudited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 127,850	\$ 44,661
Accounts receivable, less allowance for doubtful accounts of \$7,253 and \$6,540, respectively	203,353	264,330
Other receivables	5,801	7,028
Income tax receivable	20,075	13,658
Inventories	9,817	9,637
Prepaid expenses and other	25,827	34,197
Costs and estimated earnings in excess of billings	20,432	26,379
 Total current assets	 413,155	 399,890
PROPERTY AND EQUIPMENT, NET	34,671	44,158
GOODWILL	100,194	148,518
IDENTIFIABLE INTANGIBLE ASSETS, NET	19,380	41,549
MARKETABLE SECURITIES	4,721	2,833
OTHER NONCURRENT ASSETS	2,827	4,285
 Total assets	 \$ 574,948	 \$ 641,233
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 250	\$ 300
Current maturities of notes to former owners	917	1,117
Accounts payable	83,848	94,522
Accrued compensation and benefits	38,043	41,134
Billings in excess of costs and estimated earnings	66,343	73,118
Accrued self-insurance expense	26,881	31,188
Other current liabilities	32,748	32,926
 Total current liabilities	 249,030	 274,305
LONG-TERM DEBT, NET OF CURRENT MATURITIES		2,700
NOTES TO FORMER OWNERS, NET OF CURRENT MATURITIES	6,441	27,200
DEFERRED INCOME TAX LIABILITIES	9,603	17,223
OTHER LONG-TERM LIABILITIES	3,890	12,091
 Total liabilities	 268,964	 333,519
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, 41,123,365 and 41,123,365 shares issued, respectively	411	411

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Treasury stock, at cost, 3,129,460 and 3,266,851 shares, respectively	(33,810)	(35,200)
Additional paid-in capital	326,103	325,895
Accumulated other comprehensive income (loss)	(181)	(109)
Retained earnings (deficit)	13,461	16,717
Total stockholders' equity	305,984	307,714
Total liabilities and stockholders' equity	\$ 574,948	\$ 641,233

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

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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,	
	2009	2010	2009	2010
REVENUES	\$ 291,591	\$ 307,648	\$ 872,214	\$ 793,711
COST OF SERVICES	234,186	257,339	701,335	661,929
Gross profit	57,405	50,309	170,879	131,782
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	41,713	41,885	126,175	114,905
GOODWILL IMPAIRMENT				4,446
GAIN ON SALE OF ASSETS	(101)	(29)	(98)	(502)
Operating income	15,793	8,453	44,802	12,933
OTHER INCOME (EXPENSE):				
Interest income	117	39	492	183
Interest expense	(301)	(832)	(946)	(1,406)
Other	3	669	5	675
Other income (expense)	(181)	(124)	(449)	(548)
INCOME BEFORE INCOME TAXES	15,612	8,329	44,353	12,385
INCOME TAX EXPENSE	6,072	2,919	17,293	4,164
INCOME FROM CONTINUING OPERATIONS	9,540	5,410	27,060	8,221
DISCONTINUED OPERATIONS:				
Operating loss, net of income tax benefit of \$, \$, \$133 and \$			(387)	
Estimated gain (loss) on disposition, net of income tax expense of \$, \$195, \$ and \$166		(39)	(93)	723
NET INCOME	\$ 9,540	\$ 5,371	\$ 26,580	\$ 8,944
INCOME PER SHARE:				
Basic				
Income from continuing operations	\$ 0.25	\$ 0.14	\$ 0.71	\$ 0.22
Discontinued operations				
Loss from operations			(0.01)	
Estimated gain (loss) on disposition				0.02
Net income	\$ 0.25	\$ 0.14	\$ 0.70	\$ 0.24
Diluted				

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Income from continuing operations	\$	0.25	\$	0.14	\$	0.70	\$	0.22
Discontinued operations								
Loss from operations						(0.01)		
Estimated gain (loss) on disposition								0.02
Net income	\$	0.25	\$	0.14	\$	0.69	\$	0.24
SHARES USED IN COMPUTING INCOME PER SHARE:								
Basic		37,995		37,560		38,135		37,564
Diluted		38,382		37,794		38,533		37,821
DIVIDENDS PER SHARE	\$	0.050	\$	0.050	\$	0.140	\$	0.150

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

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COMFORT SYSTEMS USA, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In Thousands, Except Share Amounts)

	STOCKHOLDERS' EQUITY								
	Comprehensive Income	Common Stock Shares	Common Stock Amount	Treasury Stock Shares	Treasury Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total Stockholders' Equity
BALANCE AT DECEMBER 31, 2008		41,123,365	\$ 411	(2,453,245)	\$(27,069)	\$ 328,621	\$ (326)	\$(15,166)	\$ 286,471
Comprehensive Income:									
Net income	\$ 34,182							34,182	34,182
Realized gain on marketable securities reclassified into earnings, net of tax	145						145		145
Comprehensive Income	\$ 34,327								
Issuance of Stock:									
Issuance of shares for options exercised including tax benefit				354,700	3,815	(1,626)			2,189
Issuance of restricted stock				241,857	2,652	(2,652)			
Shares received in lieu of tax withholding payment on vested restricted stock				(45,779)	(459)				(459)
Stock-based compensation expense						3,454			3,454
Forfeiture of unvested restricted stock				(15,193)	(165)	165			
Tax benefit from vesting of restricted stock						(124)			(124)
Dividends						(1,735)		(5,555)	(7,290)
Share repurchase				(1,211,800)	(12,584)				(12,584)
BALANCE AT DECEMBER 31, 2009		41,123,365	411	(3,129,460)	(33,810)	326,103	(181)	13,461	305,984
Comprehensive Income:									
Net income (unaudited)	\$ 8,944							8,944	8,944
Realized gain on marketable securities, reclassified into earnings, net of tax (unaudited)	72						72		72
Comprehensive Income (unaudited)	\$ 9,016								
Issuance of Stock:									
Issuance of shares for options exercised including tax benefit (unaudited)				90,459	978	(400)			578
Issuance of restricted stock (unaudited)				225,122	2,755	(2,505)			250
Shares received in lieu of tax withholding payment on vested restricted stock (unaudited)				(50,561)	(619)				(619)
Stock-based compensation expense (unaudited)						2,591			2,591
Tax benefit from vesting of restricted stock (unaudited)						106			106
Dividends (unaudited)								(5,688)	(5,688)
Share repurchase (unaudited)				(402,411)	(4,504)				(4,504)
BALANCE AT SEPTEMBER 30, 2010 (unaudited)		41,123,365	\$ 411	(3,266,851)	\$(35,200)	\$ 325,895	\$ (109)	\$ 16,717	\$ 307,714

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

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COMFORT SYSTEMS USA, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
CASH FLOWS FROM OPERATING ACTIVITIES				
Net income	\$ 9,540	\$ 5,371	\$ 26,580	\$ 8,944
Adjustments to reconcile net income to net cash used in operating activities				
Estimated loss (gain) on disposition of discontinued operations		39	93	(723)
Write-off of debt financing costs		181		181
Amortization of identifiable intangible assets	709	1,877	2,511	4,023
Depreciation expense	2,541	2,925	7,357	7,859
Goodwill impairment				4,446
Bad debt expense	467	578	2,577	701
Deferred tax benefit	(380)	(1,484)	(2,427)	(4,750)
Amortization of debt financing costs	27	48	81	102
Gain on sale of assets	(101)	(29)	(97)	(502)
Changes in the fair value of contingent earn-out obligation		(650)		(650)
Stock-based compensation expense	481	517	2,543	2,591
Changes in operating assets and liabilities, net of effects of acquisitions				
(Increase) decrease in				
Receivables, net	28,360	(19,814)	36,230	(21,483)
Inventories	767	230	1,898	762
Prepaid expenses and other current assets	(321)	(6,777)	(1,421)	(4,448)
Costs and estimated earnings in excess of billings	(1,052)	5,875	1,747	4,254
Other noncurrent assets	(1,803)	(747)	(1,837)	(1,079)
Increase (decrease) in				
Accounts payable and accrued liabilities	(5,790)	11,656	(24,655)	(4,634)
Billings in excess of costs and estimated earnings	(10,564)	3,385	(7,829)	(2,988)
Taxes paid related to pre-acquisition equity transactions of an acquired company		(7,056)		(7,056)
Other long-term liabilities	1,922	103	1,403	(21)
Net cash provided by (used in) operating activities	24,803	(3,772)	44,754	(14,471)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of property and equipment	(1,986)	(2,021)	(6,420)	(4,103)
Proceeds from sales of property and equipment	326	11	500	1,229
Proceeds from notes receivable		47		142
Proceeds from businesses sold	278	156	584	1,325
Sale of marketable securities	1,000	1,000	3,000	2,925
Cash paid for acquisitions, earnouts and intangible assets, net of cash acquired	(1,056)	(38,358)	(4,905)	(41,935)
Net cash used in investing activities	(1,438)	(39,165)	(7,241)	(40,417)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Net borrowings on revolving line of credit				
Payments on other long-term debt	(365)	(16,382)	(2,074)	(17,299)
Debt financing costs		(911)		(911)
Payments of dividends to shareholders	(1,912)	(1,881)	(5,365)	(5,652)
	(2,652)	(861)	(8,843)	(5,123)

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Share repurchase program and shares received in lieu of tax withholding				
Excess tax benefit of stock-based compensation	439	15	593	447
Proceeds from exercise of options	573	16	1,024	237
Net cash used in financing activities	(3,917)	(20,004)	(14,665)	(28,301)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	19,448	(62,941)	22,848	(83,189)
CASH AND CASH EQUIVALENTS, beginning of period continuing and discontinued operations	120,415	107,602	117,015	127,850
CASH AND CASH EQUIVALENTS, end of period continuing and discontinued operations	\$ 139,863	\$ 44,661	\$ 139,863	\$ 44,661

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

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2010

(Unaudited)

1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation, provides comprehensive heating, ventilation and air conditioning ("HVAC") installation, maintenance, repair and replacement services within the mechanical services industry. We operate primarily in the commercial, industrial and institutional HVAC markets, and perform most of our services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, we provide specialized applications such as building automation control systems, fire protection, process cooling, electronic monitoring and process piping. Certain locations also perform related activities such as electrical service and plumbing. Approximately 47% of our consolidated 2010 revenues are attributable to installation of systems in newly constructed facilities, with the remaining 53% attributable to maintenance, repair and replacement services. The following service activities account for our consolidated 2010 revenues: HVAC 77%, plumbing 15%, building automation control systems 4%, and other 4%. These service activities are within the mechanical services industry which is the single industry segment we serve.

2. Summary of Significant Accounting Policies

Basis of Presentation

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission ("SEC") for the year ended December 31, 2009 (the "Form 10-K").

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

Cash Flow Information

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

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

2. Summary of Significant Accounting Policies (Continued)

Cash paid (in thousands) for:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Interest	\$ 278	\$ 308	\$ 817	\$ 720
Income taxes for continuing operations	9,886	655	22,609	2,308
Income taxes for discontinued operations	9		41	
Total	\$ 10,173	\$ 963	\$ 23,467	\$ 3,028

Segment Disclosure

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

Use of Estimates

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

Income Taxes

We are subject to income tax in the United States and Puerto Rico and we file a consolidated return for federal income tax purposes. Income taxes are provided for under the liability method, which takes into account differences between financial statement treatment and tax treatment of certain transactions.

Deferred income taxes are based on the difference between the financial reporting and tax basis of assets and liabilities. The deferred income tax provision represents the change during the reporting period in the deferred tax assets and deferred tax liabilities, net of the effect of acquisitions and dispositions. Deferred tax assets include tax loss and credit carry-forwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

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

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

2. Summary of Significant Accounting Policies (Continued)

dependent upon the generation of future taxable income during the periods in which the activity underlying these assets becomes deductible. We consider projected future taxable income and tax planning strategies in making this assessment. If actual future taxable income is less than the estimates, we may not realize all or a portion of the recorded deferred tax assets.

Significant judgment is required in assessing the timing and amounts of deductible and taxable items. We establish reserves when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may be challenged and potentially disallowed. When facts and circumstances change, we adjust these reserves through our provision for income taxes.

To the extent interest and penalties may be assessed by taxing authorities on any underpayment of income tax, such amounts have been accrued and are classified as a component of income tax expense in our consolidated statements of operations.

Our year to date effective tax rate for 2010 was 33.6% as compared to 39.0% in 2009. The decrease in the effective tax rate for 2010 is primarily due to the release of certain valuation allowances during the second quarter of 2010 and accrual-to-return differences.

Financial Instruments

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

Marketable securities are classified as available-for-sale. These investments are recorded at fair value and are classified as marketable securities in the accompanying consolidated balance sheets. The changes in fair values, net of applicable taxes, are recorded as unrealized gains (losses) as a component of accumulated other comprehensive income (loss) in stockholders' equity.

Recent Accounting Pronouncements

In the first quarter of 2010, certain disclosure provisions of the FASB Accounting Standards Update 2010-06 became effective for the Company. This standard clarified existing fair value requirements under the FASB ASC's Fair Value Measurements and Disclosures Topic 820, including the level of disaggregation required for fair value disclosures and disclosure of the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. Our adoption of this standard did not have a material impact on our financial position, results of operations or cash flows.

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.

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

3. Fair Value Measurements

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

Level 1 defined as observable inputs such as quoted prices in active markets;

Level 2 defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and

Level 3 defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The assets and liabilities measured at fair value on a recurring basis as of September 30, 2010 are as follows (in thousands):

	Total	Fair Value Measurements at Reporting Date Using		
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	\$ 44,661	\$ 44,661	\$	\$
Auction rate securities	\$ 2,833	\$	\$	\$ 2,833
Contingent earn-out obligation	\$ 8,390	\$	\$	\$ 8,390

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

As of September 30, 2010, our marketable securities consisted of \$2.8 million of auction rate securities, which are variable rate debt instruments, having long-term maturities (with final maturities up to June 2032), but whose interest rates are designed to reset through an auction process at 35 day intervals. We had investments in marketable securities of \$5.6 million as of December 31, 2009. All of our auction rate securities are high quality municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. We sold \$0.9 million of these auction rate securities during the first quarter of 2010, \$1.0 million during the second quarter of 2010 and \$1.0 million during the third quarter of 2010, at face value. The remaining \$2.8 million has been classified as a noncurrent asset on the consolidated balance sheet as we have the intent and ability to hold these securities until the market for auction rate securities stabilizes or until the issuer refinances the underlying security.

The auction events for some of these instruments failed during 2008 due to events in the credit markets. As a result, we have determined the estimated fair values of these securities based on discounted cash flow analyses or other types of valuation models. We have performed and routinely update these valuations considering, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose

Table of Contents**COMFORT SYSTEMS USA, INC.****CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2010****(Unaudited)****3. Fair Value Measurements (Continued)**

to sell the securities in the absence of a successful auction. These securities are also compared, when possible, to observable market data with similar characteristics.

In association with our estimate of fair value as of September 30, 2010, we have recorded a temporary unrealized decline in fair value of \$0.1 million, net of tax, with an offsetting entry to accumulated other comprehensive income (loss). We continue to believe that this decline is due to liquidity issues rather than credit issues. We continue to collect interest when due on all of our auction rate securities. Any future fluctuation in fair value related to these instruments that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive income (loss). If we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings as appropriate.

The valuation of the Company's contingent earn-out obligation is determined using a probability weighted discounted cash flow method. This fair value measurement is based on significant unobservable inputs in the market and thus represents a Level 3 measurement within the fair value hierarchy. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payments, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate. The contingent earn-out obligation is measured at fair value each reporting period and changes in estimates of fair value are recognized in earnings.

The table below presents a reconciliation of the fair value of our liabilities that use significant unobservable inputs (Level 3).

Balance at December 31, 2009	\$ 2,380
Issuances (See Note 4)	6,660
Gain included in other income (expense)	(650)
Balance at September 30, 2010	\$ 8,390

We measure certain assets, including our goodwill and intangible assets, at fair value on a nonrecurring basis. In addition, as discussed in Note 4, we acquired intangible assets as a result of the ColonialWebb acquisition. The estimated fair value of these long-lived assets was measured using Level 3 inputs. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. During the nine months ended September 30, 2010, we recorded a goodwill impairment charge of \$4.4 million. We did not recognize any other impairments on those assets required to be measured at fair value on a nonrecurring basis.

4. Acquisitions*Description of transaction*

On July 28, 2010, we entered into a stock purchase agreement to purchase all of the issued and outstanding stock of ColonialWebb Contractors Company ("ColonialWebb"). As a result of the acquisition, ColonialWebb is a wholly owned subsidiary of the Company. ColonialWebb operates as a comprehensive, single-source construction, service, manufacturing and refrigeration service firm

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

4. Acquisitions (Continued)

servicing the Mid-Atlantic region. ColonialWebb is headquartered in Richmond, Virginia with seven other locations, approximately 1,200 employees and a fleet of over 500 vehicles.

Fair value

The following summarizes the acquisition date fair value of consideration transferred and the acquisition date fair value of the identifiable assets acquired and liabilities assumed, including an amount for goodwill (in thousands):

Consideration transferred:	
Cash paid from available funds	\$ 57,072
Cash paid for excess working capital	23,256
Receivable for working capital adjustment	(931)
Notes issued to former owners	24,200
Estimated fair value of contingent earn-out obligation	6,660
	110,257
Less Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and cash equivalents	43,798
Receivables	33,186
Costs and estimated earnings in excess of billings	10,150
Other current assets	1,348
Property and equipment	13,288
Estimated identifiable intangible assets	24,750
Current maturities of long-term debt	(12,215)
Accounts payable and other current liabilities	(31,177)
Billings in excess of costs and estimated earnings	(9,700)
Long-term debt, net of current maturities	(4,593)
Effect of transaction on deferred income taxes	(7,857)
Other long-term liabilities	(458)
	60,520
Goodwill	\$ 49,737

Goodwill represents the future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. ColonialWebb had \$8.4 million of tax deductible goodwill from a previous transaction that has a carryover basis. There is no additional tax deductible goodwill recognized as a result of this transaction.

In estimating the fair value of the acquired intangible assets, we utilized the valuation methodology determined to be the most appropriate for the individual intangible asset. In order to estimate the fair value of the backlog and customer relationships, we utilized an excess earnings methodology, which consisted of the projected cash flows attributable to these assets discounted to present value using a

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

4. Acquisitions (Continued)

risk-adjusted discount rate that represented the required rate of return. The trade name value was determined based on the relief-from-royalty method, which applies a royalty rate to the revenue stream attributable to this asset and the resulting royalty payment is tax affected and discounted to present value. The non-compete agreement value was determined based on a discounted cash flow analysis comparing the present value of the cash flows with and without the asset. Some of the more significant estimates and assumptions inherent in determining the fair value of the identifiable intangible assets are associated with forecasting cash flows and profitability. The primary assumptions used were generally based upon the present value of anticipated cash flows discounted at rates ranging from 13%-19%. Estimated years of projected earnings generally follow the range of estimated remaining useful lives for each intangible asset class.

The acquired intangible assets include the following (dollars in thousands):

	Valuation Method	Estimated Amortization Life	Estimated Value
Backlog	Excess earnings	2 years	\$ 580
Customer relationships	Excess earnings	15 years	13,900
Non-compete agreement	Discounted cash flow	5 years	170
Trade name	Relief-from-royalty	25 years	10,100
Total acquired intangible assets			\$ 24,750

The contingent earn-out obligation is associated with the achievement of specified earnings milestones over a four year period and the range of estimated milestone payments is from \$3 million to \$14 million (undiscounted). We determined the initial fair value of the contingent earn-out obligation based on a probability weighted income approach. The resulting probability-weighted cash flows were discounted using a 5% discount rate, which we believe is appropriate and representative of a market participant assumption. Subsequent to the acquisition date, we will measure the contingent earn-out obligation at fair value each reporting period. Future changes in the estimated fair value of the contingent payments will be recognized immediately in earnings.

Actual and Pro Forma Impact of the Acquisition

The revenue and pre-tax income of ColonialWebb included in the Company's consolidated statements of operations since the acquisition date are as follows (in thousands):

	From Acquisition Date through September 30, 2010
Revenue	\$ 38,722
Pre-tax income	\$ 220

The following unaudited pro forma information presents the consolidated results of the Company and ColonialWebb for the three and nine months ended September 30, 2010 and 2009, with adjustments to give effect to pro forma events that are directly attributable to the acquisition and have

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

4. Acquisitions (Continued)

a continuing impact. The unaudited pro forma information is presented for illustrative purposes only and is not necessarily indicative of the results of operations of future periods or the results of operations that actually would have been realized had the entities been a single company during the periods presented or the results that the company will experience after the acquisition. The unaudited pro forma information does not give effect to the potential impact of current financial conditions, regulatory matters or any operating efficiencies that may be associated with the acquisition.

The unaudited pro forma consolidated results of operations, assuming the acquisition had occurred on January 1, 2009, are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Revenue	\$ 344,803	\$ 326,154	\$ 1,037,373	\$ 904,531
Pre-tax income	\$ 20,050	\$ 8,935	\$ 57,302	\$ 18,649

Other acquisitions

We completed one acquisition in the first quarter of 2010 and one "tuck-in" acquisition in the third quarter of 2010, which were not material individually or in the aggregate. There were no acquisitions for the nine months ended September 30, 2009. Our consolidated balance sheets include preliminary allocations of the purchase price to the assets acquired and liabilities assumed based on estimates of fair value, pending completion of final valuation and purchase price adjustments. The results of operations of these acquisitions are included in our consolidated financial statements from their respective acquisition dates. Additional contingent purchase price ("earn-out") has been and will be paid if certain acquisitions achieve predetermined profitability targets.

5. Discontinued Operations

We sold a small operating company in June 2009. This company's after-tax loss of \$0.4 million for the nine months ended September 30, 2009 has been reported in discontinued operations under "Operating loss, net of income tax benefit." During the first quarter of 2010, we recorded an income tax benefit of \$0.3 million related to the adjustment of certain valuation allowances related to this discontinued operation. During the third quarter of 2010, we recorded a gain of \$0.2 million related to a settlement with the former owner of this company. This gain was offset by income tax expense of \$0.2 million.

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

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

5. Discontinued Operations (Continued)

Revenues and pre-tax loss related to this company in 2009 and 2010 were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Revenues	\$	\$	\$ 1,795	\$
Pre-tax loss	\$	\$	\$ (520)	\$

Sale of Companies to Emtor In March 2002, we sold 19 operations to Emtor Group, Inc. ("Emtor"). The total purchase price was \$186.25 million, including the assumption by Emtor of approximately \$22.1 million of subordinated notes to former owners of certain of the divested companies. Of Emtor's purchase price, \$5 million was deposited into an escrow account to secure potential obligations on our part to indemnify Emtor 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 our liability to Emtor in connection with the settlement of certain claims. The remaining \$1 million of escrow was disbursed to us in March 2010.

There are ongoing open matters relating to this transaction that we continue to address with Emtor. We do not believe these open matters, either individually or in the aggregate, will have a material adverse effect on our financial position when ultimately resolved. During the fourth quarter of 2009, we recorded a gain of \$0.8 million based upon a review of open matters. During the first quarter of 2010, in connection with the final escrow release, we recorded an additional gain of \$0.5 million (net of income tax expense of \$0.3 million) based upon a further review of open matters. The gain recorded during the first quarter is included in discontinued operations in the caption "Estimated gain (loss) on disposition, net of income tax expense."

6. Goodwill and Identifiable Intangible Assets, net

The changes in the carrying amount of goodwill are as follows (in thousands):

	December 31,		September 30,	
	2009		2010	
Balance at beginning of year	\$	90,940	\$	100,194
Additions		9,254		52,770
Impairment adjustment				(4,446)
Balance at end of period	\$	100,194	\$	148,518

As discussed in Note 4, the ColonialWebb acquisition resulted in goodwill of approximately \$49.7 million.

We recorded a goodwill impairment charge of \$4.4 million (\$2.7 million after tax, or \$0.07 per diluted share) during the second quarter of 2010. This impairment charge resulted from our estimation that the operating environment, conditions and performance at our operating location based in

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

6. Goodwill and Identifiable Intangible Assets, net (Continued)

Delaware could no longer support the related goodwill balance. Impairment must be reflected when the value of a given business unit in excess of its identifiable assets and liabilities falls below the goodwill asset balance carried for that unit on our books. The fair value was estimated using a discounted cash flow model combined with market valuation approaches.

Identifiable intangible assets consist of the following (dollars in thousands):

	Estimated Useful Lives in Years	December 31, 2009		September 30, 2010	
		Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Customer relationships	2 - 15	\$ 10,943	\$ (2,196)	\$ 25,685	\$ (4,195)
Backlog	1 - 2	4,150	(3,304)	4,740	(3,952)
Noncompete agreements	2 - 7	2,960	(1,046)	3,490	(1,534)
Tradenames	2 - 25	9,240	(1,367)	19,570	(2,255)
Total		\$ 27,293	\$ (7,913)	\$ 53,485	\$ (11,936)

The tradename associated with an acquisition completed in prior years previously had an indefinite life. We determined that this asset had a finite life as a result of the ColonialWebb acquisition, since both companies are in similar geographical markets. The Company performed an impairment test on this asset as of the third quarter 2010 and did not incur a charge for impairment. This asset is now being amortized over its 20 year estimated useful life.

7. Long-Term Debt Obligations

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

	December 31, 2009	September 30, 2010
Revolving credit facility	\$	\$
Other debt	250	3,000
Notes to former owners	7,358	28,317
Total debt	7,608	31,317
Less current portion	(1,167)	(1,417)
Total long-term portion of debt	\$ 6,441	\$ 29,900

Revolving Credit Facility

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On July 16, 2010, we entered into a \$125.0 million senior credit facility (the "Facility") provided by a syndicate of banks. The Facility, which is available for borrowings and letters of credit, expires in July 2014 and is secured by the capital stock of our current and future subsidiaries. As of September 30, 2010, we had no outstanding borrowings, \$40.6 million in letters of credit outstanding, and \$84.4 million of credit available.

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

7. Long-Term Debt Obligations (Continued)

We have a choice of two interest rate options for borrowings under the Facility, the Base Rate Option and the Eurodollar Rate Option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

The following is a summary of the margins above:

	Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA			
	Less than 0.75	0.75 to 1.25	1.25 to 2.00	2.00 or greater
Additional Per Annum Interest Margin Added Under:				
Base Rate Option	0.75%	1.00%	1.25%	1.50%
Eurodollar Rate Option	1.75%	2.00%	2.25%	2.50%

We estimate that the interest rate applicable to the borrowings under the Facility would be approximately 4.0% as of September 30, 2010. Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.25%-0.45% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

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

Leverage Ratio The Facility requires that the ratio of our Adjusted Indebtedness to our Credit Facility Adjusted EBITDA not exceed 2.50. The leverage ratio as of September 30, 2010 was 0.45.

Fixed Charge Coverage Ratio The Facility requires that the ratio of Credit Facility Adjusted EBITDA, less non-financed capital expenditures and tax provision, dividends and amounts used to repurchase stock to the sum of interest expense and scheduled principal payments of indebtedness be at least 2.00; provided that the calculation of the fixed charge coverage ratio excludes stock repurchases and the payment of dividends at any time that the Company's Net Leverage Ratio does not exceed 1.0. Capital expenditures, tax provision, dividends and stock repurchase payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of September 30, 2010 was 20.25.

Other Restrictions The Facility permits acquisitions of up to \$5.0 million per transaction, provided that the aggregate purchase price of such an acquisition and of acquisitions in the preceding 12 month period does not exceed \$10.0 million. However, these limitations only apply when the Company's Net Leverage Ratio is equal to or greater than 1.5.

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

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

7. Long-Term Debt Obligations (Continued)

We are in compliance with all the financial covenants as of September 30, 2010.

We incurred approximately \$0.9 million in financing and professional costs in connection with the arrangement of the Facility. These costs are amortized on a straight-line basis as a non-cash charge to interest expense over the term of the Facility. We wrote off approximately \$0.2 million in unamortized debt costs related to our previous credit facility during the third quarter of 2010. This write-off is included in interest expense.

Notes to Former Owners

We issued subordinated notes to the former owners of acquired companies, as part of the consideration used to acquire these companies. These notes had an outstanding balance of \$28.3 million as of September 30, 2010, of which \$1.1 million is current as of September 30, 2010 and bear interest, payable annually, at a weighted average interest rate of 3.4%.

Other Debt

In conjunction with our acquisition of ColonialWebb, we acquired \$3.0 million of long-term debt related to an industrial revenue bond associated with its office building and warehouse. We have included both the \$0.3 million current portion and the \$2.7 million long-term portion on our balance sheet as of September 30, 2010. We also assumed a \$9.3 million revolving loan and \$4.3 million in notes payable for vehicles and equipment. These debt instruments were paid off during the third quarter of 2010.

8. Commitments and Contingencies

Claims and Lawsuits

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

In addition to the matters described above, we have accrued \$6.5 million as of September 30, 2010 for potential and asserted backcharges from several customers of our large multi-family operation based in Texas. The additions and reductions to the accrual were included in "Cost of Services". The accrual is included in "Other Current Liabilities". We believe these accruals reflect a probable outcome with respect to such backcharges and potential backcharges, however, if we are not successful in resolving these disputes, we may in the future experience a material adverse effect on our operating results.

Table of Contents**COMFORT SYSTEMS USA, INC.****CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****September 30, 2010****(Unaudited)****8. Commitments and Contingencies (Continued)**

The following summarizes the backcharge activity during the nine months ended September 30, 2010 (in thousands):

Balance at December 31, 2009	\$ 6,489
Additions	
Utilization	
Balance at September 30, 2010	\$ 6,489

Surety

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

Surety market conditions remain challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 35% of our business has required bonds. While we have strong surety relationships to support our bonding needs, current market conditions as well as changes in the sureties' assessment of our operating and financial risk could cause the sureties to decline to issue bonds for our work. If that were to occur, the alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics, including a significant amount of cash on our balance sheet, would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenues and profits to decline in the near term.

Self-Insurance

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

COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

8. Commitments and Contingencies (Continued)

Our self-insurance arrangements currently are as follows:

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

Employer's Liability For employer's liability, the per-incident deductible is \$500,000. We are fully insured for the next \$500,000 of each loss, and then have several layers of excess loss insurance policies that cover losses up to \$75 million in aggregate across this risk area (as well as general liability and auto liability noted below).

General Liability For general liability, the per-incident deductible is \$500,000. We are fully insured for the next \$1.5 million of each loss, and then have several layers of excess loss insurance policies that cover losses up to \$75 million in aggregate across this risk area (as well as employer's liability and auto liability noted below).

Auto Liability For auto liability, the per-incident deductible is \$500,000. We are fully insured for the next \$1.5 million of each loss, and then have several layers of excess loss insurance policies that cover losses up to \$75 million in aggregate across this risk area (as well as employer's liability and general liability noted above).

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

Our \$75 million of aggregate excess loss coverage above applicable per-incident deductibles represents one policy limit that applies to all lines of risk; we do not have a separate \$75 million of excess loss coverage for each of general liability, employer's liability and auto liability.

9. Stockholders' Equity

Earnings Per Share

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

There were approximately 0.4 million and 0.7 million of anti-dilutive stock options that were excluded from the calculation of diluted EPS for the three months ended September 30, 2009 and 2010, respectively. There were approximately 0.6 million and 0.5 million of anti-dilutive stock options that were excluded from the calculation of diluted EPS for the nine months ended September 30, 2009 and 2010, respectively.

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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(Unaudited)

9. Stockholders' Equity (Continued)

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,	
	2009	2010	2009	2010
Common shares outstanding, end of period(a)	37,919	37,491	37,919	37,491
Effect of using weighted average common shares outstanding	76	69	216	73
Shares used in computing earnings per share basic	37,995	37,560	38,135	37,564
Effect of shares issuable under stock option plans based on the treasury stock method	350	234	380	257
Effect of contingently issuable restricted stock	37		18	
Shares used in computing earnings per share diluted	38,382	37,794	38,533	37,821

(a) Excludes 0.4 million and 0.4 million shares of unvested contingently issuable restricted stock outstanding as of September 30, 2009 and 2010, respectively.

Share Repurchase Program

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to one million shares of our outstanding common stock. As of December 31, 2009, the Board approved extensions of the program to cover an additional 3.9 million shares. During the first quarter of 2010, the Board approved an extension of the program to cover an additional 0.7 million shares. Since the inception of the repurchase program, the Board has approved 5.6 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 0.4 million shares during the nine months ended September 30, 2010, at an average price of \$11.19 per share. Since the inception of the program in 2007, we have repurchased a cumulative total of 4.8 million shares as of September 30, 2010, at an average price of \$11.15 per share.

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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, 2009 (the "Form 10-K"). This discussion contains "forward-looking statements" regarding our business and industry within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on our current plans and expectations and involve risks and uncertainties that could cause our actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in "Item 1A. Company Risk Factors" included in our Form 10-K. The terms "Comfort Systems," "we," "us," or "the Company," refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

Introduction and Overview

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

Nature and Economics of Our Business

Approximately 83% 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, and 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.

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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, 2010, we had 5,258 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$375,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. We have what we believe is a well-diversified distribution of revenues across end-use sectors that we believe reduces our exposure to negative developments in any given sector. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

We also perform larger HVAC projects. As of September 30, 2010, we had 6 projects in process with a contract price greater than \$15 million, 20 projects between \$10 million and \$15 million, 37 projects between \$5 million and \$10 million, and 180 projects between \$1 million and \$5 million. Taken together, projects with contract prices of \$1 million or more totaled \$1,062.3 million of aggregate contract value as of September 30, 2010, or approximately 54%, out of a total contract value for all projects in progress of \$1,965.0 million. Generally, projects closer in size to \$1 million will be completed in one year or less. It is unusual for us to work on a project that exceeds two years in length.

In addition to project work, approximately 17% 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 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

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

Profile and Management of Our Operations

We manage our 40 operating units based on a variety of factors. Financial measures we emphasize include profitability, and use of capital as indicated by cash flow and by other measures of working capital principally involving project cost, billings and receivables. We also monitor selling, general, administrative and indirect project support expense, backlog, workforce size and mix, growth in revenues and profits, variation of actual project cost from original estimate, and overall financial performance in comparison to budget and updated forecasts. Operational factors we emphasize include project selection, estimating, pricing, management and execution practices, labor utilization, safety, training, and the make-up of both existing backlog as well as new business being pursued, in terms of project size, technical application and facility type, end-use customers and industries, and location of the work.

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

Economic and Industry Factors

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

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

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Operating Environment and Management Emphasis

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

As discussed at greater length in "Results of Operations" below, we have seen declining activity levels in our industry since late 2008 and we expect price competition to continue to be strong, as local and regional competitors respond cautiously to changing conditions. We will continue our efforts to find the more active sectors in our markets, and to increase our regional and national account business. Our primary emphasis for 2010 will be on execution and cost control, and on maintaining activity levels that will permit us to earn reasonable profits while preserving our core workforce. We have increased our focus on project qualification, estimating, pricing and management, and on service performance.

As a result of our continued strong emphasis on cash flow, our debt outstanding under our revolving credit facility is zero, and we have substantial uncommitted cash balances, as discussed further in "Liquidity and Capital Resources" below. We have a credit facility in place with considerably less restrictive terms than those of our previous facilities; this facility is scheduled to expire in July 2014. We have strong surety relationships to support our bonding needs, and we believe our relationships with the surety markets are positive in light of our strong current results and financial position. We have generated positive free cash flow in each of the last eleven calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our balance sheet and surety support as compared to most companies in our industry represent competitive advantages for us.

Critical Accounting Policies

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

Percentage of Completion Method of Accounting

Approximately 83% of our revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method contract revenue recognizable at any time during the life of a contract is determined by multiplying expected total contract revenue by the percentage of contract costs incurred at any time to total estimated contract costs. More specifically, as part of the negotiation and bidding process in which we engage in connection with

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

We generally do not incur significant costs prior to receiving a contract, and therefore, these costs are expensed as incurred. In limited circumstances, when significant pre-contract costs are incurred, they are deferred if the costs can be directly associated with a specific contract and if their recoverability from the contract is probable. Upon receiving the contract, these costs are included in contract costs. Deferred costs associated with unsuccessful contract bids are written off in the period that we are informed that we will not be awarded the contract.

Our contracts typically provide for a schedule of billings or invoices to the customer based on reaching agreed-upon milestones or as we incur costs. The schedules for such billings usually do not precisely match the schedule on which we incur costs. As a result, contract revenues recognized in the statement of operations can and usually do differ from amounts that can be billed or invoiced to the customer at any point during the contract. Amounts by which cumulative contract revenues recognized on a contract as of a given date exceed cumulative billings to the customer under the contract are reflected as a current asset in our balance sheet under the caption "Costs and estimated earnings in excess of billings." Amounts by which cumulative billings to the customer under a contract as of a given date exceed cumulative contract revenues recognized on the contract are reflected as a current liability in our balance sheet under the caption "Billings in excess of costs and estimated earnings."

The percentage of completion method of accounting is also affected by changes in job performance, job conditions, and final contract settlements. These factors may result in revisions to estimated costs and, therefore, revenues. Such revisions are frequently based on further estimates and subjective assessments. We recognize these revisions in the period in which they are determined. If such revisions lead us to conclude that we will recognize a loss on a contract, the full amount of the estimated ultimate loss is recognized in the period we reach that conclusion, regardless of the percentage of completion of the contract.

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

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Accounting for Allowance for Doubtful Accounts

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

Accounting for Self-Insurance Liabilities

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

Accounting for Deferred Tax Assets

We regularly evaluate valuation allowances established for deferred tax assets for which future realization is uncertain. We perform this evaluation quarterly. Estimations of required valuation allowances include estimates of future taxable income. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which the activity underlying these assets becomes deductible. We consider projected future taxable income and tax planning strategies in making this assessment. If actual future taxable income differs from our estimates, we may not realize deferred tax assets to the extent we have estimated.

Recoverability of Goodwill and Identifiable Intangible Assets

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

We currently perform our annual impairment testing as of October 1 and any impairment charges resulting from this process are reported in the fourth quarter. We segregate our operations into reporting units based on the degree of operating and financial independence of each unit and our related management of them. We perform our annual goodwill impairment testing at the reporting unit level. We have 40 reporting units of which 28 reporting units have a goodwill balance. These reporting units are tested for impairment by comparing each unit's fair value to its carrying value. The fair value of each reporting unit was estimated using a discounted cash flow model combined with market

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valuation approaches. Significant estimates and assumptions are used in assessing the fair value of reporting units. These estimates and assumptions involved future cash flows, growth rates, discount rates, weighted average cost of capital and estimates of market valuations for each of the reporting units.

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

Results of Operations (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2009	%	2010	%	2009	%	2010	%
Revenues	\$ 291,591	100.0%	\$ 307,648	100.0%	\$ 872,214	100.0%	\$ 793,711	100.0%
Cost of services	234,186	80.3%	257,339	83.6%	701,335	80.4%	661,929	83.4%
Gross profit	57,405	19.7%	50,309	16.4%	170,879	19.6%	131,782	16.6%
Selling, general and administrative expenses	41,713	14.3%	41,885	13.6%	126,175	14.5%	114,905	14.5%
Goodwill impairment							4,446	0.6%
Gain on sale of assets	(101)		(29)		(98)		(502)	(0.1)%
Operating income	15,793	5.4%	8,453	2.7%	44,802	5.1%	12,933	1.6%
Interest income	117		39		492	0.1%	183	
Interest expense	(301)	(0.1)%	(832)	(0.3)%	(946)	(0.1)%	(1,406)	(0.2)%
Other income	3		669	0.2%	5		675	0.1%
Income before income taxes	15,612	5.4%	8,329	2.7%	44,353	5.1%	12,385	1.6%
Income tax expense	6,072		2,919		17,293		4,164	
Income from continuing operations	9,540	3.3%	5,410	1.8%	27,060	3.1%	8,221	1.0%
Discontinued operations								
Operating loss, net of tax					(387)			
Estimated gain (loss) on disposition, net of tax			(39)		(93)		723	
Net income	\$ 9,540		\$ 5,371		\$ 26,580		\$ 8,944	

Revenues Revenues increased \$16.1 million, or 5.5% to \$307.6 million for the third quarter of 2010 compared to the same period in 2009. The increase included an 10.8% decrease in revenues related to the same store activity offset by 16.3% increase from acquisitions. The same store revenue decrease stemmed from reduced activity in the nonresidential markets throughout the United States primarily in the education sector (approximately \$16.7 million) as well as continued decreases in the multi-family sector (approximately \$15.9 million). We have seen decreased activity, primarily in our Maryland and Denver operations, resulting from a significant decrease in these markets resulting in limited new projects. On July 28, 2010, we acquired ColonialWebb Contractors Company ("Colonial Webb"). ColonialWebb is a large regional contractor with its principal operations in Richmond and Norfolk, Virginia. During the third quarter of 2010, ColonialWebb contributed revenues of approximately \$38.7 million and pre-tax income of approximately \$0.2 million after the effect of intangible amortization.

Revenues for the first nine months of 2010 decreased \$78.5 million, or 9.0%, to \$793.7 million as compared to the same period in 2009. Approximately 16.3% of the decrease in revenues related to same store activity offset by 7.3% increase from acquisitions. The same store decrease stemmed primarily from decreased activity in the nonresidential markets throughout the United States especially in the education sector (approximately \$63.9 million) and in the multi-family sector (approximately \$50.8 million). We have seen decreased activity, mainly in our Maryland, Delaware and Denver

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operations resulting from the closeout of several large projects as well as a decline in market activity in these markets.

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

Backlog as of September 30, 2010 was \$638.5 million, a 26.0% increase from June 30, 2010 backlog of \$506.5 million, and a 15.2% increase from the September 30, 2009 backlog of \$554.3 million. On a same store basis, backlog increased 5.3% from June 30, 2010 and decreased 6.3% from September 30, 2009. The sequential increase was primarily related to our California and Maryland operations. The year-over-year decrease is primarily related to decreases at our Colorado, Wisconsin and Delaware operations due to the close out of several jobs and a decline in market activity.

Following the three-year period of industry activity declines from 2001-2003 noted previously, we saw modest year-over-year revenue increases at our ongoing operations beginning in mid-2003 and continuing throughout 2009. Based on our backlog and forecasts from industry construction analysts, we expect that activity levels in our industry are likely to decrease over the next twelve months, particularly in the area of new construction.

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

Gross Profit Gross profit decreased \$7.1 million, or 12.4%, to \$50.3 million for the third quarter of 2010 as compared to the same period in 2009. As a percentage of revenues, gross profit decreased from 19.7% in 2009 to 16.4% in 2010. The quarter over quarter decrease in gross profit percentage resulted primarily from a write-down on a large, fast-paced job at our Arizona operation (approximately \$1.6 million) and job write-downs at our northern Maryland operation (approximately \$1.5 million). This operation was merged into an existing, more established operating company during the third quarter of 2010. We also had less profitability from our Delaware operation (approximately \$1.6 million) due to weak market conditions.

Gross profit for the first nine months of 2010 decreased \$39.1 million, or 22.9% to \$131.8 million, as compared to the same period in 2009. As a percentage of revenues, gross profit decreased from 19.6% in 2009 to 16.6% in 2010. The year-over-year decrease in gross profit percentage for the first nine months of 2010 resulted primarily from lower profitability at our Central Florida operation (approximately \$3.8 million), as well as write downs on two jobs that are substantially complete at our Delaware operation (approximately \$4.5 million) and job underperformance at our northern Maryland operations (approximately \$3.0 million).

Selling, General and Administrative Expenses ("SG&A") SG&A increased \$0.2 million, or 0.4%, for the third quarter of 2010 as compared to the same period in 2009. On a same store basis, excluding amortization expense, SG&A decreased \$6.6 million, or 16.0%. The same store decrease was primarily related to lower medical costs related to employees terminated in the prior year who elected health insurance coverage under COBRA, overhead reductions and lower compensation accruals due to lower profitability during the third quarter of 2010 as compared to the same period in 2009. Amortization expense increased \$1.0 million, or 184%, primarily related to 2010 acquisitions. As a percentage of revenues, SG&A decreased from 14.3% in 2009 to 13.6% in 2010 due to a higher revenue base in 2010.

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SG&A decreased \$11.3 million, or 8.9%, to \$114.9 million for the first nine months ended September 30, 2010 as compared to the same period in 2009. On a same store basis, excluding amortization expense, SG&A decreased \$20.0 million, or 16.1%. Approximately \$8.6 million of the decrease is due to overhead reductions, lower medical costs related to employees terminated in the prior year who elected health insurance coverage under COBRA, lower compensation accruals and lower bad debt expense. Amortization expense increased \$1.6 million, or 87%, primarily related to 2010 acquisitions. As a percentage of revenues, SG&A remained flat at 14.5% for the first nine months of 2009 and 2010.

Goodwill Impairment We recorded a goodwill impairment charge of \$4.4 million (\$2.7 million after tax, or \$0.07 per diluted share) during the second quarter of 2010. This impairment charge resulted from our estimation that the operating environment, conditions and performance at our operating location based in Delaware could no longer support the related goodwill balance. Impairment must be reflected when the value of a given business unit in excess of its identifiable assets and liabilities falls below the goodwill asset balance carried for that unit on our books.

Income Tax Expense Our year to date effective tax rate for 2010 was 33.6%, as compared to 39.0% in 2009. The decrease in the effective tax rate for 2010 is primarily due to the release of certain valuation allowances during the second quarter of 2010 and accrual-to-return differences. Adjustments to tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. We currently estimate our annual effective tax rate for 2010 will be between 36% and 38%.

Outlook We expect that developing weakness in the underlying environment for nonresidential activity will affect 2010 activity levels in our industry compared to recent years. Our backlog, while still at solid levels by historical standards, has experienced declines. Our primary emphasis for 2010 will be on execution, including a focus on cost controls and efficient project and service performance at the unit level. Based on our backlog and despite weak economic conditions for our industry, we expect a profitable fourth quarter, and we anticipate continued profitability in 2011.

Liquidity and Capital Resources:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
	(in thousands)			
Cash provided by (used in):				
Operating activities	\$ 24,803	\$ (3,772)	\$ 44,754	\$ (14,471)
Investing activities	(1,438)	(39,165)	(7,241)	(40,417)
Financing activities	(3,917)	(20,004)	(14,665)	(28,301)
Net increase (decrease) in cash and cash equivalents	\$ 19,448	\$ (62,941)	\$ 22,848	\$ (83,189)
Free cash flow:				
Cash provided by (used in) operating activities	\$ 24,803	\$ (3,772)	\$ 44,754	\$ (14,471)
Taxes paid related to pre-acquisition equity transactions of an acquired company		7,056		7,056
Purchases of property and equipment	(1,986)	(2,021)	(6,420)	(4,103)
Proceeds from sales of property and equipment	326	11	500	1,229
Free cash flow	\$ 23,143	\$ 1,274	\$ 38,834	\$ (10,289)

Cash Flow We define free cash flow as cash provided by operating activities less customary capital expenditures, plus the proceeds from asset sales and taxes paid related to pre-acquisition equity

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transactions of an acquired company. Positive free cash flow represents funds available to invest in significant operating initiatives, to acquire other companies, or to reduce a company's outstanding debt or equity. If free cash flow is negative, additional debt or equity is generally required to fund the outflow of cash. Free cash flow may be defined differently by other companies.

Our business does not require significant amounts of investment in long-term fixed assets. The substantial majority of the capital used in our business is working capital that funds our costs of labor and installed equipment deployed in project work until our customers pay us. Customary terms in our industry allow customers to withhold a small portion of the contract price until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage. Our average project duration together with typical retention terms generally allow us to complete the realization of revenue and earnings in cash within one year. Accordingly, we believe free cash flow, by encompassing both profit margins and the use of working capital over our approximately one year working capital cycle, is an effective measure of operating effectiveness and efficiency. We have included free cash flow information here for this reason, and because we are often asked about it by third parties evaluating us. However, free cash flow is not considered under generally accepted accounting principles to be a primary measure of an entity's financial results, and accordingly free cash flow should not be considered an alternative to operating income, net income, or amounts shown in our consolidated statements of cash flows as determined under generally accepted accounting principles.

For the three months ended September 30, 2010, we had free cash flow of \$1.3 million as compared to free cash flow of \$23.1 million in 2009. For the nine months ended September 30, 2010, we had negative free cash flow of \$10.3 million as compared to free cash flow of \$38.8 million for the first nine months of 2009. This decrease is due to lower profitability and less favorable billing and collections as a result of economic conditions.

Marketable Securities

As of September 30, 2010, our marketable securities consisted of \$2.8 million of auction rate securities, which are variable rate debt instruments, having long-term maturities, but whose interest rates are designed to reset through an auction process at 35 day intervals. We had investments in marketable securities of \$5.6 million as of December 31, 2009. All of our auction rate securities are high quality direct municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. The auction events for some of these instruments failed during 2008 due to events in the credit markets. As a result, we have determined the estimated fair values of these securities based on discounted cash flow analyses or other types of valuation models. We have performed and routinely update these valuations considering, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose to sell the securities in the absence of a successful auction. These securities are also compared, when possible, to observable market data with similar characteristics.

In association with our estimate of fair value as of September 30, 2010, we have recorded a temporary unrealized decline in fair value of \$0.1 million, net of tax, with an offsetting entry to accumulated other comprehensive income (loss). We continue to believe that this decline is due to liquidity issues rather than credit issues. We continue to collect interest when due on all of our auction rate securities. Any future fluctuation in fair value related to these instruments that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive income (loss). If we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings as appropriate.

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As a result of the current situation in the auction markets, our ability to liquidate our investment in auction rate securities and fully recover the carrying value of our investment in the near term may be limited or impossible. If in the future the issuers are unable to successfully close future auctions and their credit ratings deteriorate and if we determine that any future valuation adjustment was other than temporary, we may be required to record an impairment charge on these investments. Because the tax exempt interest rates on these bonds are relatively attractive, we believe that we may be able to liquidate our investment without significant loss in the foreseeable future; however, it could take until the final maturity of the underlying notes (up to June 2032) to be repaid. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

Share Repurchase Program

In March 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to one million shares of our outstanding common stock. As of December 31, 2009, the Board approved extensions of the program to cover an additional 3.9 million shares. During the first quarter of 2010, the Board approved an extension of the program to cover an additional 0.7 million shares. Since the inception of the repurchase program, the Board has approved 5.6 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 0.4 million shares during the nine months ended September 30, 2010, at an average price of \$11.19 per share. Since the inception of the repurchase program in 2007, we have repurchased a cumulative total of 4.8 million shares as of September 30, 2010, at an average price of \$11.15 per share.

Credit Facility On July 16, 2010, we entered into a \$125.0 million senior credit facility (the "Facility") provided by a syndicate of banks. The Facility, which is available for borrowings and letters of credit, expires in July 2014 and is secured by the capital stock of our current and future subsidiaries. As of September 30, 2010, we had no outstanding borrowings, \$40.6 million in letters of credit outstanding, and \$84.4 million of credit available.

We have a choice of two interest rate options for borrowings under the Facility, the Base Rate Option and the Eurodollar Rate Option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

The following is a summary of the margins above:

	Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA			
	Less than 0.75	0.75 to 1.25	1.25 to 2.00	2.00 or greater
Additional Per Annum Interest Margin Added Under:				
Base Rate Option	0.75%	1.00%	1.25%	1.50%
Eurodollar Rate Option	1.75%	2.00%	2.25%	2.50%

We estimate that the interest rate applicable to the borrowings under the Facility would be approximately 4.0% as of September 30, 2010. Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.25%-0.45% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

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

Leverage Ratio The Facility requires that the ratio of our Consolidated Indebtedness to our Credit Facility Adjusted EBITDA not exceed 2.50. The leverage ratio as of September 30, 2010 was 0.45.

Fixed Charge Coverage Ratio The Facility requires that the ratio of Credit Facility Consolidated EBITDA, less non-financed capital expenditures and tax provision, dividends and amounts used to repurchase stock to the sum of interest expense and scheduled principal payments of indebtedness be at least 2.00; provided that the calculation of the fixed charge coverage ratio excludes stock repurchases and the payment of dividends at any time that the Company's Net Leverage Ratio does not exceed 1.0. Capital expenditures, tax provision, dividends and stock repurchase payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of September 30, 2010 was 20.25.

Other Restrictions The Facility permits acquisitions of up to \$5.0 million per transaction, provided that the aggregate purchase price of such an acquisition and of acquisitions in the preceding 12 month period does not exceed \$10.0 million. However, these limitations only apply when the Company's Net Leverage Ratio is equal to or greater than 1.5.

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

We are in compliance with all the financial covenants as of September 30, 2010.

We incurred approximately \$0.9 million in financing and professional costs in connection with the arrangement of the Facility. These costs are amortized on a straight-line basis as a non-cash charge to interest expense over the term of the Facility. We wrote off approximately \$0.2 million in unamortized debt costs related to our previous credit facility during the third quarter of 2010. This write-off is included in interest expense.

Notes to Former Owners We issued subordinated notes to the former owners of acquired companies, as part of the consideration used to acquire these companies. These notes had an outstanding balance of \$28.3 million, of which \$1.1 million is current as of September 30, 2010. These notes bear interest, payable annually, at a weighted average interest rate of 3.4%.

Other Debt In conjunction with our acquisition of ColonialWebb, we acquired \$3.0 million of long-term debt related to an industrial revenue bond associated with its office building and warehouse. We have included both the \$0.3 million current portion and the \$2.7 million long-term portion on our balance sheet as of September 30, 2010. We also assumed a \$9.3 million revolving loan and \$4.3 million in notes payable for vehicles and equipment. These debt instruments were paid off during the third quarter of 2010.

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

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obligation to the lessor. If we decide to cancel or terminate a lease before the end of its term, we would typically owe the lessor the remaining lease payments under the term of the lease.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. The letters of credit we provide are actually issued by our lenders through the Facility as described above. A letter of credit commits the lenders to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, we would be required to reimburse the lenders. Depending on the circumstances of such a reimbursement, we may also have to record a charge to earnings for the reimbursement. Absent a claim, there is no payment or reserving of funds by us in connection with a letter of credit. However, because a claim on a letter of credit would require immediate reimbursement by us to our lenders, letters of credit are treated as a use of the Facility's capacity just the same as actual borrowings. Claims against letters of credit are rare in our industry. To date we have not had a claim made against a letter of credit that resulted in payments by a lender or by us. We believe that it is unlikely that we will have to fund claims under a letter of credit in the foreseeable future.

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

Surety market conditions are currently challenging as a result of significant losses incurred by many sureties in recent periods, both in the construction industry as well as in certain larger corporate bankruptcies. As a result, less bonding capacity is available in the market and terms have become more restrictive. Further, under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 25% to 35% of our business has required bonds. While we have strong surety relationships to support our bonding needs, current market conditions as well as changes in our sureties' assessment of our operating and financial risk could cause our sureties to decline to issue bonds for our work. If that were to occur, our alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics, including a significant amount of cash on our balance sheet, would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenues and profits to decline in the near term.

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The following recaps the future maturities of our contractual obligations as of September 30, 2010 (in thousands):

	Twelve Months Ended September 30,						
	2011	2012	2013	2014	2015	Thereafter	Total
Notes to former owners	\$ 1,117	\$ 1,350	\$ 13,450	\$ 12,400	\$	\$	\$ 28,317
Other debt	300	300	300	300	300	1,500	3,000
Interest payable	881	895	815	462			3,053
Operating lease obligations	10,146	8,604	7,049	4,671	2,882	4,792	38,144
Total	\$ 12,444	\$ 11,149	\$ 21,614	\$ 17,833	\$ 3,182	\$ 6,292	\$ 72,514

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

As of September 30, 2010, we have \$40.6 million letter of credit commitments, of which \$33.5 million will expire in 2010, \$4.0 million will expire in 2011 and \$3.1 million will expire in 2012. The substantial majority of these letters of credit are posted with insurers who disburse funds on our behalf in connection with our worker's compensation, auto liability and general liability insurance program. These letters of credit provide additional security to the insurers that sufficient financial resources will be available to fund claims on our behalf, many of which develop over long periods of time, should we ever encounter financial duress. Posting of letters of credit for this purpose is a common practice for entities that manage their self-insurance programs through third-party insurers as we do. While most of these letter of credit commitments expire in 2010, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually.

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

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

Cyclicality and Seasonality

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

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

Table of Contents**Recent Accounting Pronouncements**

In the first quarter of 2010, certain disclosure provisions of the FASB Accounting Standards Update 2010-06 became effective for the Company. This standard clarified existing fair value requirements under the FASB ASC's Fair Value Measurements and Disclosures Topic 820, including the level of disaggregation required for fair value disclosures and disclosure of the valuation techniques and inputs used in estimating level 2 and level 3 fair value measurements. Our adoption of this standard did not have a material impact on our financial position, results of operations or cash flows.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

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

The following table presents principal amounts (stated in thousands) and related average interest rates by year of maturity for our debt obligations and their indicated fair market value at September 30, 2010:

	Twelve Months Ended September 30,						
	2011	2012	2013	2014	2015	Thereafter	Fair Value
Fixed Rate Debt	\$ 1,117	\$ 1,350	\$ 13,450	\$ 12,400	\$	\$	\$ 28,317
Average Interest Rate	5.6%	3.8%	3.3%	3.2%			3.4%
Variable Rate Debt	\$ 300	\$ 300	\$ 300	\$ 300	\$ 300	\$ 1,500	\$ 3,000

The weighted average interest rate on the variable rate debt as of September 30, 2010 was approximately 0.5%.

As of September 30, 2010, our marketable securities consisted of \$2.8 million of auction rate securities, which are variable rate debt instruments, having long-term maturities, but whose interest rates are designed to reset through an auction process at 35 day intervals. We had investments in marketable securities of \$5.6 million as of December 31, 2009. All of our auction rate securities are high quality direct municipal obligations which have high investment grade ratings or otherwise are backed by high investment grade rated insurance agencies. The auction events for some of these instruments failed during 2008 due to events in the credit markets. As a result, we have determined the estimated fair values of these securities based on discounted cash flow analyses or other types of valuation models. We have performed and routinely update these valuations considering, among other items, the creditworthiness of the counterparty, the timing of expected future cash flows, and the possibility that a discount may be required if we choose to sell the securities in the absence of a successful auction. These securities are also compared, when possible, to observable market data with similar characteristics.

In association with our estimate of fair value as of September 30, 2010, we have recorded a temporary unrealized decline in fair value of \$0.1 million, net of tax, with an offsetting entry to accumulated other comprehensive income (loss). We continue to believe that this decline is due to liquidity issues rather than credit issues. We continue to collect interest when due on all of our auction

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rate securities. Any future fluctuation in fair value related to these instruments that we deem to be temporary, including any recoveries of previous write-downs, would be recorded to accumulated other comprehensive income (loss). If we determine that any future valuation adjustment was other than temporary, we would record a charge to earnings as appropriate.

As a result of the current situation in the auction markets, our ability to liquidate our investment in auction rate securities and fully recover the carrying value of our investment in the near term may be limited or impossible. If in the future the issuers are unable to successfully close future auctions and their credit ratings deteriorate and if we determine that any future valuation adjustment was other than temporary, we may be required to record an impairment charge on these investments. Because the tax exempt interest rates on these bonds are relatively attractive, we believe that we may be able to liquidate our investment without significant loss in the foreseeable future; however, it could take until the final maturity of the underlying notes (up to June 2032) to be repaid. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

We measure certain assets, including our goodwill and intangible assets, at a fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. During the nine months ended September 30, 2010, we recorded a goodwill impairment charge of \$4.4 million. We did not recognize any other impairments on those assets required to be measured at fair value on a nonrecurring basis.

The valuation of the Company's contingent earn-out payments is determined using a probability weighted discounted cash flow method. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payment, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the three months ended September 30, 2010 that have materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

Table of Contents**COMFORT SYSTEMS USA, INC.****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

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

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

None.

Issuer Purchases of Equity Securities

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to one million shares of our outstanding common stock. As of December 31, 2009, the Board approved extensions of the program to cover an additional 3.9 million shares. During the first quarter of 2010, the Board approved an extension of the program to cover an additional 0.7 million shares. Since the inception of the repurchase program, the Board has approved 5.6 million shares to be repurchased.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. We repurchased 0.4 million shares during the nine months ended September 30, 2010, at an average price of \$11.19 per share. Since the inception of the program, we have repurchased a cumulative total of 4.8 million shares as of September 30, 2010, at an average price of \$11.15 per share.

During the quarter ended September 30, 2010, we purchased our common shares in the following amounts at the following average prices:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 - July 31		\$	4,734,506	888,781
August 1 - August 31		\$	4,734,506	888,781
September 1 - September 30	80,014	\$ 10.64	4,814,520	808,767
	80,014	\$ 10.64	4,814,520	808,767

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

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During the quarter ended September 30, 2010, we withheld common shares to satisfy these tax withholding obligations as follows:

Period	Number of Shares Purchased	Average Price Paid Per Share
July 1 - July 31		
August 1 - August 31	221	\$ 10.50
September 1 - September 30		
	221	\$ 10.50

Item 6. Exhibits

(a)

Exhibits.

- 10.1 Second Amended and Restated Credit Agreement by and among Comfort Systems USA, Inc., as Borrower and Wells Fargo Bank, National Association, as Administrative Agent/Wells Fargo Securities LLC, as Sole Lead Arranger and Sole Lead Book Runner/Bank of Texas, N.A., Capital One, N.A. and Regions Bank as Co-Syndication Agent/and Certain Financial Institutions as Lenders (incorporated by reference to Exhibit 10.1 to the Company's current report on Form 8-K/A filed on July 22, 2010).
- 10.2 Stock Purchase Agreement, dated July 28, 2010 (incorporated by reference to Exhibit 10.1 to the Company's current report on Form 8-K filed on July 30, 2010).
- 31.1 Rule 13a-14(a) Certification of William F. Murdy pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Rule 13a-14(a) Certification of William George pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Section 1350 Certification of William F. Murdy pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Section 1350 Certification of William George pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

