LEGG MASON INC
Form 10-Q
August 05, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from to

Commission file number: 1-8529

LEGG MASON, INC.
(Exact name of registrant as specified in its charter)

MARYLAND	52-1200960
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 International Drive - Baltimore, MD	21202
(Address of principal executive offices)	(Zip code)

(410) 539-0000
(Registrant s telephone number, including area code)

100 Light Street - Baltimore, MD 21202
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

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 (§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 X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	X	Accelerated filer	
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

142,665,053 shares of common stock and 1,126,573 exchangeable shares as of the close of business on August 3, 2009. The exchangeable shares, which were issued by a subsidiary of the registrant, are exchangeable at any time into common stock on a one-for-one basis and entitle holders to dividend, voting and other rights equivalent to common stock.

PART I. FINANCIAL INFORMATION

Item 1.

Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

(Unaudited)

	June 30, 2009	March 31, 2009
ASSETS		
Current Assets		
Cash and cash equivalents	$ 1,539,295	$ 1,084,474
Restricted cash	34,720	41,688
Receivables:		
Investment advisory and related fees	297,447	293,084
Other	229,362	306,837
Investment securities	356,008	336,092
Refundable income taxes	23,700	603,668
Deferred income taxes	90,970	94,112
Other	66,060	99,432
Total current assets	2,637,562	2,859,387
Fixed assets, net	380,408	367,043
Intangible assets, net	3,918,993	3,922,801
Goodwill	1,207,579	1,186,747
Deferred income taxes	753,474	759,433
Other	146,677	136,888
Total Assets	$ 9,044,693	$ 9,232,299
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities		
Current Liabilities		
Accrued compensation	$ 188,684	$ 374,025
Accounts payable and accrued expenses	396,908	400,761
Short-term borrowings	250,000	250,000
Current portion of long-term debt	7,964	8,188
Fund support	5,500	20,631

Other	145,224	227,588
Total current liabilities	994,280	1,281,193
Deferred compensation	99,890	105,115
Deferred income taxes	256,812	258,944
Other	218,146	225,400
Long-term debt	2,738,524	2,732,002
Total Liabilities	4,307,652	4,602,654
Commitments and Contingencies (Note 8)		
Redeemable Noncontrolling Interests	36,626	31,020
Stockholders Equity		
Common stock, par value $.10; authorized 500,000,000 shares; issued 142,452,080 shares and 141,853,025 shares, respectively	14,245	14,185
Preferred stock, par value $10; authorized 4,000,000 shares;		
no shares outstanding	-	-
Shares exchangeable into common stock	2,830	3,069
Additional paid-in capital	3,467,437	3,452,530
Employee stock trust	(33,238)	(35,094)
Deferred compensation employee stock trust	33,238	35,094
Retained earnings	1,177,376	1,131,625
Accumulated other comprehensive income (loss), net	38,527	(2,784)
Total Stockholders Equity	4,700,415	4,598,625
Total Liabilities and Stockholders Equity	$ 9,044,693	$ 9,232,299

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008
Operating Revenues		
Investment advisory fees		
Separate accounts	$ 190,888	$ 316,675
Funds	328,024	569,558
Performance fees	5,684	10,145
Distribution and service fees	86,701	153,499
Other	1,787	4,154
Total operating revenues	613,084	1,054,031
Operating Expenses		
Compensation and benefits	268,812	377,668
Distribution and servicing	172,464	307,873
Communications and technology	40,490	50,286
Occupancy	32,584	34,144
Amortization of intangible assets	5,628	9,624
Other	34,791	45,489
Total operating expenses	554,769	825,084
Operating Income	58,315	228,947
Other Income (Expense)		
Interest income	1,821	23,268
Interest expense	(43,390)	(44,463)
Fund support	17,558	(266,874)
Other	46,400	1,307
Total other income (expense)	22,389	(286,762)
Income (Loss) from Operations before Income Tax Provision (Benefit)	80,704	(57,815)
Income tax provision (benefit)	28,380	(21,734)
Net Income (Loss)	52,324	(36,081)
Less: Net income attributable to noncontrolling interests	2,270	46
Net Income (Loss) Attributable to Legg Mason, Inc.	$ 50,054	$ (36,127)

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(continued)

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008
Net Income (Loss) per Share attributable to Legg Mason, Inc. common shareholders:		
Basic	$ 0.35	$ (0.26)
Diluted	$ 0.35	$ (0.26)
Weighted Average Number of Shares Outstanding:		
Basic	142,006	140,505
Diluted	143,126	140,505
Dividends Declared per Share	$ 0.03	$ 0.24

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30,	
	2009	2008
Net Income (Loss)	$ 52,324	$ (36,081)
Other comprehensive income gains (losses):		
Foreign currency translation adjustment	41,335	12,538
Unrealized holding losses on investment securities, net of tax benefit of $16 and $31, respectively	(24)	(46)
Unrealized and realized gains on cash flow hedge, net of tax provision of $368		459
Total other comprehensive income	41,311	12,951
Comprehensive Income (Loss)	93,635	(23,130)
Less: Comprehensive income attributable to noncontrolling interests	2,270	46
Comprehensive Income (Loss) Attributable to Legg Mason, Inc.	$ 91,365	$ (23,176)

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF

CHANGES IN STOCKHOLDERS EQUITY

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008
COMMON STOCK		
Beginning balance	$ 14,185	$ 13,856
Stock options and other stock-based compensation		38
Deferred compensation employee stock trust	9	9
Deferred compensation, net	41	30
Exchangeable shares	10	11
Preferred share conversions		36
Ending balance	14,245	13,980
SHARES EXCHANGEABLE INTO COMMON STOCK		
Beginning balance	3,069	4,982
Exchanges	(239)	(277)
Ending balance	2,830	4,705
ADDITIONAL PAID-IN CAPITAL		
Beginning balance, as reported	3,284,347	3,278,376
Initial recognition of conversion value of 2.5% senior notes, net of tax,		
pursuant to FSP APB 14-1	168,183	168,183
Beginning balance, as adjusted	3,452,530	3,446,559
Stock options and other stock-based compensation	5,526	16,183
Deferred compensation employee stock trust	1,950	2,740
Deferred compensation, net	7,201	9,221
Convertible debt		(73,416)
Exchangeable shares	230	266
Preferred share conversions		(36)
Ending balance	3,467,437	3,401,517
EMPLOYEE STOCK TRUST		
Beginning balance	(35,094)	(29,307)
Shares issued to plans	(1,496)	(2,341)
Distributions and forfeitures	3,352	
Ending balance	(33,238)	(31,648)

DEFERRED COMPENSATION EMPLOYEE STOCK TRUST		
Beginning balance	35,094	29,307
Shares issued to plans	1,496	2,341
Distributions and forfeitures	(3,352)	
Ending balance	33,238	31,648
RETAINED EARNINGS		
Beginning balance, as reported	1,155,660	3,240,359
Initial recognition of conversion value of 2.5% senior notes, net of tax,		
pursuant to FSP APB 14-1	(24,035)	(4,045)
Beginning balance, as adjusted	1,131,625	3,236,314
Net income (loss) attributable to Legg Mason, Inc.	50,054	(36,127)
Dividends declared	(4,303)	(34,113)
Ending balance	1,177,376	3,166,074
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET		
Beginning balance	(2,784)	82,930
Unrealized holding losses on investment securities, net of tax	(24)	(46)
Unrealized and realized gains on cash flow hedge, net of tax		459
Foreign currency translation adjustment	41,335	12,538
Ending balance	38,527	95,881
TOTAL STOCKHOLDERS EQUITY	$ 4,700,415	$ 6,682,157

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30, 2009	2008
Cash Flows from Operating Activities		
Net income (loss)	$ 52,324	$ (36,081)
Non-cash items included in net income (loss):		
Depreciation and amortization	27,644	32,450
Imputed interest for 2.5% convertible senior notes	8,364	7,853
Amortization of deferred sales commissions	7,011	9,508
Accretion and amortization of securities discounts and premiums, net	2,910	1,738
Stock-based compensation	12,872	15,523
Unrealized losses (gains) on investments	(49,287)	13,475
Unrealized losses (gains) on fund support	(16,502)	266,874
Deferred income taxes	34,442	(77,613)
Other	1,020	154
Decrease (increase) in assets excluding acquisitions:		
Investment advisory and related fees receivable	(2,864)	16,689
Net sales (purchases) of trading investments	34,603	(36,353)
Refundable income taxes	579,968	1,868
Other receivables	79,751	(10,172)
Other assets	59,370	9,486
Increase (decrease) in liabilities excluding acquisitions:		
Accrued compensation	(187,538)	(328,839)
Deferred compensation	(5,225)	(8,668)
Accounts payable and accrued expenses	(3,853)	31,396
Other liabilities	(131,991)	12,981
Cash Provided by (Used for) Operating Activities	503,019	(77,731)
Cash Flows from Investing Activities		
Payments for fixed assets	(34,037)	(26,027)
Proceeds from sale of assets	-	181,147
Fund Support:		
Restricted cash, net (principally fund support collateral)	6,966	(264,987)

Payments under liquidity fund support arrangements	-	(5,231)
Proceeds from sale of SIV securities	-	81,834
Purchases of SIV securities, net of distributions	-	(58,527)
Net increase in securities purchased under agreements to resell	-	(54,910)
Purchases of investment securities	(361)	(252)
Proceeds from sales and maturities of investment securities	688	1,237
Cash Used for Investing Activities	(26,744)	(145,716)

LEGG MASON, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(continued)

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30, 2009	2008
Cash Flows from Financing Activities		
Proceeds from issuance of long-term debt, net	-	1,096,362
Third-party distribution financing, net	(779)	(598)
Repayment of principal on long-term debt	(1,287)	(1,186)
Issuance of common stock	1,958	13,298
Dividends paid	(34,337)	(33,816)
Net subscriptions received/(redemptions/distributions paid) from noncontrolling interest holders	3,336	(144)
Excess tax benefit associated with stock-based compensation	-	1,236
Cash (Used for) Provided by Financing Activities	(31,109)	1,075,152
Effect of Exchange Rate Changes on Cash	9,655	696
Net Increase in Cash and Cash Equivalents	454,821	852,401
Cash and Cash Equivalents at Beginning of Period	1,084,474	1,463,554
Cash and Cash Equivalents at End of Period	$ 1,539,295	$ 2,315,955

See Notes to Consolidated Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts, unless otherwise noted)

June 30, 2009

(Unaudited)

1. Interim Basis of Reporting

The accompanying unaudited interim consolidated financial statements of Legg Mason, Inc. and its subsidiaries (collectively Legg Mason) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information. The interim consolidated financial statements have been prepared using the interim basis of reporting and, as such, reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. Legg Mason has evaluated all subsequent events through the time that we filed these financial statements in our quarterly report on Form 10-Q Report with the Securities and Exchange Commission on August 5, 2009.

The nature of our business is such that the results of any interim period are not necessarily indicative of the results of a full year. The fiscal year-end condensed balance sheet was derived from audited financial statements and, in accordance with interim financial information standards, does not include all disclosures required by U.S. GAAP for annual financial statements. Certain amounts in prior period financial statements have been reclassified to conform to the current period presentation, including fund support previously reported as Other non-operating expense and Net purchases of trading investments.

The information contained in the interim consolidated financial statements should be read in conjunction with our latest Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Unless otherwise noted, all per share amounts include both common shares of Legg Mason and shares issued in connection with the acquisition of Legg Mason Canada Inc., which are exchangeable into common shares of Legg Mason on a one-for-one basis at any time. The preparation of interim consolidated financial statements requires management to make assumptions and estimates that affect the amounts reported in the interim consolidated financial statements and accompanying notes. Actual amounts could differ from those estimates and the differences could have a material impact on the interim consolidated financial statements.

Terms such as we, us, our, and company refer to Legg Mason.

2. Significant Accounting Policies

Retroactive Accounting Policies Adopted

Certain prior year amounts have been retroactively revised as a result of the adoption of Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51 and Financial Accounting Standards Board (FASB) Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement).

SFAS 160 has both retroactive and prospective provisions that change the accounting and reporting for minority interests. Under its retroactive provisions, minority interests have been recharacterized as noncontrolling interests and classified as a component of equity, if permanent. Also, net income (loss) is no longer affected by minority interests, but under SFAS 160, both net income (loss) and comprehensive income (loss) are attributed to noncontrolling and parent interests. Further, EITF Topic No. D-98, Classification and Measurement of Redeemable Securities , requires temporary equity classification for instruments that are currently redeemable or convertible for cash or other assets at the option of the holder. For Legg Mason, minority interests of $31,020 related to consolidated sponsored investment funds that are redeemable for cash or other assets have been recharacterized and classified as Redeemable noncontrolling interests on the Consolidated Balance Sheets as of March 31, 2009. During the quarter ended June 30, 2009, net income attributable to noncontrolling interests was $2,270 and net subscriptions received were $3,336 resulting in a balance as of June 30, 2009 of $36,626. Redeemable noncontrolling interests and related activity for the quarter ended June 30, 2008 were not material. The prospective provisions of SFAS 160 do not have a material impact on Legg Mason s consolidated financial statements.

FSP APB 14-1 requires that issuers of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) should separately account for the liability and equity (conversion feature) components of the instruments. As a result, interest expense should be imputed and recognized based upon the entity s nonconvertible debt borrowing rate at the date of issuance, which results in lower net income. The 2.5% convertible senior notes issued by Legg Mason in January 2008 are subject to FSP APB 14-1. Prior to FSP APB 14-1, Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14), provided that no portion of the proceeds from the issuance of the instrument should be attributable to the conversion feature. Upon retroactive application of FSP APB 14-1, the effects on Net loss and Net loss per share for the quarter ended June 30, 2008, and on Long-term debt, Retained earnings, Additional paid-in capital and Deferred income tax assets as of March 31, 2009 were as follows:

	Three Months Ended June 30, 2008
Net loss, as previously reported	$(31,273)
Additional interest expense pursuant to FSP APB 14-1, net of income taxes	(4,854)
Net loss attributable to Legg Mason, Inc., as currently reported	$(36,127)
Net loss per share attributable to Legg Mason, Inc. common shareholders:	
Basic, as previously reported	$ (0.22)
Additional interest expense pursuant to FSP APB 14-1, net of income taxes	(0.04)
Basic, as currently reported	$ (0.26)
Diluted, as previously reported	$ (0.22)
Additional interest expense pursuant to FSP APB 14-1, net of income taxes	(0.04)
Diluted, as currently reported	$ (0.26)

	March 31, 2009
Long-term debt, as previously reported	$ 2,965,204
Impact of FSP APB 14-1	(233,202)
Long-term debt, as currently reported	$ 2,732,002
Retained earnings, as previously reported	$ 1,155,660
Impact of FSP APB 14-1	(24,035)
Retained earnings, as currently reported	$ 1,131,625
Additional paid-in capital, as previously reported	$ 3,284,347
Impact of FSP APB 14-1	168,183
Additional paid-in capital, as currently reported	$ 3,452,530
Deferred income tax assets, as previously reported	$ 848,488
Impact of FSP APB 14-1	(89,055)
Deferred income tax assets, as currently reported	$ 759,433

Additional disclosures required under FSP APB 14-1 are addressed in Note 6.

Fair Value Measurements

FASB Statement No. 157, Fair Value Measurements (SFAS 157), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Under SFAS 157, a fair value measurement should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of nonperformance.

SFAS 157 establishes a hierarchy that prioritizes the inputs for valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

Legg Mason s financial instruments measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 - Financial instruments for which prices are quoted in active markets, which for Legg Mason, include investments in publicly traded mutual funds with quoted market prices and equities listed in active markets.

Level 2 Financial instruments for which: prices are quoted for similar assets and liabilities in active markets; prices are quoted for identical or similar assets in inactive markets; or prices are based on observable inputs, other than quoted prices, such as models or other valuation methodologies. For Legg Mason, this category may include repurchase agreements, fixed income securities, and certain proprietary fund products.

Level 3 Financial instruments for which values are based on unobservable inputs, including those for which there is little or no market activity. This category includes derivative assets and liabilities related to fund support arrangements on non-structured investment vehicle (SIV) related securities, investments in partnerships, limited liability companies, and private equity funds. Previously, this category included derivative assets related to fund support agreements and certain owned securities issued by SIVs. This category may also include certain proprietary fund products with redemption restrictions.

The valuation of an asset or liability may involve inputs from more than one level of the hierarchy. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Any transfers between categories are measured at the beginning of the period.

See Note 3 for additional information regarding fair value measurements.

Recent Accounting Developments

The following relevant accounting pronouncement was recently issued.

In June 2009, the FASB issued Statement No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS 167), which will be effective for Legg Mason for fiscal 2011. SFAS 167 amendments include a new approach for determining who should consolidate a variable interest entity (VIE), changes to when it is necessary to reassess who should consolidate a VIE and changes in the assessment of which entities are VIEs. The new approach for determining who should consolidate a VIE requires an analysis of whether a variable interest gives an enterprise a controlling financial interest in a VIE through both the power to direct the activities that most significantly impact the VIE s economic performance and the obligation to absorb losses or the right to benefits that could potentially be significant to the VIE. SFAS 167 eliminates the quantitative approach previously required to determine whether a VIE should be consolidated. It also requires that for kick-out rights to be effective, they must be vested with one investor, rather than a simple majority of investors, as under prior guidance. Legg Mason is continuing to evaluate the impact of SFAS 167 and currently expects that it will require the consolidation of certain sponsored funds that will be material to its balance sheet, revenues and expenses, but have no impact on net income attributable to Legg Mason, Inc.

3. Fair Values of Assets and Liabilities

The fair values of financial assets and (liabilities) of the Company were determined using the following categories of inputs:

	Value as of June 30, 2009			
	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
ASSETS:				
Investments relating to long-term incentive compensation plans[1]	$ 145,399	$ -	$ -	$ 145,399
Proprietary fund products and other investments[2]	91,468	67,142	51,999	210,609
Total trading investment securities	236,867	67,142	51,999	356,008
Available-for-sale investment securities	2,521	3,917	12	6,450
Investment in partnerships and LLCs	928	-	70,967	71,895
Derivative assets:				
Currency hedge derivatives	3,283	-	-	3,283
Equity Securities	-	-	2,142	2,142
	$ 243,599	$ 71,059	$ 125,120	$ 439,778
LIABILITIES:				
Derivative Liabilities:				
Fund support	$ -	$ -	$ (5,500)	$ (5,500)
Currency hedge derivatives	(2,044)	-	-	(2,044)
	$ (2,044)	$ -	$ (5,500)	$ (7,544)

	Value as of March 31, 2009			
	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total
ASSETS:				
Investments relating to long-term incentive compensation plans[1]	$ 128,785	$	$	$ 128,785
Proprietary fund products and other investments[2]	115,117	51,471	40,719	207,307
Total trading investment securities	243,902	51,471	40,719	336,092
Available-for-sale investment securities	3,105	3,701	12	6,818
Investment in partnerships and LLCs	796		58,719	59,515
Derivative assets:				
Currency hedge derivatives	8,976			8,976
Equity Securities			2,340	2,340
	$ 256,779	$ 55,172	$ 101,790	$ 413,741
LIABILITIES:				
Derivative Liabilities:				
Fund support	$	$	$ (20,631)	$ (20,631)
Currency hedge derivatives	(773)			(773)
	$ (773)	$	$ (20,631)	$ (21,404)

(1)

Primarily mutual funds where there is minimal market risk to the Company as any change in value is offset by an adjustment to compensation expense and related deferred compensation liability.

(2)

Primarily mutual funds that are invested approximately 60% and 40% in equity and debt securities, respectively. Includes approximately $27.2 million and $16.6 million related to noncontrolling interests of consolidated investment funds as of June 30, 2009 and March 31, 2009, respectively.

The tables below present a summary of changes in financial assets and (liabilities) measured at fair value using significant unobservable inputs (Level 3) for the periods from April 1, 2009 to June 30, 2009 and April 1, 2008 to June 30, 2008:

	Value as of April 1, 2009	Purchases, sales, issuances and settlements, net	Net transfer in (out) of Level 3	Realized and unrealized gains/(losses), net	Value as of June 30, 2009
ASSETS:					
Proprietary fund products and other investments	$ 40,719	$ 448	$ 5,777	$ 5,055	$ 51,999
Investment in partnerships and LLCs	58,719	12,275		(27)	70,967
Other investments	2,352	(24)		(174)	2,154
	$ 101,790	$ 12,699	$ 5,777	$ 4,854	$ 125,120
LIABILITIES:					
Fund support	$ (20,631)	$	$	$ 15,131	$ (5,500)
Total realized and unrealized gains, net				$ 19,985	

	Value as of April 1, 2008	Purchases, sales, issuances and settlements, net	Net transfer in (out) of Level 3	Realized and unrealized gains/(losses), net	Value as of June 30, 2008
ASSETS:					
Securities issued by SIVs	$ 141,509	$ (23,307)	$	$ (18,575)	$ 99,627
Proprietary fund products and other investments	23,781	(13,781)		(149)	9,851
Investment in partnerships and LLCs	67,022	(7,908)		(102)	59,012
Total return swap	45,706	5,230		(5,085)	45,851
Other investments	1,903			(650)	1,253
	$ 279,921	$ (39,766)	$	$ (24,561)	215,594
LIABILITIES:					
Fund support	$ (551,654)	$	$	$ (242,434)	$ (794,088)
Total realized and unrealized (losses), net				$ (266,995)	

Realized and unrealized gains and losses recorded for Level 3 investments are included in Other non-operating income (expense) on the Consolidated Statements of Operations. The total net

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realized and unrealized gains (losses) of $20.0 million and $(267.0) million for the quarters ended June 30, 2009 and 2008, respectively, are attributable to the change in unrealized gains (losses) relating to the assets and liabilities still held at the reporting date.

4. Fixed Assets

Fixed assets consist of equipment, software and leasehold improvements and capital lease assets. Equipment consists primarily of communications and technology hardware and furniture and fixtures. Software includes purchased software and internally developed software. Fixed assets are reported at cost, net of accumulated depreciation and amortization. The following table reflects the components of fixed assets as of:

	June 30, 2009	March 31, 2009
Equipment	$ 188,899	$ 180,668
Software	199,990	193,109
Leasehold improvements and capital lease assets	332,477	314,963
Total cost	721,366	688,740
Less: accumulated depreciation and amortization	(340,958)	(321,697)
Fixed assets, net	$ 380,408	$ 367,043

Depreciation and amortization expense included in operating income was $22,016 and $22,826 for the quarters ended June 30, 2009 and 2008, respectively.

5. Intangible Assets and Goodwill

The following tables reflect the components of intangible assets as of:

	June 30, 2009	March 31, 2009
Amortizable asset management contracts		
Cost	$ 210,851	$ 208,416
Accumulated amortization	(115,475)	(108,376)
Net	95,376	100,040
Indefinite life intangible assets		
Fund management contracts	3,753,817	3,752,961
Trade names	69,800	69,800
	3,823,617	3,822,761
Intangible assets, net	$ 3,918,993	$ 3,922,801

As of June 30, 2009, management contracts are being amortized over a weighted-average life of 4.9 years. Estimated amortization expense for each of the next five fiscal years is as follows:

Remaining 2010	$ 17,041
2011	22,646
2012	19,661
2013	14,660
2014	12,455
Thereafter	8,913
Total	$ 95,376

The increase in the carrying value of goodwill for the three months ended June 30, 2009 is summarized below:

Balance, beginning of period	$ 1,186,747
Impact of excess tax basis amortization	(5,456)
Other, including changes in foreign exchange rates	26,288
Balance, end of period	$ 1,207,579

6. Long-Term Debt and Equity Units

The accreted value of long-term debt consists of the following:

	June 30, 2009			March 31, 2009
	Current Accreted Value	Unamortized Discount	Maturity Amount	Current Accreted Value
5-year term loan	$ 550,000	$	$ 550,000	$ 550,000
2.5% convertible senior notes	1,025,162	224,838	1,250,000	1,016,798
5.6% senior notes from Equity Units	1,150,000		1,150,000	1,150,000
Third-party distribution financing	3,288		3,288	4,067
Other term loans	18,038		18,038	19,325
Subtotal	2,746,488	224,838	2,971,326	2,740,190
Less: current portion	7,964		7,964	8,188
Total	$ 2,738,524	$ 224,838	$ 2,963,362	$ 2,732,002

As of June 30, 2009, the aggregate maturities by fiscal year of long-term debt based on the contractual terms are as follows:

Remaining 2010	$ 5,992
2011	554,348
2012	2,373
2013	887
2014	894
Thereafter	2,406,832
Total	$ 2,971,326

At June 30, 2009, the estimated fair value of long-term debt was approximately $2,473,445.

In accordance with FSP APB 14-1, Legg Mason is accreting the carrying value of the 2.5% convertible senior notes to the principal amount at maturity using an interest rate of 6.5% (the effective borrowing rate for non-convertible debt at the time of issuance) over its expected life of seven years, resulting in additional interest expense for the quarter ended June 30, 2009 of approximately $8.4 million. The amount by which the notes accreted value exceeds the if-converted value using a current interest rate of 8.13% as of June 30, 2009 (representing a potential gain) is approximately $104 million.

On July 15, 2009, Legg Mason commenced an offer to exchange its Equity Units in the form of Corporate Units in order to increase its equity capital levels and reduce the amount of its outstanding debt and related interest expense. See footnote 13 - Subsequent Event for more information regarding this transaction.

7. Stock-Based Compensation

Compensation expense relating to stock options, the stock purchase plan and deferred compensation for the three months ended June 30, 2009 and 2008 was $5,703 and $6,948, respectively.

Stock option transactions during the three months ended June 30, 2009 and 2008, respectively, are summarized below:

	Three months ended June 30,			
	2009		2008	
	Number of shares	Weighted-average exercise price per share	Number of shares	Weighted-average exercise price per share
Options outstanding at March 31	5,200	$ 65.19	5,464	$ 67.20
Granted	115	19.42		
Exercised			(434)	31.79
Canceled/ forfeited	(227)	66.42	(27)	101.72
Options outstanding at June 30	5,088	$ 64.10	5,003	$ 70.09

At June 30, 2009, options were exercisable for 2,281 shares with a weighted-average exercise price of $67.11 and a weighted-average remaining contractual life of 2.8 years. Unamortized compensation cost related to unvested options (2,807 shares) at June 30, 2009 of $40,399 is expected to be recognized over a weighted-average period of 2.0 years.

The weighted average fair value of option grants of $11.29 for the three months ended June 30, 2009, is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: expected dividend yield, 1.19%; risk-free interest rate, 2.79%; expected volatility, 65.92%; and expected lives (in years), 6.8. There were no option grants for the three months ended June 30, 2008.

Compensation expense relating to restricted stock for the three months ended June 30, 2009 and 2008 was $7,169 and $8,575, respectively.

Restricted stock transactions during the three months ended June 30, 2009 and 2008, respectively, are summarized below:

	Three months ended June 30,			
	2009		2008	
	Number of shares	Weighted-average grant date value	Number of shares	Weighted-average grant date value
Unvested shares at March 31	1,328	$ 51.41	642	$ 98.30
Granted	448	19.42	313	61.85
Vested	(258)	60.25	(96)	105.55
Canceled/ forfeited	(34)	57.44	(8)	87.71
Unvested shares at June 30	1,484	$ 40.14	851	$ 84.20

Unamortized compensation cost related to unvested restricted stock awards at June 30, 2009 of $47,994 is expected to be recognized over a weighted-average period of 2.5 years.

Restricted stock unit transactions during the three months ended June 30, 2009 and 2008, respectively, are summarized below:

	Three months ended June 30,			
	2009		2008	
	Number of shares	Weighted-average grant date value	Number of shares	Weighted-average grant date value
Unvested shares at March 31	13	$ 36.03		$
Granted	57	19.82	6	61.85
Vested				
Canceled/ forfeited			(1)	61.85
Unvested shares at June 30	70	$ 22.89	5	$ 61.85

Unamortized compensation cost related to unvested restricted stock units at June 30, 2009 of $1,579 is expected to be recognized over a weighted-average period of 2.4 years.

8. Commitments and Contingencies

Legg Mason leases office facilities and equipment under non-cancelable operating leases and also has multi-year agreements for certain services. These leases and service agreements expire on varying dates through fiscal 2025. Certain leases provide for renewal options and contain escalation clauses providing for increased rentals based upon maintenance, utility and tax increases.

As of June 30, 2009, the minimum annual aggregate rentals under operating leases and servicing agreements are as follows:

Remaining 2010	$ 121,923
2011	129,113
2012	118,802
2013	106,268
2014	89,233
Thereafter	686,185
Total	$ 1,251,524

The minimum rental commitments shown above have not been reduced by $103,704 for minimum sublease rentals to be received in the future under non-cancelable subleases, of which approximately 90% is due from one counterparty. If a sub-tenant defaults on a sublease, Legg Mason may incur operating expense charges to reflect expected future sublease rentals at reduced amounts, as a result of the current commercial real estate market.

The table above also does not include aggregate obligations of $35,067 for property and equipment under capital leases.

As of June 30, 2009, Legg Mason had commitments to invest approximately $25,372 in investment vehicles. These commitments will be funded as required through the end of the respective investment periods through fiscal 2011.

See Note 10, Liquidity Fund Support, for additional information related to Legg Mason commitments.

In the normal course of business, Legg Mason enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. Legg Mason s maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against Legg Mason that have not yet occurred.

Legg Mason has been the subject of customer complaints and has also been named as a defendant in various legal actions arising primarily from securities brokerage, asset management and investment banking activities, including certain class actions, which primarily allege violations of securities laws and seek unspecified damages, which could be substantial. Legg Mason is also involved in governmental and self-regulatory agency inquiries, investigations and proceedings.

In accordance with SFAS No. 5 Accounting for Contingencies, Legg Mason has established provisions for estimated losses from pending complaints, legal actions, investigations and proceedings when it is probable that a loss has been incurred and a reasonable estimate of loss can be made. While the ultimate resolution of these matters cannot be currently determined, in the opinion of management, after consultation with legal counsel, Legg Mason does not believe that the resolution of these actions will have a material adverse effect on Legg Mason s financial condition. However, the results of operations could be materially affected during any period if liabilities in that period differ from Legg Mason s prior estimates, and Legg Mason s cash flows could be materially affected during any period in which these matters are resolved. In addition, the ultimate costs of litigation-related charges can vary significantly from period to period, depending on factors such as market conditions, the size and volume of customer complaints and claims, including class action suits, and recoveries from indemnification, contribution or insurance reimbursement.

Legg Mason and a current and former officer, together with an underwriter in a public offering, are named as defendants in a consolidated legal action. The action alleges that the defendants violated the Securities Act of 1933 by omitting certain material facts with respect to the acquisition of Citigroup s worldwide asset management business in a prospectus used in a secondary stock offering in order to artificially inflate the price of Legg Mason common stock. The action sought certification of a class of shareholders who purchased Legg Mason common stock in a secondary public offering on or about March 9, 2006 and seeks unspecified damages. Legg Mason intends to defend the action vigorously. On March 17, 2008, the action was dismissed with prejudice. However, the plaintiffs have appealed the dismissal. Legg Mason cannot predict the eventual outcome of the appeal at this point, or whether the action will have a material adverse effect on Legg Mason.

9. Earnings Per Share

Basic earnings per share attributable to Legg Mason, Inc. common shareholders (EPS) is calculated by dividing net income or loss attributable to Legg Mason, Inc. by the weighted average number of shares outstanding. The calculation of weighted average shares includes common shares and shares exchangeable into common stock. Diluted EPS is similar to basic EPS, but adjusts for the effect of potentially issuable common shares, except when inclusion is antidilutive.

For periods where a net loss attributable to Legg Mason, Inc. is reported, the inclusion of potentially issuable common shares will decrease the net loss per share. Since this would be antidilutive, such shares are excluded from the calculation. Basic and diluted earnings per share for the three months ended June 30, 2009 and 2008 include all vested shares of restricted stock related to Legg Mason s deferred compensation plans.

The following table presents the computations of basic and diluted EPS:

	Three Months Ended June 30,			
	2009		2008	
	Basic	Diluted	Basic	Diluted (1)
Weighted average shares outstanding	142,006	142,006	140,505	140,505
Potential common shares:				
Employee stock options	-	17	-	-

Unvested shares related to deferred compensation	-	121	-	-
Shares issuable upon payment of contingent consideration	-	982	-	-
Total weighted average diluted shares	142,006	143,126	140,505	140,505
Net income (loss) attributable to				
Legg Mason, Inc.	$ 50,054	$ 50,054	$(36,127)	$(36,127)
Net income (loss) per share attributable to				

0.01	(0.09)	(0.03)	(0.01)		
Estimated gain (loss) on disposition	(0.31)	(0.14)	0.01	0.25	0.01
Cumulative effect of change in accounting principle	(5.31)				
Net income (loss)	$ (5.48)	$ (0.17)	$ 0.27	$ (0.16)	$ 0.70
Cash dividends per share				$ 0.025	$ 0.140
BALANCE SHEET DATA:					
Working capital	$ 92,140	$ 93,003	$ 106,478	$ 130,915	$ 158,225
Total assets	$ 366,535	$ 351,110	$ 383,116	$ 408,683	$ 460,874
Total debt, excluding discount	$ 15,200	$ 10,394	$ 8,822	$	$
Total stockholders equity	$ 205,086	$ 200,660	$ 216,597	$ 213,523	$ 242,714

(a) Included in operating income (loss) are goodwill impairment charges of $0.2 million, $2.7 million, $0.6 million, $33.9 million and $ million for 2002, 2003, 2004, 2005 and 2006, respectively.

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ITEM 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and related notes included elsewhere in this annual report on Form 10-K. Also see Forward-Looking Statements discussion.

Introduction and Overview

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

Nature and Economics of Our Business

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

When competing for project business, we usually estimate the costs we will incur on a project, then propose a bid to the customer that includes a contract price and other performance and payment terms. Our bid price and terms are intended to cover our estimated costs on the project and provide a profit margin to us commensurate with the value of the installed system to the customer, the risk that project costs or duration will vary from estimate, the schedule on which we will be paid, the opportunities for other work that we might forego by committing capacity to this project, and other costs that we incur more broadly to support our operations but which are not specific to the project. Typically customers will seek bids from competitors for a given project. While the criteria on which customers select the winning bid vary widely and include factors such as quality, technical expertise, on-time performance, post-project support and service, and company history and financial strength, we believe that price is the most influential factor for most customers in choosing an HVAC installation and service provider.

After a customer accepts our bid, we generally enter into a contract with the customer that specifies what we will deliver on the project, what our related responsibilities are, and how much and when we will be paid. Our overall price for the project is typically set at a fixed amount in the contract, although changes in project specifications or work conditions that result in unexpected additional work are usually subject to additional payment from the customer via what are commonly known as change orders. Project contracts typically provide for periodic billings to the customer as we meet progress milestones or incur cost on the project. Project contracts in our industry also frequently allow for a small portion of progress billings or contract price to be withheld by the customer until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage.

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

As of December 31, 2006, we had 3,638 projects in process. Our average project takes three to six months to complete, with an average contract price of approximately $400,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

We also perform larger HVAC projects. As of December 31, 2006, we had four projects in process with a contract price of between $15 and $35 million, eleven projects between $10 million and $15 million, 43 projects between $5 million and $10 million, and 194 projects between $1 million and $5 million. Taken together, projects with contract prices of $1 million or more totaled $960.8 million of aggregate contract value as of December 31, 2006, or approximately 66%, out of a total contract value for all projects in progress of $1,451.4 million. Generally, projects closer in size to $1 million will be completed in one year or less. It is unusual for us to work on a project that exceeds two years in length.

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

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

Profile and Management of Our Operations

Our company was originally formed in 1997 through an initial public offering, or IPO, and simultaneous acquisition of 12 companies engaged in our business. From the time we completed our IPO through December 1999, we acquired 107 HVAC and complementary businesses, of which 26 were tuck-in operations that were integrated upon acquisition with existing operations. From 2000 through 2005 we acquired only one company and shifted our strategy from an emphasis on acquisition-based growth to a focus on improving the performance of our existing operations. During that time, we sold or ceased operations at 40 companies and consolidated another 14 companies into other operations. During 2006, we sold certain assets and ceased operations at one of our operating companies and consolidated one company into other operations. Today we have 38 operating units.

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

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

Economic and Industry Factors

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

Spending decisions for building construction, renovation and system replacement are generally made on a project basis, usually with some degree of discretion as to when and if projects proceed. With larger amounts of capital, time, and discretion involved, spending decisions are affected to a significant degree by uncertainty, particularly concerns about macroeconomic and geopolitical trends. We have experienced periods of time, such as after the terrorist incidents on September 11, 2001 in the US, and prior to and during the war in Iraq that occurred in early 2003, when uncertainty caused a significant slowdown in decisions to proceed with installation and replacement project work. The Company believes that the current economic environment is favorable relative to the activity levels of recent years.

Operating Environment and Management Emphasis

Nonresidential building construction and renovation activity, as reported by the federal government, declined over the three year period of 2001 to 2003 and has expanded moderately during 2004 and 2005, and has been strong during 2006. 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 health care 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 have experienced notable improvements in both industry activity as well as our own results from 2004 to 2006, as discussed further under Results of Operations below.

As a result of our sale of certain assets and our continued strong emphasis on cash flow, our debt outstanding is now zero, and we have substantial uncommitted cash balances, as discussed further in Liquidity and Capital Resources below. On February 20, 2007, we put a new credit facility in place with considerably less restrictive terms than those of our previous facilities. In addition, we have added a second surety to further support our bonding needs, and we believe our relationships with the surety markets are positive in light of our strong current results and financial position. We have generated positive free cash flow in each of the last eight calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our balance sheet and surety support as compared to most companies in our industry represent competitive advantages for us.

As discussed at greater length in Results of Operations below, we have seen increased activity levels in our industry from 2004 to 2006. We expect price competition to continue to be strong, as local and regional competitors respond cautiously to changing conditions. We will continue our efforts to find the more active sectors in our markets, and to increase our regional and national account business. However, our primary emphasis for 2007 will be on internal execution and margin improvement, rather than on revenue growth. We plan to continue our involvement in multi-family work; however, we have decided to focus a portion of our resources away from this work and we expect that as a result, the portion of our work that is multi-family will diminish somewhat in the future. In addition to the work we have done on our underperforming units, we have increased our focus on project qualification, estimating, pricing and management, and on service performance. This focus includes significant increases in unit level training.

Beginning in 2004, there has been substantial cost fluctuation in certain commodities that are used in construction activity, including steel, iron, copper, lumber, and poly-vinyl chloride (PVC) pipe. We estimate that direct purchase of these commodities, principally steel, iron and copper, comprises between 10% and 15% of our average project cost. As noted below in Results of Operations, for some of the project work we have performed in 2004, the actual cost of certain commodities necessary for these projects was significantly greater than the commodity cost estimates we used when we committed to prices for these projects, which typically was done in 2003 before commodity cost inflation became apparent. We experienced most of the negative effect of this unrecovered commodity cost inflation in the second quarter of 2004. We began taking steps early in 2004 to reduce future commodity cost exposure. Among these steps were early buying of commodities for particular projects, or for general inventory, as well as including escalation and escape provisions in project bids and contracts wherever possible. Since mid-2004, we have experienced minimal unrecovered cost inflation. However, commodity markets remain unsettled, and while we are taking steps as noted above to minimize unrecoverable commodity cost inflation, these steps cannot guarantee that we will avoid all such exposure. It is also possible that further increases in or uncertainty about commodity costs will decrease demand for nonresidential construction activity, which could in turn reduce our future revenues.

Based on indications of stabilizing industry conditions and on our emphasis on internal execution and margin improvement, we expect that our 2007 profitability will improve as compared to our 2006 results, although there can be no assurance that we will achieve this outcome. Over the longer term, if industry conditions are stable to improving, we believe we will experience more periods of increased revenues. In addition, given the size and fragmentation of our industry, we believe it makes sense for us to consider acquisition possibilities. However, we plan to do so on a selective and opportunistic basis, and expect our growth in 2007 will largely be generated internally.

Critical Accounting Policies

In response to the Commission s Release No. 33-8040, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, we identified our critical accounting policies based upon the significance of the accounting policy to our overall financial statement presentation, as well as the complexity of the accounting policy and our use of estimates and subjective assessments. We have concluded that our most critical accounting policy is our revenue recognition policy. As discussed elsewhere in this annual report on Form 10-K, 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 elsewhere in this annual report on Form 10-K.

Percentage of Completion Method of Accounting

Approximately 86% of our revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method as provided by American Institute of Certified Public Accountants Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, contract revenue recognizable at any time during the life of a contract is determined by multiplying expected total contract revenue by the percentage of contract costs incurred at any time to total estimated contract costs. More specifically, as part of the negotiation and bidding process in which we engage in connection with obtaining installation contracts, we estimate our contract costs, which include all direct materials (exclusive of rebates), labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. These contract costs are included in our results of operations under the caption Cost of Services. Then, as we perform under those contracts, we measure such costs incurred, compare them to total estimated costs to complete the contract, and recognize a corresponding proportion of contract revenue. Labor costs are considered to be incurred as the work is performed. Subcontract labor is recognized as the work is performed, but is generally subjected to approval as to milestones or other evidence of completion. Non-labor project cost consists of purchased equipment, prefabricated materials and other materials. Purchased equipment on our projects is substantially produced to job specifications and is a value added element to our work. The costs are considered to be incurred when title is transferred to us, which typically is upon delivery to the worksite. Prefabricated materials, such as ductwork and piping, are generally performed at our shops and recognized as contract costs when fabricated for the unique specifications of the job. Other materials cost are not significant and are generally recorded when delivered to the worksite. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments.

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

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

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

Accounting for Allowance for Doubtful Accounts

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

Accounting for Self-Insurance Liabilities

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

Accounting for Deferred Tax Assets

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

Accounting for Goodwill and Other Intangible Assets

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

Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets requires us to assess our goodwill asset amounts for impairment each year, and more frequently if circumstances suggest an impairment may have occurred. Impairment must be reflected when the value of a given business unit in excess of its tangible net assets falls below the goodwill asset balance carried for that unit on our books. If other business units have had increases in the value of their respective goodwill balances, such increases may not be recorded under SFAS No. 142. Accordingly, such increases may not be netted against impairments at other business units. The requirements for assessing whether goodwill assets have been impaired involve market-based information. This information, and its use in assessing goodwill, entails some degree of subjective assessment.

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

We recorded goodwill impairment charges of $0.6 million and $33.9 million in operating results during the fourth quarters of 2004 and 2005, respectively. We recorded an additional impairment charge of $2.7 million in 2004 related to operations that were subsequently discontinued in 2005. This impairment charge is reflected in operating loss associated with discontinued operations. The impairment charge during 2004 from continuing operations of $0.6 million related to a reporting unit in northern Michigan and was a result of concerns about the activity levels in this market. During 2005, we experienced modest revenue growth and improved profitability due to increased industry activity and favorable market conditions. However, the revenue, operating profits and cash flows for certain reporting units were lower than expected despite these favorable market conditions. Primarily based upon this trend, the revenue, earnings and cash flow projections for certain reporting units were revised downward for the next several years as compared to previous projections. As a result, an impairment charge of $33.9 million was recognized in 2005 for these reporting units including operations in San Diego, Houston, Grand Rapids, central Iowa, Birmingham, Buffalo and Albany. We did not have a goodwill impairment charge in 2006.

Results of Operations (in thousands):

Table 1 Historical Results

	Year Ended December 31, 2004		2005		2006	
Revenues	$ 767,358	100.0 %	$ 892,549	100.0 %	$ 1,056,525	100.0 %
Cost of services	644,318	84.0 %	744,407	83.4 %	885,508	83.8 %
Gross profit	123,040	16.0 %	148,142	16.6 %	171,017	16.2 %
Selling, general and administrative expenses	98,429	12.8 %	113,285	12.7 %	126,620	12.0 %
Goodwill impairment	637	0.1 %	33,877	3.8 %		
Gain on sale of assets	(115)		(85)		(125)	
Operating income	24,089	3.1 %	1,065	0.1 %	44,522	4.2 %
Interest income (expense), net	(1,394)	(0.2 %)	(323)		1,969	0.2 %
Other income (expense)	(427)	(0.1 %)	107		100	
Write-off of debt costs			(870)	(0.1 %)		
Income (loss) before income taxes	22,268	2.9 %	(21)		46,591	4.4 %
Income tax expense	8,589		14,848		17,874	
Income (loss) from continuing operations	13,679	1.8 %	(14,869)	(1.7 %)	28,717	2.7 %
Discontinued operations						
Operating loss, net of tax	(3,447)		(1,309)		(203)	
Estimated gain on disposition, including tax	481		9,952		210	
Net income (loss)	$ 10,713		$ (6,226)		$ 28,724	

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

The following table presents information excluding write-off of debt costs and goodwill impairment charges. We have included this table because we believe it offers an additional view of the core results of our continuing operations in a way we find useful in managing these operations, and in a way which also responds to frequent questions we receive about the Company from third parties. However, this presentation of operating results is not in accordance with generally accepted accounting principles, and should not be considered an alternative to income as determined under generally accepted accounting principles and presented above in Table 1 Historical Results. In particular, impairment charges under the goodwill accounting rules are generally expected to occur periodically as goodwill recognized in connection with the acquisition of businesses responds over time to changes in those businesses markets and operations. We recorded goodwill impairment charges in 2004 and 2005.

	2004		2005		2006	
Income (loss) from continuing operations (after tax)	$ 13,679		$ (14,869)		$ 28,717	
Goodwill impairment (after tax)	637		33,955			
Write-off of debt costs (after tax)			479			
Income from continuing operations (after tax), excluding goodwill impairment and the write-off of debt costs	$ 14,316	1.9 %	$ 19,565	2.2 %	$ 28,717	2.7 %
Diluted earnings per share income from continuing operations (after tax), excluding goodwill impairment and the write-off of debt costs	$ 0.36		$ 0.49		$ 0.70	

2006 Compared to 2005

Revenues Revenues increased $164.0 million, or 18.4% to $1,056.5 million in 2006 compared to 2005. The revenue growth stemmed primarily from generally improving nonresidential facilities markets throughout the United States especially in markets such as the multi-family sector (approximately $86.8 million), office buildings (approximately $37.9 million) and schools (approximately $45.2 million). We have seen increased activity, primarily in our Texas, California, Tennessee and Maryland operations, resulting from the start-up of several large projects.

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

Backlog associated with continuing operations as of December 31, 2006 was $653.8 million, a 3.7% decrease from September 30, 2006 backlog of $678.9 million, and a 3.9% decrease from December 31, 2005 backlog of $680.6 million. The sequential and year over year decrease is primarily from one of our larger multi-family operations working through its larger than usual existing backlog. We plan to continue our involvement in multi-family work; however, we have decided to focus a portion of our resources away from this work and we expect that as a result, the portion of our work that is multi-family will diminish somewhat in the future.

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 2006. We continue to see signs that activity levels in our industry will remain strong throughout 2007. These observations are based on nonresidential construction spending trends, shipment data from HVAC equipment manufacturers, forecasts from construction industry analysts, and anecdotal indications of project consideration.

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

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

While we believe we will see continued strength in industry activity levels throughout 2007, in view of all of the foregoing factors, we may experience modest revenue growth or revenue declines in upcoming periods. In addition, if general economic activity in the US slows significantly from current levels, we may realize decreases in revenue and lower operating margins.

Gross Profit Gross profit increased $22.9 million, or 15.4%, to $171.0 million in 2006 compared to 2005. As a percentage of revenues, historical gross profit for 2006 was 16.2%, down from 16.6% in 2005. The decrease in gross profit percentage resulted primarily from an increased proportion of new construction work due to stronger activity, and by job underperformance at our Connecticut operations (approximately $3.2 million), and at our large multi-family operation based in Texas (approximately $2.3 million). These decreases were partially offset by improved profitability at our Southern California operation (approximately $1.9 million). In addition, we realized higher risk management expense in 2006 ($3.4 million) primarily due to general liability claims associated with our work in the multi-family market.

As noted in the *Introduction* above, we are currently placing a greater emphasis on internal execution and margin improvement than on revenue growth. This includes a strong focus on those of our units that have underperformed, along with increased training efforts on project qualification, estimating, pricing and management, and on service performance. While we believe these efforts will help us increase gross profits, we cannot assure that this will occur. Further, if we are successful in these efforts, we cannot assure that they will offset adverse industry trends, if such trends occur.

Selling, General and Administrative Expenses (SG&A) SG&A increased $13.3 million, or 11.8% for 2006 as compared to 2005. This is primarily due to an increase in the number of overhead personnel to manage internal growth. As a percentage of revenues, SG&A declined from 12.7% in 2005 to 12.0% in 2006. This decrease is consistent with our effort to control our SG&A expenses as we experience internal revenue growth.

Goodwill Impairment We recorded goodwill impairment charges of $33.9 million during the fourth quarter of 2005 and recorded no goodwill impairment charge in 2006. During 2005, we experienced modest revenue growth and improved profitability due to increased industry activity and favorable market conditions. However, the revenue, operating profits and cash flows for certain reporting units were lower than expected despite these favorable market conditions. Primarily based upon this trend, the revenue, earnings and cash flow projections for certain reporting units were revised downward for the next several years as compared to previous projections. As a result, an impairment charge of $33.9 million was recognized in 2005 for these reporting units including operations in San Diego, Houston, Grand Rapids, central Iowa, Birmingham, Buffalo and Albany. Impairment must be reflected when the value of a given business unit in excess of its tangible net assets falls below the goodwill asset balance carried for that unit on the Company s books. If other business units have had increases in the value of their respective goodwill

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balances, such increases may not be recorded under SFAS No. 142. Accordingly, such increases may not be netted against impairments at other business units.

Interest Income (Expense), Net Interest expense, net was $0.3 million in 2005 and interest income, net was $2.0 million in 2006. The decrease in interest expense, net is a result of payments on the term loan throughout 2005 thereby having no debt outstanding in 2006, and the increase in interest income is due to interest income earned from higher cash balances in the current year. See Liquidity and Capital Resources for a detail of the components of interest income (expense), net for 2005 and 2006.

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

Income Tax Expense Our effective tax rate associated with results from continuing operations for 2006 was 38.4%. Excluding effects of the goodwill impairment charge, our 2005 effective tax rate was 43.6%. Our effective tax rate is generally higher than statutory rates because of the effect of certain expenses that are not deductible for tax purposes. In addition, adjustments to tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. The decrease in the effective tax rate is primarily due to an improvement in operating results which dilutes the impact of non-deductible expenses and adjustments to our tax reserves. Furthermore, our state tax rate is lower due to the change in where our income is being earned.

During 2004, the American Jobs Creation Act of 2004 was signed into law. The primary effect of this legislation was to permit us to claim a deduction for 3% of earnings related to certain of our construction-related activities beginning in 2005. This deduction modestly decreased our effective tax rate. We currently estimate that our effective tax rate for 2007 will be between 38% and 42%.

Discontinued Operations

Sale of Assets to MESA Energy Systems, Inc. On June 1, 2006, we, along with our wholly-owned subsidiary, ARC Comfort Systems USA, Inc. (ARC), entered into an asset purchase agreement to sell certain assets of ARC to Mesa Energy Systems, Inc. (a subsidiary of Emcor Group, Inc.) for approximately $0.7 million in cash. These assets were sold at book value. The after-tax losses of this company of $1.5 million and $0.2 million, for 2005 and 2006, respectively, have been reported in discontinued operations under Operating loss, net of income tax benefit.

Sale of Companies to ALC On December 31, 2005, we sold two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. (together, ALC) for approximately $22.9 million in cash, net of transaction costs and a purchase price adjustment based upon the closing balance sheet for the transferred assets. The receivable related to this sale was paid during the first quarter of 2006. We paid $7.0 million in taxes related to this transaction during the first quarter of 2006. The after-tax income of these companies of $1.3 million for 2005 has been reported in discontinued operations under Operating loss, net of income tax benefit. The gain recognized during 2005 on the sale of these units was $9.8 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income taxes. During the fourth quarter of 2006, we recorded an additional gain of $0.1 million, net of tax, related to the collection of certain receivables.

Individual Sales of Operating Companies In 2005, we also sold two small operating companies in separate transactions and shutdown the operations at another small operating company. The after-tax loss of these companies was $1.2 million in 2005, and has been reported in discontinued operations under Operating loss, net of income tax benefit. The gain recognized on the sale of these units was $0.1 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income taxes.

Outlook As noted earlier in this review, while we see signs that industry activity levels are continuing to increase in 2007, our primary emphasis for this year is on margin improvement rather than revenue growth. Our ongoing margin efforts include a focus on improving the results of units that incurred losses or subpar income in 2006, and on intensified project and service performance training at the unit level. Based

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on these margin improvement efforts and developments, on our increased level of backlog as compared to recent periods, and on our belief that industry and economic conditions will remain strong, we expect that our full-year 2007 profitability will improve as compared to our 2006 results.

2005 Compared to 2004

Revenues Revenues increased $125.2 million, or 16.3%, to $892.5 million in 2005 compared to 2004. Approximately 12.6% of the increase in revenues related to internal growth and the remaining 3.7% resulted from the acquisition of Granite State Plumbing & Heating (Granite) in January 2005. The internal revenue growth stemmed primarily from generally improving nonresidential facilities markets throughout the United States especially in the institutional markets such as schools and hospitals (approximately $34.8 million), hotels (approximately $12.5 million), and in the multi-family sector (approximately $23.2 million). We have seen increased activity, primarily in our Alabama, Arizona, Florida and Wisconsin operations, resulting from the start-up of several large projects. These gains were offset to a lesser degree by lower revenues relating to our operations in Southern California that were impacted by continued project delays resulting from extended inclement weather in the first quarter of 2005.

Backlog associated with continuing operations as of December 31, 2005 was $680.6 million (including $13.0 million from the acquisition of Granite), a 7.3% increase from September 30, 2005 backlog of $634.1 million, and a 34.1% increase from December 31, 2004 backlog of $507.8 million. These gains result primarily from significant new multi-family projects in Alabama, as well as office building projects in the Washington, D.C. area.

Gross Profit Gross profit increased $25.1 million, or 20.4%, to $148.1 million in 2005 compared to 2004. As a percentage of revenues, historical gross profit for 2005 was 16.6%, up from 16.0% in 2004. The increase in gross profit percentage resulted primarily from increased profitability in our Arizona operations (approximately $3.4 million), higher margin storm-related project repair work performed by our operation in Central Florida (approximately $3.7 million) and improved margins at an operation in Wisconsin which was negatively impacted by increases in the prices for certain commodity materials in 2004 (approximately $3.7 million). These gains were partially offset by job underperformance at one of our larger operations (approximately $5.0 million).

Selling, General and Administrative Expenses (SG&A) SG&A increased $14.9 million, or 15.1% for 2005 as compared to 2004. As a percentage of revenues, SG&A declined from 12.8% in 2004 to 12.7% in 2005. This decrease is consistent with our effort to control our SG&A expenses as we experience internal revenue growth, partially offset by an increase resulting from higher medical costs (approximately $3.1 million) in 2005 due to medical inflation in 2005 and favorable claims experience in 2004.

Goodwill Impairment We recorded goodwill impairment charges of $0.6 million and $33.9 million during the fourth quarters of 2004 and 2005, respectively. The impairment charge during 2004 from continuing operations of $0.6 million related to a reporting unit in northern Michigan and was a result of concerns about the activity levels in this market that resulted in lower cash flow forecasts for the next several years. During 2005, we experienced modest revenue growth and improved profitability due to increased industry activity and favorable market conditions. However, the revenue, operating profits and cash flows for certain reporting units were lower than expected despite these favorable market conditions. Primarily based upon this trend, the revenue, earnings and cash flow projections for certain reporting units were revised downward for the next several years as compared to previous projections. As a result, an impairment charge of $33.9 million was recognized in 2005 for these reporting units including operations in San Diego, Houston, Grand Rapids, central Iowa, Birmingham, Buffalo and Albany. Impairment must be reflected when the value of a given business unit in excess of its tangible net assets falls below the goodwill asset balance carried for that unit on the Company s books. If other business units have had increases in the value of their respective goodwill balances, such increases may not be recorded under SFAS No. 142. Accordingly, such increases may not be netted against impairments at other business units.

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Interest Expense, Net The decrease in interest expense, net is a result of payments on the term loan throughout 2004 and 2005 thereby reducing and eliminating our average debt outstanding, and interest income earned from higher cash balances in 2005. See Liquidity and Capital Resources for a detail of the components of interest expense, net for 2004 and 2005.

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

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

Income Tax Expense *Our* effective tax rate associated with results from continuing operations for 2005 was (707.0)%. Excluding effects of the goodwill impairment charges, our 2005 effective tax rate was 43.6% as compared to 37.5% in 2004. Our 2004 rate is lower than usual due to an increase in the fourth quarter of 2004 in our estimate of the amount of future state taxable income we will have against which we can apply state tax loss carryforwards. This change in estimate resulted in a reduction in our allowance against state-level deferred tax assets. Our effective tax rate is generally higher than statutory rates because of the effect of certain expenses that are not deductible for tax purposes. In addition, adjustments to tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. During 2004, the American Jobs Creation Act of 2004 was signed into law. The primary effect of this legislation was to permit us to claim a deduction for 3% of earnings related to certain of our construction-related activities beginning in 2005. This deduction moderately decreased our effective tax rate.

Discontinued Operations

Sale of Assets to MESA Energy Systems, Inc. *On* June 1, 2006, we, along with our wholly-owned subsidiary, ARC Comfort Systems USA, Inc. (ARC), entered into an asset purchase agreement to sell certain assets of ARC to Mesa Energy Systems, Inc. (a subsidiary of Emcor Group, Inc.) for approximately $0.7 million in cash. These assets were sold at book value. The after-tax loss of this company of $2.3 million and $1.5 million, for 2004 and 2005, respectively, has been reported in discontinued operations under Operating loss, net of income tax benefit.

Sale of Companies to ALC On December 31, 2005, we sold two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. (together, ALC) for approximately $22.9 million in cash, net of transaction costs and a purchase price adjustment based upon the closing balance sheet for the transferred assets. The receivable related to this sale was paid during the first quarter of 2006. We paid $7.0 million in taxes related to this transaction during the first quarter of 2006. The after-tax income of these companies of $1.3 million in both 2004 and 2005 has been reported in discontinued operations under Operating loss, net of income tax benefit. The gain recognized during 2005 on the sale of these units was $9.8 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income taxes.

Individual Sales of Operating Companies *In* 2005, we also sold two small operating companies in separate transactions and shutdown the operations at another small operating company. The after-tax loss of these companies was $2.5 million in 2004 and $1.2 million in 2005, and has been reported in discontinued operations under Operating loss, net of income tax benefit. The gain recognized on the sale of these units was $0.1 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income taxes.

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

Sale of Companies to Emcor *In* March 2002, we sold 19 operations to Emcor Group, Inc. (Emcor). The total purchase price was $186.25 million, including the assumption by Emcor of approximately $22.1 million of subordinated notes to former owners of certain of the divested companies. Of Emcor s purchase price, $5 million was deposited into an escrow account to secure potential obligations on our part to indemnify Emcor for future claims and contingencies arising from events and circumstances prior to closing, all as specified in the transaction documents. Of this escrow, $4 million has been applied in determining our liability to Emcor in connection with the settlement of certain claims. The remaining $1 million of escrow is available for book purposes to apply to any future claims and contingencies in connection with this transaction, and has not been recognized as part of the Emcor transaction purchase price.

There are ongoing open matters relating to this transaction that we continue to address with Emcor. We do not believe these open matters, either individually or in the aggregate, will have a material effect on our financial position when ultimately resolved. We maintain reserves for these matters, net of amounts receivable from escrow that we believe will ultimately be applied in settling these matters. During the second quarter of 2004, we concluded that the related reserves should be reduced by $0.3 million, net of tax benefit. Additionally, during the fourth quarter of 2004, we reduced these reserves by $0.2 million, net of tax. During the third quarter of 2005, we reduced tax reserves by $0.1 million in connection with the resolution of state tax examinations. These amounts are reflected in discontinued operations in 2004 and 2005 in the caption Estimated gain on disposition, including income tax benefit (expense).

Liquidity and Capital Resources

	Year ended December 31, 2004 (in thousands)	2005	2006
Cash provided by (used in):			
Operating activities	$ 26,184	$ 37,446	$ 17,734
Investing activities	$ (2,476)	$ (6,769)	$ 17,721
Financing activities	$ (1,268)	$ (7,660)	$ (762)
Free cash flow:			
Cash provided by operating activities	$ 26,184	$ 37,446	$ 17,734
Taxes paid related to the sale of businesses			7,020
Purchases of property and equipment	(4,998)	(6,188)	(8,113)
Proceeds from sales of property and equipment	545	696	477
Free cash flow	$ 21,731	$ 31,954	$ 17,118

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

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

For the year ended December 31, 2006, we had free cash flow of $17.1 million as compared to $32.0 million in 2005. This decrease primarily resulted from an investment in working capital due to higher activity levels.

During 2006, we collected approximately $25.7 million, primarily related to the sale of two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. of $23.8 million and $0.7 million related to the sale of ARC to Mesa Energy Systems, Inc.

For the year ended December 31, 2005, we had free cash flow of $32.0 million as compared to $21.7 million in 2004. This increase resulted primarily from increased profitability, net of a slight increase in capital expenditures.

Credit Facility *In* June 2005, we entered into a $75.0 million senior credit facility (the Facility) which is available for borrowings and letters of credit. The Facility is secured by substantially all of our assets except for assets related to projects subject to surety bonds. As of December 31, 2006, the total of the Facility was $75.0 million, with no outstanding borrowings, $25.2 million in letters of credit outstanding, and $49.8 million of credit available.

On February 20, 2007, we amended the Facility (the Amended Facility). The Amended Facility consists of a $100.0 million revolving credit facility which is available for borrowings and letters of credit. The Amended Facility will expire in February 2012.

We have a choice of two interest rate options for borrowings under the Amended Facility; these rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Excluding the amortization of debt financing and arrangement costs, we estimate that the interest rate applicable to the borrowings under the Amended Facility would be approximately 6.57% as of December 31, 2006. The Company incurred certain financing and professional costs in connection with the arrangement of the Facility and the related amendment. These costs will be amortized as a non-cash charge to interest expense over the term of the Amended Facility. Commitment fees are payable on the portion of the capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20%-0.30% per annum, based on the ratio of debt to Credit Facility Adjusted EBITDA.

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Interest expense for 2004, 2005 and 2006 included the following primary elements (in thousands):

	2004	2005	2006
Interest expense on borrowings, and unused commitment fees	$ 704	$ 391	$ 166
Letter of credit fees	443	389	351
Amortization of deferred debt arrangement costs and discount	419	295	99
Total	$ 1,566	$ 1,075	$ 616

When a previous credit facility was replaced in 2005, a corresponding amount of deferred debt arrangement costs were written off. This charge of $0.9 million is reported as Write-off of debt costs in our consolidated statement of operations for the year ended December 31, 2005.

Covenant compliance is assessed as of each quarter end. Credit Facility Adjusted EBITDA is defined under the Facility for financial covenant purposes as net earnings for the four quarters ending as of any given quarterly covenant compliance measurement date, plus the corresponding amounts for (a) interest expense; (b) income taxes; (c) depreciation and amortization; and (d) other non-cash charges. The following is a reconciliation of Credit Facility Adjusted EBITDA to net income (in thousands):

Net income	$ 28,724
Income taxes continuing operations and discontinued operations	17,646
Interest income, net	(1,970)
Depreciation and amortization expense	5,265
Credit Facility Adjusted EBITDA	$ 49,665

Under the Amended Facility, only two financial covenants remain.

Leverage Ratio *The* Amended Facility requires that the ratio of the Company s total indebtedness less cash and cash equivalents to its Credit Facility Adjusted EBITDA not exceed 2.50.

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

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

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

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

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

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

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

The following recaps the future maturities of our contractual obligations as of December 31, 2006 (in thousands):

	Twelve Months Ended December 31,						
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**
Operating lease obligations	$ 9,797	$ 8,077	$ 7,841	$ 3,219	$ 2,200	$ 6,442	$ 37,576

Absent any significant commitments of capital for items such as capital expenditures, acquisitions, dividends and share repurchases, it is reasonable to expect the Company to continue to maintain excess

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cash on its balance sheet. Therefore, we assumed that the Company would continue its current status of not utilizing any borrowings under its revolving loan.

As of December 31, 2006 we also have $25.2 million letter of credit commitments, of which $24.8 million expire in 2007 and $0.4 million expire in 2008. 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 2007, 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 eight calendar years, most of which occurred during challenging economic and industry conditions. We also expect to have no debt, significant borrowing capacity under our credit facility, and substantial uncommitted cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

Seasonality and Cyclicality

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

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

New Accounting Pronouncements

We have various stock-based compensation plans. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock-Based Compensation. No stock-based employee compensation cost was recognized in the consolidated statements of operations for the years ended December 31, 2004 or 2005, except with respect to the amortization of the intrinsic value of restricted stock grants totaling $0.4 million and $0.5 million, respectively. Options granted under our equity compensation plans had an exercise price equal to the market value of the underlying common stock on the date of grant and all terms were fixed, accordingly, no expense was recognized under APB Opinion No. 25. Effective January 1, 2006, we adopted the fair value recognition provisions of FASB Statement No. 123R, Share-Based Payment (Statement 123R), using the modified-prospective-transition method. Results for prior periods have not been restated. The adoption of Statement 123R resulted in compensation expense of $1.8 million ($1.1 million after-tax or $0.03 per basic share and $0.03 per diluted share) for the year ended December 31, 2006. Prior to adopting Statement 123R, we presented the benefits of tax deductions in excess of recognized compensation costs (excess tax benefits) as operating cash flows in the consolidated statements of cash flows. Statement 123R requires these excess tax benefits to be reported as financing cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes. FIN 48 will be effective for us beginning January 1, 2007. We are currently evaluating the impact, if any, that FIN 48 will have on our financial statements.

ITEM 7-A. ***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. Management is actively involved in monitoring exposure to market risk and continues to develop and utilize appropriate risk management techniques. We are not exposed to any other significant financial market risks including commodity price risk, foreign currency exchange risk or interest rate risks from the use of derivative financial instruments. The Company does not use derivative financial instruments.

We have limited exposure to changes in interest rates due to our lack of indebtedness for borrowed money. We have a debt facility under which we may borrow funds in the future. We do not currently foresee any borrowing needs.

ITEM 8. *Financial Statements and Supplemental Data*

INDEX TO FINANCIAL STATEMENTS

Management s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006 based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on that evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which is included elsewhere herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Comfort Systems USA, Inc.

We have audited the accompanying consolidated balance sheets of Comfort Systems USA, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Comfort Systems USA, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 14 to the consolidated financial statements, effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Comfort Systems USA, Inc. s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2007 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Houston, Texas
February 28, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Stockholders
Comfort Systems USA, Inc.

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Comfort Systems USA, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Comfort Systems USA, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Comfort Systems USA, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Comfort Systems USA, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Comfort Systems USA, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006 of Comfort Systems USA, Inc. and our report dated February 28, 2007 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Houston, Texas
February 28, 2007

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

	December 31, 2005	2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 55,593	$ 90,286
Accounts receivable, less allowance for doubtful accounts of $3,538 and $3,301, respectively	195,025	234,763
Receivable from sale of operations	23,800	142
Other receivables	5,784	4,887
Inventories	8,083	8,762
Prepaid expenses and other	11,282	13,644
Costs and estimated earnings in excess of billings	22,512	23,680
Assets related to discontinued operations	3,996	221
Total current assets	326,075	376,385
PROPERTY AND EQUIPMENT, net	12,705	15,504
GOODWILL	62,954	62,954
OTHER NONCURRENT ASSETS	6,949	6,031
Total assets	$ 408,683	$ 460,874
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	$	$
Accounts payable	71,922	81,180
Accrued compensation and benefits	29,347	35,058
Billings in excess of costs and estimated earnings	53,279	65,949
Income taxes payable	7,615	734
Accrued self insurance expense	17,350	19,618
Other current liabilities	14,338	15,171
Liabilities related to discontinued operations	1,309	450
Total current liabilities	195,160	218,160
LONG-TERM DEBT, NET OF CURRENT MATURITIES		
Total liabilities	195,160	218,160
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY:		
Preferred stock, $.01 par, 5,000,000 shares authorized, none issued and outstanding		
Common stock, $.01 par, 102,969,912 shares authorized, 39,979,687 and 40,710,003 shares issued, respectively	400	407
Treasury stock, at cost, none outstanding		
Additional paid-in capital	340,264	339,589
Deferred compensation	(1,135)	
Retained earnings (deficit)	(126,006)	(97,282)
Total stockholders equity	213,523	242,714
Total liabilities and stockholders equity	$ 408,683	$ 460,874

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)

	Year Ended December 31, 2004	2005	2006
REVENUES	$ 767,358	$ 892,549	$ 1,056,525
COST OF SERVICES	644,318	744,407	885,508
Gross profit	123,040	148,142	171,017
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	98,429	113,285	126,620
GOODWILL IMPAIRMENT	637	33,877	
GAIN ON SALE OF ASSETS	(115)	(85)	(125)
Operating income	24,089	1,065	44,522
OTHER INCOME (EXPENSE):			
Interest income	172	752	2,585
Interest expense	(1,566)	(1,075)	(616)
Write-off of debt costs		(870)	
Other	(427)	107	100
Other income (expense)	(1,821)	(1,086)	2,069
INCOME (LOSS) BEFORE INCOME TAXES	22,268	(21)	46,591
INCOME TAX EXPENSE	8,589	14,848	17,874
INCOME (LOSS) FROM CONTINUING OPERATIONS	13,679	(14,869)	28,717
DISCONTINUED OPERATIONS:			
Operating loss, net of income tax benefit of $295, $818 and $160	(3,447)	(1,309)	(203)
Estimated gain on disposition, including income tax benefit (expense) of $12, $(7,103) and $68	481	9,952	210
NET INCOME (LOSS)	$ 10,713	$ (6,226)	$ 28,724
INCOME (LOSS) PER SHARE:			
Basic			
Loss from continuing operations	$ 0.36	$ (0.38)	$ 0.71
Discontinued operations			
Loss from operations	(0.09)	(0.03)	(0.01)
Estimated gain on disposition	0.01	0.25	0.01
Net income (loss)	$ 0.28	$ (0.16)	$ 0.71
Diluted			
Income (loss) from continuing operations	$ 0.35	$ (0.38)	$ 0.70
Discontinued operations			
Loss from operations	(0.09)	(0.03)	(0.01)
Estimated gain on disposition	0.01	0.25	0.01
Net income (loss)	$ 0.27	$ (0.16)	$ 0.70
SHARES USED IN COMPUTING INCOME (LOSS) PER SHARE:			
Basic	38,409	39,298	40,247
Diluted	39,505	39,298	41,146
DIVIDENDS PER SHARE	$	$ 0.025	$ 0.140

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

COMFORT SYSTEMS USA, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In Thousands, Except Share Amounts)

	Common Stock		Treasury Stock		Additional Paid-In Capital	Deferred Compensation	Retained Earnings (Deficit)	Total Stockholders Equity
	Shares	Amount	Shares	Amount				
BALANCE AT DECEMBER 31, 2003	39,258,913	$ 393	(1,041,864)	$ (6,305)	$ 337,605	$ (540)	$ (130,493)	$ 200,660
Issuance of Stock:								
Issuance of shares for options exercised including tax benefit			440,508	2,658	(724)			1,934
Issuance of restricted stock			225,000	1,353	361	(1,714)		
Forfeiture of unvested restricted stock			(56,250)	(308)		259		(49)
Amortization of deferred compensation					115	408		523
Shares issued for exercise of warrant			408,144	2,454	337			2,791
Other					25			25
Net income							10,713	10,713
BALANCE AT DECEMBER 31, 2004	39,258,913	393	(24,462)	(148)	337,719	(1,587)	(119,780)	216,597
Issuance of Stock:								
Issuance of shares for options exercised including tax benefit	650,954	6	114,959	835	2,987			3,828
Issuance of restricted stock	82,500	1			574	(575)		
Shares received in lieu of tax withholding payment on vested restricted stock			(40,797)	(318)				(318)
Forfeiture of unvested restricted stock	(12,500)		(50,000)	(372)	(74)	360		(86)
Dividends					(999)			(999)
Amortization of deferred compensation					60	667		727
Other			300	3	(3)			
Net loss							(6,226)	(6,226)
BALANCE AT DECEMBER 31, 2005	39,979,867	400			340,264	(1,135)	(126,006)	213,523
Issuance of Stock:								
Issuance of shares for options exercised including tax benefit	592,636	6	61,360	786	3,868			4,660
Issuance of restricted stock	137,500	1			(1)			
Shares received in lieu of tax withholding payment on vested restricted stock			(46,985)	(597)				(597)
Statement 123R adoption					(1,135)	1,135		
Stock-based compensation expense					1,800			1,800
Forfeiture of unvested restricted stock			(14,375)	(189)	151			(38)
Tax benefit from vesting of restricted stock					316			316
Dividends					(5,674)			(5,674)
Net income							28,724	28,724
BALANCE AT DECEMBER 31, 2006	40,710,003	$ 407		$	$ 339,589	$	$ (97,282)	$ 242,714

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)

	Year Ended December 31, 2004	2005	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$ 10,713	$ (6,226)	$ 28,724
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Estimated gain on disposition of discontinued operations	(481)	(9,952)	(210)
Write-off of debt costs		870	
Depreciation and amortization expense	4,684	4,818	5,266
Goodwill impairment	3,347	33,877	
Bad debt expense	2,873	1,769	686
Deferred tax expense (benefit)	(367)	3,336	(887)
Tax benefit of stock-based compensation expense (pre-Statement 123R)	672	1,267	
Amortization of debt financing costs	419	295	99
Gain on sale of assets	(24)	(36)	(125)
Stock-based compensation expense	372	519	1,762
Mark-to-market warrant obligation	449		
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures (Increase) decrease in			
Receivables, net	(10,741)	(26,439)	(38,849)
Inventories	(764)	1,553	(713)
Prepaid expenses and other current assets	1,129	(1,365)	(435)
Costs and estimated earnings in excess of billings	(9,280)	2,217	(688)
Other noncurrent assets	303	(518)	427
Increase (decrease) in			
Accounts payable and accrued liabilities	15,446	12,028	17,187
Billings in excess of costs and estimated earnings	7,447	19,368	12,509
Other, net	(13)	65	1
Taxes paid related to the sale of businesses			(7,020)
Net cash provided by operating activities	26,184	37,446	17,734
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(4,998)	(6,188)	(8,113)
Proceeds from sales of property and equipment	545	696	477
Proceeds from businesses sold, net of cash sold and transaction costs	1,977	1,666	25,737
Cash paid for acquisition and intangible assets, including cash acquired		(2,943)	(380)
Net cash provided by (used in) investing activities	(2,476)	(6,769)	17,721
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net borrowings on revolving line of credit			
Payments on other long-term debt	(1,607)	(8,822)	
Borrowings of other long-term debt	40		
Debt financing costs	(963)	(400)	
Payments of dividends to shareholders		(999)	(5,674)
Tax benefit of stock-based compensation			2,487
Proceeds from exercise of options	1,262	2,561	2,425
Net cash used in financing activities	(1,268)	(7,660)	(762)
NET INCREASE IN CASH AND CASH EQUIVALENTS	22,440	23,017	34,693
CASH AND CASH EQUIVALENTS, beginning of year continuing operations and discontinued operations	10,136	32,576	55,593
CASH AND CASH EQUIVALENTS, end of year continuing operations and discontinued operations	$ 32,576	$ 55,593	$ 90,286

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

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COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006

1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation (Comfort Systems and collectively with its subsidiaries, the Company), is a national provider of comprehensive heating, ventilation and air conditioning (HVAC) installation, maintenance, repair and replacement services within the mechanical services industry. The Company operates primarily in the commercial, industrial and institutional HVAC markets, and performs most of its services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. In addition to standard HVAC services, the Company provides specialized applications such as building automation control systems, fire protection, process cooling, electronic monitoring and process piping. Certain locations also perform related activities such as electrical service and plumbing. Approximately 61% of the Company s consolidated 2006 revenues are attributable to installation of systems in newly constructed facilities, with the remaining 39% attributable to maintenance, repair and replacement services. The following service activities account for the Company s consolidated 2006 revenues: HVAC - 74%, plumbing - 18%, building automation control systems 3%, and other 5%. These service activities are within the mechanical services industry which is the single industry segment served by Comfort Systems.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Comfort Systems and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Cash Flow Information

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Cash paid for interest in 2004, 2005 and 2006 was approximately $0.9 million, $0.8 million, and $0.5 million, respectively. Cash paid for income taxes for continuing operations in 2004, 2005 and 2006 was approximately $6.3 million, $13.0 million and $15.6 million, respectively. Cash paid for income taxes for discontinued operations in 2004, 2005 and 2006 was approximately $0.5 million, $0.1 million and $7.1 million, respectively. The taxes paid for discontinued operations for 2006 related to the sale in 2005 of two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. These taxes are included in the caption Taxes paid related to the sale of business in the accompanying consolidated statement of cash flows.

Inventories

Inventories consist of parts and supplies that the Company purchases and holds for use in the ordinary course of business and are stated at the lower of cost or market using the first-in, first-out method.

Property and Equipment

Property and equipment are stated at cost, and depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are capitalized and amortized over the lesser of the expected life of the lease or the estimated useful life of the asset.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

2. Summary of Significant Accounting Policies (Continued)

Expenditures for repairs and maintenance are charged to expense when incurred. Expenditures for major renewals and betterments, which extend the useful lives of existing equipment, are capitalized and depreciated over the remaining useful life of the equipment. Upon retirement or disposition of property and equipment, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized in Gain on sale of assets in the statement of operations.

Goodwill

Goodwill represents the excess of the aggregate purchase price paid by the Company in acquisitions over the fair value of the net tangible and intangible assets acquired.

Long-Lived Assets

Long-lived assets are comprised principally of goodwill, property and equipment, and deferred income tax assets. The Company periodically evaluates whether events and circumstances have occurred that indicate that the remaining balances of these assets may not be recoverable. The Company uses estimates of future income from operations and cash flows, as well as other economic and business factors, to assess the recoverability of these assets.

Revenue Recognition

Approximately 86% of the Company s revenues were earned on a project basis and recognized through the percentage of completion method of accounting. Under this method as provided by American Institute of Certified Public Accountants Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, (SOP 81-1) 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 the Company engages in connection with obtaining installation contracts, the Company estimates its contract costs, which include all direct materials (exclusive of rebates), labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. These contract costs are included in the Company s results of operations under the caption Cost of Services. Then, as the Company performs under those contracts, such costs are measured as incurred, compared to total estimated costs to complete the contract, and a corresponding proportion of contract revenue is recognized. Labor costs are considered to be incurred as the work is performed. Subcontractor labor is recognized as the work is performed, but is generally subjected to approval as to milestones or other evidence of completion. Non-labor project cost consists of purchased equipment, prefabricated materials and other materials. Purchased equipment on the Company s projects are substantially all produced to job specifications and are a value added element to the Company s work. The costs are considered to be incurred when title is transferred to the Company, which typically is upon delivery to the work site. Prefabricated materials, such as ductwork and piping, are generally performed at the Company s shops and recognized as contract costs when fabricated for the unique specifications of the job. Other materials cost are not significant and are generally recorded when delivered to the work site. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

2. Summary of Significant Accounting Policies (Continued)

Project contracts typically provide for a schedule of billings or invoices to the customer based on reaching agreed-upon milestones or as the Company incurs costs. The schedules for such billings usually do not precisely match the schedule on which costs are incurred. 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 the Company s 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 the Company s 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. The effects of these revisions are recognized in the period in which the revisions are determined. When such revisions lead to a conclusion that a loss will be recognized on a contract, the full amount of the estimated ultimate loss is recognized in the period such a conclusion is reached, 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 the Company 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, the Company does 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 the Company s operating results, depending on project size, and the recoverability of the variation via additional customer payments.

Revenues associated with maintenance, repair and monitoring services and related contracts are recognized as services are performed.

Accounts Receivable

Accounts receivable include amounts billed to customers under retention or retainage provisions in construction contracts. Such provisions are standard in the Company s industry and usually allow for a small portion of progress billings or the contract price to be withheld by the customer until after the Company has completed work on the project, typically for a period of six months. Based on the Company s experience with similar contracts in recent years, billings for such retention balances at each balance sheet date are finalized and collected within the subsequent year. Retention balances at December 31, 2005 and 2006 are $45.1 million and $61.1 million, respectively, and are included in accounts receivable.

The carrying value of the Company s receivables, net of the allowance for doubtful accounts, represents their estimated net realizable value. The Company estimates its allowance for doubtful accounts

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

2. Summary of Significant Accounting Policies (Continued)

based upon the creditworthiness of its customers, prior collection history, ongoing relationships with its customers, the aging of past due balances, the Company s lien rights, if any, in the property where the Company performed the work, and the availability, if any, of payment bonds applicable to the contract. The receivables are written off when they are deemed to be uncollectible.

Self-Insurance Liabilities

The Company is substantially self-insured for worker s compensation, employer s liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident deductibles the Company absorbs under its insurance arrangements for these risks. Losses up to deductible amounts are estimated and accrued based upon known facts, historical trends and industry averages. Loss estimates associated with the larger and longer-developing risks worker s compensation, auto liability and general liability are reviewed by a third-party actuary quarterly. The Company s self-insurance arrangements are further discussed in Note 12 Commitments and Contingencies.

Warranty Costs

The Company typically warrants labor for the first year after installation on new HVAC systems. The Company generally warrants labor for 30 days after servicing of existing HVAC systems. A reserve for warranty costs is estimated and recorded based upon the historical level of warranty claims and management s estimate of future costs.

Income Taxes

The Company files a consolidated return for federal income tax purposes. Income taxes are provided for under the liability method in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes, which takes into account differences between financial statement treatment and tax treatment of certain transactions. Deferred tax assets represent the tax effect of activity that has been reflected in the financial statements but which will not be deductible for tax purposes until future periods. Deferred tax liabilities represent the tax effect of activity that has been reflected in the financial statements but which will not be taxable until future periods.

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

New Accounting Pronouncements

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, Share-Based Payment (Statement 123R) using the modified-prospective method. See Note 14 Stock-Based Compensation.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of SFAS

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

2. Summary of Significant Accounting Policies (Continued)

No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes. FIN 48 will be effective for the Company beginning January 1, 2007. The Company is currently evaluating the impact, if any, that FIN 48 will have on the financial statements.

Segment Disclosure

Comfort Systems activities are within the mechanical services industry, which is the single industry segment served by the Company. Under SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, each operating subsidiary represents an operating segment and these segments have been aggregated, as no individual operating unit is material and the operating units meet a majority of SFAS No. 131 s aggregation criteria.

Use of Estimates

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

Concentrations of Credit Risk

The Company provides services in a broad range of geographic regions. The Company s credit risk primarily consists of receivables from a variety of customers including general contractors, property owners and developers, and commercial and industrial companies. The Company regularly reviews its accounts receivable and estimates an allowance for uncollectible amounts. The Company has a diverse customer base, with no single customer accounting for more than 5% of consolidated 2006 revenues.

Financial Instruments

The Company s financial instruments consist of cash and cash equivalents, accounts receivable, receivables from related parties, other receivables, accounts payable and a line of credit. The Company believes that the carrying values of these instruments on the accompanying balance sheets approximate their fair values.

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.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

3. Acquisition

On January 17, 2005, the Company completed the acquisition of Granite State Plumbing & Heating (Granite), an HVAC contractor located near Manchester, New Hampshire. This acquisition has increased the Company s presence in the Northeast, specifically in the Boston region and southern New Hampshire. The total consideration paid in this transaction was approximately $2.9 million, comprised entirely of cash, including cash acquired. The fair value of the tangible net assets acquired exceeded the total consideration paid. As a result, the long-term fixed assets of the acquisition were reduced by this excess amount. The consolidated balance sheet of Comfort Systems includes an allocation of the purchase price to the assets acquired and liabilities assumed based on estimates of fair value. The purchase price was allocated as follows (amounts in thousands):

Accounts receivable, net	$ 5,223
Costs and estimated earnings in excess of billings	1,156
Other current assets	284
Property and equipment	210
Less: Accounts payable	(2,983)
Less: Billings in excess of costs and estimated earnings	(175)
Less: Other current liabilities	(747)
Less: Other long-term liabilities	(25)
Cash paid, including cash acquired	$ 2,943

The results of operations of Granite are included in the Company s consolidated financial statements from January 17, 2005 through December 31, 2006.

4. Discontinued Operations

Sale of Assets to MESA Energy Systems, Inc. On June 1, 2006, the Company along with its wholly-owned subsidiary, ARC Comfort Systems USA, Inc. (ARC), entered into an asset purchase agreement to sell certain assets of ARC to Mesa Energy Systems, Inc. (a subsidiary of Emcor Group, Inc.) for approximately $0.7 million in cash. These assets were sold at book value. The after-tax losses of this company of $2.3 million, $1.5 million and $0.2 million for the years ended December 31, 2004, 2005 and 2006, respectively, have been reported in discontinued operations under Operating loss, net of income tax benefit.

Sale of Companies to ALC On December 31, 2005, the Company sold two operations to Automated Logic Corporation and Automated Logic Contracting Services, Inc. (together, ALC) for approximately $22.9 million in cash, net of transaction costs and a purchase price adjustment based upon the closing balance sheet for the transferred assets. The receivable related to this sale was paid during the first quarter of 2006. The gain recognized on the sale of these units was $9.8 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income tax benefit (expense). During the fourth quarter of 2006, the Company recorded an additional gain of $0.1 million, net of tax, related to the collection of certain receivables. The Company paid $7.0 million in taxes related to this transaction during the first quarter of 2006. The after-tax income of these companies of $1.3 million

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

4. Discontinued Operations (Continued)

in both 2004 and 2005 has been reported in discontinued operations under Operating loss, net of income tax benefit.

Individual Sales of Operating Companies In 2005, the Company sold two small operating companies in separate transactions and shutdown the operations at another small operating company. The after-tax loss of these companies was $2.5 million in 2004 and $1.2 million in 2005, and has been reported in discontinued operations under Operating loss, net of income tax benefit. The gain recognized on the sale of these units was $0.1 million, including tax expense, and was reported in discontinued operations under Estimated gain on disposition, including income taxes.

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

Assets and liabilities related to discontinued operations are as follows (in thousands):

	December 31, 2005	December 31, 2006
Accounts receivable, net	$ 2,457	$ 216
Other current assets, net	238	5
Costs and estimated earnings in excess of billings	480	
Property, plant and equipment, net	139	
Other noncurrent assets	682	
Total assets	$ 3,996	$ 221
Accounts payable.	$ 232	$ 27
Billings in excess of costs and estimated earnings	161	
Other current liabilities	916	423
Total liabilities	$ 1,309	$ 450

Revenues and pre-tax losses related to the operations discontinued in 2004, 2005 and 2006 are as follows (in thousands):

	Year Ended December 31,		
	2004	2005	2006
Revenues	$ 52,533	$ 37,831	$ 2,564
Pre-tax loss	$ (3,742)	$ (2,127)	$ (363)

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

4. Discontinued Operations (Continued)

The Company s consolidated statements of operations and the related earnings per share amounts have been restated to reflect the effects of the discontinued operations. No interest expense is allocated to discontinued operations.

Sale of Companies to Emcor In March 2002, the Company sold 19 operations to Emcor Group, Inc. (Emcor). The total purchase price was $186.25 million, including the assumption by Emcor of approximately $22.1 million of subordinated notes to former owners of certain of the divested companies. Of Emcor s purchase price, $5 million was deposited into an escrow account to secure potential obligations on the Company s part to indemnify Emcor for future claims and contingencies arising from events and circumstances prior to closing, all as specified in the transaction documents. Of this escrow, $4 million has been applied in determining the Company s liability to Emcor in connection with the settlement of certain claims. The remaining $1 million of escrow is available for book purposes to apply to any future claims and contingencies in connection with this transaction, and has not been recognized as part of the Emcor transaction purchase price.

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

5. Goodwill

In most businesses the Company has acquired, the value paid to buy the business was greater than the value of specifically identifiable net assets in the business. Under generally accepted accounting principles, this excess is termed goodwill and is recognized as an asset at the time the business is acquired. It is generally expected that future net earnings from an acquired business will exceed the goodwill asset recognized at the time the business is bought. Under previous generally accepted accounting principles, goodwill was required to be amortized, or regularly charged to the Company s operating results in its statement of operations.

SFAS No. 142, Goodwill and Other Intangible Assets requires companies to assess goodwill asset amounts for impairment each year, and more frequently if circumstances suggest an impairment may have occurred. Impairment must be reflected when the value of a given business unit in excess of its tangible net assets falls below the goodwill asset balance carried for that unit on the Company s books. If other business units have had increases in the value of their respective goodwill balances, such increases may not be recorded under SFAS No. 142. Accordingly, such increases may not be netted against impairments at other business units.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

5. Goodwill (Continued)

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

The Company recorded goodwill impairment charges of $0.6 million, $33.9 million in operating results during the fourth quarters of 2004 and 2005, respectively. The Company recorded an additional impairment charge of $2.7 million in 2004 related to operations that were subsequently discontinued in 2005. This impairment charge is reflected in the operating loss associated with discontinued operations. The impairment charge during 2004 from continuing operations of $0.6 million related to a reporting unit in northern Michigan and was a result of concerns about the activity levels in this market. During 2005, the Company experienced modest revenue growth and improved profitability due to increased industry activity and favorable market conditions. However, the revenue, operating profits and cash flows for certain reporting units were lower than expected despite these favorable market conditions. Primarily based upon this trend, the revenue, earnings and cash flow projections for certain reporting units were revised downward for the next several years as compared to previous projections. As a result, an impairment charge of $33.9 million was recognized in 2005 for these reporting units including operations in San Diego, Houston, Grand Rapids, central Iowa, Birmingham, Buffalo and Albany. The Company did not have a goodwill impairment charge in 2006.

The changes in the carrying amount of goodwill for the years ended December 31, 2004, 2005 and 2006 are as follows (in thousands):

Goodwill balance as of December 31, 2004	$	100,123	
Goodwill related to sale of operation	(3,292		)
Impairment adjustment	(33,877		)
Goodwill balance as of December 31, 2005	$	62,954	
Goodwill related to sale of operation			
Impairment adjustment			
Goodwill balance as of December 31, 2006	$	62,954	

6. Restructuring Charges

The Company recorded restructuring charges of approximately $3.2 million pre-tax in 2003. These charges included approximately $1.5 million for severance costs and retention bonuses primarily associated with the curtailment of the Company s energy efficiency marketing activities, a reorganization of the Company s national accounts operations as well as a reduction in corporate personnel. The restructuring charges for this period also included approximately $1.6 million for remaining lease obligations and $0.1 million of other costs recorded in connection with the actions described above. The Company

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COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

6. Restructuring Charges (Continued)

increased its accrual for these remaining lease obligations by $0.6 million in 2004, $0.3 million in 2005 and $0.1 million in 2006 based on revised estimates of when and to what extent it believes it can sublease the related facilities. These increases to the accrual were included in Cost of Services and in Selling, General and Administrative Expenses in the Company s consolidated statement of operations. Accrued lease termination costs remaining from past restructuring charges are expected to be completed by 2009.

The following table shows the remaining liabilities associated with the cash portion of the restructuring charges as of December 31, 2004, 2005 and 2006 (in thousands):

Lease termination costs and other:	Balance at Beginning of Period	Additions	Payments	Balance at End of Period
Year ended December 31, 2004	$ 1,745	$ 610 (a)	$ (1,074)	$ 1,281
Year ended December 31, 2005	$ 1,281	$ 273 (a)	$ (593)	$ 961
Year ended December 31, 2006	$ 961	$ 88 (a)	$ (363)	$ 686

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

7. Property and Equipment

Property and equipment consist of the following (dollars in thousands):

	Estimated Useful Lives in Years	December 31, 2005	2006
Transportation equipment	3-7	$ 8,118	$ 8,638
Machinery and equipment	3-10	14,415	15,218
Computer and telephone equipment	3-7	13,699	14,523
Buildings and leasehold improvements	3-40	7,742	8,588
Furniture and fixtures	3-10	4,077	3,872
		48,051	50,839
Less Accumulated depreciation		(35,346)	(35,335)
Property and equipment, net		$ 12,705	$ 15,504

Depreciation expense for the years ended December 31, 2004, 2005 and 2006 was $4.1 million, $4.2 million and $5.0 million, respectively.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

8. Detail of Certain Balance Sheet Accounts

Activity in the Company s allowance for doubtful accounts consists of the following (in thousands):

	December 31, 2004	2005	2006
Balance at beginning of year	$ 4,547	$ 5,171	$ 3,538
Additions for bad debt expense	2,346	1,202	686
Deductions for uncollectible receivables written off, net of recoveries	(2,422)	(2,835)	(923)
Other receivables reserves previously included in other accrued liabilities	700		
Balance at end of year	$ 5,171	$ 3,538	$ 3,301

Other current liabilities consist of the following (in thousands):

	December 31, 2005	2006
Accrued warranty costs	$ 3,998	$ 4,313
Other current liabilities	10,340	10,858
	$ 14,338	$ 15,171

Contracts in progress are as follows (in thousands):

	December 31, 2005	2006
Costs incurred on contracts in progress	$ 622,104	$ 1,177,317
Estimated earnings, net of losses	138,214	256,177
Less Billings to date	(791,085)	(1,475,763)
	$ (30,767)	$ (42,269)
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 22,512	$ 23,680
Billings in excess of costs and estimated earnings on uncompleted contracts	(53,279)	(65,949)
	$ (30,767)	$ (42,269)

9. Long-Term Debt Obligations

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

	December 31, 2005	2006
Revolving credit facility	$	$
Other		
Total debt		
Less current maturities		
Total long-term portion of debt	$	$

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

9. Long-Term Debt Obligations (Continued)

Credit Facility

On June 30, 2005, the Company entered into a senior credit facility (the Facility) provided by a syndicate of banks. The Facility consists of a $75.0 million revolving credit facility which is available for borrowings and letters of credit. The Facility was scheduled to expire on June 30, 2009. On February 20, 2007, the Company amended the Facility, increasing the available borrowing capacity to $100.0 million and amending certain covenants. See Note 16 Subsequent Events for additional information. As of December 31, 2006, the total of the Facility was $75.0 million, with no outstanding borrowings, $25.2 million in letters of credit outstanding, and $49.8 million of credit available.

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

The Company s borrowing and letter of credit capacity under the Revolving Loan portion of the Facility is $75.0 million less borrowings and letters of credit outstanding, subject to a borrowing base. The borrowing base is defined under the Facility as 65% of the following: total trade receivables including costs and estimated earnings in excess of billings, less allowances for doubtful accounts, less receivables related to projects that are subject to payment or performance bonds. The borrowing base as of December 31, 2006 was $85.3 million. This borrowing base is substantially greater than the $75.0 million face-value limit of the Facility as of December 31, 2006.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which the Company must comply, as discussed below under Covenants and Restrictions. Covenant compliance is measured as of each quarter-end. While the Facility s financial covenants do not

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

9. Long-Term Debt Obligations (Continued)

specifically govern capacity under the Facility, if the Company s debt level under the Facility at a quarter-end covenant compliance measurement date were to cause the Company to violate the Facility s debt-to-Credit Facility Adjusted EBITDA covenant (described in more detail below), the Company s borrowing capacity under the Facility could be restricted by the lenders. Accordingly, available capacity amounts shown below are presented both on a financial covenant basis and on a Facility face value basis.

	As of December 31, 2006 (in thousands)	
Amounts Outstanding:		
Revolving loan	$	
Other non-Facility debt		
Total debt	$	
Letters of credit	$	25,166
Available Capacity:		
Unused Revolving Loan and letter of credit capacity based on Revolving Loan face value of $75 million	$	49,834
Unused Revolving Loan and letter of credit capacity based on quarter-end debt-to-Credit Facility Adjusted EBITDA covenant	$	49,834

Collateral

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

A common practice in the Company s industry is the posting of payment and performance bonds with customers. These bonds are offered by financial institutions known as sureties, and provide assurance to the customer that in the event the Company encounters significant financial or operational difficulties, the surety will arrange for the completion of the Company s contractual obligations and for the payment of the Company s vendors on the projects subject to the bonds. In cooperation with its lenders, the Company has granted its surety a first lien on assets such as receivables, costs and estimated earnings in excess of billings, and equipment specifically identifiable to projects for which bonds are outstanding, as collateral for potential obligations under bonds. As of December 31, 2006 the amount of these assets was approximately $88.4 million.

Interest Rates and Fees

At December 31, 2006, the Company had a choice of two interest rate options for borrowings under the Facility. Under one option termed the Base Rate Option, the interest rate is determined based on the higher of the Federal Funds Rate plus 0.5% or the prime lending rate offered by Citibank, N.A. (not one of the banks providing the Facility to the Company). Additional margins are then added to the higher of these two rates. These additional margins are determined based on the ratio of the Company s total debt

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

9. Long-Term Debt Obligations (Continued)

outstanding as of a given quarter end to its earnings before interest, taxes, depreciation and amortization (Credit Facility Adjusted EBITDA) for the twelve months ending as of that quarter end, as shown below. Credit Facility Adjusted EBITDA as defined under the Facility is discussed in more detail below under *Covenants and Restrictions.*

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

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

The interest rates underlying the Base Rate and Eurodollar Rate Options under the Facility are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. For illustrative purposes, the following are the respective market rates as of December 31, 2006 relating to interest options under the Facility:

Base Rate Option The higher of:	
Federal Funds Rate plus 0.50%	5.75 %
Citibank, N.A. Prime Rate	8.25 %
Eurodollar Rate Option:	
One-month LIBOR	5.32 %
Six-month LIBOR	5.37 %

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

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

The Company incurred approximately $0.4 million in financing and professional costs in connection with the arrangement of the Facility. These costs are amortized as a non-cash charge to interest expense over the term of the Facility in an amount of approximately $0.1 million per year, and will continue to be amortized through the term of the Facility as amended. Excluding the amortization of debt financing and arrangement costs, the Company estimates that the interest rate applicable to borrowings under the Facility would be approximately 7.32% as of December 31, 2006.

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COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

9. Long-Term Debt Obligations (Continued)

Covenants and Restrictions

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

Net income	$ 28,724
Income taxes continuing operations and discontinued operations	17,646
Interest income, net	(1,970)
Depreciation and amortization expense	5,265
Credit Facility Adjusted EBITDA	$ 49,665

The Facility s principal financial covenants include:

Fixed Charge Coverage Ratio The Facility requires that the ratio of Credit Facility Adjusted EBITDA, less non-financed capital expenditures, tax provision, dividends and amounts used to repurchase stock to the sum of interest expense and scheduled principal payments be at least 1.50. Capital expenditures, tax provision, dividends and stock repurchase payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. Interest expense is defined under the Facility as interest expense for the four quarters ending as of any given quarterly covenant compliance measurement date, excluding corresponding twelve-month amounts for (a) amortization of deferred debt arrangement costs; and (b) mark-to-market interest expense. Scheduled principal payments for this ratio are also measured for the twelve months ending as of any given quarterly covenant compliance measurement date. The Company s fixed charge coverage ratio as of December 31, 2006 as measured under this covenant was 36.47 as compared to a minimum covenant requirement of 1.50.

Tangible Net Worth The Facility requires that the Company s tangible net worth not be less than the sum of (a) $100.5 million; (b) 50% of net income earned beginning April 1, 2005; and (c) the net proceeds of any equity transactions. For purposes of this ratio, the Facility defines tangible net worth as stockholders equity less the book value of the following intangible assets: goodwill, patents, copyrights, licenses, franchises, trade names, trade secrets, and operating leases. The Facility also provides that for purposes of this ratio, net income (loss) excludes any goodwill impairment charges. The Company s tangible net worth as of December 31, 2006 as measured under this covenant was $179.4 million, as compared to a covenant minimum of $136.0 million.

Debt to Credit Facility Adjusted EBITDA The Facility requires that the Company s ratio of debt to Credit Facility Adjusted EBITDA not exceed 2.5. The Company s debt-to-Credit Facility Adjusted EBITDA ratio as of December 31, 2006 as measured under this covenant was zero because the Company has no debt.

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COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

9. Long-Term Debt Obligations (Continued)

Capital Expenditures The Facility limits capital expenditures to $20.0 million per year. The Company s capital expenditures during the year ended December 31, 2006 were $8.1 million.

Other Restrictions The Facility limits payment of dividends and repurchase of shares by the Company to a combined maximum of $20.0 million per year, and otherwise limits non-Facility debt, capital lease obligations, acquisitions, investments, and sales of assets. During the fourth quarter of 2005, the Company amended the Facility to permit the sale of substantially all of the assets of two subsidiaries. That sale is discussed in Note 4 Discontinued Operations. The amendment also provides additional flexibility for the Company to purchase its common shares.

Interest Expense and Related Charges in Connection with Previous Credit Facilities

The credit facility that preceded the Company s current one was in place from December 2003 to June 2005. The Company s next previous credit facility had been in place from October 2002 to December 2003. Interest expense for 2004, 2005 and 2006 included the following primary elements (in thousands):

	2004	2005	2006
Interest expense on borrowings, and unused commitment fees	$ 704	$ 391	$ 166
Letter of credit fees	443	389	351
Amortization of deferred debt arrangement costs and discount	419	295	99
Total	$ 1,566	$ 1,075	$ 616

When the Company s previous credit facilities were reduced in size or terminated, corresponding amounts of deferred debt arrangement costs were written off. This charge in the amount of $0.9 million is reported as Write-off of debt costs in the Company s consolidated statement of operations for the year ended December 31, 2005.

10. Income Taxes

The provision for income taxes relating to continuing operations consists of the following (in thousands):

	Year Ended December 31, 2004	2005	2006
Current			
Federal	$ 7,345	$ 9,592	$ 16,639
State and Puerto Rico	1,511	2,113	2,122
	8,856	11,705	18,761
Deferred			
Federal	638	948	(1,236)
State and Puerto Rico	(905)	2,195	349
	(267)	3,143	(887)
	$ 8,589	$ 14,848	$ 17,874

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COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

10. Income Taxes (Continued)

The difference in income taxes provided for and the amounts determined by applying the federal statutory tax rate to income before income taxes results from the following (in thousands):

	Year Ended December 31, 2004	2005	2006
Income tax expense (benefit) at the statutory rate	$ 7,794	$ (7)	$ 16,307
Increase resulting from			
State income taxes, net of federal tax effect	652	2,481	1,412
Increase (decrease) in valuation allowance	(621)	131	355
Increase (decrease) in contingency reserves	12	(14)	(419)
Non-deductible goodwill impairment	224	11,857	
Non-deductible expenses	474	619	289
Production activity deduction		(182)	(320)
Other	54	(37)	250
	$ 8,589	$ 14,848	$ 17,874

Significant components of the net deferred tax assets and net deferred tax liabilities as reflected on the balance sheet are as follows:

	December 31, 2005	2006
	(In thousands)	
Deferred income tax assets		
Accounts receivable and allowance for doubtful accounts	$ 1,371	$ 1,258
Goodwill	4,557	3,217
Accrued liabilities and expenses	8,934	11,277
State net operating loss carryforwards	2,539	2,611
Other	450	962
Total deferred income tax assets	17,851	19,325
Deferred income tax liabilities		
Property and equipment	(779)	(595)
Long-term contracts	(759)	(689)
Other	(43)	(255)
Total deferred income tax liabilities	(1,581)	(1,539)
Less Valuation allowance	(2,027)	(2,616)
Net deferred income tax assets	$ 14,243	$ 15,170

The deferred income tax assets and liabilities reflected above are included in the consolidated balance sheets as follows (in thousands):

	December 31, 2005	2006
Deferred income tax assets		
Prepaid expenses and other	$ 8,650	$ 10,456
Other non-current assets	5,593	4,714
Total deferred income tax assets	$ 14,243	$ 15,170

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

10. Income Taxes (Continued)

As of December 31, 2006 the Company had future tax benefits of $2.6 million related to $62 million of available state net operating loss carryforwards for income tax purposes which expire in 2007 through 2026. Valuation allowances of $2.2 million and $0.4 million, respectively, have been recorded against net operating loss carryforwards and related net state deferred tax assets. The Company recorded an increase in valuation allowances of $0.4 million for the year ending December 31, 2006. A deferred tax asset for state net operating loss carryforwards, net of related valuation allowance, of $0.4 million reflects the Company s conclusion that is likely that this asset will be realized based upon expected future earnings in certain subsidiaries. The Company updates this assessment of the realizability of deferred tax assets relating to state net operating loss carryforwards quarterly.

Federal, state and local authorities routinely audit income tax returns filed by the Company. During 2005, the Company concluded an Internal Revenue Service (IRS) examination of its 2003 federal income tax return. No change was made to the Company s tax return. It is the Company s policy to establish reserves for taxes that may become payable in future years as a result of tax examinations. The Company establishes reserves for taxes based on management s assessment of the probability that examinations will result in additional income tax payments. Tax reserves are analyzed quarterly and adjustments are recorded, as events occur to warrant adjustment to reserves. The Company has recorded $0.5 million in income tax reserves as of December 31, 2006. For the years ended December 31, 2005 and 2006 the Company has recorded decreases of $0.2 million and $0.4 million to tax reserves respectively.

During 2004, the American Jobs Creation Act of 2004 was signed into law. The primary effect of this legislation was to permit the Company to claim a deduction for 3% of earnings related to certain of the Company s construction-related activities beginning in 2005. This deduction modestly decreased the effective rate.

11. Employee Benefit Plans

The Company and certain of the Company s subsidiaries sponsor various retirement plans for most full-time and some part-time employees. These plans consist of defined contribution plans and multi-employer pension plans and cover employees at substantially all of the Company s operating locations. The defined contribution plans generally provide for contributions up to 2.5% of covered employees salaries or wages. These contributions totaled $2.6 million for 2004, $3.1 million for 2005 and $3.3 million for 2006. Of these amounts, approximately $0.3 million and $0.3 million were payable to the plans at December 31, 2005 and 2006, respectively.

Certain of the Company s subsidiaries also participate or have participated in various multi-employer pension plans for the benefit of employees who are union members. As of December 31, 2005 and 2006, the Company had 83 and 6 employees, respectively, who were union members. During 2006, two of the Company s operations withdrew from multi-employer pension plans; accordingly, the Company is subject to unfunded pension plan liability related to these two withdrawals, and has accrued $1.2 million in anticipation of these liabilities. The data available from administrators of other multi-employer pension plans is not sufficient to determine the accumulated benefit obligations, nor the net assets attributable to the multi-employer plans in which Company employees participate or previously participated. Company contributions to these plans were approximately $0.1 million for 2004, $0.1 million for 2005 and zero for 2006.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

12. Commitments and Contingencies

Leases

The Company leases certain facilities and equipment under noncancelable operating leases. Rent expense for the years ended December 31, 2004, 2005 and 2006 was $14.1 million, $14.9 million, and $14.7 million, respectively. The Company recognizes escalating rental payments that are quantifiable at the inception of the lease on a straight-line basis over the lease term. Concurrent with the acquisitions of certain acquired companies, the Company entered into various agreements with previous owners to lease land and buildings used in the Company s operations. The terms of these leases generally range from three to ten years and certain leases provide for escalations in the rental expenses each year, the majority of which are based on inflation. Included in the 2004, 2005 and 2006 rent expense above are approximately $2.8 million, $2.5 million and $2.4 million of rent paid to these related parties, respectively. The following represents future minimum rental payments under noncancelable operating leases (in thousands):

Year ending December 31	
2007	$ 9,797
2008	8,077
2009	7,841
2010	3,219
2011	2,200
Thereafter	6,442
	$ 37,576

Claims and Lawsuits

The Company is subject to certain claims and lawsuits arising in the normal course of business. The Company maintains various insurance coverages to minimize financial risk associated with these claims. The Company has estimated and provided accruals for probable losses and related legal fees associated with certain of its litigation in the accompanying consolidated financial statements. While the Company 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 the Company s operating results or financial condition, after giving effect to provisions already recorded.

In addition to the matters described above, the Company is defending a dispute arising out of an alleged delay related to a multi-family construction project. Plaintiffs allege actual damages of approximately $7 million plus attorneys fees, punitive damages and pre-judgment interest. The trial relating to this matter is currently scheduled for the second quarter of 2007. The Company anticipates that contribution from a co-defendant and insurance proceeds will, in part, offset any adverse judgment. Management believes the accruals relating to the matter appropriately reflect a probable outcome; however, if the Company is not successful in this dispute, it could have a material adverse effect on the Company s operating results.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

12. Commitments and Contingencies (Continued)

Surety

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

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

Self-Insurance

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

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

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

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

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

12. Commitments and Contingencies (Continued)

Auto Liability For auto liability, the Company self-insures the first $500,000 of each loss, is fully insured for the next $1.5 million of each loss, then has a single, aggregate excess loss insurance policy that covers losses up to $50 million.

Employee Medical The Company s deductible for employee group health claims is $300,000 per person, per policy (calendar) year. Insurance then covers any Company responsibility for medical claims in excess of the deductible amount.

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

13. Stockholders Equity

Long-Term Incentive Plans

In March 1997, the Company s stockholders approved the Company s 1997 Long-Term Incentive Plan (the 1997 Plan) which provides for the granting of incentive or non-qualified stock options, stock appreciation rights, restricted or deferred stock, dividend equivalents or other incentive awards to directors, employees and consultants to the Company. Aggregate options granted under the 1997 Plan may not exceed 13% of the total number of shares of Common Stock outstanding at the time of any grant under the plan. The options the Company has granted under the 1997 Plan have exercise prices that were equal to the fair market value of the Common Stock on the date of grant, and which become exercisable in five equal annual installments beginning on the first anniversary of the date of grant. The options expire after seven years from the date of grant if unexercised. The 1997 Plan will expire in March 2007.

In May 2000, the Company s stockholders approved the Company s 2000 Incentive Plan (the 2000 Plan) which provides for the granting of incentive or non-qualified stock options, restricted stock or performance awards to directors, employees and other persons or entities as approved by the Board of Directors. The options the Company has granted under the 2000 Plan have exercise prices that were equal to the fair market value of the Common Stock on the date of grant, and which become exercisable in four equal annual installments beginning on the first anniversary of the date of grant. The options expire after ten years from the date of grant if unexercised. Under the 2000 Plan, 3.5 million shares were authorized for issuance, of which none remain available for issuance as of December 31, 2006.

In May 2006, the Company s stockholders approved the Company s 2006 Equity Incentive Plan (the 2006 Plan) which provides for the granting of incentive or non-qualified stock options, stock appreciation rights, restricted or deferred stock, dividend equivalents or other incentive awards to directors, employees and consultants to the Company. The number of shares authorized and reserved for issuance under the 2006 Plan is 3,200,000 shares. The number of shares available under this plan varies with the total number of shares of Common Stock outstanding. As of December 31, 2006, there were 3,185,000 shares available for issuance under this plan. The 2006 Plan will expire in May 2016. The Company will make all future grants under the 2006 Plan.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

13. Stockholders Equity (Continued)

Non-Employee Directors Stock Plan

In March 1997, the Company s stockholders approved the 1997 Non-Employee Directors Stock Plan (the Directors Plan), which provides for the granting of stock options or stock appreciation rights to non-employees. The number of shares authorized and reserved for issuance under the Directors Plan is 500,000 shares. Under the Directors Plan, each non-employee director is granted options to purchase 10,000 shares at the time of the director s initial election. In addition, each non-employee director is automatically granted options to purchase an additional 10,000 shares at each annual meeting of the stockholders that is more than two months after the date of the director s initial election. All options are granted with an exercise price equal to the fair market value at the date of grant and are immediately vested upon grant. The 1997 Plan will expire in March 2007.

2006 Stock Options/SAR Plan for Non-Employee Directors

In May 2006, the Company s stockholders approved the Company s 2006 Stock Options/SAR Plan for Non-Employee Directors (the 2006 Directors Plan), which provides for the granting of stock options or stock appreciation rights to non-employees. The number of shares authorized and reserved for issuance under the 2006 Directors Plan is 500,000 shares. Outstanding options may be canceled and reissued under terms specified in the plan. The number of shares available under this plan varies with the total number of shares of Common Stock outstanding. As of December 31, 2006, there were 500,000 shares available for issuance under this plan. The 2006 Directors Plan will expire in May 2016.

Under the 2006 Directors Plan, each participant who has served since at least the previous annual meeting and is continuing in office and each newly elected non-employee director will be awarded an award covering 10,000 shares (which will be the maximum number of shares of Common Stock subject to awards that may be granted to any participant in the aggregate in any calendar year). All options will be granted with an exercise price equal to the fair market value at the date of grant and become exercisable on the first anniversary of the date of grant. The options expire after ten years from the date of grant if unexercised. The Company will make all future grants under the 2006 Directors Plan.

The Company has never altered the price of any option after its grant.

Warrant

In connection with a previous credit facility, the Company granted a lender a warrant to purchase 409,051 shares of Company common stock (Common Stock) for nominal consideration. When the warrant was originally issued, the warrant holder had the right to put, or require the Company to repurchase some or all of the shares related to the warrant in certain circumstances. The warrant was exercised in October 2004 in a cashless transaction, whereby the Company issued 408,144 shares upon exercise of the warrant. As a result of the exercise, all rights under the warrant have terminated and the remaining value of the warrant was eliminated as an obligation and added to stockholders equity in October 2004. Because the warrant and put did not relate to the Company s current credit facility, mark-to-market adjustments during the year ended December 31, 2004, which were losses of $0.4 million, are reflected as other income (expense) in the Company s statement of operations. There are no further mark-to-market adjustments to income associated since the warrant and put are no longer outstanding.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

13. Stockholders Equity (Continued)

Restricted Common Stock

In March 1997, Notre Capital Ventures II, L.L.C. (Notre) exchanged 2,742,912 shares of Common Stock for an equal number of shares of restricted voting common stock (Restricted Voting Common Stock). In November 2006, the Board voted to convert all existing Restricted Voting Common Stock into Common Stock . As a result of this action, all outstanding shares of Restricted Voting Common Stock immediately converted into shares of Common Stock of the Company on a share for share basis.

Earnings Per Share

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

Under EPS calculation methods established by generally accepted accounting principles, including the effect of options whose exercise price exceeds the average market price of the Common Stock for a given period would increase calculated EPS. This impact is called anti-dilutive. Generally accepted accounting principles for determining EPS require that any options or other common stock equivalents whose inclusion in determining EPS would have an anti-dilutive effect be excluded. Accordingly, options to purchase 1.3 million shares of Common Stock at prices ranging from $7.00 to $21.438 per share which were outstanding for the year ended December 31, 2004, and options to purchase 0.1 million shares at prices ranging from $12.75 to $21.125 per share which were outstanding for the year ended December 31, 2006, were not included in the computation of diluted EPS because they were anti-dilutive.

Including options in an EPS calculation for a period in which a loss is reported is also anti-dilutive. Accordingly, because the Company reported a loss from continuing operations for the year ended December 31, 2005, options to purchase 0.9 million shares of common stock at prices ranging from $1.90 to $21.438 per share were excluded from the computation of diluted EPS because they were anti-dilutive.

As noted above, the Company issued a warrant to purchase 409,051 shares of Common Stock along with related put rights which were exercised in October 2004. As the impact of the warrant was anti-dilutive for the year ended December 31, 2004, the effect of the warrant was excluded from earnings per share. As a result of the warrant s exercise in October 2004, its related shares have now become part of the Company s outstanding Common Stock.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

13. 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):

	Year Ended December 31, 2004	2005	2006
Common shares outstanding, end of period (a)	38,909	39,737	40,462
Effect of using weighted average common shares outstanding	(500)	(439)	(215)
Shares used in computing earnings per share basic	38,409	39,298	40,247
Effect of shares issuable under stock option plans based on the treasury stock method	1,056		818
Effect of contingently issuable restricted shares	40		81
Shares used in computing earnings per share diluted	39,505	39,298	41,146

(a) Excludes 325,000, 242,917 and 247,709 shares of unvested contingently issuable restricted stock outstanding as of December 31, 2004, 2005 and 2006 respectively (see Note 14 Stock-Based Compensation.)

14. Stock-Based Compensation

The Company has various stock-based compensation plans which are administered by the compensation committee of the board of directors. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock-Based Compensation. No stock-based employee compensation cost was recognized in the Consolidated Statements of Operations for the years ended December 31, 2004 and December 31, 2005, except with respect to the amortization of the intrinsic value of restricted stock grants totaling $0.4 million and $0.5 million, respectively. Options granted under the Company s equity compensation plans had an exercise price equal to the market value of the underlying common stock on the date of grant and all terms were fixed; accordingly, no expense was recognized under APB Opinion No. 25. Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement 123R, using the modified-prospective-transition method. Results for prior periods have not been restated.

The impact of the adoption of FAS 123R resulted in compensation expense of $1.8 million ($1.1 million after-tax or $0.03 per basic share and $0.03 per diluted share) for the year ended December 31, 2006.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

14. Stock-Based Compensation (Continued)

The following table sets forth pro forma information as if compensation expense for the years ended December 31, 2004 and December 31, 2005 had been determined consistent with the requirements of Statement No. 123. For purposes of this pro forma disclosure, the value of the stock options was estimated using a Black-Scholes option-pricing formula and amortized to expense over the options vesting periods (in thousands, except per share amounts):

	Year Ended December 31, 2004	2005
Net income (loss) as reported	$ 10,713	$ (6,226)
Add: Stock-based compensation included in reported net income, net of tax	242	337
Less: Compensation expense per Statement 123, net of tax	(1,431)	(1,028)
Pro forma net income (loss)	$ 9,524	$ (6,917)
Net income (loss) per share Basic		
Net income (loss) per share as reported	$ 0.28	$ (0.16)
Pro forma net income (loss) per share	$ 0.25	$ (0.18)
Net income (loss) per share Diluted		
Net income (loss) per share as reported	$ 0.27	$ (0.16)
Pro forma net income (loss) per share	$ 0.24	$ (0.18)

Prior to adopting Statement 123R, the Company presented the benefits of tax deductions in excess of recognized compensation costs (excess tax benefits) as operating cash flows in the consolidated statements of cash flows. Statement 123R requires these excess tax benefits to be reported as financing cash flows.

Stock Options

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

	2004	2005	2006			
Stock Options	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	5,625,814	$ 7.43	3,508,051	$ 5.49	2,667,863	$ 4.18
Granted	144,000	$ 6.76	467,500	$ 6.60	65,000	$ 12.87
Exercised	(440,508)	$ 2.87	(765,913)	$ 3.34	(653,996)	$ 3.71
Forfeited	(658,986)	$ 9.85	(175,750)	$ 7.79	(93,625)	$ 6.35
Expired	(1,162,269)	$ 13.55	(366,025)	$ 9.90	(51,500)	$ 12.73
Outstanding at end of year	3,508,051	$ 5.49	2,667,863	$ 4.18	1,933,742	$ 4.30
Options exercisable at end of year	2,661,601		1,795,113		1,448,992	

The total intrinsic value of options exercised during the years ended December 31, 2004, 2005 and 2006 was $1.8 million, $3.5 million and $6.0 million, respectively. Stock options outstanding as of

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

14. Stock-Based Compensation (Continued)

December 31, 2006 have a weighted-average remaining contractual term of 5.6 years and an aggregate intrinsic value of $16.2 million. Stock options exercisable as of December 31, 2006 have a weighted-average remaining contractual term of 5.0 years and an aggregate intrinsic value of $12.6 million. As of December 31, 2006, the Company has 1,835,541 shares that are vested or expected to vest; these shares have a weighted average exercise price of $4.28 per share, have a weighted-average remaining contractual term of 5.5 years and an aggregate intrinsic value of $15.3 million.

The following table summarizes information about stock options outstanding at December 31, 2006:

	Options Outstanding			**Options Exercisable**	
Range of Exercise Prices	**Number Outstanding at 12/31/06**	**Weighted-Average Remaining Contractual Life**	**Weighted-Average Exercise Price**	**Number Exercisable at 12/31/06**	**Weighted-Average Exercise Price**
$1.90 2.875	819,117	5.13 years	$ 2.33	662,992	$ 2.43
$3.39 7.94	1,029,625	5.89 years	$ 5.10	716,000	$ 4.52
$11.75 13.00	75,000	8.25 years	$ 12.88	60,000	$ 12.92
$16.31 21.125	10,000	1.89 years	$ 18.72	10,000	$ 18.72
$1.90 21.125	1,933,742	5.64 years	$ 4.30	1,448,992	$ 4.01

The fair value of each option award is estimated, based on several assumptions, on the date of grant using the Black-Scholes option valuation model. Upon adoption of SFAS No. 123R, the Company modified its methods used to determine these assumptions based on the Securities and Exchange Commission s Staff Accounting Bulletin No. 107. The fair values and the assumptions used for the 2004-2006 grants are shown in the table below:

	2004	**2005**	**2006**
Weighted-average fair value per share of options granted	$4.33	$4.22	$5.53
Fair value assumptions:			
Expected dividend yield	0.00%	0.00%	1.09% - 1.10%
Expected stock price volatility	61.24%	61.23%-63.99%	45%
Risk-free interest rate	3.96%-4.38%	3.91%-4.31%	4.81% - 4.94%
Expected term	7 years	7 years	5.0 - 6.3 years

Stock options are accounted for as equity instruments, and compensation cost is recognized using straight-line vesting over the four-year vesting period. As of December 31, 2006, the unrecognized compensation cost related to stock options was $1.1 million, which is expected to be recognized over a weighted-average period of 1.0 years. The total fair values of shares vested during the year ended December 31, 2006 was $1.1 million.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

14. Stock-Based Compensation (Continued)

The following table summarizes information about nonvested stock option awards as of December 31, 2006 and changes for the year ended December 31, 2006:

Stock Options	Shares	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	872,750	$ 2.99
Granted	65,000	$ 5.53
Vested	(363,625)	$ 2.92
Forfeited	(89,375)	$ 3.97
Nonvested at December 31, 2006	484,750	$ 3.20

The Company generally issues new shares for stock options and restricted stock, unless treasury shares are available.

Restricted Stock

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

Restricted Stock	2004	2005	2006
Unvested at beginning of year	225,000	325,000	242,917
Granted	225,000	82,500	45,833
Vested	(68,750)	(102,083)	(118,333)
Forfeited	(56,250)	(62,500)	(14,375)
Expired			
Unvested at end of year	325,000	242,917	156,042

Approximately $0.6 million of compensation expense related to restricted stock will be recognized over a weighted-average period of 1.5 years. The total fair value of shares vested during year ended December 31, 2006 was $0.6 million. The weighted-average fair value of restricted stock shares awarded during 2004, 2005 and 2006 was $6.10, $5.58 and $11.07, respectively. The aggregate intrinsic value of restricted stock vested during the years ended December 31, 2004, 2005 and 2006 was $0.2 million, $0.5 million and $1.5 million, respectively.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

15. Quarterly Results of Operations (Unaudited)

Quarterly financial information for the years ended December 31, 2005 and 2006 is summarized as follows (in thousands, except per share data):

	2005 Q1	Q2	Q3	Q4
Revenues	$ 194,100	$ 229,547	$ 235,252	$ 233,650
Gross profit	$ 28,117	$ 38,251	$ 39,148	$ 42,626
Operating income(loss)(a)	$ 2,412	$ 9,711	$ 10,890	$ (21,948)
Income (loss) from continuing operations(a)	$ 1,280	$ 4,883	$ 6,096	$ (27,128)
Discontinued operations				
Operating results, net of tax	$ (751)	$ (342)	$ 73	$ (289)
Estimated gain (loss) on disposition, including tax	$	$ 137	$ (38)	$ 9,853
Net income (loss)	$ 529	$ 4,678	$ 6,131	$ (17,564)
INCOME (LOSS) PER SHARE:				
Basic				
Income (loss) from continuing operations	$ 0.03	$ 0.12	$ 0.16	$ (0.68)
Discontinued operations				
Income (loss) from operations	(0.02)			(0.01)
Estimated gain on disposition				0.25
Net income (loss)	$ 0.01	$ 0.12	$ 0.16	$ (0.44)
Diluted				
Income (loss) from continuing operations	$ 0.03	$ 0.12	$ 0.15	$ (0.68)
Discontinued operations				
Income (loss) from operations	(0.02)			(0.01)
Estimated gain on disposition				0.25
Net income (loss)	$ 0.01	$ 0.12	$ 0.15	$ (0.44)
Cash flow from operations	$ (5,541)	$ 11,929	$ 8,103	$ 22,955

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

15. Quarterly Results of Operations (Unaudited) (Continued)

	2006 Q1	Q2	Q3	Q4
Revenues	$ 236,385	$ 264,390	$ 287,676	$ 268,074
Gross profit	$ 36,768	$ 42,464	$ 46,209	$ 45,576
Operating income	$ 7,045	$ 12,099	$ 14,155	$ 11,223
Income from continuing operations	$ 4,534	$ 7,717	$ 8,967	$ 7,499
Discontinued operations				
Operating results, net of tax	$ (207)	$ (5)	$ (5)	$ 14
Estimated gain on disposition, including tax	$	$ 209	$	$ 1
Net income	$ 4,327	$ 7,921	$ 8,962	$ 7,514
INCOME PER SHARE:				
Basic				
Income from continuing operations	$ 0.11	$ 0.19	$ 0.22	$ 0.19
Discontinued operations				
Income from operations				
Estimated gain on disposition		0.01		
Net income	$ 0.11	$ 0.20	$ 0.22	$ 0.19
Diluted				
Income from continuing operations	$ 0.11	$ 0.19	$ 0.22	$ 0.18
Discontinued operations				
Income from operations				
Estimated gain on disposition				
Net income	$ 0.11	$ 0.19	$ 0.22	$ 0.18
Cash flow from operations	$ (20,508)	$ 8,586	$ 5,556	$ 24,100

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

(a) Fourth quarter 2005 includes a goodwill impairment charge of $33.9 million.

The sums of the individual quarterly earnings per share amounts do not necessarily agree with year-to-date earnings per share as each quarter s computation is based on the weighted average number of shares outstanding during the quarter, the weighted average stock price during the quarter and the dilutive effects of options and contingently issuable restricted stock in each quarter.

16. Subsequent Events

On February 20, 2007, the Company amended its senior credit facility (the Amended Facility) provided by a syndicate of banks. The Amended Facility consists of a $100.0 million revolving credit facility which is available for borrowings and letters of credit. The Amended Facility expires in February 2012. Under the Amended Facility, only two financial covenants remain.

COMFORT SYSTEMS USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
December 31, 2006

16. Subsequent Events (Continued)

Leverage Ratio The Amended Facility requires that the ratio of the Company s total indebtedness less cash and cash equivalents to its Credit Facility Adjusted EBITDA not exceed 2.50.

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

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

The Company continues to have a choice of two interest rate options for borrowings under the Facility, the Base Rate Option and the Eurodollar Rate Option. Under the Base Rate Option, the interest rate is determined based on the higher of the Federal Funds Rate plus 0.5% or the prime lending rate offered by Citibank, N.A. (not one of the banks providing the Facility to the Company). Additional margins are then added to the higher of these two rates. These additional margins are determined based on the ratio of the Company s Credit Facility Adjusted EBITDA for the twelve months ending as of that quarter end, as shown below. Under the Eurodollar Rate Option, borrowings bear interest based on designated one to six-month Eurodollar rates that correspond very closely to rates described in various general business media sources as the London Interbank Offered Rate or LIBOR. Additional margins are then added to LIBOR for borrowings based on the Company s ratio of debt to Credit Facility Adjusted EBITDA, as shown below. Letter of credit fees under the Facility are also based on the Company s ratio of debt to Credit Facility Adjusted EBITDA, as shown below.

	Debt 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	0.25 %	0.50 %	0.75 %	1.00 %
Eurodollar Rate Option	1.25 %	1.50 %	1.75 %	2.00 %
Commitment fees on any portion of the Revolving Loan capacity not in use for borrowings or letters of credit at any given time	0.20 %	0.20 %	0.25 %	0.30 %

Excluding the amortization of debt financing and arrangement costs, we estimate that the interest rate applicable to the borrowings under the Amended Facility would be approximately 6.57% as of December 31, 2006. The Company incurred certain financing and professional costs in connection with the arrangement of the Facility and the related amendment. These costs will be amortized as a non-cash charge to interest expense over the term of the Amended Facility.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

ITEM 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Internal Controls over Financial Reporting

Management s report on our internal controls over financial reporting can be found in Item 8 of this report. The Independent Registered Public Accounting Firm s Attestation Report on management s assessment of the effectiveness of our internal controls over financial reporting can also be found in Item 8 of this report.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) during the three months ended December 31, 2006 that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

ITEM 9B. Other Information

None.

PART III

ITEM 10. Directors, Executive Officers, and Corporate Governance

We have adopted a code of ethics that applies to our principal executive officer, our principal financial officer, and our principal accounting officer, as well as to our other employees. This code of ethics consists of our Corporate Compliance Policy. The Company has made this code of ethics available on our website, as described in Item 1 of this annual report on Form 10-K. If we make substantive amendments to this code of ethics or grant any waiver, including any implicit waiver, we will disclose the nature of such amendment or waiver on our website or in a report on Form 8-K within four business days of such amendment or waiver.

The other information called for by this item has been omitted in accordance with the instructions to Form 10-K. The Company will file with the Commission a definitive proxy statement including the other information to be disclosed under this item in the 120 days following December 31, 2006 and such information is hereby incorporated by reference.

ITEMS 11, 12, 13 AND 14.

These items have been omitted in accordance with the instructions to Form 10-K. The Company will file with the Commission a definitive proxy statement including the information to be disclosed under the items in the 120 days following December 31, 2006 and such information is hereby incorporated by reference.

PART IV

ITEM 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this annual report on Form 10-K:

(1) Consolidated Financial Statements (Included Under Item 8): The Index to the Consolidated Financial Statements is included on page 33 of this annual report on Form 10-K and is incorporated herein by reference.

(2) Financial Statement Schedules: None.

(b) Exhibits

Reference is made to the Index of Exhibits beginning on page 80 which index is incorporated herein by reference.

(c) Excluded financial statements:

None.

SIGNATURES

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

COMFORT SYSTEMS USA, INC.	
By:	/s/ WILLIAM F. MURDY
	William F. Murdy
	Chairman of the Board and Chief Executive Officer
By:	/s/ WILLIAM GEORGE
	William George
	Executive Vice President and Chief Financial Officer
By:	/s/ JULIE S. SHAEFF
	Julie S. Shaeff
	Senior Vice President and Chief Accounting Officer

Date: February 28, 2007

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the date indicated.

Signature	**Title**	**Date**
/s/ WILLIAM F. MURDY William F. Murdy	Chairman of the Board and Chief Executive Officer	February 28, 2007
/s/ HERMAN E. BULLS Herman E. Bulls	Director	February 28, 2007
/s/ FRANKLIN MYERS Franklin Myers	Director	February 28, 2007
/s/ ALFRED J. GIARDINELLI, JR. Alfred J. Giardinelli, Jr.	Director	February 28, 2007
/s/ JAMES H. SCHULTZ James H. Schultz	Director	February 28, 2007
/s/ ROBERT D. WAGNER, JR. Robert D. Wagner, Jr.	Director	February 28, 2007

INDEX OF EXHIBITS

		Incorporated by Reference to the Exhibit Indicated Below and to the Filing with the Commission Indicated Below	
Exhibit Number	**Description of Exhibits**	**Exhibit Number**	**Filing or File Number**
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant.	3.1	333-24021
3.2	Certificate of Amendment dated May 21, 1998.	3.2	1998 Form 10-K
3.3	Certificate of Amendment dated July 19, 2003.	3.3	2003 Form 10-K
3.4	Bylaws of Registrant, as amended.	3.3	1998 Form 10-K
4.1	Form of certificate evidencing ownership of Common Stock of the Registrant.	4.1	333-24021
*10.1	Comfort Systems USA, Inc. 1997 Long-Term Incentive Plan	10.1	333-24021
*10.2	Comfort Systems USA, Inc. 1997 Non-Employee Directors Stock Plan	10.2	333-24021
*10.3	Amendment to the 1997 Non-Employee Directors Stock Plan dated May 23, 2002.	10.3	Second Quarter 2002 Form 10-Q/A
*10.4	Comfort Systems USA, Inc. 2006 Equity Incentive Plan	10.4	333-138377
*10.5	Comfort Systems USA, Inc. 2006 Stock Options/SAR Plan for Non-Employee Directors.	10.5	333-138377
*10.6	Form of Option Award under the Comfort Systems USA, Inc. 2006 Equity Incentive Plan.	10.6	Filed Herewith
*10.7	Form of Option Award under the Comfort Systems USA, Inc. 2006 Stock Options/SAR Plan for Non-Employee Directors.	10.7	Filed Herewith
*10.8	Employment Agreement dated June 27, 2000 by and among Comfort Systems USA (Texas), L.P. and William F. Murdy.	10.2	Second Quarter 2000 Form 10-Q
*10.9	Employment Agreement dated December 1, 2003 by and among Comfort Systems USA (Texas), L.P. and William George.	10.8	2003 Form 10-K
*10.10	Employment Agreement dated January 1, 2004 by and among Comfort Systems USA (Texas), L.P. and Thomas N. Tanner.	10.10	2003 Form 10-K
*10.11	Employment Agreement dated December 1, 2003 by and among Comfort Systems USA (Texas), L.P. and Julie S. Shaeff.	10.10	2005 Form 10-K
*10.12	Employment Agreement dated January 1, 2006 by and among Comfort Systems USA (Texas), L.P. and Trent T. McKenna.	10.12	Filed Herewith
*10.13	Employment Agreement between the Company, Eastern Heating & Cooling, Inc. and Alfred J. Giardinelli, Jr.	10.1	Second Quarter 2003 Form 10-Q
*10.14	Form of Restricted Stock Award Agreement between William F. Murdy and the Company dated March 22, 2002.	10.2	First Quarter 2002 Form 10-Q

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10.15	Amended and Restated Credit Agreement by and among the Company and Wachovia Bank, N.A., Bank of Texas, N.A., Capital One, N.A. and Certain Financial Institutions dated as of February 20, 2007.	10.1	February 26, 2007 Form 8-K
*10.16	Restricted Stock Award Agreement dated June 8, 2004 by the Company to William F. Murdy.	10.1	Second Quarter 2004 Form 10-Q
*10.17	Restricted Stock Award Agreement dated June 8, 2004 by the Company to William George.	10.3	Second Quarter 2004 Form 10-Q
*10.18	Restricted Stock Award Agreement dated June 8, 2004 by the Company to Thomas N. Tanner.	10.4	Second Quarter 2004 Form 10-Q
*10.19	Restricted Stock Award Agreement dated June 8, 2004 by the Company to Julie S. Shaeff.	10.18	2005 Form 10-K
*10.20	Restricted Stock Award Agreement dated April 1, 2006 by the Company to William F. Murdy.	10.20	Filed Herewith
*10.21	Restricted Stock Award Agreement dated April 1, 2006 by the Company to William George, III.	10.21	Filed Herewith
*10.22	Restricted Stock Award Agreement dated April 1, 2006 by the Company to Thomas N. Tanner.	10.22	Filed Herewith
*10.23	Restricted Stock Award Agreement dated April 1, 2006 by the Company to Julie S. Shaeff.	10.23	Filed Herewith
*10.24	Restricted Stock Award Agreement dated April 1, 2006 by the Company to Trent T. McKenna.	10.24	Filed Herewith
21.1	List of subsidiaries of Comfort Systems USA, Inc.		Filed Herewith
23.1	Consent of Ernst & Young LLP.		Filed Herewith
31.1	Rule 13a-14(a) Certification of William F. Murdy pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		Filed Herewith
31.2	Rule 13a-14(a) Certification of William George pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		Filed Herewith
32.1	Section 1350 Certification of William F. Murdy pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		Furnished Herewith
32.2	Section 1350 Certification of William George pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		Furnished Herewith

* - Management contract or compensatory plan